THE THIRD EU DIRECTIVE ON MONEY LAUNDERING AND TERRORIST FINANCING

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In May of this year, the European Parliament and Council adopted the Directive on the prevention of the use of the financial system for the purpose of money laundering and terrorist financing.[1] ***This is the third European Union document that determines basic procedures and measures to guard against the use of funds derived from criminal activity***[2]***, and it also covers the use of such funds for terrorist financing.***

Flows of dirty money can damage the stability and reputation of the financial sector and threaten the single market, while terrorism endangers human life and the foundations of society. Criminals naturally seek to exploit financial sector institutions in order to legalise illicitly acquired funds. Terrorist financing may also be conducted through such institutions, though other methods or even legally acquired money may be used for this purpose too.

The Directive will repeal the currently applicable Council Directive 91/308/EEC as amended by Directive 2001/97/EC, which are loosely designated as the first and second directives on money laundering. That is why the Directive adopted in May of this year is called "the Third Directive on Money Laundering", with the supplement "and terrorist financing", which is the name used in this article.

The first and second directives fail to cover all the areas where preventive measures for protecting the financial sector need to be applied; nor do they address the methods whereby criminals can legalise illicit income or persons can finance terrorism. The Third Directive ("Directive") should be an effective instrument of the EU in protecting against the legalisation of illicit income – not only in the relevant areas of the financial sector and the relevant activities performed through this sector, but also in areas which cannot be classified within the financial sector (so-called non-financial businesses and professions). However, the stricter and more effective measures should protect above all the Community financial system and the financial systems of the Member States.

Like the currently applicable directives, the Directive is based on the Forty Recommendations (June 2003) and the Nine Special Recommendations issued by the Financial Action Task Force (FATF)[3], a leading international organisation in the fight against money laundering and terrorist financing. The FATF recommendations set out the basic and most effective principles and procedures in the fight against money laundering and terrorist financing; the aim being to have them applied as a worldwide standard at national levels.

The Directive deepens the incorporation of the FATF recommendations into the EU legislation (both in the preamble and in individual articles). This applies to the basic provisions setting out the content and scope of the measures and the methodology for their incorporation into the legislation of EU Member States. The Directive will enter into force on the twentieth day after its publication in the Official Journal of the European Union, which is expected to take place not later than the fourth quarter of 2005. As for

[1] Since the Directive had still not been published in the Official Journal of the European Union at the time that this issue of Biatec went to press, the Article uses the final draft of the Directive, submitted for approval to the European Parliament and Council.

[2] The Directive more specifically defines criminal activity and serious offences in Article 3(4) and (5).

[3] The FATF is an international body set up by the original member states of the OECD. It is recognized worldwide as an authority in the field of combating money laundering and terrorist financing, and its recommendations are followed not only by FATF members but also by other states, groups of states and international organizations. Headquartered in Paris, the FATF currently has 33 members, 7 regional blocs and one observer.

the adoption of the respective national legislation, the Member States have quite a long deadline – up to two years after the Directive enters into force.

In adopting respective legislation and in implementing institutional measures for protection against the legalisation of income derived from criminal activity and against terrorist financing, it should be noted that the EU Member States have already acted on the basis of the first and second directives as well as on the basis of other requirements – arising mainly from membership of the Council of Europe MONEYVAL Committee (or, in the case of original EU Member States, membership of the FATF) and from evaluations by the World Bank and International Monetary Fund. The Directive takes account of the current development, knowledge and requirements regarding protection of the financial sector, and it also includes provisions enabling the European Commission to adopt implementing measures which correspond to current needs for further development.

The Directive contains basic provisions and regulations representing both the minimum required of Member States and a framework for the content and scope of responsibilities towards the institutions and persons covered by the Directive, residing or conducting business in any Member State and, in certain cases, in third countries. Among these basic regulations, closer attention should be paid to those directly concerning credit institutions and financial institutions. The Directive is divided into the following seven chapters, which are subdivided into sections and articles:

1. Subject-matter, scope and definitions,
2. Customer due diligence,
3. Reporting obligations,
4. Record keeping and statistical data,
5. Enforcement measures,
6. Implementing measures,
7. Final provisions.

