association of the luxembourg fund industry

ALFI opinion on the EU Commission's "AML package"

General remarks

ALFI supports the European Commission's efforts to fight money-laundering and financing of terrorism and is in favour of harmonising further certain professional obligations of European financial industry stakeholders. This is to the benefit of the Luxembourg fund industry, which is largely cross-border. We would however like to underline that the legislative proposals published on the 20th of July are very much banking oriented and do not necessarily take into account the specificities of the investment fund industry.

In particular, the following provisions could have an adverse impact on the efficiency of the anti-money laundering measures in our industry:

- Compliance functions (Compliance Manager/Compliance Officer)
- Scope of the "AMLA" Regulation and assessment methodology used for selecting Obliged Entities falling under direct supervision of the new agency
- Provisions in regard of beneficial ownership

Other envisaged rules could also be of concern, more specifically, as regards the definition of Politically Exposed Persons and of Senior Management, as well as nominees' obligations.

Therefore, we are of the view that the formulation of a certain number of draft provisions should either be further adapted or be clarified at appropriate level, as detailed below.

I. Key points

1) **Compliance functions** - Art. 9 of Proposal for a Regulation of the European Parliament and of the Council on the prevention of the use of the financial system for the purposes of money laundering or terrorist financing (the "Regulation"): This article clearly makes the distinction between (i) the person at board/governing body level to be appointed as responsible for the implementation of measures to ensure compliance with the Regulation ("**Compliance Manager**" - corresponding to the "RR" in Luxembourg), and (ii) the compliance officer to be appointed by the board/governing body and in charge of the daily AML/CFT operations of the entity (corresponding to the "RC" in Luxembourg).

This article does not however take into account the specificities of investment funds and their investment fund managers and does not allow as the appointment of the board as a collegial body to serve as Compliance Manager. It must be underlined that it is market practice that the Board receives regular updates on AML matters and therefore develops collective intelligence in such matters over the years. Whilst appointing a contact person on board level would make sense, selecting only one individual with the responsibility of compliance manager could have a negative effect on the efficiency of the implementation of measures to ensure compliance with the Regulation. Moreover, in certain countries, among which Luxembourg, *commercial law* sets as a principle the collective and joint liability of board members.

The *same remark* is valid in regard of the **appointment of a third party as Compliance Officer**, for which flexibility is not granted by the proposal. *Banning the appointment of a Compliance Officer outside of the same group could actually prove counterproductive*, as small entities with less resources may opt not to appoint a Compliance Officer at all. Furthermore, if a fund manager is appointed, the compliance officer cannot be appointed at the fund level, and should one decide to appoint such compliance officer

always on fund manager level, managers would take too many mandates, which would reduce their efficiency. It must be noted that in this context the recent EBA consultation on the role of the compliance officers[1] states that "However, due to the nature of the Collective Investment Sector, the AML/CFT compliance officer should be in a position to service several parties which are not necessarily part of the same group."

ALFI is therefore of the view that this article should be clarified to take the abovementioned elements into consideration. Alternatively, mandate could be given to the AMLA/national competent authorities to define more specific rules depending e.g., on the sector of activity.

2) Draft Regulation establishing the European Authority for Countering Money Laundering and Financing of Terrorism ***(AMLA)***

- Apart from its monitoring, coordination and regulatory powers, the newly created Authority intended to be set up on European level, will also ***directly supervise financial sector entities*** that are exposed to the highest risk of money laundering and terrorism financing. Entities concerned are those that have activities in a minimum number of Member States, and in at least a certain number of these Member States must be categorised in the highest risk category by the supervisory authority, based on a harmonised risk assessment methodology. We are of the view that the **RESIDUAL RISK** (and not the inherent risk as seems to be contemplated by the European Commission in the proposal for a Regulation establishing the European Authority for Countering Money Laundering and Financing of Terrorism ***(the "Regulation"***) should be the criteria to be taken into consideration in this regard. Indeed, as mentioned by the FATF in its Guidance for a risk-based approach for supervisors[2], an entity with high inherent risks may not necessarily be high-risk if strong AML/CFT controls are applied to mitigate the risks and consequently will results in a residual risks, which are lowered, and this residual risk may influence the intensity/scope of supervision, and where necessary be used to prioritise between entities. This concept is also taken into account in the EBA's consultation on the Risk-Based Supervision Guidelines of 17 March 2021[3].

