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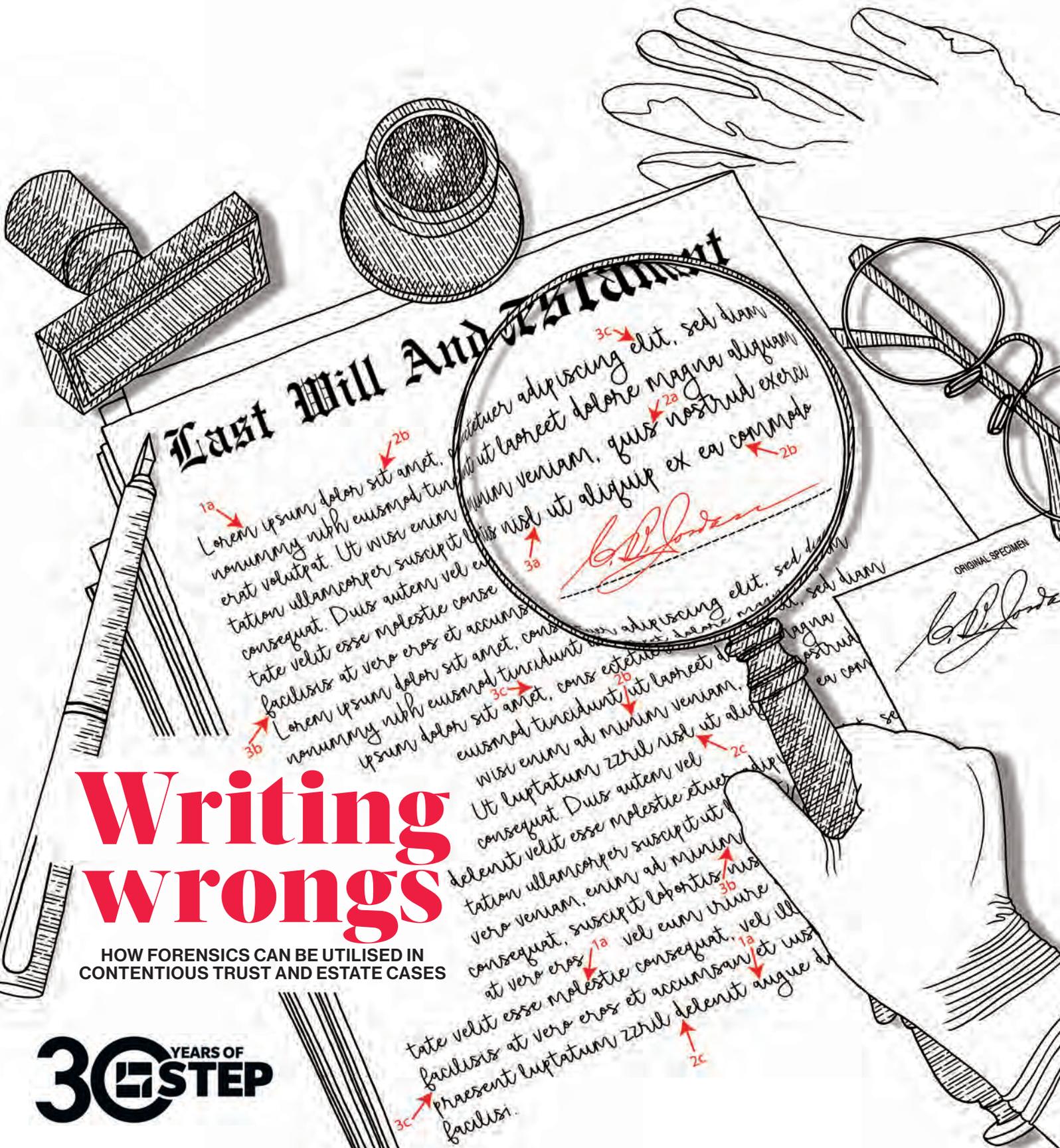
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KEY POINTS

What is the issue?

In February 2021, the Financial Action Task Force (FATF) initiated and widely sought input for its project 'Mitigating the Unintended Consequences of the FATF Standards'.

What does it mean for me?

The FATF regards the project as an opportunity to inform itself of, as well as study trends and propose solutions to, the unintended consequences of the Standards' misapplication.

What can I take away?

The FATF's unintended consequences may be mitigated by the application of a risk-based approach to anti-money laundering and counter-terrorist financing compliance.