Scope and definitions

The Directive provides more precise definitions of the terms "money laundering" and "terrorist financing". Money laundering means the intentional conversion or transfer of property, knowing that such property is derived from criminal activity, for the purpose of concealing or disguising the illicit origin of the property, or for concealing or disguising the true nature, source, location, disposition, movement or rights with respect to such property, or the acquisition, possession or use of such property, or participation in, attempts to commit, and aiding, abetting, facilitating and counselling the commission of such actions. Money laundering will be regarded as such even where the activities which generated the property to be laundered were carried out in the territory of another Member State or in that of a third country.

Property means assets of every kind, whether tangible or intangible, movable or immovable, and legal documents or instruments in any form, including electronic and digital, evidencing title to or interests in such assets.

Terrorist Financing means the provisions or collection of funds, by any means, with the intention that they should be used or in the knowledge that they are to be used, even in part, in order to commit any of the offences within the meaning of Articles 1 to 4 of Council Framework Decision 2002/475/JHA. This Council Framework Decision on Combating Terrorism, of 13 June 2002, defines a terrorist group and distinguishes the following categories of terrorist-related crime: terrorist acts against fundamental rights and principles, offences connected with terrorist groups, and offences connected with terrorist activities.

The Directive defines for the first time the term "beneficial owner". It is the natural person who ultimately owns or controls the customer/legal person, and/or it is the natural person on whose behalf a transaction is being conducted, in other words the person who uses the advantages arising from the transaction or related transactions. This term is defined more narrowly for corporate entities, for other legal entities, such as foundations, and for legal arrangements, such as trust and company service providers, which administer and distribute funds.

A new element is the definition of "politically exposed persons". These are natural persons who are or have been entrusted with prominent public functions and immediate family members or persons known to be close associates of such persons.

Also important is the definition of a "shell bank". This is a credit institution, or an institution engaged in equivalent activities, which is incorporated in a given state but which has its head office registered there only as a formality while its business activities and their management are in fact conducted outside this state.

The Directive applies to the legal persons and natural persons mentioned in Article 2 (hereinafter "obliged persons"). In comparison with the first and second directive, it applies to a broader group of per-

sons. It requires Member States to ensure by legislation that the provisions of the Directive are extended in whole or in part to professions and to categories of undertakings which engage in activities which are likely to be used for money laundering or terrorist financing purposes. At the same time, Member States may retain in force the stricter provisions of their own legislation in the field covered by the Directive.

Credit institution means a credit institution as defined in Article 1 of Directive 2000/12/EC on the taking up and pursuit of the business of credit institutions, which has its head office inside or outside the Community.

Financial institution means in particular an insurance company, investment firm, collective investment undertaking, currency exchange office, or a money transmission or remittance office, including the branches of such an entity.

Other obliged persons include auditors, external accountants, tax advisors, notaries, attorneys-at-law, real estate agents, casinos, and other natural or physical persons to the extent that they make payments in cash in an amount of EUR 15,000 or more, whether the transaction is carried out in a single operation or in several linked operations.

The group of obliged persons is being extended to include trust and company service providers and similar companies operating within the framework (legislative) of certain Member States. Trust and company service providers include any natural or legal persons providing services related to the formation and activity of a corporate entity or another legal person. These obliged persons must be either licensed or registered.

Customer due diligence

The Directive is mostly devoted to the obligations of obliged persons in relation to customer due diligence and the ascertaining of customer trustworthiness (Articles 6 to 10). In the first place, it is not allowed that credit and financial institutions keep anonymous accounts or issue anonymous passbooks. This obligation is not new; in this regard, our legislation has been changed so that banks and the branches of foreign banks may not provide customer services on an anonymous basis (amendments to Act No. 367/2000 Coll. on protection against legalisation of incomes from criminal activities, the Banking Act, and the Civil Code).

