EXPLANATORY MEMORANDUM TO

THE MONEY LAUNDERING, TERRORIST FINANCING AND TRANSFER OF FUNDS (INFORMATION ON THE PAYER) REGULATIONS 2017

2017 No. 692

1. Introduction

1.1 This explanatory memorandum has been prepared by HM Treasury and is laid before Parliament by Command of Her Majesty.

1.2 This memorandum contains information for the Joint Committee on Statutory Instruments.

2. Purpose of the instrument

These Regulations replace the Money Laundering Regulations 2007 and the Transfer of Funds (Information on the Payer) Regulations 2007 with updated provisions that implement in part the Fourth Money Laundering Directive (4MLD or "the Directive") 2015/849/EU and the Funds Transfer Regulation (FTR) 2015/847/EU. 4MLD seeks to give effect to the updated Financial Action Task Force (FATF) global standards which promote effective implementation of legal, regulatory and operational measures for combating money laundering, terrorist financing and other related threats to the integrity of the international financial system.

3. Matters of special interest to Parliament

Matters of special interest to the Joint Committee on Statutory Instruments

3.1 The Regulations come into force in national law on 26 June as this is the transposition and implementation date in the Directive and FTR. This means that the '21 day rule' will be broken in order to meet the transposition deadline. Due the dissolution of Parliament for the General Election which was held on 8 June, and the need for new ministers to approve the Regulations it has not been possible to lay these Regulations any earlier.

3.2 4MLD will be transposed into UK law through the Money Laundering, Terrorist Financing and Transfer of Funds (Information on the Payer) Regulations 2017 ("the Regulations"). The FTR works in conjunction with 4MLD. Unlike 4MLD, the FTR does not need to be transposed because it has 'direct effect' from 26 June 2017. However, the powers to supervise, enforce and investigate breaches of the FTR, as well as related regulations such as setting thresholds for customer due diligence and increased data retention periods to assist with law enforcement investigations, will be included in the MLRs.

Other matters of interest to the House of Commons

3.3 As this instrument is subject to negative resolution procedure and has not been prayed against, consideration as to whether there are other matters of interest to the House of Commons do not arise at this stage.

4. Legislative Context

4.1 These Regulations introduce a number of new requirements on relevant businesses and changes to some of the obligations found under the current regime. In addition, the new FTR accompanies the Directive and will come in to force alongside the Directive in all EU Member States. It updates the rules on information on payers and payees, accompanying transfer of funds, in any currency, for the purposes of preventing, detecting and investigating money laundering and terrorist financing, where at least one of the payment service providers involved in the transfer of funds is established in the EU.

4.2 Provision for anti-money laundering and counter-terrorist financing controls is also made under the Proceeds of Crime Act 2002 and the Terrorism Act 2000.

4.3 New provision relevant to information on beneficial ownership of legal entities is also being made by the Information about People with Significant Control (Amendment) Regulations 2017 and the Scottish Partnerships (Register of People with Significant Control) Regulations 2017, which are being laid at the same time as these Regulations.

4.4 There was full scrutiny of 4MLD before it was finalised in June 2015.

5. Extent and Territorial Application

5.1 The territorial application of this instrument is all of the United Kingdom.

5.2 This instrument extends to all of the United Kingdom.

6. European Convention on Human Rights

6.1 The Economic Secretary to the Treasury, Stephen Barclay MP, has made the following statement regarding Human Rights:

"In my view the provisions of The Money Laundering, Terrorist Financing and Transfer of Funds (Information on the Payer) Regulations 2017 are compatible with the Convention rights."

7. Policy background

What is being done and why

7.1 The principal policy objective behind 4MLD is to update and enhance European legislation to bring it in line with the international standards on combating money laundering and terrorist financing as set out in the revision to the FATF standards in 2012. Consequently, the Regulations are underpinned by the principles of effectiveness and proportionality as well as continuing the focus on a risk-based approach. The UK government's objective, through transposing 4MLD, is to make the financial system a hostile environment for illicit finance while minimising the burden on legitimate businesses.

