Money Laundering Bulletin
Business intelligence | informa
www.moneylaunderingbulletin.com

FEATURE › PEPs

Left exposed - PEPs

New provisions on Politically Exposed Persons (PEPs) entered into force on 26 June, under the Fourth Money Laundering Directive (4MLD), with practical application by the UK financial sector the subject of intense scrutiny and conflicting messages. **Dr Anna Bradshaw** and **James Le Gallais**, Of Counsel at Peters & Peters LLP discuss the consequences for PEPs and PEP-related persons: they question if adequate protections are in place for those who find their legitimate interests adversely affected by flawed or disproportionate risk assessments.

Readers will know that the concept of a PEP has been a feature of the AML/CTF landscape since 2003, when it was first used by the Financial Action Task Force (FATF) in Recommendation 6. The specific measures to mitigate the higher risk posed by a PEP have been mandatory in the UK since the entry into force of the 2007 Money Laundering Regulations: operate appropriate and risk-sensitive policies and procedures to determine whether a customer is a PEP; obtain senior management approval for establishing the business relationship; take adequate measures to establish the source of wealth and source of funds involved in the proposed business relationship or occasional transaction; and conduct enhanced ongoing monitoring of the relationship.

These obligations are largely replicated in the new Money Laundering, Terrorist Financing and Transfer of Funds (Information on the Payer) Regulations 2017 ("the Regulations"), but related amendments to key terms and the new emphasis on risk assessments means that they are likely to become yet more burdensome to perform in practice. Most significant is the new definition of a PEP: the indicative list of qualifying functions remains largely unchanged, but for the first time catches domestic as well as overseas and international functions. PEP status continues for as long as the money laundering or terrorist financing risk is considered to persist: the 12-month reference period is only a minimum. Family members and known close associates are no longer PEPs themselves, but their respective definitions (similarly expressed by reference to indicative examples) are otherwise unchanged. A definition of "senior management" has been added to make it clear that the officer or employee in question must be sufficiently knowledgeable about AML/CTF risk and in a position to make decisions that affect it.

In practice, large parts of the UK financial sector will have been directly or indirectly applying an extended understanding of PEPs for some time, in line with the more extensive FATF guidance on PEPs published in June 2013. In the absence of any official "PEP list", the burgeoning commercial compliance industry has identified individuals as PEPs on the basis of the widest possible criteria, and will likely continue to do so following the implementation of 4MLD. A further consequence of the lack of regulation of these service providers is that the information they provide to their subscribers may not always be factually accurate, particularly where based on foreign language sources of questionable repute. Nevertheless, regulated persons have never been prevented from going beyond the obligations imposed on them by the EU Money Laundering Directives and the relevant implementing legislation. In the UK, the trend is recognised and (at least implicitly) condoned. The Financial Conduct Authority's Guidance notes for completion of the Annual Financial Crime Report – which requires firms to disclose the number of PEP or PEP-related customers they have had during the period in question – recognises that a firm may in its internal policies use "its own alternative, wider, PEP definition", and requires reports to be submitted on any such wider basis rather than by reference to the strict legal position.

Designation costs

The problem for many individuals and companies related to them is not so much being identified as a PEP, or as the family member or known close associate of a PEP; it is what happens afterwards. The internal control requirements are now much more exacting under the new Regulations. The systems and procedures that those within the scope of the Regulations are required to have in place must not only identify whether a customer (or a customer's beneficial owner) is a PEP or a family member or known close associate of a PEP, but must also "manage" the enhanced risks flowing from that status. In this connection, regulated persons are specifically required to consider the extent to which a business relationship with a PEP (or a PEP's family member or known close associate) would increase the money laundering and terrorist financing risk facing the business, which begs the question whether regulated persons could ever conclude that it does not. Relevant information made available by EU and national supervisory authorities must be taken into account, including joint guidelines issued by the European Supervisory Authorities (ESAs).