- Moreover, the ***scope*** of the Regulation encompasses financial institutions and therefore investment funds as such. It must be underlined that in practice it is not possible to perform on-site visits on a fund. Management companies are actually the focus of on-site inspections, except for cases where the fund is a self-managed structure.

- Furthermore, *the Regulation does not specify* whether:

[1] EBA Consultation Paper on Draft Guidelines On policies and procedures in relation to compliance management and the role and responsibilities of the AML/CFT Compliance Officer under Article 8 and Chapter VI of Directive (EU) 2015/849

[2] Guidance on Risk-based Supervision, FATF, 4 March, 2021

[3] Consultation Paper on Draft Guidelines on the characteristics of a risk-based approach to anti-money laundering and terrorist financing supervision, and the steps to be taken when conducting supervision on a risk-sensitive basis under Article 48(10) of Directive (EU) 2015/849 (amending the Joint Guidelines ESAs 2016 72), EBA, 17 March 2021

- entities selected for direct supervision by AMLA will be directly supervised with regard to all their activities or only parts of those activities which have been classified as having a high-risk criteria for classification as a selected obliged entity.

- where a selected obliged entity is part of a group, all members of the group will be subject to direct supervision or only those members classified as having a high inherent risk within a given Member State.

- it needs to be clarified as to how funds will be considered when discussing group structures. They are legally not part of a group, but strongly dependent on the Management company/AIFM.

- additional clarification is required as to how relationships between AMLA, the obliged entities concerned and local regulators will be organised.

- ALFI notes that the Regulation requires that, on an exceptional basis, AMLA may also request an EU Commission's decision placing a financial sector Obliged entity under its direct supervision, in cases where there is an indication that an entity does not meet its AML/CFT requirements. We would suggest that the text clarifies what is meant by "indication".

- It would also be important in our view that the AMLA is staffed with a range of experts who are knowledgeable about the various segments of the financial industry and of the specificities of each sector concerned.
- Finally, Art.12.1(a) and (b) of the Regulation refer to the "***Member State of establishment***" . These terms should be replaced with the terms "the Member State where their head office is situated". Indeed, Art.2(8) of the Directive defines "establishment" as a branch, a subsidiary, or any other form of establishment in a country other than the country where the head office/parent company is located. However, this appears in contradiction with the aim of this Art.12.1 which we understand purports to include the home Member State in the computation for the purpose of determining whether the credit/financial institution might be considered by the AMLA in its selection process of selected obliged entities. Moreover, we would like to underline that referring to the Member State of establishment would be in contradiction with and could even destroy existing passporting principles granted under other specific financial legislation, for example under MiFID II.

3) Beneficial owners ("BO")

- *Identification information* for beneficial owners of legal entities (Art.18.2) :

    a. This Article provides that the beneficial owners of legal entities shall be identified notably based on the information referred to in Article 18.1(b), while Article 18.1(b) details the identification information required for legal entities. This may seem contradictory with the general rule that beneficial owners are always natural persons.

    b. It is not clear whether, in case senior managing officials must be regarded as beneficial owners, they shall be identified using same information as the information provided in Article 44.1(a) – i.e. aligning with the information required for beneficial owners based on ownership or control. In contrast, in the context of the information to be held by each corporate and legal entities in respect of its own beneficial owners, Art.45(3)(b) expressly aligns the information required in respect of senior managing officials with the information generally required for beneficial owners through cross-reference to Art.44.1;

Article 44.1 is of a general nature ("beneficial ownership information shall include"), therefore it should be applicable here as well.

- *Generic definition of beneficial owner* Art.2(22): ALFI notes that the definition of beneficial owner is now limited to the principle, with the identification rules (e.g. threshold of 25%, list of persons to regarded as Beneficial Owner of trusts) being detailed in Chapter IV (art.42 & sqq).