7.2 Alternatives to the Regulations are not available and the UK must transpose 4MLD into domestic legislation by 26 June 2017 to meet EU obligations.

7.3 Money laundering can undermine the integrity and stability of our financial markets and institutions. It is a global problem, however, and the UK must play its part in strengthening our regime and working with international partners to tackle money laundering. The National Crime Agency (NCA) judge that billions of pounds of

suspected proceeds of corruption are laundered through the UK each year. Money laundering is also a key enabler of serious and organised crime, the social and economic costs of which are estimated to be £24 billion a year.

7.4 There are over 100,000 businesses covered under the Regulations which require that these businesses know their customers and manage their risks. The Regulations are deliberately not prescriptive, providing flexibility in order to promote a proportionate and effective risk-based approach.

Scope

7.5 The Regulations apply to financial institutions, including money service businesses, and to those sectors that are seen as 'gatekeepers' to the financial system including auditors, legal advisers, insolvency practitioners, external accountants, tax advisers, estate agents, casinos, high value dealers (HVDs) and trust or company service providers (TCSPs).

7.6 One important change applies to HVDs, where the threshold for eligible transactions in cash (either in one transaction or a series of transactions that appear to be linked) will come down from £12,544 (EUR 15,000) to £8,361 (EUR 10,000); and will be extended to receiving as well as making payments in cash. This is a specific requirement of the Directive and therefore must be implemented.

7.7 The above businesses (or "relevant persons") are required to have policies, controls and procedures to mitigate and manage effectively the risks of money laundering and terrorist financing. These businesses will be in the best position to understand the risks within their sectors and take a proportionate approach when implementing the Regulations.

7.8 4MLD allows member states to exempt persons that engage in financial activity on an occasional or very limited basis. A threshold may be set below which 4MLD will not apply as there is little risk of money laundering. Under the Regulations, the government is increasing the existing threshold limit from £64,000 to £100,000. The aim is to reduce the administrative burden on businesses whilst retaining a "sufficiently low" figure as required by the Directive and in line with proper risk-assessment.

Supervision and the risk based-approach

7.9 An assessment of risk will take place at all levels, including at a national level, conducted by HM Treasury and the Home Office.

7.10 Underpinning all supervisory action is the risk based approach, which depends on a supervisory authority (supervisor) understanding risk across the businesses it regulates and taking appropriate action such as reviewing risk profiles at regular intervals, especially if circumstances change.

7.11 The Regulations also introduce a 'criminality test' for certain sectors to prevent criminals convicted in relevant areas or their associates from holding a management function in or being the beneficial owners of those obliged entities. The government will not permit supervisors to take into account spent convictions and cautions when assessing whether a person should be prohibited from being a beneficial owner, officer or manager of a supervised business. This recognises that the rehabilitation period of relevant convictions and cautions provides appropriate safeguards. High value dealers will now also be covered by the test due to evidence pointing towards an increased risk in the sector.

7.12 The Regulations clarify that an estate agent is to be considered as entering into a "business relationship" with a purchaser as well as with a seller. This means that estate agents must apply customer due diligence checks to both contracting parties in a transaction. This clarification has been made because evidence suggests that the purchase of real estate is an attractive and lucrative option for money laundering purposes. It also became clear that many estate agents did not consider the purchaser to be their customer, consequently not doing customer due diligence.

Application of customer due diligence

7.13 Businesses that fall under the scope of the Regulations will need to apply different levels of due diligence measures (e.g. identifying and verifying the customer's identity) to manage the risk of money laundering and terrorist financing. This may entail either simplified due diligence (SDD), customer due diligence (CDD), or enhanced due diligence (EDD), based on the level of perceived risk.

7.14 These Regulations bring in a greater emphasis on taking a risk-based approach when assessing what type of checks to undertake on a customer.

7.15 The Regulations allow relevant businesses to apply SDD measures for areas of lower risk. Annex II of the Directive sets out a non-exhaustive list of factors that should be considered when deciding whether SDD is appropriate and these have also been set out in these Regulations.