Due diligence on customers is based on their satisfactory identification by a designated method, in particular a risk assessment which depends on the type of customer, business relationship and the transaction being conducted. The customer risk assessment is based on the consistent application of principles and the practice of "know your customer". Obliged persons must be able to demonstrate to the competent authorities (including self-regulatory authorities) that the extent of these measures is appropriate in view of the risks of money laundering and terrorist financing, especially with regard to the type of business or transaction being conducted by the customer.

Included in customer due diligence is the identification of any beneficial owner in connection with the transaction being conducted. Credit institutions (banks, branches of foreign banks, electronic money institutions) must satisfy themselves that for any given customer, in relation to a particular transaction, they know who the beneficial owner is. Customer due diligence also involves conducting ongoing monitoring of the business relationship including scrutiny of transactions undertaken during the course of that relationship and knowledge of the customer's business and risk profile, including the source of funds, and ensuring that the documents submitted by the customer are kept up-to-date.

The Directive allows for national regulations to make certain derogations from the basic requirements of customer due diligence, mainly in respect of dealings or transactions where there is little risk of money laundering or terrorist financing occurring (so-called simplified due diligence). This will apply to obliged persons where, for example, they conduct business in life insurance or pension schemes, or in respect of electronic money (where, if the device can be recharged, a limit of EUR 2,500 is imposed on the total amount transacted per year), or in cases where notaries, attorneys-at-law, auditors, external accountants, or tax advisors are in the course of ascertaining the legal position for their client or they are representing their client in judicial proceedings.

For dealings and transactions which present a higher risk of money laundering or terrorist financing, Member States are, on the other hand, obliged by the Directive to require that obliged persons apply enhanced customer due diligence measures. This requirement must be carried out by applying specific and appropriate measures to compensate for the higher risk, at least in the following situations:

- where the customer of the obliged person has not been (cannot be) physically present for identification purposes,

- in respect of correspondent banking with respondent institutions from third countries,
- in respect of politically exposed persons residing in another Member State or in a third country.

The Directive imposes on Member States an obligation to prohibit credit institutions from entering into a correspondent banking relationship with a shell bank or with a foreign correspondent bank which is known to permit its accounts to be used by a shell bank.

A separate section of the Directive governs obligations relating to the performance of customer due diligence by third parties, where the legislation of a Member State permits such a method of identification. In cases, however, where the obliged person relies upon a third party to identify and verify customers, the responsibility for the performance of obligations in this regard will remain with the obliged person. For the purposes of this section, third parties mean the obliged persons listed in Article 2 of the Directive (See Scope and definitions). These third parties are required to apply customer due diligence measures and measures for keeping record of dealings and transactions with customers. These provisions do not apply to cases of outsourcing.

Reporting obligations

The Directive requires each Member State to establish a financial intelligence unit (FIU) as a central national unit responsible for combating money laundering and terrorist financing. It should be noted that the Slovak Republic has had an FIU since 1996, operating within the Police Force as a service of the Financial Police. According to the Directive, the FIU should have timely access to financial, administrative and law enforcement information that it requires to properly undertake its functions.

Obliged persons and their representatives will continue to be required to inform the FIU if they suspect that the activity of their customer involves money laundering or terrorist financing and to furnish the FIU with all necessary information. Obliged persons, their representatives and employees must not disclose to the customer concerned that they have communicated their suspicions or that an investigation is being conducted in this regard. The prohibition on disclosing such information does not include disclosure to supervisory authorities or other obliged persons, even if they are situated in another Member State. Obliged persons must not in certain cases carry out suspicious transactions for the customer, or they may postpone such transactions. If supervisory authorities during the course of inspecting obliged persons discover facts that could be related to money laundering or terrorist financing, they are obliged to inform the FIU of these facts. Member States must adopt regulations to protect from threats or hostile action those obliged persons, including their employees, who in good faith inform the FIU about a suspicious transaction.