  The definition "in principle" remains unchanged, with the addition however that the Beneficial Owner is also the natural person "***for the benefit of whom*** *a transaction or activity is being conducted*". It could be argued that this element of "*benefit*" is already functionally included in the fact that Beneficial Owners are already defined notably as the persons "*on whose* ***behalf***" the transaction is carried out. Hence the addition of the notion of "*benefit*", without further clarifications, could lead to confusions/uncertainty as to whether additional criteria should be taken into consideration. Indeed the FATF Guidance on transparency and beneficial ownership dated October 2014, and in particular §16 thereof, tends to consider that both concepts include one another:

  "*Another essential element to* ***the FATF definition of beneficial owner is that it includes natural persons on whose behalf a transaction is being conducted*** *[…]. This element of the FATF definition of beneficial owner focuses on individuals that are central to a transaction being conducted even where the transaction has been deliberately structured to avoid control or ownership of the customer* ***but to retain the benefit of the transaction***."

  Finally, it must be underlined that a Beneficial Owner is not necessarily any client of a nominee or intermediary.

  In light of the above, retaining the definition of Beneficial Owner as provided by Directive 2015/849, as amended (i.e. without adding the notion of "*benefit*"), could be preferable in our view to avoid any confusion.

- Art.44.2 of the draft Regulation sets forth the obligation to obtain the Beneficial Owner information within *14 calendar days* from the creation of the legal entities or legal arrangements and, in case of change, within 14 calendar days following change of Beneficial Owner, as well as on an annual basis.

  ALFI would like to insist that the Regulation clearly states that this rule applies only in respect of the concerned legal entity, as part of its obligation to maintain information on its own Beneficial Owner. Indeed this provision is not compatible with the KYC obligations of the obliged entities, as the obliged entities remain free to determine the applicable period to review their KYC files, on a risk-based approach and in any case without exceeding 5 years;
  Moreover, 14 calendar days may prove too short and should be extended (e.g. one month).

  Furthermore, the abovementioned delay should be computed in business days, instead of calendar days;

- We would also like to add that the interest of imposing an annual review is debatable, as a review would be already imposed upon change of Beneficial Owners.

- Finally; Art.12.1 of the draft Directive on the mechanisms for the prevention of the use of the financial system for the purposes of money laundering or terrorist financing and repealing Directive (EU)2015/849 provides that access to certain Beneficial Ownership information of legal entities held in central registers is open to the general public, while, for trusts, this is limited to members of the general public "*provided that a legitimate interest can be demonstrated*". ALFI is of the view that the condition of legitimate interest should be extended to legal entities as well.

II. Other

We would like to point out that the AML/TF legislative frameworks currently in place in certain jurisdictions such as Luxembourg may be more stringent on certain aspects than the texts contained in the European Commission's AML package. For example:

1) Definition of Politically Exposed Persons (PEP):

- Art.2(25) of the Regulation on the prevention of the use of the financial system for the purposes of money laundering or terrorist financing: Under Luxembourg law, "family members" and "close associates" are included in the PEP definition, while the EU AML/CFT directives and the Regulation do not include them in the PEP definition, but rather provide that the Enhanced Due Diligence measures provided for Politically Exposed Persons also apply for them.

- Art.2(25)(a)(vii) of the Regulation - notion of *State-owned enterprise:* For the purpose of the PEP definition, it should be clarified whether "State-owned enterprises" include (i) enterprises partially owned by a State, or only enterprises wholly-owned by a State, and (ii) enterprises indirectly owned by a State, or only enterprises directly owned by a State.

2) Art.2(28) of the Regulation – Definition of senior management: "executive members" of the board or of equivalent governing body shall now be systematically considered as in scope of this definition, while previously they needed not be systematically included. This would result notably:

(a) in additional obligations in terms e.g. of approval of certain high risk relationships (at least correspondent and PEP relationships), which, pursuant to the Regulation, should be systematically approved by the senior management (thus including at least "executive members" of the board or equivalent);
(b) pursuant to Art.7.2, para.2, in the obligation for the "executive members" of the board of director (or equivalent) to approve any AML/CFT procedures, while in practice and based on current legislation in a number of countries, the board only approves the policies, the approval of procedures being limited to the conducting officers, where relevant .
Although we appreciate that par 2.4 provides for the possibility to apply the proportionality principle, we would suggest that the definition of senior management be kept unchanged, in order to grant flexibility in the internal arrangements/risk-based approach of the obliged entities whilst ensuring harmonization across the EU in this regard.