7.16 4MLD requires firms to apply EDD (more stringent due diligence checks) to business relationships with politically exposed persons (PEPs), their family members and their known close associates. However, the level of risk varies substantially from case to case. The government has therefore taken steps to address concern about the disproportionate application of EDD to lower-risk PEPs and its consequential impact on financial inclusion. The Regulations require firms to assess the risk posed by individual PEPs on a case-by-case basis and tailor the extent of EDD accordingly. Refusing 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. The Financial Ombudsman Service may assess complaints from PEPs, family members or known close associates where they have been treated unreasonably by financial institutions.

7.17 The transposition of 4MLD represents a significant tightening of regulation for e-money. Customers that now wish to spend more than €250 in a single month will be required to undergo CDD checks. To ensure a balanced approach, the government will apply all the exemptions to CDD allowed by 4MLD and is putting in place the maximum exemption for e-money products that present low risks such as gift cards and store vouchers to continue to benefit from SDD measures.

7.18 Pooled client accounts are accounts held by accountants, legal professionals and notaries with financial institutions to hold money on trust or for a purpose designated by a client. The government has taken the decision not to allow pooled client accounts to be automatically subject to SDD, but instead for this to be applied on a risk based approach.

7.19 The Regulations also broaden the requirement to perform EDD to all financial institutions engaged in cross-border correspondent relationships with a third country (i.e. a state other than a European Economic Area (EEA) state) respondent institution. This reflects the high risk nature of third country correspondent relationships with the aim to ensure the consistent application of rules, tailored to the money laundering risk,

of this type of relationship. EDD is required for intra-EEA relationships which are considered high risk, in line with the risk-based approach. This gives financial and credit institutions the flexibility to apply the level of due diligence that is commensurate with the risk posed.

Reliance and record keeping

7.20 In Part 4 of the Regulations, there has been significant expansion of the third parties that can be relied upon for carrying out CDD checks, with the Regulations now allowing reliance on all of the regulated sector captured under these Regulations.

7.21 The Directive requires that businesses retain CDD information and transaction data for a period of five years at the end of a relationship. Member States are given flexibility to allow or require further retention of data for an additional five-year period, if deemed necessary. The UK has chosen not to require businesses to retain data for this additional period as it was not considered necessary and would have increased the burden on obliged entities. In order to avoid a potentially open-ended requirement for the retention of transaction data in the Directive, the government has included a maximum limit of ten years for the retention of this data. This will ensure that the burden on businesses is not increased unnecessarily.

7.22 The Regulations also introduce a new requirement that businesses must delete data once the five-year period has elapsed. This change will align the UK framework with the 4MLD and international standards on data protection.

Beneficial Ownership

7.23 The requirements of transparency of beneficial ownership for legal arrangements apply to trustees in express trusts, and therefore not to partners in partnerships or trustees in statutory, constructive or resulting trusts. Under the Regulations (Part 5), trustees of express trusts must hold accurate and up-to-date information on the trust's beneficial owners and any potential beneficiaries named in a letter of wishes or other relevant document. "Potential beneficiary" refers to someone named in such a document who clearly stands to benefit from the trust as a result of the settlor's expressed wishes. It does not include a person who is unlikely to benefit from the asset despite being named in a letter of wishes (if, for example, they are named as a potential beneficiary only if other named potential beneficiaries predecease them).

7.24 To provide law enforcement with timely access to beneficial ownership information, HMRC will maintain a register of trusts with tax consequences. The register has been built on the existing tax reporting framework to minimise administrative costs for trustees. When considering what information to collect, the government has sought to strike the right balance between minimising administrative costs to trustees and giving law enforcement the tools they need to combat the misuse of trusts. By collecting the information outlined in the Regulations, HMRC and law enforcement will, for the first time, be able to draw links between all parties related to an asset in a trust. This will deliver a marked change in their ability to identify and interrupt suspicious activity involving the misuse of trusts.

Supervision and Registration

7.25 Under Part 6 of the Regulations, all supervisory authorities are subject to a duty to cooperate with other supervisory authorities, the Treasury and law enforcement authorities, and have a duty to collect and share information. This is to ensure that information flows among supervisors, between supervisors and law enforcement, and

between supervisors and the businesses they supervise, and is a key feature of a robust and effective AML/CTF framework.

