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

Dear Secretary,

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

Please find attached the ABA submission to the Committee's inquiry, which has broad support across the finance sector.

Banks, other financial institutions and industry bodies have been working have been working within the advisory framework established by the Minister for Justice, Senator Ellison, to provide advice on the Anti-Money Laundering (AML)/Counter Terrorism Financing (CTF) Exposure Draft (ED) and to consult with the Attorney-General's Department (AGD) and AUSTRAC on the development of AML rules and guidelines.

Work on the detail of the ED, rules and guidelines continues, however a number of key issues have emerged which must be addressed in the legislation to be presented to Parliament. This submission tables those issues now, in order to assist the Committee's consideration of the ED and draft rules. They will be amplified in a further industry submission to Government on all aspects of the ED and draft rules at the end of the consultation period.

At this point, we must raise two fundamental concerns relating to the pace of development of the legislative package and the way in which the ED, and such rules as are available, have been drafted.

These concerns have been raised with the Minister directly and via the AML/CTF Advisory Group as well as in ongoing discussions with officials of AGD and AUSTRAC, within the consultative process established by the Minister.

It is hoped that these discussions will lead to resolution of industry's concerns - before the AML legislative package is finalised and presented to Parliament. In this context, we note that industry's concerns were raised at a meeting of the AML/CTF Advisory Group, chaired by the Minister, on 7 March. As a result of that

discussion, the Minister directed that AGD should review the ED with the aim of restoring the principle of a risk-based AML regime and removing unnecessarily prescriptive elements from the Bill. Draft AML rules were also to be reviewed in accordance with a risk-based approach. The direction from the Minister was welcomed by industry.

This development occurred at the time we were finalising this submission to meet the Committee's timetable and, at time of writing, we do not know whether the outcome will satisfy industry's concerns. We raise them here so that the Committee is aware of them and can take industry's views into account in making recommendations to Government on both the ED and the final Bill.

It was agreed during the industry roundtable meetings in 2005 that the new AML/CTF system for Australia would be risk-based rather than prescriptive, and would be designed to counter money laundering rather than be a compliance tool for monitoring in detail the AML performance of reporting entities:

> *"There was a general agreement on the concept that the new system should allow a risk-based approach, with a regulatory framework, which allows the flexible application of obligations."* [1]

The draft legislation revealed to date has not followed this approach and is delivering a very large overhang of mandatory and prescriptive (rather than risk-based) legislation and rules, with very little scope left for industry guidelines.

Additionally there are serious reservations among industry participants that the April deadline set for the consultation period cannot be met at the present pace. The consultative framework set up by the Minister is workable but the issues are very complex, there are many uncertainties in the existing drafts, and progress is slower than expected. A large number of stakeholders are involved and extensive internal industry consultation must be carried out.

While the joint industry-Government working groups have reached agreement on a number of aspects of the legislation (as noted in the submission), industry is unable to commit at this point to particular changes in the draft legislation and a full written submission on all issues will still be required.

The industry concern is that if the AML legislative package is pulled together in a rush to meet the current mid-April deadline, issues will not be properly resolved, or will be overlooked, resulting in implementation difficulties and ongoing operational problems.

The position put to the Minister is that industry must have the full package of draft legislation, and all draft rules which give effect to primary obligations, before consultation can conclude and submissions be completed. It estimated that at least 5-6 weeks will be required from the date of delivery of the full package to conduct a complete analysis and prepare detailed submissions.

The industry view is that it is better to take a little longer to get the AML package right than to race to meet a self-imposed deadline.

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[1] Joint Communiqué: Industry Roundtable on Anti-Money Laundering between the Minister for Justice and Customs, Senator Chris Ellison, and representatives of the Financial Services Sector- 21 July 2005

The Minister said at the March 7 meeting that he wanted to adhere to the legislative timetable as the Government was committed to passing the AML legislation in the second half of 2006.

As the AML/CTF regime we are working towards will require substantial and costly modification of existing complex IT systems, management systems and staff training, particularly for financial institutions, it is essential that industry see the final picture before embarking on system changes. It is only when the last piece of the jigsaw is fitted into place, that industry can then go ahead with confidence and commit financial and management resources to the AML/CTF system changes.

This will take some time and industry is seeking a reasonable and practical transition phase for implementation. We estimate this could take up to 3 years, although it may be possible to phase in the new measures. This transition timetable has yet to be discussed in detail with the Government.

Yours faithfully

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Tony Burke

AML/CTF Exposure Draft – Key Issues February 2006

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1. Level and scope of regulation

1.1 Inconsistency with international standards

It has been consistently stated that the AML/CTF regulatory regime in Australia would not exceed the levels set by FATF and in comparable jurisdictions, and that a workable, risk-based approach would be taken, for example:

> *"The roundtable meeting recognised the importance of the FATF recommendations and the need to progress their implementation. In addition, the participants also agreed that any implementation must produce workable solutions that recognise the government's obligations and the needs of the financial services sector.*
>
> *Senator Ellison agreed with the industry representatives that the new regime should avoid unnecessary duplication and costs, while respecting competitive neutrality.*
>
> *There was a general agreement on the concept that the new system should allow a risk-based approach, with a regulatory framework, which allows the flexible application of obligations."*[2]

The Exposure Draft (ED[3]) however differs significantly from:

- the FATF Recommendations;
- overseas AML legislation;
- overseas practices and regulators' approaches; and
- the approach being taken by the Government regulation review programs such as the FSAC review and the Regulation Taskforce.