3) Art.47 – *Nominee obligations*

- We would suggest that the scope of this article be clarified, i.e. it should clear state that they apply only to nominee shareholders/nominee directors of corporate or other legal entities **established in a Member State**.

Art.47, para.2 provides that corporate and legal entities shall make available information on the nominators (and Beneficial Owners thereof) notably of their *nominee shareholders* to the obliged entities when they perform their Customer Due Diligence obligations. In other words, for customers which are entities established in a Member State, the model currently in place in the fund industry for nominees would be jeopardized as the obliged entity would need to obtain information on the nominators and Beneficial Owners thereof. While the intention of this provision in the broader financial industry is understood, as currently drafted it inadvertently encompasses the use of nominees and intermediaries in the funds industry in facilitating distributions and subscriptions. ALFI would like to underline that nominees are not necessarily equal to intermediaries. Investing into a fund via an intermediary does not mean entering into a nominee agreement but just a standard investment agreement, i.e. case where the investor simply buys the fund from a bank for example. Omnibus accounts held for another financial institution are not to be considered as falling under the concept of nominee arrangements.

It should be borne in mind that guidance has already been issued at both EU and international level to the legitimate use of nominee arrangements within the funds industry, in particular by the FATF Guidance on a Risk-Based Approach for the Securities Sector[4] and the EBA in its recently reviewed AML Risk-factor Guidelines[5]. Those principles should remain valid in our view.

Moreover, it must be noted that the definition of formal nominee arrangements provided for in article 2 (24) of the draft Regulation implies that there is a contract or formal arrangement between the nominator and the nominee, where the nominator issues instructions to a nominee to act on their behalf in a certain capacity. In the investment fund environment though, no instructions are given during the life of the relationship.

We would suggest that the Regulation therefore clarifies that the obligation to make such information available applies in certain circumstances only, e.g. upon request from the competent authorities of the relevant obliged entity.

- More generally, it must be underlined that such obligation, as it would oblige notably *foreign (nominee) entities* to disclose and file their nominator and Beneficial Owners thereof in registers in the Member States will inevitably hurt the attractiveness of the European Union's financial markets and investments on these markets and will be a deterrent for a number of foreign investors which would presumably prefer opting for other jurisdictions which would not be bound by such requirements.

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[4] Risk-based Approach Guidance for the Securities Sector, 26 October 2018

[5] EBA Guidelines on customer due diligence and the factors credit and financial institutions should consider when assessing the money laundering and terrorist financing risk associated with individual business relationships and occasional transactions ('The ML/TF Risk Factors Guidelines') under Articles 17 and 18(4) of Directive (EU) 2015/849, 1 March, 2021

This material, negative impact should be assessed against the benefits expected from these transparency requirements, since:

(i) the confidentiality sought e.g. by (underlying) investors resorting to nominee arrangements is not necessarily linked to ML/TF, as explained above – while the proposed transparency requirements seem based on a contrary assumption; and

(ii) other safeguards may be considered, e.g.:

- relying on the fact that the nominee is itself a regulated entity subject to the Regulation or equivalent AML/CFT/KYC requirements in respect of its nominator and Beneficial Owners thereof, to waive the obligation to register with central registers maintained by the Member States; or

- more fundamentally, maintaining current framework, as mentioned above: it should be left to obliged entities to assess the risks linked to nominee arrangements and implement adequate, proportionate and risk-based mitigating measures to address those – which may result, in higher risk situations, in the obliged entity implementing a "look through" approach, i.e. performing Customer Due Diligence directly on the nominator and its Beneficial Owners.

Luxembourg, November 11, 2021