9 March 2006

The Committee Secretary
Senate Legal and Constitutional Committee
Department of the Senate
Parliament House
Canberra ACT 2600

Dear Sir/Madam

Inquiry into the Exposure Draft of the Anti-Money Laundering and Counter-Terrorism Financing Bill 2005

We thank you for the invitation to comment on the Exposure Draft of the Anti-Money Laundering and Counter-Terrorism Financing Bill 200. We welcome the opportunity to enter into a constructive dialogue and to facilitate the ongoing consultation process.

The current exposure period has provided us with an opportunity to analyse and assess the significance of the Bill (with accompanying Draft Rules and Guidance) as it affects and will affect us as lawyers, as it impacts upon our clients and also as it affects the wider financial services industry.

We have in the period since the Bill was released consulted extensively with our clients in the financial services sector, with other professionals and with the various industry groups. This consultation exercise is an ongoing process as some issues are crystallised and others resolved.

Given the complexity of the legislation we are concerned that a number of the critical draft rules are still outstanding. We (and our clients) consider that we are unable to conduct a complete analysis of the impact of the legislation without those rules.

It is our intention to provide more detailed comments on specific aspects of the Bill in our final submission to Government. Additionally, there are a number of major issues, for example the effective application of a risk based approach in contrast to some of the more prescriptive requirements of the Bill, that we will address in that submission.

At this stage our comments address what we see as some specific legal and technical aspects of the proposed legislation. These include the Rule making power, the suspicious matter reporting regime and the extra-territoriality requirements of an anti-money laundering/ counter terrorist financing program.

We enclose our submission, which should be read in conjunction with this letter.

Our Ref MYJS:205506276

Yours faithfully

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Submission to the Senate Legal and Constitutional Committee on the Inquiry into the Exposure Draft of the Anti-Money Laundering and Counter-Terrorism Financing Bill 2005

1. Designated Services

We have some specific concerns regarding a number of the designated services listed in section 6 of the Bill. These include:

(a) Item 6. We submit this item should be restricted to those who make loans in the course of a business relating to lending. As presently drafted this item (because the definition of "loan" includes the provision of credit or any other form of financial accommodation) could be interpreted to include telecommunication companies, utilities and others who allow time to pay their bills and employers who lend funds to employees.

(b) Item 17. Bills of exchange, promissory notes and letters of credit. It appears to us that the wrong party is shown as the customer for all 3 instruments.

(i) Bills of Exchange – in our view the designated service should be "accepting, endorsing, purchasing, discounting or otherwise acquiring a bill of exchange or agreeing to do any of those things". The customer should be the issuer or drawer of the bill.

(ii) Promissory notes – in our view the designated service should be "purchasing, discounting or otherwise acquiring a promissory note or agreeing to do any of those things" and the customer should again be the issuer or drawer of the promissory note.

(iii) Letters of Credit – in our view the customer should be both the person who has agreed to indemnify or reimburse the issuer of the letter of credit in respect of payments under it and the beneficiary of the letter of credit, as the beneficiary will receive funds if a payment is made under the letter of credit.

(c) Item 57. This should be restricted to payments made under guarantees provided in the course of carrying on a business.

2. The Control Test

Section 10 defines a "control test" in relation to an unlisted company or a trust by reference to sections 1207Q and 1207V of the *Social Security Act 1991*. Relevantly paragraph 2(i) of the Draft AML/CTF Rules on customer identification applies this test as the minimum customer identification requirement for unlisted companies.

We submit that the application of the *Social Security Act* test in this context is inappropriate in the financial services context. The test is complicated (and not generally used in the financial services sector) and requires the collection of information on individuals and more

importantly, their associates, (who are very widely defined) which the customer may not have and which the reporting entity may not be able to obtain.

We consider that the use of this prescriptive and complicated test, which requires the collection of information, but does not require any analysis or understanding of that information, detracts from the underlying FATF requirement that financial institutions should take reasonable measures to understand the ownership and control of their customers.

