Europe's upcoming Fourth AML/CFT Directive

In February 2013, the European Commission adopted two proposals: the Fourth AML Directive and a complementary regulation on what information must accompany fund transfers to ensure traceability. The European Parliament's and European Council's so-called "draft directive on the prevention of the use of the financial system for the purpose of money laundering and terrorist financing" (the Fourth EU AML Directive) entered into the final rounds of consultation in the autumn of 2014 and is due to be passed by the end of the year. It should then be implemented into national legislation of the EU member states by 2017.[1]

By discussing the key changes compared with former and international legislation, and outlining the standards and the challenges ahead in the final rounds of discussion, the reader will gain an insight into the challenges facing financial institutions and corporations in meeting the requirements of the Fourth EU AML Directive.

From the Third EU to the Fourth AML Directive

The Third AML Directive currently in force, applies to the financial sector (credit institutions, financial institutions) as well as to professionals such as lawyers, notaries, accountants, real estate agents, casinos and company service providers. Its scope also encompasses all providers of goods, when payments are made in cash in excess of 15,000 euros. All these addressees are considered 'obliged entities.' The Directive requires these obliged entities to identify and verify the identity of customers (through customer due diligence [CDD]) and beneficial owners, and to monitor the financial transactions of the customers. It then includes obligations to report suspicions of money laundering or terrorist financing to the relevant financial intelligence units (FIUs), as well as other accompanying obligations. The Directive also introduces additional requirements and safeguards (such as the requirement to conduct customer enhanced due diligence [EDD]) for situations of higher risk.

[1] See proposal here: http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=COM:2013:0045:FIN:EN:PDF

The proposed Directive extends the scope of the current framework and aims at strengthening obligations in the following areas:

- Currently financial professionals can take advantage of simplified due diligence rules for transactions originating from areas on the member states' list of "equivalent" third countries. The proposal favors a more risk-based approach, with enhanced efforts targeted at higher risk sectors, with regard to CDD;
- Rules on beneficial ownership identification and record keeping requirements regarding ultimate beneficial ownership;
- Definition of politically exposed persons (PEPs) expanded to include domestic as well as foreign PEPs, and those within international organizations. The rule would apply to heads of state, government and parliament members, members of the judiciary and directors of state-owned enterprises, among others such as close family members;
- Tax crimes also are added to the list of predicate offenses for money laundering;
- Scope of rules extended to the entire gambling sector rather than just casinos;

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- The threshold to trigger AML procedures from cash payments has been lowered from 15,000 to 7,500 euros. Lawmakers said offenders were taking advantage of the 15,000 euros threshold. Member states would be allowed to set thresholds even lower;
- Cooperation between national FIUs, which analyze and disseminate information about suspected money laundering or terrorist financing strengthened;
- Administrative sanctioning powers of the national authorities reinforced and cooperation between national authorities on cross-border cases required.

The proposed regulation replaces Regulation (EC) No 1781/2006 on information on the payer accompanying transfers of funds (hereinafter also referred to as the Funds Transfers Regulation), which has the aim to improve traceability of payments. The Funds Transfers Regulation complements the other AML measures by ensuring that basic information on the payer of transfers of funds is immediately available to law enforcement and/or prosecutorial authorities to assist them in detecting, investigating, prosecuting terrorists or other criminals and tracing the assets of terrorists.

Striving for a compromise–Parliament, Council and Commission

The European Parliament is striving for greater transparency, whereas the Commission is aiming for a more flexible compromise.

The Parliament's preferred outcome would be a public central register in each EU country, which would list information on the ultimate beneficial owners of a wide range of legal entities, including companies, foundations, holdings and trusts. The parliament proposes that the registers should be interconnected across the EU and be "publicly available following prior identification of the person wishing to access the information through basic online registration." Provisions have been made in the amended Directive to secure data privacy and to ensure that only the minimum information necessary is placed in the register.

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Following months of discussions, the European Council took a softer approach finally agreeing on its own 'general approach' in June 2014. The Council is not in favor of creating public registries, or even non-public ones. Instead, the Council is calling for beneficial ownership information to be held in a 'specified location,' as is currently the case in most EU countries. Incorporation agents, for example, are often required to collect beneficial ownership data and make it available to law enforcement and tax authorities upon request.

The Commission's proposal, which was published in June 2014, involves an even more flexible approach regarding the storage of information on beneficial ownership. Its approach would require unrestricted access for competent authorities, FIUs and, if allowed by the member state, the obliged entity (e.g., the bank). It, however, allows flexibility for member states in establishing the means for ensuring this, whilst providing indicative examples of the form that a storage mechanism can take.

Beyond this, the Commission calls for the following points to be amended in the original draft:

- Extension of the Directive's scope, introducing requirements for a greater number of traders (i.e., reducing from 15,000 to 10,000 euros the cash payment threshold for the inclusion of traders in goods, and also including providers of certain gambling services);
- A requirement for evidence-based measures, and the provision of guidance by the European supervisory authorities, in the risk-based approach used to better target risks;

- Tighter rules on CDD, whereby obliged entities such as banks are required to take enhanced measures where the risks are greater, and can take simplified measures where risks are demonstrated to be smaller.

For gambling services, the Council's position allows member states to introduce exemptions, but only after a risk assessment has been undertaken and without allowing exemptions for casinos and cross-border online gambling. Other member states would be informed of any exemptions granted. Member states would similarly be allowed exemptions, under certain conditions, for certain types of e-money instruments.

Member states can set a maximum level of pecuniary fines of no less than 1 million euros, or, in the case of breaches involving credit or financial institutions, a maximum level of sanctions of at least 5 million euros.[2]

Challenges for customer due diligence

What appears to be clear at this stage, regardless of the final outcome of the negotiations, is that a greater emphasis will be placed on the enhanced risk-based approach coupled with multi-level interconnected risk assessment requirements set at the country, institutional and customer level.

The new measures proposed, which require evidence-based measures to be implemented and supplemented with a minimum list of factors to be developed by the European Supervisory Authorities, will be at the core of the challenges facing institutions in adapting their existing systems.

Regardless of the outcome of the negotiations, institutions and organizations will be required to become more risk focused in the way they manage their CDD programs. That applies not only to the question as to whether simplified or EDD should apply but also to which methods, sources and monitoring approaches are appropriate.

Developing sophisticated and flexible risk assessment tools will be of the essence in order to generate a more solid basis on which risk-based and evidence-based decision are possible.

Conclusion

The draft Directive not only seeks to meet the amendments made by the revised Financial Action Task Force (FATF) Recommendations published in 2012, but goes beyond international requirements to expand the scope of increasing transparency vis-à-vis beneficial ownership of corporations, a matter of controversy in the ongoing *Trialogue* discussions. The review of the law is to be finalized this autumn in *Trialogue* negotiations that start under the auspices of the Italian Presidency, which ends in December 2014. As reported in the *EUobserver*, although it will not be easy to come to a final agreement on the Fourth EU AML Directive, all the ingredients for a ground-breaking new AML regime are on the table.

Those organizations, which have already implemented the revised FATF standards, will most likely only have some minor adjustments to make to their systems including the implementation of risk assessments based on the requirements brought forward by the regulators. Those organizations, whose processes are still embedded in the Third EU AML/CFT Directive, will be faced with more major reforms, in particular in relation to the issue of PEPs. The general trend of the new Directive is already clear and organizations can therefore start planning their journey toward implementation.

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[2] See press release here: http://www.consilium.europa.eu/uedocs/cms_data/docs/pressdata/en/ecofin/143250.pdf