MEMORANDUM

BELL GULLY

TO **AML/CFT Consultation Team**
OF Ministry of Justice

FROM **Rachel Paris / Jayne Kirton / Kerry Beaumont / Andy Glenie**

BY EMAIL aml@justice.govt.nz

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Ministry of Justice consultation paper of Phase Two of the Anti-Money Laundering and Countering Financing of Terrorism Act 2009 (the Act) - Bell Gully submission

1. Introduction

1.1 We refer to the publication entitled *Improving New Zealand's ability to tackle money laundering and terrorist financing – Ministry of Justice consultation paper on Phase Two of the AML/CFT Act* dated August 2016 (the **Consultation Paper**).

1.2 This memorandum sets out our feedback on certain parts of the Consultation Paper, namely the questions concerning:

(a) the legal services sector (Part 2);

(b) supervision (Part 3);

(c) the appropriate implementation period and costs (Part 5); and

(d) reliance on third parties (Part 6).

2. Legal services sector – scope of regulated services / stage of business relationship

How should AML/CFT requirements apply to the legal services sector to help ensure the Act addresses the risks specific to it? For example, which business activities should the requirements apply to? At what stage in a business relationship should checks, assessments and suspicious transaction reports be done?

Appropriate scope of regulated legal services

2.1 We accept that there is persuasive international evidence that certain parts of the legal services sector should be subject to certain AML/CFT requirements.

2.2 However, we strongly submit that the list of proposed services that will be subject to AML/CFT requirements on page 13 of the Consultation Paper (the **Proposed List**) is too broad and requires further refinement for the following three key reasons:

(a) **Unnecessary capture**

The regulated legal services should be limited to ones which are capable of playing a material role in money laundering or terrorism financing (**ML/TF**) activity, such as handling client funds, acting as a formation agent, arranging nominee directors / shareholders / trustees, providing a registered office, or executing sales or purchases of real estate.

The current Proposed List extends considerably beyond the FATF list (set out on page 43 of the Consultation Paper).

Furthermore, including a broad category such as "preparing for or carrying out transactions for customers related to creating, operating or managing companies" is capable of applying to almost all services performed by corporate law firms. Most of these services present nil or negligible ML/TF risk.

Similarly, while we accept that provision of a registered office should be regulated, the other services in bullet point three of the Proposed List ("providing a business address, a correspondence address or an administrative address") would have unintended consequences for lawyers. For example, would the common practice of naming a law firm or providing its details as an address for notices / service / process agent in a commercial transaction document in itself trigger AML/CFT obligations for that law firm?

New Zealand's risk-based approach to AML/CFT regulation is based on the principle that AML/CFT efforts should be proportionate to the risks. We submit that the current Proposed List is inconsistent with that stated policy objective.

(b) **Access to legal services**

There is potential for the proposed reforms to impact on legitimate access to legal services if the full Proposed List is covered under 'phase two'.

As practitioners who have had substantial experience advising clients on the application of the AML/CFT regime, we are aware that many willing compliers have found it difficult to apply the broad, principles-based legislation to their business activities in practice. This has often resulted in a conservative approach being taken, resulting in 'over' compliance to avoid potential liability or reputational damage.

It is foreseeable that if the scope of regulated legal services is not clearly defined and targeted, or if the application of the regime to lawyers is uncertain or costly, lawyers will similarly take a conservative approach. For instance, lawyers may turn away prospective clients, or clients could experience delays before receiving necessary assistance. This could undermine access to justice and legitimate legal advice and assistance for New Zealand individuals, charities and commercial entities alike.

(c) **Avoiding regulatory arbitrage**

To prevent unfair sectoral competitive advantages, and opportunities for regulatory arbitrage, the scope of overlapping regulated services across sectors should be consistent, where applicable. For instance, there is cross-over among lawyers, accountants, financial advisers and real estate professionals in relation to some of the services specified on the Proposed List. (We note that the scope of regulated services in the Consultation Paper for the legal services sector and the accounting sector respectively are currently consistent, and we support that approach. Accordingly, we suggest that any changes to these respective lists be considered in parallel).