Other jurisdictions appear to adopt a much simpler approach. In the United Kingdom, Guidance published by Joint Money Laundering Steering Group, suggests regulated firms obtain the names of individual beneficial owners holding (directly or indirectly) 25% or more of an unlisted company. The equivalent guidance in Hong Kong, (the Hong Kong Monetary Authority Guidelines) requires identification of shareholders with more than 10%.

We accept that reporting entities may find it useful to apply this control test in some circumstances (for example where no other method of assessing ownership/control of an unlisted company is available). However, we submit that its use should not be prescriptive. Rather it should be one method by which a reporting entity can assess who owns or controls their customer. Other methods may also be suitable, if the assessment can be justified.

3. The rule making power

The interplay between the customer identification procedures required by the Bill and the KYC and risk classification requirements of the AML/CTF program rules raises the question can the Rules regulate, for example, for the application of customer identification procedures to customers, beyond what is required by the Act. If so, this raises the wider issue of the extent of AUSTRAC's rule making powers.

Persons who were customers before the commencement of the Act who do not receive any designated services after the commencement of the Act (***dormant customers)*** are not customers (existing or otherwise) for the purposes of the Act and not subject to KYC procedures.

They do however seem to be customers for the purposes of the AML/CTF draft program Rules. Rule 17[1] (risk classification), Rule 11[2] (minimum or additional KYC information), and Rule 13 [3] (updating KYC information) of the AML/CTF draft program require a degree of KYC information for such customers.

[1] A reporting entity must assign each existing customer with a risk classification as soon as is practicable but no later than (still to be defined) months from commencement

[2] A reporting entity must determine, as soon as is practicable after commencement, whether any minimum or additional KYC information is required for each existing customer (as defined by section 27(1) of the Act)

[3] A reporting entity must update its KYC information on each customer (including existing customers) at appropriate intervals and on a risk basis.

It is the extension of Rules 11, 13 and 17 to dormant customers, who would otherwise not be covered by the Act, which raises the question can the rules regulate beyond what is required by the Act.

Section 191 is the source of Austrac's power to make Rules and makes Rules enforceable by stating them to be legislative instruments. Section 73 requires reporting entities to develop and comply with an AML/CTF program. Section 74 defines what such a program is, in paragraphs (a) to (g) of s74(1). Paragraphs (a) to (d) all refer to the provision of designated services as a necessary precondition to the applicability of the program. Those paragraphs therefore support the view that Rules 11, 13 and 17 do not apply to dormant customers.

Paragraphs (f) and (g) of s74(1) both support the view that Rules 11, 13 and 17 apply to dormant customers. Paragraph (f) in particular supports Rule 13 as it requires a program to comply with Rules relating to ongoing due diligence. Paragraph (g) simply requires a program to comply with any requirement specified in the Rules, so appears to oblige a reporting entity to comply with Rules 11, 13 and 17 even in circumstances where the Act imposes no obligations on the reporting entity (eg in relation to dormant customers).

We raise this issue for two reasons. In the first instance the extension of the AML/CTF program rules to customers who may no longer have an ongoing relationship with the reporting entity and no KYC obligations under the Act has practical and resource implications.

More importantly if the Rules can regulate beyond the Act it is imperative that AUSTRAC's Rule making power is subject to, (at the least) industry consultation and some form of parliamentary scrutiny. At present it is not.

AUSTRAC functions as set out in Section 173(1)(d) include such functions as are conferred under the Act. Section 191, AUSTRAC's rule making power, falls within this category. Although section 173 (2)(a) requires AUSTRAC to consult with reporting entities or their representatives in performing its functions (such as making Rules), section 173(3) provides that any failure to do so does not invalidate any action that AUSTRAC might take in performing its function. In practice this means that AUSTRAC can issue Rules under section 191 without effective industry consultation.

We submit that the Government should consider either:

(a) amending the Bill to clarify that the Rules cannot regulate beyond what is required in the Act; or, alternatively

(b) excluding section 191 (the rule making power) from the application of section 173(3) so that a failure by AUSTRAC to consult on the Rules would invalidate those Rules.

4. Intermediaries

Section 34 facilitates the use of by reporting entities of intermediaries and is therefore welcome.