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ASHLEY FIFE AND GINA PEREIRA DISCUSS THE UNINTENDED CONSEQUENCES OF THE FATF STANDARDS, WITH AN EMPHASIS ON BERMUDA

The Financial Action Task Force (FATF) describes itself as the 'global money laundering and terrorist financing watchdog'. A G7 summit in Paris in July 1989 established the FATF in response to concerns regarding a global drug problem. Its objectives have since evolved and presently include setting standards and the effective implementation of legal, regulatory and operational measures for combatting money laundering, terrorist financing, corruption and other related threats to the financial system's integrity. In February 2012, the FATF published the revised FATF Recommendations (also known as the Standards). The Standards continue to develop to detect and prevent new money laundering and terrorist-financing techniques impacting the international financial system, such as misuse of virtual assets and COVID-19 related threats.² More than 200 countries and jurisdictions are now committed to implementing the Standards, which testifies to the recognition and influence of the FATF as a standard-setter.

UNINTENDED CONSEQUENCES

In February 2021, the FATF initiated and widely sought input for its project 'Mitigating the Unintended Consequences of the FATF Standards'³ as an opportunity to inform itself of the unintended consequences of the Standards' misapplication. The project focuses on four undesirable effects (particularly upon poorer countries) arising from the misapplication of the Standards:

- De-risking, or the loss or limitation of access to financial services. The practice has notably affected non-profit organisations (NPOs) and correspondent banking relationships.
- Financial exclusion, a phenomenon whereby individuals are denied access to basic financial services.

- Suppression of NPOs or the NPO sector (through failure to properly apply a risk-based approach).
- Threats to fundamental human rights stemming from the misuse of the Standards or anti-money laundering and counter-terrorist financing (AML/CFT) assessment processes to support laws that may violate rights such as due process or the right to a fair trial.

IMPACT ON NPOs

Bermuda is an attractive jurisdiction for philanthropic structures, particularly those with cross-border giving strategies. Although NPOs are not immune to abuse, applying a one-size-fits-all approach to transparency results in a disproportionate burden to actual levels of risk. Increasingly, in financial centres throughout the world, NPOs appear to be swept up in transparency regimes. As a result, they are subject to the same burden of proof of compliance regulation as commercial and private wealth vehicles, even where most NPOs' risk to money laundering and terrorist financing may generally be relatively low.

The Standards initially described charities and NPOs as 'particularly vulnerable' to terrorist financing.⁴ Despite amendments to this language in the FATF's 2016 Standards, many NPOs continue to experience difficulties opening or maintaining bank accounts or onerous due-diligence requirements and challenges affecting wire transfers, due to being classified as 'high-risk' business.^{5,6} These assumptions often affect legitimate and urgent philanthropic and charitable activities by cutting off timely access to finances. In early 2021, millions of dollars of aid had to find alternative ways into India during the height of its COVID-19 crisis due to the impact of strict new AML laws.⁷

The EU AML/CFT Global Facility also noted the increased pressures on the non-profit sector because of COVID-19.⁸ It stated that 'cooperative coordinated action' is essential and reiterated that 'collaborative working between governments

and charitable organisations will become ever more important as the full extent of the impact of the pandemic continues to unfold.⁹

Some countries have hostile attitudes towards NPOs and have developed more subtle legal measures and policies restricting civil society activities, including limiting foreign donations.¹⁰

International initiatives, including those of the FATF, may be used to legitimise government repression of civil activism, labelling such activism as terrorist activity and justifying repressive restrictions as required by international norms.¹¹ These abuses of power against civil society and NPOs can make it more difficult to provide financial support for legitimate causes in these jurisdictions.

Possible solutions

The FATF must continue reinforcing that charities and NPOs are not automatically high risk for AML/CFT purposes. Many will carry out activities in underdeveloped and war-torn jurisdictions. In general, access to financial services should be readily available, particularly considering the need for relief resulting from the impact of the pandemic.

IMPACT ON IFCs

The Standards and other international initiatives may be disproportionately focused and enforced on entities established in international financial centres (IFCs), such as Bermuda. An overarching theme in recent years has been global banks' reassessment of business strategies to take into account lower profitability, reduced risk appetite, tighter regulation and supervision following the global financial crisis. A disproportionate focus of the Standards and other international regulatory initiatives upon IFCs increases the burden on global banks that are continually reassessing the services they are willing to provide IFCs.

De-risking by correspondent banks has also made it difficult for several industries perceived as high risk (e.g., gaming, fintech) operating from IFCs. Despite these businesses operating onshore, it is challenging to establish or maintain such industries in Bermuda as correspondent banks may withdraw their arrangements with local financial institutions (FIs) with clients operating in such sectors.

Possible solutions

In promoting a risk-based approach for customer due diligence, the FATF might stress to FIs that IFC jurisdiction signatories to international transparency regimes (e.g., the Common Reporting Standard or the *Foreign Account Tax Compliance Act*) are not automatically a higher risk.