Once a customer has been identified as a PEP, or the family member or known close associate of a PEP, a separate risk assessment is then required to identify the particular level of money laundering and terrorist financing risk posed by the particular customer in question and the extent of the enhanced due diligence measures required to mitigate it. In doing so, regulated persons are permitted to take into account guidance issued by FCA (Financial Conduct Authority) or Treasury-approved guidance. When deciding whether a relevant requirement has been contravened, designated supervisory authorities and the criminal courts are only required to consider the ESAs' and FCA's guidance and any Treasury-approved guidance. This is a notable departure from the draft version of the Regulations, which envisaged that guidance issued by any appropriate body could be taken into account in these scenarios. There is, however, no express prohibition on considering other factors or relevant guidance in this connection; and it is not clear whether the intention is to remove the option for regulated persons to voluntarily go above and beyond their legal obligations.

For example, the ESA *Risk Factor Guidelines* (finalised shortly after the Regulations) suggest that credit and financial institutions may take account of information from industry bodies and civil society; and should always consider information from government, including policy statements and explanatory memorandums to relevant legislation. The UK Government's recent policy statements on PEPs have been clear. The publication of the draft Regulations was accompanied by a written statement by the then Economic Secretary to the Treasury which relayed the Government's view that it is not acceptable for firms to refuse to establish a business relationship or carry out a transaction based solely on anyone's status as a PEP, and that this was never the intention of the 4MLD. The Government's response to the consultation on the transposition of the 4MLD, published at the same time, contained similar messages: risk assessments should not be based solely on anyone's status as a PEP, and not all PEPs present the same risk of money laundering and terrorist financing.

The consultation response also promised that steps would be taken to address concern about the disproportionate application of enhanced due diligence and its consequential impact on financial inclusion. The explanatory notes to the Regulations claim that these steps have now been taken. This appears to be a reference to a new caveat inserted in the provisions dealing with enhanced and simplified customer due diligence, warning regulated persons against equating the presence of one or more of the specified risk factors with a high or low risk of money laundering or terrorist financing (which the ESAs also regard as "key" to the correct interpretation of their *Risk Factor Guidelines*). The explanatory notes further confirm that "[r]efusing to establish a business relationship or carry out a transaction with a person simply on the basis that they are a PEP is contrary to the letter and the spirit of the law".

Access denied

The scenario these comments are aimed at had already been recognised as a problem before the adoption of 4MLD in 2015. A customer unexpectedly receives notice that their bank account will be closed. Attempts to clarify the nature or source of the bank's concerns are typically met with a standard response, citing "risk appetite" or "regulatory obligations", without particular reference to any aspect specific to the customer's affairs. The ensuing search for replacement banking facilities is necessarily fraught with difficulty, as the customer will be asked to explain why their current provider is not prepared to continue the relationship. Where the account in question is a business account, commercial operations are bound to suffer and may even grind to a complete halt. The potential hardship is no less severe for individual customers, who, in the words of one MP in the course of Parliamentary debates last year, find that they are "non-persons" if they do not have access to a bank account. The *Payment Account Regulations 2015*, which came into force last year to implement the EU Payment Accounts Directive, require designated banks to make basic payment accounts available to all eligible natural customers; but there are broad exceptions which permit banks to decline applications by reference to their legal AML/CTF obligations. There is no corresponding right to a basic payment account for corporates or other legal entities.

There has been some reluctance on the part of international standard-setters to characterise these practices exclusively as an AML issue, but there is growing recognition of both their prevalence as well as the wider systematic implications. There is less consensus on the appropriate response. The FATF's initiatives have, to date, largely focused on the correspondent banking sector. By contrast, the Financial Conduct Authority has approached "de-risking" more broadly. On the basis of external research commissioned in response to anecdotal evidence of the problem, FCA concluded last year that the problem was the result of a complex set of drivers and that there would consequently be no "silver bullet" to solve it. In addition to various outreach activities FCA has, more concretely, committed to specifically considering as part of its AML requirements work whether firms' de-risking strategies could lead to consumer protection and/or competition issues.

Legislative response, limited impact

This was the context in which *section 30* of the *Bank of England and Financial Services Act 2016* was passed, inserting new *section 333U* into the *Financial Services and Markets Act 2000*. Whilst it has yet to be brought into force, the provision signals Parliament's clear intention that 4MLD is implemented in a manner that avoids stigmatising PEPs and which distinguishes between the different levels of risk posed by PEPs. FCA was tasked with engendering a "proportional, risk-based and differentiated approach" through guidance. The Secretary of State was empowered to add to the topics to be addressed by FCA's guidance, as well as to provide arrangements for complaints about the treatment of PEPs to be received, assessed and adjudicated by FCA and, if upheld, the circumstances in which compensation payments were to be awarded or financial penalties to be imposed.