Record keeping and statistical data

Obliged persons will continue to be required to keep documents concerning customer due diligence and transactions conducted by the customer, for a period of at least five years after the execution of the transaction or the end of the business relationship. Credit institutions and financial institutions will be required to apply, where applicable, in their branches and majority owned subsidiaries located in third countries customer due diligence measures as laid down by the Directive. Credit and financial institutions will have to have information systems that enable them to respond fully and rapidly to enquiries from the FIU, self-regulatory authorities, or investigative authorities. Member States must have at their disposal systems enabling them to keep comprehensive statistics in connection with combating money laundering and terrorist financing, covering at least the minimum data laid down by the Directive. They should also ensure that a consolidated review of these statistics is published.

Enforcement measures

Member States will have to require that obliged persons adhere to regulations, follow appropriate customer due diligence procedures, keep records on customers and their financial transactions, assess and manage risk, ensure internal control, report suspicious transactions, and exchange information in order to prevent transactions related to money laundering and terrorist financing. The Directive requires obliged persons to be aware of these obligations and also the practices that criminals and terrorists are liable to misuse for their own ends. Important will be the provision of feedback, wherever practicable, on reports of suspicious transactions. The Directive designates which obliged persons must be registered, be licensed, or be entered in the Commercial Register. Apart from currency exchange offices and trust and company service providers, these

include casinos and money transmission and remittance offices. The competent authorities will be required to refuse licensing or registration if they are not satisfied that the persons who control such entities, or the beneficial owners of such entities, are fit and proper persons. The competent authorities will carry out effective monitoring of the obliged persons and take necessary measures in this regard.

Obliged persons will be held liable for infringements of the provisions adopted pursuant to the Directive, while the sanctions imposed for infringements must be effective, proportionate and dissuasive. In such cases of administrative sanctions, natural persons who are representatives of the obliged person-legal person will bear liability.

Implementing measures

In order to take account of technical developments and to ensure uniform application of the Directive, the European Commission may adopt implementing measures, in particular: to clarify the technical aspects of the definitions (for example, financial institution, beneficial owner, trust and company services provider, politically exposed persons, shell bank); to establish technical criteria for assessing whether situations represent a low or high risk of money laundering or terrorist financing; and to determine whether it is justified to apply the Directive to certain persons carrying out a financial activity on an occasional or very limited basis.

With regard to the implementing measures, the Directive establishes the Committee on the Prevention of Money Laundering and Terrorist Financing, as an auxiliary committee of the Commission, whose activity will be governed by the rules of procedure.

Final provisions

The Directive requires the European Commission to draw up within four years, and at least at three yearly intervals thereafter, a report on the implementation of the Directive and submit it to the European Parliament and the Council. The Directive in this chapter states the date of its entry into force and the deadline for its transposition by Member States, as previously mentioned in the introduction.

Conclusion

The Directive on the prevention of the use of the financial system for the purpose of money laundering and terrorist financing brings many positives and improves the quality of financial system protection against both threats. At the same time, it specifically regulates the procedures which Member States should follow when making legislation and consequently applies to obliged persons with regard to guarding against money laundering and terrorist financing.

Although there are two years within which to transpose the Directive, this is not a long period in relative terms. Consistent adoption of the Directive's provisions will require both comprehensive and detailed amendments to national legislation, not just the basic preventive law but also related acts.

Satisfactory implementation of the Directive into our legal system will require legislative, but probably also institutional, measures and changes. From the legislative-technical perspective, it will be necessary to meet this task not only by adopting comprehensive amendments to the applicable Act No. 367/2000 Coll., or adopting a new preventive law on protection against legalisation of incomes from criminal activities and terrorist financing, but also by amending separate laws such as the Banking Act, the Act on Securities and Investment Services, and the Act on Collective Investment. Moreover, the financial system will require a preventive analysis of dealings and transactions conducted by obliged persons. At the same time, a substantial share of the obliged persons within the financial system will, from 1 January 2006, be subject to monitoring and regulation by the National Bank of Slovakia.

The fact that cases of money laundering continue to arise and that there have been recent terrorist attacks on European territory indicates that measures to guard against money laundering and terrorist financing need to be taken as soon as possible. The Slovak Republic and its financial system is not immune to such negative disruptions and that is why the task of implementing the Directive must begin as soon as the Directive has entered into force. The cooperation of bodies responsible for implementing the Directive should be as objective as possible.