Anti Money Laundering

New obligations affect lawyers

By Ron Pol

Many law firms and accounting practices are temporarily exempt from new anti-money laundering legislation which comes into force on 30 June 2013, but some may be affected before the exemption expires, possibly as early as 2014.

More than $1.5 billion of criminal funds is conservatively estimated to be laundered through New Zealand businesses every year, and by some estimates may be as high as $10 billion. Our involvement in terrorist financing is a lower risk. However, the Prime Minister – responsible for the intelligence agencies – has acknowledged local funding links to overseas terror groups. Money laundering and terrorist financing are global issues that present serious threats to New Zealand's economy and international reputation.

The Anti-Money Laundering and Countering Financing of Terrorism Act 2009 is a key component in closing gaps identified in international evaluations of New Zealand's regulatory environment. New risk assessment, customer due diligence, identity verification, compliance, monitoring, reporting and audit obligations will start building capabilities towards matching our international trading partners. The first tranche, from 30 June, applies mostly to banks and other financial institutions.

Specified non-financial businesses, including lawyers and accountants, are generally exempt until the second tranche, expected to be finalised in 2014. However, many of these firms may be affected earlier through their interaction with banks and other financial institutions. Those with structures and operations not covered by the temporary exemption may also be affected.

Lawyers affected from outset

Deep within the regulations is a seemingly innocuous indicator in which "exempt" professional services firms may be affected earlier than generally expected.

The regulations enable banks to ask firms with trust accounts in effect to underwrite the veracity of much of their client base. If banks obtain written agreements for firms to produce on request details of clients whose funds are held in trust accounts, and verification, banks needn't conduct their own due diligence. In effect, professional services firms will have done it for them.

Firms that choose not to underwrite banks' risks in this area may face a difficult election or pressure to conform. Declining to provide blanket warranties may slow transactions if banks need to undertake their own due diligence. In a competitive environment pressure may grow as other firms' clients experience more streamlined service.

Banks dealing with lawyers acting as trustees or agents may also seek detailed information on the identity of beneficiaries and clients in order to meet banks' due diligence requirements.

Some may not be exempt after all

A wide definition of "financial institution" includes a range of activities often carried out by professional services firms, including:

- accepting deposits or other repayable funds;
- investing, administering or managing funds or money on behalf of another person; and
- transferring money or value for or on behalf of a client.

Most firms operating trust accounts will be included within the definition of "financial institution" which usually triggers becoming a "reporting entity" covered by the Act from 30 June 2013.

The blanket temporary exemption should, however, exclude specified firms that carry out these financial activities. This so-called "sanctioned loophole" may also extend to exempt the relatively few lawyers and accountants carrying out certain financial activities typically conducted by banks and other financiers; even though other providers of those services will be included from 30 June.

However, lawyers and accountants sometimes carry out services through separate entities. Solicitor nominee companies are an obvious example. Separate entities wholly or in some cases partly owned or operated by firms may also deliver services to the firm's clients, for example company and trust formation and administration, and estate and tax planning services.

In these circumstances, the primary business may be exempt, but the separate entity – not itself an exempt law or accounting firm – might not be.

Last minute amendments to the regulations as this article was finalised – adding exemptions for online auctions and certain estate administration services – also widens the exemption for professional services firms. The new regulation extends the exemption to directors, employees and others acting in the course of and for the purposes of exempt firms. It may have been intended also to stretch the exemption across those businesses' separate entities – even though other businesses offering such services aren't exempt – yet the regulation is unclear; it refers to specified people in the *exempt* business.

Reality may trump uncertainty

If lawyers are covered by the Act, the Department of Internal Affairs (DIA) is the default supervising regulator, already responsible for around 800 reporting entities from a wide range of businesses, including "other"

What is Money Laundering?

Money laundering is not confined to overseas funds, or criminals. It involves legitimate businesses, including so-called "gatekeeper" professionals such as lawyers, accountants and real estate agents who facilitate financial transactions. Money laundering is a three-stage process which obscures the true ownership of criminal proceeds:

- **Placement** introduces criminal funds into the financial system.
- **Layering** involves apparently legitimate business activity such as transfers, loans and invoices.
- **Integration** includes buying assets and investments.

The integration of funds into the mainstream economy completes the process, but the reality is that seemingly legitimate enterprises continue their commercial activities; and it becomes more difficult to identify the true source of funds. Legitimate businesses are involved at every stage, and recent trends towards more sophisticated transactions increasingly require the services of lawyers and accountants.

businesses not supervised by the Reserve Bank or Financial Markets Authority.

Early indications suggest that DIA may be as unprepared to supervise lawyers and accountants as these businesses themselves may be surprised that some elements of their operations could technically be covered by the Act from 30 June. Amid a deluge of guidelines, there are none for these firms, nor has any law or accounting firm been listed as anticipated "reporting entities".