2.3 We recommend the following changes to the Proposed List on the basis that a more targeted list will regulate activities capable of materially contributing to ML/TF, while avoiding unnecessary capture and the creation of barriers to the delivery of legitimate legal services:

- acting as a formation agent of legal persons or arrangements
- arranging for a person to act as a nominee director or nominee shareholder or

trustee in relation to legal persons or arrangements

- providing a registered office~~, a business address, a correspondence address, or an administrative address~~ for a company, a partnership, or any other legal person~~ or arrangement~~
- managing or receiving client funds, accounts, securities or other assets
- ~~preparing for or~~ carrying out ~~real estate~~ transactions involving the sale or purchase of real estate on behalf of a customer
- ~~preparing for or carrying out transactions for customers related to creating, operating or managing companies.~~

To ensure effective compliance, the above refined categories should be further explained - in the Act itself, or in the underlying regulations / guidelines / codes - well before implementation of these new obligations for the legal services sector.

We also submit in section 6 that the 'reliance' framework for customer due diligence (**CDD**) should be reconsidered in relation to the legal services sector or, alternatively, that an appropriate exemption be introduced for lawyers in relation to CDD.

Appropriate stage of the business relationship for compliance

2.4 In relation to *new* clients (i.e. business relationships formed after the 'phase two' reforms take effect for the legal services sector), the legal services sector should be able to exercise judgment to determine the appropriate time for undertaking CDD in view of all relevant circumstances. This flexibility is needed to accommodate the varied nature of the work undertaken by the legal services sector, and time-sensitive client instructions. It would be sub-optimal for New Zealand's international reputation if, for example, the CDD process on a low risk client were to delay the completion of a commercial transaction.

2.5 In relation to *existing* clients (i.e. clients with whom lawyers or law firms have existing business relationships when the 'phase two' reforms take effect for the legal services sector), we submit that no CDD should be undertaken unless there is a material change in the nature of the business relationship. Such a material change would only occur if the client wished to undertake one of the categories of regulated transaction described in the box in paragraph 2.3 above.

3. Legal services sector – interaction with legal professional privilege

Is the existing mechanism that protects legal professional privilege appropriate for responding to money laundering and terrorist financing, and for the legal profession to comply with its expected obligations under the Act? If not, what else is required?

3.1 Legal professional privilege (**LPP**) is a core element of our legal system, so it is encouraging to see that the Ministry of Justice has indicated that there is no policy intention to override it.

3.2 Nevertheless, the current scope of legal privilege in the Act is narrower than the accepted scope in the Evidence Act 2006. We submit that the Evidence Act provisions should be the starting point for the Ministry of Justice's consideration of this issue.

3.3 In relation to the duty to file suspicious transaction reports (**STRs**) under section 40:

(a) The qualified exception for privileged communications (section 42) is appropriate in principle and generally sensible in drafting. However, it might be more efficient and consistent to incorporate subpart 8 of Part 2 of the Evidence Act 2006 (especially section 54 relating to legal advice privilege, section 56 relating to litigation privilege, and section 67 relating to the ability of a judge to disallow privilege in the presence of dishonesty or criminality) rather than to retain the narrower definition of "privileged circumstances". That reference to "privileged circumstances" appears to date from 1996 before evidence law was largely codified by way of the Evidence Act 2006, and makes no provision for litigation privilege.

(b) The qualified protection for disclosure under section 44 is appropriate, given the policy goals of the AML/CFT regime. That protection is arguably already reflected in r 8.4 of the Lawyers and Conveyancers Act (Lawyers: Conduct and Client Care) Rules 2008, but that protection should probably be clarified to ensure that lawyers do not face disciplinary proceedings if they make an STR in good faith.