The title to section 34 "When general customer identification procedures may be carried out by another person" appears somewhat misleading in that it implies that the section will apply to methods by which someone other than the reporting entity will carry out the appropriate procedure. However section 34 includes (at subsection (1)(a)) a provision whereby the procedures can be carried out by "internal agents" of the reporting entity. As internal agents are defined in section 11 as employees or directors of the reporting entity, in practice the reporting entity will itself be carrying out the customer identification procedure.

The application of this section to the reporting entity itself seems superfluous and unnecessarily complicated. The requirement in section 34(1) that written authorisation is required before the customer identification procedure can be carried out obliges a reporting entity to provide written authorisation to its own employees before they can carry out a customer identification procedure.

Section 34 also authorises external agents to carry out customer identification procedures but because of section 12 they are prohibited from providing information obtained by that procedure to anyone other than the reporting entity. In order to facilitate the sharing of information between related entities in a group structure (and thereby reducing costs) we suggest external agents should be able to provide customer identification information to related entities of the reporting entity if so authorised by the reporting entity.

5. Suspicious matter reporting obligations

5.1 Section 39(1) and section 39(2)

There is an inconsistency between the scope of the obligation in section 39(1) and the reporting obligation in section 39 (2) that undermines the intention of the section.

Sections 39(1)(d), (e), and (f) apply if a reporting entity has "reasonable grounds to suspect", that is, an objective test applies. In contrast section 39(2) requires a reporting entity to make a report to AUSTRAC within 3 business days (or 24 hours) after the day on which the reporting entity formed the "relevant suspicion". "Relevant suspicion" is not defined. The obligation to report (under section 39(2)) therefore only applies when a suspicion is formed, not, when there are reasonable grounds to suspect but no suspicion is actually formed.

This section is drafted in similar terms to the existing reporting obligation under section 16 of the *Financial Transaction Reports Act 1988 (Cth).*

The difficulty could be cured if section 39(2) was amended so that the obligation to report arose within 3 days or 24 hours of forming the suspicion or having reasonable grounds to do so. Alternatively the language of section 311 of the *Corporations Act*, (where an auditor is required to report within 28 days of becoming aware of circumstances that he has reasonable grounds to suspect are a contravention) could provide a precedent.

5.2 Section 39(6)

There is an inconsistency between:

(a) the prescriptive obligations imposed by section 39(6) and paragraph 1 of the Draft Rules on Suspicious Matters (to take into account a list of 24 matters set out in that paragraph); and

(b) the Statement in paragraph 10 of the Draft Guidelines on Suspicious Matter Reporting.

The prescriptive nature of the obligations is reinforced by the language of paragraph 9 of the Draft Guidelines.[4]

In contrast, paragraph 10 of the Guidelines implies that a reporting entity need only take into account such of the 24 matters as are relevant to the individual circumstances of each case. This approach is consistent with the view, which we understand to have been expressed by AUSTRAC's representatives, that the list in paragraph 1 is not prescriptive.

If the matters listed in paragraph 1 of the Rules are for guidance only (as is the case in comparable jurisdictions) we submit this should be made clear in the Act and the Rules.

5.3 Section 40(3)

We are concerned that this section is unworkable in practice and goes beyond the requirements of the relevant FATF Recommendation.

(a) The section extends the reporting obligation in section 39(1)(d)(i) to information relevant to the investigation of an evasion, or attempted evasion of a law of a foreign country or part of a country that deals with taxation. The foreign tax evasion does not have to correspond to any Australian taxation law, neither does it have to constitute an offence in Australia or in the foreign jurisdiction.

(b) It presupposes that the reporting entity is in a position to know what may be relevant to an investigation into the evasion or attempted evasion of every foreign taxation law, whether that law has any similarity to an Australian tax law or not.

(c) FATF Recommendation 13 requires financial institutions to report funds that are the proceeds of "criminal activity". The Interpretive Note to the Recommendation refers to criminal activity as:

  (i) all criminal acts that would constitute a predicate offence for money laundering in the jurisdiction; or

  (ii) at a minimum offences that would constitute a predicate offence as required by Recommendation 1 (that is all serious offences).