1.2 FATF

The FATF Recommendations, according to their introduction, "set minimum standards for action for countries to implement the detail according to their particular circumstances and constitutional frameworks." FATF recognises that "countries have diverse legal and financial systems and so all cannot take identical measures to achieve the common objective…"

Yet the proposed AML regime in certain key respects extends beyond the expectations of the FATF. An example is provided by sections 73 and 74 of the ED, which together require reporting entities to implement AML/CTF programs that achieve a particular outcome – namely – that "materially mitigate" AML/CTF risk.

FATF Recommendation 15 (the development of programs against money laundering and terrorist financing) recognises and promotes the implementation of a risk-based regime. Recommendation 15 requires that AML/CTF programs

[2] Joint Communiqué: Industry Roundtable on Anti-Money Laundering between the Minister for Justice and Customs, Senator Chris Ellison, and representatives of the Financial Services Sector, 21 July 2005

[3] AML/CTF Exposure ED, Rules and Guidelines issued 16 December 2005

include certain elements (namely policies, procedures and controls, employee screening programs, employee training programs and auditing), and provides that "*the type and extent of measures to be taken …should be appropriate having regard to the risk of money laundering and terrorist financing and the size of the business*".[4]

FATF Recommendation 15 does not include a recommendation to impose an obligation to "materially mitigate" risk. Further, it does not oblige financial institutions to ensure any particular outcome.

1.3 Comparable jurisdictions

The United Kingdom (UK) and the United States of America (USA) have had considerable experience with the implementation of AML/CTF regimes and have led international efforts in this area. Both countries have sought to implement regimes that are risk-based, consistent with international requirements, best practice and their domestic legal environment. Further, both countries have had significant enforcement experience.

Neither of these two countries imposes an obligation to materially mitigate AML/CTF risk as part of the obligation to implement AML/CTF programs.

For example, in the UK, under the Money Laundering Regulations 2003 (ML Regulations), relevant businesses are required to establish internal control and communication procedures which are "appropriate for forestalling and preventing" money laundering.[5] A defence to prosecution is provided where an entity "took reasonable steps and exercised all due diligence" to implement such a program.[6] In deciding whether an offence has been committed a court must take into account whether the person followed relevant industry guidance.[7]

The AUSTRAC response to industry's concerns about "materially mitigate" is that the UK obligation to "prevent" is a higher standard than mitigation. This response ignores the legislative elements that make the UK approach fundamentally different from the proposed regime. It ignores the qualifier "appropriate" and critically, ignores the overall defences. The US obligation contains no reference to "materially mitigate" or to any particular outcome. It requires the establishment of programs (defined solely in accordance with FATF minimum recommendations) with the objective of guarding against money laundering.

Part 7 of the ED does not include any specific defences and no reasonableness nor due diligence defence, relying instead on certain of those found in the Criminal Code (for example mistake of fact) in respect of AML criminal offences with "appropriate amendments" where a civil penalty is sought.

1.4 Sound regulatory practice

The proposed AML regime if implemented in its current form will impose a disproportionate burden on business and is not consistent with good regulatory practice, which demands the dual goals of efficiency and effectiveness.

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4 FATF, *The Forty Recommendations*, 20 June 2003 (incorporating amendments of 22 October 2004), Annex at page 5 (Interpretative Notes to Recommendation 15).

5 Money Laundering Regulations 2003, regulation 3(1)(b).

6 ML Regulations, regulation 3(5).

7 ML Regulations, regulation 3(3).

The undesirability of inappropriate regulation, as having the potential to impede economic growth, limit innovation, undermine entrepreneurial growth and reduce productivity and competition, has been recognised by the Government.[8]

The UK experience highlights the difficulties with adopting a regulatory regime which the regulator itself recognised as promoting "tick box overkill rather than risk-based proportionality".[9] The broad range of offence provisions under the ED (most of which have identical penalties attached, meaning that failing to identify a single customer is as significant as failing to maintain an AML/CTF program) suggests a regime which will make industry focus on "box ticking".

The Minister said at the March 7 meeting that he wanted to adhere to the legislative timetable as the Government was committed to passing the AML legislation in the second half of 2006.

In the UK, regulatory retreat and early legislative reform has been necessitated in the face of unworkable obligations and industry uncertainty. The ABA sees the UK experience as an important working example of industry and the regulator working through significant problems to achieve a workable, current best practice regulatory scheme. The ABA urges adoption of the key elements in the most recent UK approach.

2. Structure of proposed legislative framework

The current ED and subordinate instruments contain overlapping obligations which would result in interpretative inconsistency and ambiguity and would raise difficult questions of construction at the time of their implementation.

In response to specific concerns about the ED, AUSTRAC has referred industry to the Rules and stated that provisions in the Rules that are not present in the Bill address industry issues with the Bill itself. It is necessary however that the key obligations and offences be contained in the primary rather than subordinate legislation.

As a matter of construction, the Rules will provide no remedy to defects in the legislation itself.

3. Definitions

There are issues with many of the definitions in the ED, some of which follow.

There are a number of terms in clause 6 of the ED which are also used in chapter 7 of the Corporations Act but the relevant definitions in the Bill are either different from those in chapter 7 (for example the definition of "issue" does not include all elements of section 761E) or are not included (for example "custodial or depository service").

A related point is where there is a cross reference to relevant definitions in chapter 7 of the Corporations Act it is not clear whether the definition for the

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8 The Hon. John Howard MP, Prime Minister of Australia and the Hon. Peter Costello MP, Treasurer, *Taskforce on Reducing the Regulatory Burden on Business*, joint press release dated 12 October 2005.