3.4 In relation to the power for enforcement agencies to execute search warrants under section 117, there is limited recognition of privilege issues. Subpart 5 of Part 4 of the Search and Surveillance Act 2012 (**SSA**) sets out a number of protections and procedural provisions governing the execution of search warrants in relation to privilege (which is defined by reference to the Evidence Act in section 136). However, those provisions do not currently apply to search warrants executed under the Act (section 117(4)). It is not intuitive that they should not apply.

3.5 In relation to the power for enforcement agencies to require production of documents or information (sections 132 to 133), there is again limited recognition of privilege issues. Rather than incorporate the search warrant provisions of the SSA, it might be more appropriate to just explicitly recognise the existence of the privileges set out in the Evidence Act. Lawyers would then be obliged to invoke those privileges on behalf of clients, unless rule 8.4 applied.

4. Supervision

Do you think any of our existing sector supervisors (the Reserve Bank, the Financial Markets Authority and the Department of Internal Affairs) are appropriate agencies for the supervision of Phase Two businesses? If not, what other agencies do you think should be considered? Please tell us why.

4.1 As a general observation (based on our experience on advising clients on the application of the Act since its inception), the existing supervisors appear to be under-resourced. The benefit of a single "super AML regulator" could be better, more focussed resourcing, as well as a consistent approach to interpreting the Act and regulations, providing guidance and (perhaps most importantly) responding to exemption applications.

4.2 If the introduction of a single "super AML regulator" is not feasible prior to the implementation of 'phase two', we suggest that, out of the three current supervisors, the Department of Internal Affairs (**DIA**) would be most appropriate to supervise the legal services sector. This is because the large law firms regularly engage (on behalf of our clients) with the other two current regulators, sometimes on contentious matters relating to other legislation. In addition to issues of LPP, supervision of lawyers by the Financial Markets Authority or the Reserve Bank of New Zealand could create complex issues relating to disclosure of confidential information. These issues are likely to arise to a much lesser degree with the DIA.

4.3 If a sector-specific supervisor were introduced for the legal services sector, the New Zealand Law Society (**NZLS**) would be an obvious candidate for consideration. However, we expect that this would require a significant amount of new resourcing in order for NZLS to set itself up with the necessary capabilities to effectively perform this role (which would be markedly different from the activities currently undertaken by NZLS). Again, this is a point that would need to be considered with regards to the proposed timetable for the implementation of these reforms. Please note that we have not engaged with NZLS on this point and, therefore, we are not aware of its views on the matter.

5. Implementation period and costs

What is the necessary lead-in period for businesses in your sector to implement measures they will need to put in place to meet their AML/CFT obligations? Where possible, please tell us how you calculated how long it will take to develop and put in place AML/CFT requirements.

5.1 In our view, the necessary implementation period for the legal services sector will directly correspond to the scope of regulated legal services. Specifically, the broader the scope of legal services to be regulated, the longer the implementation period that will be necessary.

5.2 We think that effective implementation of AML/CFT compliance for the legal services sector within a short time period will be challenging for the following reasons:

(a) Unlike banks, insurers, casinos, and other financial institutions which are well-resourced with compliance teams due to their prudential or other governing legislation, lawyers (including even the largest commercial law firms) are not currently resourced to prepare for and implement compliance on the scale required by the proposed AML/CFT reforms.

(b) We are aware that there is an acute shortage of compliance experts with AML/CFT experience available to the New Zealand market from our work advising ‘phase one’ reporting entities on their on-going compliance with the Act. Accordingly, the ability of the legal services sector to hire external compliance expertise will be very limited.

(c) We are also aware that even the most sophisticated and well-resourced ‘phase one’ reporting entities found it challenging to implement their AML/CFT compliance processes within the two-year period they were afforded. For many, compliance is still being developed well into the ‘business-as-usual’ phase.