IMPACT ON TRUSTS

Trustees and underlying entities based in IFCs often feel discriminated against and

are denied financial services due to their inability to meet excessive and ill-fitting customer due diligence requirements stemming from the Standards that do not reflect the trust industry's nature. Several FIs, perhaps more accustomed to dealing with individuals and corporate entities, often appear to require due diligence information that fails to recognise the nature of trusts properly. The imprecise expansive provision of what constitutes a 'beneficial owner' (or equivalent) of a trust for the Standards, along with different definitions or concepts under common law, laws requiring maintenance of beneficial ownership registers, and automatic exchange of information regimes may exacerbate the problem.

Regulators in civil-law jurisdictions whose laws do not recognise trusts appear to more readily assume that trusts are frequently used for money laundering or terrorist financing. FIs in such jurisdictions may be more likely to be required by their regulator to adopt the position that trust business is high risk to avoid being sanctioned by their regulator.

The ability to open or close bank, custody or investment accounts for trusts and trusts' underlying companies in IFCs is often delayed. A fundamental problem appears to be the resistance of many FIs to effectively apply a risk-based approach as contemplated by the Standards as opposed to seeking to implement the Standards by way of a prescriptive rules-based approach.¹² The risk-based approach promulgated by the Standards recognises that not all discretionary beneficiaries are created equal. For example, a discretionary trust may have been established to benefit one or more beneficiaries in the near term, with the view of making distributions to other beneficiaries in the distant future. Simply because a beneficiary is named or within a class of beneficiaries does not mean that a distribution is imminent or contemplated.

Despite the distinction between beneficiaries with current interests and those with a mere hope to benefit, FIs often seek identification information on the latter, regardless of whether they are minors or not, and irrespective of genuine and legitimate concerns (e.g., kidnapping risk) about providing the information. In some instances, to protect minors' identities, families have requested trustees exclude them from the class of beneficiaries when there is no history of distributions or intention for the child to benefit from the trust until some years in the future.

Possible solutions

To mitigate the risk of unintended consequences for trusts, the FATF might consider adopting more precise definitions of 'trust' and a less open-ended definition

of 'beneficial owner'. Further, as in the case of NPOs, the FATF could promote such statements as: a trust is not in and of itself a high-risk entity for AML/CFT purposes and that, as with corporations, the risk is dependent on how it is used. Compliance functions may be encouraged to gather due diligence on beneficiaries who are currently benefitting or are likely to in the near term.

CONCLUSION

The FATF works to generate the necessary political will to bring about national legislative and regulatory reform as a policy-making body. Ongoing peer reviews of members assess each country's system for preventing criminal abuse of the financial system. For instance, Bermuda's most recent review, published in January 2020,¹³ found Bermuda to have a 'high level of understanding' regarding money laundering and terrorist financing overall.

With the ever-increasing number and scope of initiatives targeted at real or assumed threats to the international financial system, it is encouraging and refreshing that the FATF undertook this project. Understandably, such regimes can pressure an FI to streamline and standardise its approaches to AML/CFT to ensure compliance. However, applying a one-size-fits-all protocol commensurate with a rules-based approach can run afoul of the spirit of these initiatives.

In June 2021, the FATF discussed the results of the Standards and announced it is building upon its existing work and identifying further mitigation options.

#BERMUDA

#COMPLIANCE AND REGULATION

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1 M. J. Wheatley: 'Without reflection, we go blindly on our way, creating more unintended consequences, and failing to achieve anything useful.' 2 FATF Recommendations 2012, fatf-gafi.org 3 bit.ly/3D6ep5p 4 FATF Recommendation 8, prior to its amendment in 2016. 5 Enhanced due diligence requirements adopted by banks often require information not always available at the time of account opening (such as the identity of beneficiaries and donation activity). Due diligence on these aspects may be more appropriate at the time of transactions, not on account opening. 6 Lia van Broekhoven, 'Derisking and Civil Society: Drivers, impact and solutions', Human Security Collective, bit.ly/37YeXvV 7 'Donations to India Get Blocked by Modi's Tough New Rules', *The New York Times*, nyti.ms/3AVPu2G 8 Created in 2017 as the European Commission's operational tool to provide support to third countries based on the deficiencies in their AML/CFT regimes. 9 'Terrorist Financing and the Non-profit Sector: The case for deepening dialogue and cooperation', EU AML/CFT Global Facility, global-amlcft.eu 10 For example, see 'Proposed Venezuelan Foreign Funding Law Could Have "Huge Impact" on Independent Outlets', bit.ly/3mfBH2Z 11 See, for example, 'Special Report: How a little-known G7 task force unwittingly helps governments target critics', Reuters, reuters/2UAa4P 12 The FATF guidance for a risk-based approach for trust and company service providers (para.20) provides that the risk-based approach to AML/CFT means that countries, competent authorities and trust and company service providers should identify, assess and understand the money laundering/terrorist financing risks to which they are exposed, and take the required measures to mitigate and manage these risks effectively and efficiently. 13 *Anti-money Laundering and Counter-Terrorist Financing Measures Mutual Evaluation Report of Bermuda*, bit.ly/3kevba3