7.26 From 26 June 2017, HMRC will act as the registering authority for all TCSPs as required by the Directive. The new Regulations will require professional body supervisors to inform HMRC of their members who carry out TCSP activity and their 'fit and proper' status so that they can be added or removed from the register.

7.27 Under the Regulations, there is a new requirement for supervisors of TCSPs and MSBs to carry out fit and proper tests on managers and owners of these entities. The FCA will also be given additional powers to refuse to register Annex I firms, where an individual holding a management function is not considered to be fit and proper. Annex I firms cover certain kinds of undertaking, other than authorised persons, that carry out activities listed in Schedule 2 of the Regulations – such as lending and financial leasing. The government believes that this step will help identify those that may seek to exploit or defraud members of the public.

Information and investigation

7.28 Part 8 of the Regulations gives supervisors the tools they need to monitor businesses effectively and to take appropriate action if needed, for example, by using their information gathering and investigatory powers.

Enforcement

7.29 The government takes the view that all supervisors should be able to demonstrate that they have provisions which enable them to impose effective, proportionate and dissuasive sanctions. The ability of a supervisor to impose sanctions (Part 9) is an important deterrent and incentivises regulated businesses to comply with the Regulations. Where supervisors are unable to impose suitable pecuniary sanctions, they may consider the use of the HMRC/FCA powers.

Consolidation

7.30 These Regulations incorporate into one instrument the provisions replacing the Money Laundering Regulations 2007; the Transfer of Funds (Information on the Payer) Regulations 2007 which are being revoked; and the changes being made now as part of the transposition of 4MLD and the FTR.

8. Consultation outcome

8.1 The Government launched an 8 week consultation on 15 September 2016 entitled 'Transposition of the Fourth Money Laundering Directive'. It outlined how the government intended to implement the Directive and the FTR, which accompanies it. The consultation closed on 10 November 2016, with the government receiving 186 responses from a cross-section of stakeholders including supervisors, industry, non-governmental organisations and government departments. A copy of the consultation is available at: https://www.gov.uk/government/consultations/transposition-of-the-fourth-money-laundering-directive

8.2 Responses to the consultations were broadly supportive of the overall policy objectives of the Regulations. Comments received as part of this consultation process were taken into consideration when preparing these Regulations, for example, the exemption of all gambling service providers from the requirements of the Directive, except remote and non-remote casinos. This was based on evidence that indicated the

gambling sector was low risk relative to other sectors. For other areas, such as customer due diligence requirements placed on estate agents, government did not see sufficiently compelling evidence to demonstrate that estate agents should not carry out due diligence checks on buyers as well as sellers.

8.3 Some respondents to the consultation preferred that industry guidance provide more detailed examples on certain areas rather than being prescribed in the Regulations, for example, in the approach to customer due diligence checks on existing customers. The government has reflected this feedback in the Regulations.

8.4 Another area where consultation responses were mixed was around pooled client accounts (PCAs) where industry argued that these were low risk and therefore should continue to be subject to simplified due diligence checks, which are less stringent. Others, however, highlighted that the risks were as high or low as the quality of the firm carrying out the checks. Given that there was no consensus, the government has taken the decision to not allow PCAs to be automatically subject to simplified due diligence, but instead for this to be allowed on a risk based approach. This should provide firms with greater flexibility when applying checks.

8.5 The Directive also gave Member States the flexibility to increase the period for retaining CDD documents and transactions data beyond five years. However, based on consultation responses that were not supportive of the extension, the government has taken the view to retain the minimum 5 year data retention period and not extend this any further.