9 Philip Robinson (Financial Crime, FSA), "The Fight Against Money Laundering: Promoting Effectiveness", Speech at City & Financial Conference, 22 June 2005.

purposes of the Bill is intended to include all exclusions or exceptions to the relevant term provided for by the Corporations Act or the Australian Securities & Investments Commission ("ASIC").

There are also a number of terms that are defined by reference to other legislation (eg the Trade Practices Act, the Retirement Savings Accounts Act, the Income Tax Assessment Act, and even the Social Security Act 1991 etc). It would be helpful if the relevant definitions were set out in full and their application clarified.

The concept of "control" is defined by reference to relevant provisions of the Social Security Act 1991. This is an extremely broad concept and unworkable as a practical test in the context of providing financial services.

A number of "designated services" are stated to exist when the relevant activity is "allowing a transaction". Although there is a form of definition in S.5 this concept is not clear.

A "person" is defined to include a "trust" and a "trust" means a person in the capacity of trustee. It is not uncommon for one company to be trustee of numerous trusts and for money to pass between those trusts. So a single corporate entity could, in effect, be a lot of reporting entities.

The definition of "security" does not explain which aspects of the definition in section 92 of the Corporations Act apply.

4. Designated services

4.1 No limits

The list of designated services does not draw any distinction on the basis of:

- a monetary limit (except the $1000 limit for stored value cards) (cf recommendation in the FATF Recommendations and especially the designated thresholds in the Interpretative Notes);
- whether the activity is carried out on an occasional or regular basis (cf FATF definition of "*financial institution*"); or
- who the service is provided to (eg a related company).

4.2 Issues with particular designated services definitions

4.2.1 "Loan"

Loan is defined very broadly to include "*provision of credit or any other form of financial accommodation*". *Credit* is not defined, but is likely to mean any debt deferral arrangement. This will catch any form of standard terms, for example, supply of any goods or services with payment due in 30 days, and any form of progress payments tied to achievement of milestones.

4.2.2 "Guarantee"

There is not yet an exemption for director guarantors or group cross guarantees from the definition of *guarantee*. Also, it is not clear how an individual guarantor can be expected to identify, and undertake customer due diligence generally

("CDD") on, a lender (such as a major bank) and a borrower (which could be a major corporate or an individual).

4.2.3 Personal advice

Arguably, such activities should not constitute provision of a designated service; rather, involvement in transactions following on from the advice should constitute the designated service.

5. Corporate Groups

The roundtable meetings recognised that the AML/CTF regime should be designed to avoid unnecessary duplication and costs. The ED does not recognise the existence of corporate groups.

It requires each entity within a group to develop its own processes, employ its own AML/CTF staff and implement separate AML/CTF systems. Reliance on third parties (anybody other than employees of the relevant entity) is only contemplated for the purpose of identifying customers. Because of the restrictive "tipping off" rule, all entities (including special purpose vehicles that currently have no employed staff) must maintain separate AML units. This will lead to significant duplication, and make worse the lack of experienced staff to fill new positions.

In addition:

- The ED makes no express mention of third party agents outside Part 2 (identification procedures).
- A key distinction is drawn between employees and officers of a corporation and everybody else (ie contractors in employment-like relationships, employees and officers of related bodies) in sections 11 and 12.
- The section 95 "tipping off" offence will prevent disclosure by one company to an officer of a related company, even if that related company employs the staff who review potentially suspicious activities on its behalf.
- The proposal in the ED would have a particularly serious impact on institutions with franchise models, where each separate branch might be treated as a reporting entity, and carry all the obligations of a large institution.

6. Risk Principles

6.1 Risk-based approach

The right balance between a risk-based approach to risk management and a more prescriptive approach requires:

- clarity in the application, scope and purpose of legal obligations;
- avoidance of legal obligations that are too prescriptive and allow no flexibility to best meet the principle objectives;

- industry be given an appropriate level of detail in the form of non-mandatory "guidance", which would represent industry best practice (rather than legal obligations); and
- inclusion of appropriate sanctions and legal defences.

There are different ways to achieve a "risk-based approach", particularly in a multi-instrument statutory regime. It can be done through both the definition of conduct as well as the defences.

The meaning of "risk-based" is not clear in the ED, although some comment is made in the Guidance Notes on AML Program Rules. The level of prescription needs to be reduced, and the ED must define a risk-based approach and its application, and specify the defence available to financial institutions for following a risk-based approach.

The proposed AML regime does not reflect a risk-based approach in that it combines mandatory, overly-prescriptive obligations, breach of which may give rise to criminal sanction, with inadequate defences. Sections 73 and 74 of the ED are again illustrative of the ED's inconsistency with a risk-based approach because the obligation imposed is outcomes-based, obliging entities to implement AML/CTF programs that achieve a particular result (ie that materially mitigate risk) and is couched in mandatory language (ie, the programs "should be designed to ensure").

The ED does not incorporate any notions of reasonableness or flexibility nor does it provide scope for industry to assess an appropriate response to individual risk or indeed for appropriate defences where reasonable steps or reasonable due diligence have been taken to meet the obligation.

7. AML Programs and Record Keeping

The sample AML Program Rules place financial institutions in the position of needing to gather more information about their customers, which they must analyse and which will generally give rise to the obligation to gather further information. All this information must be stored, be accessible, be interpreted and kept current.

A minimum time requirement for retention of records was not included in the ED and industry again asks for any time requirement to be aligned to other legislative record retention requirements.