Section 40(3) goes beyond the Recommendation as the conduct to be reported, i.e. the evasion or attempted evasion of a foreign tax law, does not constitute a predicate offence for the purposes of the Recommendation. There is reference in the Interpretive Note to Recommendation 13 to the effect that suspicious transactions should be reported regardless of whether they involve tax matters. Section 40(3) goes beyond this.

[4] it refers to the Rules as "prescribing matters that a reporting entity must take into account"

5.4 Section 40(5)

Similar issues arise under section 40(5) as those which arise under section 40(3).

Section 40(5) extends the reporting obligations in section 39(1)(d)(ii) to information relevant to the investigation of an offence that is an offence against the law of a foreign country and that corresponds to an Australian offence. In practical terms this requires the reporting entity to consider (and therefore by implication have full knowledge of) offences in all foreign jurisdictions.

Although FATF Recommendation 1 makes it clear that predicate offences should include conduct that occurs in another country, that constitutes an offence in that country and which would constitute a predicate offence if it occurred domestically (this is the format followed by section 40(4)) it also suggests a simpler approach, that is, that countries may provide that the only prerequisite for a predicate offence is that the conduct would have constituted a predicate offence domestically. This simpler approach has been adopted by other jurisdictions (section 326(1)(b) of the UK Proceeds of Crime Act is an example).

We suggest that section 40(5) should adopt the simpler (and more practical) approach and provide that only information relevant to conduct overseas which if committed in Australia would be an offence against an Australian law, should be reported. This approach complies with Recommendation 1 but obviates the need for a reporting entity to consider offences in overseas jurisdictions.

5.5 Section 40(7)

We submit this is impractical in that it presupposes a reporting entity will have full knowledge of the proceeds of crime law in all other jurisdictions. This is not a FATF requirement.

5.6 Section 46(1)

This section provides protection to any person in relation to any action taken in good faith and without negligence in fulfilment of any requirements under sections 39, 41, 42 or 45 or in the mistaken belief that action was required under those sections.

We consider that this protection should also include any actions taken to comply with the Rules and Guidelines. An example of where such protection might be required is where enhanced due diligence (with the attendant risk of tipping off) is carried out as required by paragraph 21(g) of the Draft Rules on AML/CTF programs.

6. AML/CTF Program

The requirement in section 75 that every AML/CTF program requires the reporting entity to monitor against the risk of foreign AML/CTF offences requires the reporting entity to have full knowledge of AML/CTF regimes and money laundering and terrorist financing risks in every other jurisdiction.

This is not qualified in any way (for example to jurisdictions that are FATF members or NCCT countries) but applies to every jurisdiction.

We accept that the global nature of money laundering/ terrorist financing requires an effective AML/CTF regime to guard against financial institutions being used to facilitate offences being committed overseas. However, we consider that a more risk based approach should be adopted and that section 75 should be amended to reflect this.

7. Tipping Off

Section 95(1) prohibits disclosing specified information .

In our view, there should be an exemption whereby a reporting entity can disclose the fact of its suspicion, or a report it has made, to an external legal advisor for the purpose of receiving legal advice.

Where the reporting entity is part of a corporate group we suggest that the reporting entity should be able to make the same disclosure to another member of the group, so long as that disclosure is not likely to prejudice an investigation which might be conducted following the report.

As a matter of sound business practice and risk management, if one member of a corporate group has information relevant to an offence or attempted offence it should be able to advise other members of the group of that suspicion, for example, to minimise the likelihood of offences being perpetrated across the group or another member of the group unwittingly facilitating a money laundering or terrorist financing offence.

We understand that this is accepted as best practice overseas. In the United Kingdom and Hong Kong a regulated entity cannot make a disclosure likely to prejudice an investigation but is not otherwise prevented from advising other members in the same corporate group of such matters. In the United States, FinCEN has recently issued Guidance (20 January 2006) to the effect that some financial institutions may share suspicious activity reports with domestic and foreign parent entities for the purpose of enabling the parent entity to discharge its oversight responsibititltes or with respect to enterprise wide risk management and compliance with applicable laws and regulations.