Guidance may be the sole legacy of *section 30*; and this obligation has now been replicated in the new UK Regulations together with an expanded list of topics which FCA must address. The Government's consultation response earlier this year made it clear that the Financial Ombudsman Service (FOS) would remain responsible for considering future PEP-based complaints; and the draft Regulations contain an amendment to *section 333U* of the *Financial Services and Markets Act 2000* (FSMA), adding FOS as an alternative adjudicator. The only change from the current position are minor amendments to the eligibility criteria for the FOS statutory scheme, to make this accessible to those identified as PEPs, or family members or known close associates of PEPs. No adjudicatory role will be performed by FCA. It is difficult to see how this position could have been considered sufficient; given the limited powers available to FOS and the modesty with which these have been exercised.

The draft guidance published by FCA earlier this year, shortly after the publication of the draft Regulations, appears to contradict the intentions of both Parliament and Government. Instead of encouraging a risk-based approach the draft guidance constrains the discretion conferred on regulated firms to differentiate between categories of PEPs and to tailor their enhanced due diligence measures. If the guidance is adopted in the form proposed, it is likely to significantly dampen the appetite for identifying PEPs as falling at the lower end of high risk: lower risk categorisation is the reserve of PEPs who are solely operational in jurisdictions which exhibit certain specified indicators of a low risk of public corruption, and is ruled out entirely for those with executive decision-making responsibilities. In any event, the suggested measures in lower-risk situations are such as to make the practical effects of a low risk categorisation largely negligible. Furthermore, FCA's draft guidance does not rule out the possibility that business relationships could be declined solely on account of AML requirements where PEPs pose a high money laundering risk (as all PEPs necessarily do under 4MLD). Indeed, it envisages that higher risk PEPs should be the subject of frequent and thorough formal reviews as to whether the business relationship should be maintained.

The ESA Risk Factor Guidelines, which will apply by 26 June 2018, confirm that neither they nor 4MLD require the wholesale exiting of entire categories of customers that are associated with higher money laundering or terrorist financing risk; but say nothing about terminating individual customer relationships based on PEP risk alone. They do, however, require risk factors to be weighed; and expressly prohibit customer risk ratings by credit and financial institutions being influenced by economic or profit considerations.

Wolfsberg, by contrast

FCA's position in the draft guidance contrasts starkly with the more recent revisions to the Wolfsberg Group's PEP guidance. The latter stands as a reminder that the purpose of PEP identification and risk management is the detection of "grand corruption" in politics rather than public or private corruption in general; and warns against the dilution of the PEP definition by including categories of individuals who do not hold public office. There is, however, no indication in 4MLD or in the Regulations of which guidance is to take precedence in the event of a conflict, particularly as between national level guidance and relevant EU or wider international guidance. The potential for mixed messages is readily illustrated by the fact that FATF's PEP guidance remains unchanged.

The upshot is that, unless FCA's draft guidance is significantly revised before it comes into effect, the application of the new PEP provisions will be likely to result in significantly increased compliance costs; as the treatment of domestic PEPs, their family and known close associates is in practice unlikely to differ much from the treatment of their foreign counterparts. At the time of writing it is still not clear how the compliance burden is to be alleviated for lower risk PEPs. There seems to be nothing to stop business relationships being declined or terminated on the basis of PEP or PEP-related status alone, and little satisfactory recourse for customers who are incorrectly categorised or treated unfairly on account of their status. The problem is not limited to the treatment of PEP-related customers by banks but extends throughout the financial sector and beyond – to the full extent of the regulated sector. Adversely affected individuals and businesses will instead need to look outside the AML/CTF framework for remedies. The unintended consequences may well extend beyond "de-risking" to include "de-association", as the temptation for businesses will be to divest themselves of any relationships with PEPs; with adverse implications for good corporate governance.

■ **Dr Anna Bradshaw** (+44 (0)20 7822 7751, abradshaw@petersandpeters.com) and **James Le Gallais** (+44 (0)20 7822 7781, jlegallais@petersandpeters.com) are Of Counsel at Peters & Peters LLP.