There is no reciprocal obligation on customers to provide details of their changes of circumstances and this should be required, matched by appropriate penalties.

7.1 "Materially mitigate"[10]

The ED proposes an obligation that reporting entities must identify the risk that their products or services might be used to commit money laundering offences or terrorist financing offences, and to materially mitigate that risk.

[10] See AUSTRAC response on this issue from 6 Jan 06 attached

There are three issues with this obligation:

- On industry's current interpretation it is unworkable, yet it carries criminal penalties.
- There is no baseline of risk from which a material reduction can be measured in quantitative terms, which is what must be demonstrated to achieve compliance.
- Comparable countries overseas, which are more advanced in their measures to prevent money laundering and terrorist financing, have not imposed such an obligation on their financial institutions.

If the relevant legal obligations are clear, if guidance is provided, and if the scope of legal sanctions and defences is appropriate, it seems unnecessary to have an additional legal obligation to "materially mitigate" risk.

7.1.1 Legal problems

Section 73 requires an entity to develop, maintain and comply with an AML/CTF program. A program is in turn defined in section 74.

Section 74 contains very specific obligations couched in mandatory language. It further, by subsections 74(c), (d), (f) and (g), requires any program to also comply with Rules. The Rules in turn, Rule 46(c), state that the Guidelines "must" be taken into consideration when designing the AML/CTF program.

The obligations described in Rule 5 are inconsistent with those of section 74. Specifically, Rule 5 refers to appropriate "risk-based systems and controls". Further Rule 5 acknowledges that the systems and controls need be directed only to "high risks" that the reporting entity may "reasonably face". None of these provisions, which make the obligations reasonably proportionate to the risks faced, are incorporated in section 74, the primary obligation.

The definition in section 74 also contains requirements that are directed to the <u>result</u> of the program not merely its <u>objectives and content</u>. Again using directive language, namely "ensure" the first component of the definition is that a program be "designed to ensure that appropriate action is taken to… materially mitigate … risk [that provision of the service] might involve or facilitate a money laundering offence or a financing of terrorism offence". Industry is concerned that without amendment section 74 is uncertain, onerous and may impose an obligation of zero tolerance for events that occur despite having compliant AML/CTF programs in place.

The "materially mitigate" obligation most strikingly (though not solely) gives rise to this concern. This is because "mitigate" involves at least some assessment or comparison of an alternate outcome and "materially" connotes quantitative and qualitative demonstration of different outcomes. The term materially mitigate is unique in Australian legislation and is not present in the legislative obligations enacted by comparable jurisdictions.

The extent of the obligation and seriousness of the concern is compounded by the breadth of the offences that programs are to protect against and the fact that "appropriate action" is not defined.

Industry has provided AUSTRAC with options for resolution of the "materially mitigate" issue. A copy of advice provided to AUSTRAC is attached.

7.2 Risk classification of individual customers

The sample AML Program Rules appear to require a risk assessment to be made about each existing customer. This is not a requirement overseas, and is not recommended by FATF.

An obligation to risk assess each individual customer is an outcome just as onerous an outcome as any obligation to re-identify the existing customer base, a measure from which the Government has withdrawn.

The position agreed with industry was that risk assessments would be based on a combination of the nature of the customer (ie natural person, listed company, non-resident) and the kind of service. The sample AML/CTF Program Rule seems to require a detailed file level review of each customer, in order to determine their transaction history and normal behaviour, and at many points, the Rule refers specifically to "each customer" rather than collectively to customers.

AML/CTF Rule 14 requires each customer (including existing customers) to be given a risk rating. AUSTRAC's position seems to be that "class" risk rating (ie assigning identical ratings to a large group of customers without file-level reviews) is permissible, provided that the entity does not know something which would suggest a different risk rating. Without undertaking a comprehensive file level review, at a very significant cost, this could not be achieved.

It must be made clear that institutions may assess customer risk on a class basis, without regard to dormant information, provided each customer class contains an acceptable spread of risk. Further, it should be made clear that institutions may tailor the application of their AML measures to reliance on class–based risk assessments, at least until suspect behaviour or future information about the customer indicate to the contrary.

7.3 Effect of foreign laws

Sections 74 and 75 have the effect that the AML program must identify and mitigate the risk that the designated services might facilitate (inadvertently or otherwise) money-laundering or terrorist financing offences under Commonwealth, State and foreign laws. This means that the AML program must consider the provisions of each of these laws.

It is industry's view that the requirement to take into account foreign laws in section 75 should only apply where they are relevant to the operations or designated services of the financial institution.

7.4 Board approval

Industry agrees that the board is responsible and is accountable for the AML/CTF program but the ED requires boards to approve every component of the AML Program. This is out of step with current corporate governance and is not achievable in practical terms. An alternative level of obligation was proposed by industry but has not appeared in the ED although AUSTRAC has made some amendment to the draft AML Programs rule.

At the joint Industry – Government forum on 30 January 2006, representatives of the Attorney General and AUSTRAC acknowledged this as a legitimate concern, agreeing to recommend removal of the words "all components" from draft AML CTF Rule 44.

8. CTF Programs

Money laundering and terrorist financing are treated the same in the ED when they are quite different activities. There must be separate and different obligations applying to each threat, with which it is possible in practice to comply.

9. Customer identification

The following comments are based on draft rules for AML/CTF Programs which were released with the ED in December 2005 and on the draft rules on Applicable Customer Identification Procedures for Individuals which were released for limited circulation by AUSTRAC to the Customer Verification Working Group in early February 2006.