It has been suggested that DIA and FMA are so overwhelmed by the reporting entities they know about that at least one has reportedly told some businesses who think they might technically be covered that they're not really intended to be included just yet, despite what the regulations seem to indicate.

DIA may choose to work with some firms on a case-by-case basis, but if these reports are correct it reflects the enormous pressure that supervisors are working under.

A "pragmatic" outcome also has precedent for lawyers. Like New Zealand, Australia adopted a two-tranche approach aimed initially at financial institutions. When the Law Council of Australia observed that the regulations seemingly included ordinary trust account activity, a flurry of negotiations resulted in lawyers exempted from one limb of the definition. In relation to other elements (similar to New Zealand's) the Law Council advised lawyers that they were "legally required to report but it is not [the regulator's] expectation that they will". Lawyers could also seek a "no action" letter directly from the regulator itself.

Likewise in New Zealand, lawyers have approached the supervisors to clarify the extent of the exemption; seeking to give effect to what is said to be the government's intention to exclude them from the first tranche of reforms. The last minute regulatory amendment may have that effect, but may need to be clarified.

Overseas experience

In other jurisdictions, there has been considerable dialogue over whether the existing regulatory functions and deep understanding of their professions suggests that lawyers' and accountants' own regulatory bodies may be more effective supervisors than government agencies; a range of different "co-regulatory" outcomes have emerged.

Questions have also been raised about balancing government action protecting public interest against the traditional concept of lawyer self-regulation and independence. The obligation to report suspicious transactions has also generated heated arguments about the apparent abrogation of lawyer-client confidentiality. These debates have had mixed results overseas, affording many lessons for New Zealand leaders keen to forge a workable path. The extensive debates have typically also resulted in a series of delays and changes; to legislation, regulations, regulatory structures and professional codes of conduct.

This process has barely begun in New Zealand. The situation for lawyers and accountants remains uncertain, and potentially fluid for some time.

Opportunity or threat?

The situation is more starkly defined for those delivering trust and company services. Originally excluded from the first tranche, trust and company service providers were later included when identified as having high levels of money laundering and terrorist financing risk.

These services are also provided by many lawyers and accountants, yet most of these firms (except perhaps those delivering services via separate entities) remain exempt until the second tranche. Some firms may regard exemption a competitive advantage; an opportunity to boost business as their specialist competitors face greater compliance obligations, costs and scrutiny.

Others may regard exemption a poisoned chalice. An unintended consequence of excluding some businesses may create substitution pressure on lawyers and accountants to provide more of these services. In most cases, this will be an innocent and welcome revenue boost. Yet business and reputational risks will increase if New Zealand lawyers and accountants become perceived as some of the last global outliers without the knowledge, resources or tools adequately to identify or assess whether their businesses are inadvertently being used to facilitate money laundering or terrorist financing.

Some exempt businesses may choose – for reasons of prudence, best practice, reputation or competitive advantage – to begin incorporating some of the capabilities that are becoming standard New Zealand business practice.

Financial businesses must now comply in the full glare of regulatory oversight. Exempt businesses have the benefit of a brief window of opportunity to build AML-CFT awareness, expand operational capabilities, and address any hidden surprises before mandatory reporting and regulatory supervision applies to their operations, possibly as early as late 2014.

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This article does not represent the views of the New Zealand Law Society. It represents the view of its author, Ron Pol. It is important to note that while lawyers and law firms will generally be exempt from the Anti-Money Laundering and Countering Financing of Terrorism Act 2009, lawyers will still need to know about the regime in order to (among other things):

- advise clients about AML/CFT matters;
- deal effectively with banks and other reporting entities:
- comply with other associated legislation that may apply (such as the Financial Transactions Reporting Act 1996);
- start preparing for the time when they will not be exempt.

Trust accounts in money launderers' sights

A combination of factors – including traditional money laundering routes such as banks and casinos blocked, the ability to transfer money instantaneously, a "substitution effect" from specialist trust and company services providers covered by the Act towards lawyers and accountants not covered, conventional trust account procedures and audit processes that don't examine the source of funds, and ironically the credibility afforded by trust accounts – mean that the trust account is fast becoming an "alluring prospect" for money launderers, according to legal researchers (*Cave Pecuniam: Lawyers as Launderers* by AJ Hamman and RA Koen, PER/PELJ 2012 (15) (5)).

They have described the modern trust account as "akin to a one-stop laundromat: money goes in dirty on one side, wends its way through an unbroken cleaning cycle and emerges spotless on the other". Even without firms' knowledge or participation, trust accounts "conceived as the beacon of unblemished integrity" can become "the vehicle of squalid criminality" in a bewildering number of ways.

This heralds new challenges for professionals "who now have to negotiate the dangers posed to the integrity of their practices by the new forms of money laundering" whether or not their businesses are temporarily exempt from anti-money laundering legislation.