(d) Given that lawyers are not currently resourced for AML/CFT, that compliance is not a core competency, and that there is a significant skills shortage, the legal services sector will have to develop capability in existing staff and systems from scratch. This will in turn involve:

(i) ensuring the relevant staff have an in-depth undertaking of the Act, the regulations and the existing guidance, in addition to the new reforms;

(ii) implementing appropriate internal systems and rolling out training across the firm or practice;

(iii) liaising (where applicable) with the firm’s risk committee and board;

(iv) factoring in the cost of the new systems and any additional compliance staff hired to financial planning and budgeting;

(v) liaising with insurers as to the impact of civil liability penalties on professional indemnity policies; and

(vi) as an industry, developing a dialogue with the sector’s AML/CFT supervisor, once the supervisor is confirmed.

5.3 In addition, since the AML/CFT regime is principles-based, it will be important that applicable regulations, codes and guidance on ‘phase two’ is available well in advance of the effective date for compliance.

5.4 Consequently, we submit that a fair and realistic time period for implementation is at least 2 years. However, we think a 12 to 18 month implementation period could be achievable if the Ministry of Justice:

(a) agrees to refine the Proposed List in accordance with our suggestion in paragraph 2.3;

(b) accepts our proposal to grandfather existing clients in accordance with paragraph 2.5;

(c) accepts our recommendations in relation to ‘reliance’ in section 6 below; and

(d) publishes appropriate regulations and guidance, and anoints the new supervisor, well in advance of the effective date.

6. Reliance on third parties

Are the existing provisions that allow reporting entities to rely on third parties to meet their AML/CFT obligations sufficient and appropriate? If not, what changes should be made?

6.1 We comment on the current reliance framework only to the extent it will affect the legal services sector in ‘phase two’.

6.2 The current AML/CFT regime provides three mechanisms for relying on a third party to conduct CDD. However, in each case the relevant reporting entity remains statutorily liable arising from a consequence for any failure by the relevant person to conduct the necessary CDD to the required standard. Commercially, this risk is usually addressed in practice by the reporting entity conducting due diligence on the third party’s CDD processes, or by seeking an indemnity from the third party to cover civil liability (and sometimes reputational liability) arising from deficient CDD, or both.

6.3 For lawyers, the civil liability risk is material because lawyers will be personally liable to an unlimited extent; that is, they will not be able to rely on the veil of incorporation to limit their liability as a company, bank or other incorporated ‘reporting entity’ is able to do.

6.4 In addition, in the context of legal services, there will usually be another reporting entity involved in transactions or dealings that are regulated by the AML/CFT regime – such as a financial institution which has already conducted CDD on the customer. In these cases, we submit that it would result in inefficient duplication for lawyers to undertake CDD independently to the same standard. Rather, it would make sense for lawyers to be able to rely on other reporting entity’s CDD where it is reasonable to do so – for example, where a registered New Zealand bank confirms it has undertaken CDD on the customer. However, it is unclear whether – for instance – banks will be willing to act as CDD agents for law firms (and the designated business group route under section 32, or the conditional regime under section 34, will not assist lawyers in these transactions). Furthermore, lawyers will have limited / no ability to undertake due diligence on another reporting entity for commercial and confidentiality reasons, and it is not realistic to expect that law firms will be indemnified by financial institutions or other reporting entities.

6.5 Additional complexity arises in relation to offshore instructions. Commercial law firms typically receive instructions from law firms in other jurisdictions to provide advice on behalf of the offshore firm’s clients. These transactions typically involve no flow of funds nor sale or purchase of assets. It would be very difficult for law firms to undertake CDD or other diligence on the instructing firms or the underlying clients in most cases. Accordingly, it would be helpful if these dealings could be specifically excluded from the scope of the legal services regulated by AML/CFT to the extent the instructions came from a law firm operating in a jurisdiction with sufficient AML/CFT systems and measures in place.

6.6 For these reasons, we would like to explore whether an amended reliance regime could be considered for the legal services sector for CDD. Alternatively, a limited exemption for legal services akin to the ‘managing intermediaries’ exemption could be adopted to enable lawyers to undertake only simplified CDD in appropriate circumstances, taking a risk-based approach. We would be happy to work with the Ministry of Justice further to discuss any of these options.

Thank you for your consideration.

Yours faithfully

Bell Gully