9.1 Customer due diligence

The sample rules relating to "Know Your Customer" and customer due diligence are too complicated. Industry proposed, in November 2005, that customer due diligence and enhanced customer due diligence be simplified into a unified approach but this has not appeared in the ED. The lack of further release of the suite of identification rules is making it almost impossible for industry to assess the scope of these due diligence requirements and their impact on businesses (and their customers).

The proposed Customer Due Diligence will require customers to spend longer conducting transactions and a significant proportion may feel the information required under the proposed regime is invasive, particularly in relation to provision of information on country of birth, residence and citizenship. International experience indicates that this information is of little value in AML/CTF control and there is concern that an obligation to ask for a place of birth may raise complaints of 'racial profiling' from many customers.

9.2 Existing customers

The "*existing customer*" exception is arguably too restrictive given:

- uncertainties about what a "*continuous relationship*" is;
- requirement to give all existing customers a risk classification; and
- requirement to determine whether additional information is required as soon as practicable after Part 7 commences.

9.3 Minimum KYC Information

Minimum KYC information is excessively detailed for certain low risk services, for example employer funded superannuation services. In addition, entities that are listed on a well-known stock exchange and/or hold an Australian Financial Services Licence are thoroughly regulated.

Additionally, not all the suggested primary documents offer meaningful verification of identity, and there is no allowance for clients who refuse to provide some of these details, either at the time of providing a service or if re-verification of identity is later required following the occurrence of risk triggers.

9.4 Customer identification procedures

9.4.1 Individuals

Currently the draft rules on Applicable Customer Identification Procedures for Individuals propose "face-to-face" versus "non-face to-face" provision of services. Given the number of ways services can be initiated (for example through financial planners, trustees, brokers, parents, guardians, officers or employees of companies and under powers of attorney) together with the allowance in the Bill for identification after commencement of a service in restricted circumstances, it is critical that the terms "face-to-face" and "non face to-face" are defined in either the Bill or the Rules.

In the consumer finance and equipment leasing area for example, many services are initiated through third parties such as motor dealers, business equipment suppliers or retailers offering interest free credit arrangements for the purchase of consumer goods. These entities will not necessarily be formally appointed as "external agents" of the reporting entity under Part 2 of the Bill, although they may collect identification information at the point of sale. The Rules should accommodate reporting entities treating these circumstances as "non face to-face" rather than requiring the customer to then attend the financial institutions premises for "face-to-face" identification which is inefficient and burdensome for customers, particularly those in rural locations.

Where a customer deals with a reporting entity through an agent, the ED imposes requirements to identify the customer's agent by following the "applicable agent identification procedures", which will be explained in the AML/CTF Rules. Customers' agents may also need to be re-identified if risk triggers occur. Many customers (both individuals and non-natural persons) use agents when obtaining services and it is of concern to industry that draft Rules covering agent identification procedures have not yet been provided.

In a recent working group meeting, AGD made it clear that the intention (not reflected in the drafting) was to permit reporting entities to decide whether to adopt the face-to-face procedures or the non-face-to-face procedures, based on which is best suited to their business processes.

9.4.2 "100 point test"/face-to-face

To enable a relationship to be established with a financial institution a customer is required to produce at least one piece of primary identification. It is possible however that a significant number of people in the community, particularly those in disadvantaged circumstances, may not have a primary identification document such as a passport or driver's licence to enable the relationship to be established.

A significant reduction in documents available for an individual to prove their identity is currently proposed in the draft Rules. While the removal of some unreliable documents such as gym memberships is commended by industry, the removal of documents such as Centrelink records, identity cards from

employment (which are capable of authentication), licences issued for the purpose of employment (which again, could be verified) will make it more difficult for people to be identified without significantly improving the risk position as these documents are all capable of verification with the issuing source.

It is possible however that a significant number of people, particularly those in disadvantaged circumstances and the very young or very elderly, may not have a secondary identification document to enable a banking relationship to be established.

While industry agrees with the comments in Clause 6 of the draft rules for Applicable Customer Identification Procedures for Individuals, the inclusion of Clause 8 makes it difficult to validate an address where documents do not contain this information. This could cause some inconsistencies within the industry.

Under the current proposed regime financial institutions will be obligated to ask each customer if they are known by any other name. As the identification documents provided by the customer should be proof of identity, industry believes that it should only be obligated to ask customers about another name if a discrepancy appears rather than at each account opening.

While industry appreciates that the government has drafted the ED and Rules to be technology neutral, the rules should allow for the efficient use of technology at a financial institution's discretion. For example, the requirement to retain a "written record" should reflect the sighting and recording of identification information rather than retention of a photocopy. Requiring copies of documents to be made, kept and stored introduces additional risks, such as privacy violations and opportunities for identity thefts to be committed.

Summary of issues:

- There is a need to ensure that methods listed under face-to-face and non-face-to-face are of the same robustness and equally positioned.
- There appears to be a positive obligation on the reporting entity to verify that the customer does not use more than one name – beyond just asking the question.
- Verification of any additional names may be problematic as the verification appears to be limited to production of documentary evidence (eg registered change of names).
- There needs to be a link between obligations to collect and verify certain information from ID Documents (Item 8 in Draft Rules) and the ID Documents to be presented (Item 6) – the obligation is to verify name/date of birth and name/address from the documents, not just any two primary/secondary combinations.
- There is a positive obligation to point out to a customer that they may be breaching the law by providing false or fraudulent information. This may be unnecessary (because covered by other legislation) and although relevant to many provisions of the ED appears to be limited to sections 107 and 111. There are also operational issues related to giving this warning and providing proof

that this has been achieved. Government education about the legislation may be the more appropriate vehicle for these warnings.

