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Financial Services Risk and Regulation

Time to implement the Money Laundering Regulations 2019

HOT TOPIC
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Highlights

Cryptoasset businesses as new obliged entities must be complying with the amended Money Laundering Regulations 2019 (MLRs) from 10 January 2020.

All obliged entities should embed additional procedures in their existing CDD framework to reflect changes in beneficial ownership and enhanced due diligence requirements.

Summary

The Fifth EU Money Laundering Directive (MLD5) was transposed into UK domestic law through the legislation entitled 'The Money Laundering and Terrorist Financing (Amendment) Regulations 2019' (MLRs) and came into force on 10 January 2020.

HM Treasury (HMT) launched a consultation in April 2019 inviting views and evidence on the steps it proposed to take to transpose MLD5 into domestic legislation. The overall aim of transposition is to ensure the UK's anti-money laundering and counter terrorist financing (AML and CTF) regime is up-to-date, effective, proportionate and in line with the international standards set by the Financial Action Task Force (FATF) and MLD5.

In January 2020, following the implementation of the MLRs, HMT published its response to the consultation, outlining final policy decisions behind the amended MLRs. The majority of the proposals have been accepted by the Government in the amending legislation and are summarised in this document.

The key changes to the 2017 Regulations impacting financial services relate to the addition of new obliged entities, changes in beneficial ownership requirements and higher standards of enhanced due diligence. The UK has 'gold plated' MLD5 in expanding the definition of cryptoassets beyond what is required in the Directive.

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New obliged entities

Expanding the definition of cryptoassets

The majority of the responses to the consultation agreed with the HMT proposal that the definition of virtual currencies as set out in MLD5 is not wide enough to cover all potential illegal activity involving cryptoassets.

The Government has decided to go beyond what is required of MLD5, mirroring the latest FATF Standards on Virtual Asset Service Providers (VASPs). In line with the FATF recommendations, the UK Cryptoasset Taskforce established a framework of three broad types of cryptoassets: exchange tokens, security tokens and utility tokens (as defined in the Cryptoasset Taskforce report).

Under the amended legislation, relevant activities (e.g. crypto exchanges, custodial wallets, issuing cryptoassets) relating to all three types of cryptoassets are regulated. However, publishers of open source software and, by extension, non-custodial wallet providers will not be brought into the scope of MLRs. The Government accepted the suggestion that AML and CTF regulation should be carried out on an activities-basis only.

What does this mean for firms?

There will be a transition period for Financial Conduct Authority (FCA) registration lasting until 10 January 2021. Regardless of whether firms have registered with the FCA, all cryptoasset firms as defined in MLRs will need to show compliance with customer due diligence (CDD) and reporting obligations from 10 January 2020. To find out more, read our blog on cryptoassets.

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HMT recognises concerns about difficulties in complying with the FATF standard on conducting cryptoasset transfers, and it has decided not to legislate on this at the moment. The FATF standard would require entities to ensure that they obtain, hold and transmit required originator and beneficiary information, immediately and securely, when conducting cryptoasset transfers. The delay in legislation is intended to give firms time to develop compliance solutions ahead of the introduction of the new obligations. Firms should refer to section IV of FATF's June 2019 guidance on Virtual Assets and VASPs. It is the Government's intention to amend the MLRs to include this requirement as soon as globally recognised ways to comply are clear.

The third UK National Risk Assessment, due to be published by July 2020, will use the latest information at the Government's disposal to further consider the money laundering and terrorist financing threats from cryptoassets.

Cryptoassets are partly characterised by their anonymity, which presents a risk of financial crime. The CDD procedures in MLRs are based on identification and verification, and will pose particular challenges for cryptoasset firms to embed.

Existing obliged entities

Additional obligations for beneficial ownership

The Government has decided not to remove 'reasonable measures' from the requirement that obliged entities should determine and verify the identity of a body corporate on the grounds that it could undermine the principle of proportionality. However, where the customer is a body corporate and the beneficial owner cannot be identified, obliged entities will be subject to an additional requirement to verify the identity of senior managing officials. The Government legislated this on the basis that it is not an onerous requirement, however, it adds an extra layer to the already existing CDD requirements and again, could be particularly challenging for new cryptoasset obliged entities.

The Government is requiring obliged entities to check public registers when entering into a new business relationship, with the onus on the company to provide relevant evidence when requested by the obliged entity.

Despite some concerns over additional administrative burdens, the Government has legislated that an obliged entity needs to report to Companies House any discrepancy found between information contained in the 'Persons of Significant Control' (PSC) register and the beneficial ownership information collected as part of CDD checks.

The Government has introduced an explicit CDD requirement to understand the ownership and control structure of customers. The Government considered it relevant to do so to align with FATF recommendation 10.8 and 22.1, and aims to give entities sufficient flexibility to enable a proportionate approach. In practice, this would mean that the firms need to evidence understanding the ownership and control structure of customers, without detailed guidance on how to do so.

What does this mean for firms?

Firms need to conduct adequate review and have sufficient oversight of the changes that have occurred, to ensure these have been embedded for new business relationships.

The requirement to report any discrepancy creates an additional layer of compliance. In practice this means that, even where a UK company registers its PSCs and provides an excerpt of the register to an obliged entity, the obliged entity may not have full information of the beneficial ownership structure of the company. Obliged entities are now required to report on an issue that is outside the strict purview of AML and CTF compliance requirements. It also brings in a new party to the CDD process (Companies House) with no information available on the effects of reporting the discrepancy for the obliged entities.

Enhanced due diligence - more high-risk factors

There are now additional enhanced due diligence (EDD) measures relating to high risk third countries. MLD5 requires the mitigation of risks arising from business relationships or transactions involving high-risk third countries. The Government recognised the need to define the terms 'involving' and 'business relationship or transaction' in the EDD process, believing that a broad interpretation would be disproportionate. The MLRs 2019 define 'business relationships or transactions involving high-risk third countries' as:

- a business relationship with a person established in a high-risk third country, or
- a transaction where either of the parties to the transaction is established in a high-risk third country.

What does this mean for firms?

In practice firms now need to conduct EDD on both the sender and the recipient in a transaction involving high-risk third countries. This is particularly relevant for businesses dealing with correspondent banking. So far obliged entities have focused on conducting CDD measures on their customers. Extending this to both parties could potentially have operational impacts, such as delays in completing EDD and de-risking.

Next steps

The FCA expects both new and existing obliged entities to be complying with the new, amended regulations from 10 January 2020. In assessing its approach to those firms that may not be compliant yet, the FCA will take into account evidence that they have taken sufficient steps before that date to comply with these new obligations.

Firms should refer to the updated Joint Money Laundering Steering Group (JMLSG) Guidance when it is published. It has been approved by HMT and is due to be published in early 2020.