8.6 In March 2017, the government published its response to the September 2016 consultation as well as consulting again for 4 weeks on the technical draft Regulations. This was a short consultation in order to meet the 26 June 2017 transposition deadline and, as it was purely technical, the government will not be doing an official response. Rather, the final Money Laundering Regulations are the response. The consultation closed on 12 April and the government received 115 responses. A copy of the government's September 2016 consultation response is available at: https://www.gov.uk/government/consultations/money-laundering-regulations-2017

9. Guidance

9.1 HM Treasury will not be issuing guidance to accompany the instrument.

9.2 The Government sees the Regulations as part of an implementation system that also includes supervisory rules (such as those that will be produced by the FCA on PEPs (FCA consultation: https://www.fca.org.uk/publication/guidance-consultation/gc17-02.pdf) and guidance to industry (e.g. the Joint Money Laundering Steering Group's guidance for financial services – once published, this will be available at: http://www.jmlsg.org.uk/). This approach leverages the supervisors' in-depth knowledge of its members and of the risks associated with the sector.

9.3 The Regulations enable firms that have followed guidance published by a supervisory authority or other appropriate body and approved by the Treasury to have this taken into account when HMRC or the FCA is deciding whether the firm contravened a requirement in relation to the imposition of civil penalties or prosecution for a criminal offence under the Regulations.

9.4 Stakeholders should also take into account guidance issued by the European Supervisory Authorities (ESAs) which are as follows:

- Finalised ESA risk-based supervision guidelines: https://esas-joint-committee.europa.eu/Publications/Guidelines/Final_RBSGL_for_publication_20161115.pdf
- ESA risk factor guidelines (to be finalised): http://www.eba.europa.eu/documents/10180/1240374/JC+2015+061+%28Joint+Draft+Guidelines+on+AML_CFT+RFWG+Art+17+and+18%29.pdf
- ESA guidelines on FTR obligations (to be published): https://www.eba.europa.eu/documents/10180/1807814/Consultation+Paper+on+draft+Joint+Guidelines+to+prevent+transfers+of+funds+can+be+abused+for+ML+and+TF+%28JC-GL-2017-16%29.pdf/dcb3dbe5-931e-42a4-9eed-364cbebd5fe3

10. Impact

10.1 The Regulations will mean that in scope businesses will need to meet familiarisation and compliance costs. The costs for regulators will involve up scaling costs (staff, IT) to meet ongoing costs of supervision. These costs will be funded by fees paid by the regulated population.

10.2 The impact on the public sector is predominantly the costs incurred by the statutory supervisors (FCA, HMRC and the Gambling Commission) in implementing any changes. It is not anticipated that there will be any significant impact on charities or voluntary bodies.

10.3 An Impact Assessment will be published alongside the Explanatory Memorandum on the legislation.gov.uk website when an opinion from the Regulatory Policy Committee has been received.

11. Regulating small business

11.1 The legislation applies to activities that are undertaken by small businesses. The global standards set out by FATF and 4MLD do not allow for the exemption of small businesses or any exemptions based on size. Money laundering and terrorist financing risks do not disappear in smaller businesses, rather experience shows that criminals often target smaller businesses. Consequently, small/micro-businesses will be in scope of transposition of the Directive.

11.2 The Impact Assessment will provide further detail on impact for small businesses.

11.3 No specific action is proposed to minimise regulatory burdens on small businesses as we must comply with 4MLD to meet our legal obligations.

12. Monitoring & review

12.1 The Treasury and Home Office must make arrangements before 26 June 2018 for a risk assessment to be undertaken to identify, assess, understand and mitigate the risks of money laundering and terrorist financing affecting the United Kingdom. The Treasury and the Home Office must take appropriate steps to ensure that the risk assessment in kept up to date, to meet the fast pace at which money laundering and terrorist financing risks are developing and/or changing.

12.2 The Treasury must, from time to time, carry out a review of the regulatory provisions contained in these Regulations and publish a report setting out the conclusions of the

review. The first report must be published before 26 June 2022. Subsequent reports must be published at intervals not exceeding 5 years.

12.3 In 2018, the UK's AML/CTF regime will be assessed during the UK's Mutual Evaluation carried out by FATF.

13. Contact

13.1 Katherine Newall at HM Treasury (Telephone: 020 7270 5803 or email: Katherine.Newall@hmtreasury.gsi.gov.uk) can answer any queries regarding the instrument.