- Verification methods will be extremely limited until electronic access to source document databases is available.
- There are cases where certain people will not 'fit' within the currently allowable face-to-face test (eg an 18 year old still living at home might only have birth certificate)?

9.4.3 Non face-to-face

Industry has the following concerns:

- The process detailed in Clauses 11 and 13 of the draft rules on Applicable Customer Identification Procedures for Individuals is impractical in view of the processes considered as Confirmation of customer information.
- The requirement to obtain phone numbers from Telstra does not reflect other carriers, silent numbers, phone in another persons name etc. This also applies for the mailing of a letter, and the requirement for a response required within 48 hours, quite apart from the cost impact on industry to implement the process, is not practical. The customer experience for both these types of "authentication process" is inappropriate.
- It is acknowledged that there are a number of rules still to be delivered under this category, but industry is concerned that a large portion of the community would not meet the stated standard, especially when the Special Circumstances Procedures are yet to be completed.
- The process defined in Draft Rules is heavily reliant upon some onerous manual procedures, with issues including:
    - Lack of process robustness;
    - Telephoning the customer appears problematic due to constraints on where telephone details can be obtained from;
    - Mailing customer does not address the variety of operational issues this may cause (ie: time frames, overseas residents, etc.);
    - Coverage of overseas customers;
    - Timeframes on mailing and telephoning appear restrictive and no detail is provided on what services may be allowed in this period (or until verification of information can be provided); and
    - Uncertainty around 'cooling off' allowance?

9.4.4 Special consideration

Some groups of customers require special consideration, and this is not to be found in the ED or available rules. Examples of such customers are:

- Customers in remote locations;
- People using a TTY (to overcome a hearing disability);
- People without a primary document;
- Older Australians; and
- Customers for whom English is not their first language.

9.5 Identification documents

Issues include:

- The existing problem of fraud relating to the use of birth certificates;
- Uncertainties in application of the proposed 'wallet test'; and
- Uncertainty concerning the use of foreign birth certificates.
- The practice of some countries of issuing "parallel passports" - to facilitate "safe passage" in volatile regions.

9.6 Who can carry out customer identification for a reporting entity?

There are issues relating to who can be authorised to undertake customer ID for a reporting entity.

With the change/removal of the Acceptable Referee method, this causes significant impact to remote customers and those with special circumstances.

Issues relating to the use of agents and/or third parties and/or reporting entities need clarification, particularly as to whether there will be a defined process for "Certifying" identification documents. Can a third party identify a customer on our behalf without a formal agreement/contract?

The issue of related entities needs clarification as to their ability to identify on behalf of the parent entity.

9.6.1 Internal agents of the reporting entity

Officers and employees of related companies are not *internal agents*, and accordingly can only be authorised to carry out customer identification as external agents (unless they are themselves a "*reporting entity*").

9.6.2 External agents of the reporting entity

There are issues around:

- external agents who act for multiple reporting entities (eg loan originators);

- disclosure of information between sub agents and primary agents; and
- extent of detail that must be included in written agreements.

9.7 3rd Party / Agent Identification

The agreed position suggested that a reporting entity could rely on identification carried out by another reporting entity. The ED allows this, but only if the original identification is carried out (by agreement) on behalf of all other reporting entities that might later need to rely on it. At the stage of identification, these other reporting entities may not have been identified.

Similarly, if a financial planner identifies a customer for one investment, and 3 months later the customer seeks a different investment, the customer would need to be re-identified for the second investment.

The roundtable discussions did not contemplate senior management being required to individually assess each third party (including the hundreds of financial planners that distribute investment products) or to provide training for them.

9.8 Electronic identification and verification

Clarification is required as to circumstances in which a customer's ID can be checked through:

- identity information being provided to the reporting entity electronically; and
- a customer's identity being verified from electronic data sources through the reporting entity either accessing those services directly from Government or through third party services.

9.9 Timing

Issues include:

- limited exceptions to the rule requiring prior identification; and
- offence provisions which apply if a reporting entity has commenced, or continued, a designated service, in reliance on the ED section 31 exception, but has not been able to get required information.

9.10 Protection from liability

It is not clear how clause 36 in the ED interacts with obligations under:

- other laws; and
- contracts.

10. Suspicious matter reports

The AML/CTF Program Rules require reporting entities to have "*appropriate systems and controls*" to identify those cases where suspicious matter reports

ought to be lodged. Clarification of what "*appropriate systems and controls*" means is desirable.

The AML/CTF Suspicious Matter Reporting Rules prescribe 24 matters to be taken into account in determining whether there are reasonable grounds for forming a suspicion that would require a suspicious matter report. It is not possible to take each of these 24 matters into account.

The AML/CTF Suspicious Matter Reporting Rules prescribe 19 details that must be contained in a suspicious matter report but the prescribed format has not yet been provided.

Ideally there would be guidance as to when a reporting entity that is not a natural person will be said to have formed a relevant suspicion.

The prohibition against tipping-off in relation to the formation of suspicion and the lodging of suspicious matter reports does not provide exemptions for disclosures:

- by reporting entities to related bodies, employees, officers, contractors and professional advisers;
- by agents to their principals;
- required by law; or
- which do not identify the individual concerned.

Persons will not be liable for actions undertaken *in good faith* and *without negligence* because of a reporting requirement. By contrast, the *Financial Transaction Reports Act 1988* does not limit relief by either a "*good faith*" or "*without negligence*" requirement.

Clarification of whether reports may be submitted electronically is desirable.

The agreed position was that organisations would need to monitor for complex and unusual transactions and also report where a customer supplies false or misleading information. This is very different from the requirement, as delivered, to consider some 24 matters (many of which will be difficult to find out) in relation to each transaction or proposed transaction, to see whether the matter could raise concerns under the criminal or taxation law of *any* country. Strict compliance with this requirement would make it impossible for the financial industry to do business.

11. Employee Due Diligence

The AML Programs rule requires industry to screen all prospective employees prior to commencement with an organisation. The screening required has not been defined and screening of all employees will be costly and inefficient.

Industry has recommended that the removal of the word prospective would enable industry to meet the government's objective while the definition of screening could be limited to "Police Checks".

12. Political Exposed Persons (PEP)

During the Industry round table meetings in 2005 it was agreed that industry could elect to purchase a commercially provided list for PEP due diligence or pursue a self-disclosure option. Industry would be in a position to select the most practical and cost effective option.

There was also agreement that government would consider defining a PEP, and this has yet to be done. AUSTRAC has recently sought industry guidance. Although a definition defined by industry requires acknowledgment that the two methods may result in different outcomes.

13. Record keeping

The extent of the obligation to keep documents and copies will have a significant impact when compared with:

- existing obligations under, for example, the *Financial Transactions Reports Act* and the *Proceeds of Crime Act*; and
- existing electronic transactions legislation.

14. International aspects of the ED

There are issues relating to:

- the workability of the measures dealing with correspondent banking relationships and shell banks which would put Australia ahead of FATF requirements and make it difficult for Australian banks to deal with other banks around the world.
- breadth of application to branches and subsidiaries overseas, and the real likelihood of subjecting Australian financial institutions to conflicting legal obligations at their offshore operations;
- requirement to consider foreign laws for purposes of reporting suspicious transactions and developing AML/CTF program;
- breadth of international funds transfer obligations; and
- differences in approach taken in comparable countries such as the United States, the United Kingdom and Canada.

While the Government, via the Minister's advisory framework, has acknowledged a number of the following concerns (and in some cases has agreed to rewrite certain provisions), not all of these issues are fully resolved at this stage and industry wishes to apprise the Committee of the key international issues posed by the exposure draft.

14.1 Correspondent banking and shell banks

The present treatment of correspondent banking set out in the ED is not risk-based and is unworkable.

The principle issues are as follows:

- The ED requires written agreements with all correspondent banks, but does not prescribe the content of these agreements.

  This exceeds current global practice and is not stipulated by FATF. It will be very difficult for Australian banks to insist on them. The Government is unable to regulate the obligations to be undertaken by foreign counterparties to such agreements, and it is difficult to understand how reduction of correspondent agreements to a single written contract will mitigate AML or CTF risk.

- The ED specifies a single, onerous due diligence standard. This includes assessing the culture of a correspondent bank, which is difficult to do.

  The standard is one that financial institutions would find difficult to apply in practice, and would apply to all correspondent relationships whether dealing with a Bank in a well regulated jurisdiction or not, and to all offshore branches and subsidiaries. It is not a risk based measure. Due diligence on correspondent banks should be risk-based and reviewed at a rate commensurate with the risk profile.

  AGD has acknowledged these concerns and have agreed to withdraw the prescriptive elements. AUSTRAC is to meet with Australian banks to be briefed on existing correspondent banking practice, with a view to rewriting these provisions as a Correspondent Banking Program Rule. As well, AUSTRAC will consider whether it would be able to provide industry with a list of countries which it considers well regulated, and whose financial institutions pose lower risks, and for which a less onerous form of counterparty due diligence would be appropriate.

- The Correspondent banking definition is unclear.

  AGD has agreed that the definition of correspondent bank must be clearer. Industry has proposed a clearer definition, confined to Vostro accounts, on the basis that this accords with international practice, and the AML/CTF risks posed by other transactions with foreign banks (eg. trade finance) are more efficiently managed by other aspects of an AML/CTF Program. The Government has deferred response pending further discussion with industry.

- The payable-through account definition is unclear.

  AGD has sought an industry proposal in this regard.

  It is not clear how a financial institution will know if another financial institution permits shell banks to maintain accounts with it.

  Industry agrees shell banks are not acceptable customers. However, the penalties that will apply under the law should distinguish between direct and indirect dealings. Section 78(1)(a) forbids direct dealings with any shell bank. It carries the same penalty as having a correspondent relationship with a bank that, in

turn, deals with a shell bank. Yet dealing inadvertently and indirectly with a shell bank as the result of a legitimate correspondent banking relationship is a lesser mischief and harder to guard against.

- The time allowed to terminate an existing relationship is too short.

  Section 78(2) allows an Australian bank 5 days after the law takes effect to terminate a correspondent banking relationship with a shell bank, or a correspondent bank that in turn deals with a shell bank. This is too short to allow the Australian bank to check all correspondent banks and their possible relationship with shell banks and then unwind any customer arrangements.

  The Government has acknowledged these concerns and has agreed to revise these provisions to provide for a longer period in which to terminate relationships with shell banks (30 days) and with correspondents which in turn deal with shell banks (as soon as practicable).

14.2 FATF Recommendation 21

The ED permits the Government to make Regulations prohibiting or regulating transactions with residents of particular countries. It is not clear why this power is necessary, as effective risk management techniques are available for high risk countries.

The ED does not set out the criteria to which the Government should have regard in making such regulations, does not require that such regulations contain any safeguards or exclusions for existing business relationships or presences, and does not impose any sunset, review or consultation requirement, nor any requirement to include an efficient process for obtaining licences or authorisations in such regulations.

This is an enormous power to wield through regulations. Such prohibitions could function as blanket economic sanctions cutting across all commercial relationships.

This is intolerable for industries, including banking, which have invested heavily in growing offshore business, and which look to continue to do so in the future.

14.3 IFTI Reporting

The meaning of 'account' is expressed more narrowly in the FTRA (as amended recently by the Anti-Terrorism Act) than it is defined in the ED definitions. This means that financial institutions will need to make system changes to meet the FTRA requirements that apply from December 2006, while the AML provisions that will apply from a later, unknown date describe an account differently.

It would make sense to align the two pieces of legislation to what is intended in the AML Bill as this legislation will, at some point, replace FTRA.

AGD have indicated that their Department takes a pragmatic view but does not wish to amend the FTRA, unless absolutely necessary, and have proposed that any systems changes that financial institutions consider necessary as a result of the AT Act amendments should be based on the wider definition of the term

'account' which appears in the ED. This approach is welcomed by industry, although it is not yet clear how financial institutions will be able to rely on the proposed AML Bill yet not be in jeopardy from the new FTRA definition.

The ED proposes IFTI reporting of payments between Australian resident "institutions" ordered by overseas residents. This would extend to internet banking or call center initiated payments for customers known to reside overseas, many of whom are likely to be expatriate wage and salary earners attending to their Australian affairs.

This is a new reporting requirement. It does not represent global practice, and is not driven by the FATF Recommendations. There is a strong case for excluding domestic payments from the IFTI reporting regime altogether, based at least on these considerations coupled with industry's belief in the majority of instances that, for example, internet banking is used from overseas, the customer is an expatriate wage or salary earner posing very little AML /CTF risk.

Australian professionals and tradespeople frequently spend time working overseas to gain international experience and accumulate savings while earning, in AUD terms, much higher salaries than available in Australia. International payments to or from such customers, which might amount to layering or integration as the point of entry of tainted funds into Australia, will be reported under the present IFTI regime.

AGD has accepted this view and has agreed to remove Items 3 and 6 from the List accompanying section 43 of the ED.

14.4 Offshore branches

During pre-release consultation Government announced an intention that Australian financial institutions will be required to meet Australian regulatory standards wherever in the world they carry on business.

The ED has extraterritorial application unless otherwise stated, and applies to the delivery of "designated services" through any offshore permanent establishments ("OPEs") of an Australian financial institution. While Government intends to minimise duplication and exposure of OPEs to significant conflicts between local and Australian obligations, there remain some areas that are potentially problematic.

The scale of this issue is significant. Australian financial institutions are actively engaged in seeking growth opportunities offshore and many have established operations in numerous overseas locations.

Industry advocates that regulation of OPEs be limited, where possible, to mandating FATF compliant precautions and measures at a principles level. However, a number of the prescriptive measures set out in the draft AML/CTF Program rules are sought to be imposed directly upon OPEs.

In addition, industry urges the Government to refrain from measures that may create a conflict between Australian and local regulatory obligations and in particular seeking to audit, monitor or measure compliance in OPEs beyond reviewing OPE policy, process and general (ie non-client specific) organisational information or otherwise seeking specific client information from OPEs. Such information generally cannot be supplied by an OPE to a foreign regulator (such

as AUSTRAC) without breaching the OPE's obligations of privacy, confidentiality and in some jurisdictions, banking secrecy.

15. Enforcement

It is unclear when conduct will be prosecuted through the civil, rather than criminal, proceedings.

Due diligence is only available as a defence to proceedings for an offence or contravention with respect to Part 2 (customer identification) of the ED.

16. Other laws

The interrelationship between the Bill and other laws needs consideration, eg laws relating to:

- privacy;
- discrimination;
- proceeds of crime;
- anti-terrorism financing; and
- electronic transactions.

The financial services industry is heavily regulated by other legislation whose obligations may be inconsistent with AML/CTF obligations. For instance, under the Corporations Act, responsible entities of registered schemes are required to comply with scheme constitutions. Constitutions typically provide for timeframes for issuing or redeeming investments.

Under the AML/CTF regime, responsible entities (as Reporting Entities) may be required to delay the issue or redemption of units because of a lack of appropriate verification.

Importantly, it has not been possible to carry out a comprehensive AML/CTF legislative impact analysis due to the incomplete nature of the package at this time.

17. Implementation/Transition

Most institutions do not currently have 'one customer view' from an AML perspective as many of their technology systems are not linked together, to enable ongoing monitoring on an account basis.

The level of change required for businesses outside the FTRA regime will be significant culturally, technologically and procedurally. Large sectors of the financial services industry have not been covered by the FTRA and those areas face substantial change.

As a consequence, industry considers a minimum implementation period of 2 to 3 years is required – commencing from the later of the passing of the legislation, or the development of the complete set of Rules and Guidelines.

18. Regulatory burden - grandfathering

The cost of these changes will be very significant. Estimates in the hundreds of millions, across industry, are considered realistic by the major banks. The cost burden, and the impact of the changes on the wider community, could be materially contained by the adoption of a greater tolerance for grandfathering of existing relationships, products and business systems.

Considerable savings could be made by:

- setting sensible triggers for enhanced due diligence on existing customers; and
- looking to institutions to introduce technology changes on a prospective basis, as new products are introduced and as systems are retired and replaced.