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FINANCIAL MARKETS LAW COMMITTEE

ISSUE 69 - PROCEEDS OF CRIME ACT 2002

Analysis of whether and, if so, of what nature there is legal uncertainty in relation to part 7 of the Proceeds of Crime Act 2002

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FINANCIAL MARKETS LAW COMMITTEE

ISSUE 69 - WORKING GROUP ON THE PROCEEDS OF CRIME ACT 2002

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The role of the Financial Markets Law Committee is to identify issues of legal uncertainty, or misunderstanding, present and future, in the framework of the wholesale financial markets which might give rise to material risks, and to consider how such issues should be addressed.

Some element of legal uncertainty is inevitable in financial markets. One possible source of legal uncertainty is proposals for new law or regulation. These can sometimes give rise to uncertainties or misunderstandings, if the specific features of wholesale market practice or of the existing framework of law have not been fully understood by a legislator or other public authority.

In the Summer of 2003 an issue arising under the Proceeds of Crime Act 2002 was raised with the Committee. At its meeting on 25 September 2003 the FMLC resolved to address the issue, in the first instance by forming a working group to analyse in detail the nature of the issue. To conduct that analysis in the first instance, the FMLC formed a Working Group. This paper was developed for the Committee by that Working Group. The views set out in this paper, however, are those of the Committee itself, as well as of the Working Group. Phil Wynn Owen took no formal part in the FMLC's discussions on this issue, as he has an official role in the negotiation of the Third Money Laundering Directive.

Remit

1. Initially the FMLC established a Working Group to explore whether, and, if so, of what nature there is a legal uncertainty in relation to Part 7, The Proceeds of Crime Act 2002 (the "**Act**" and "**POCA**"). During the course of this work on POCA the European Commission made a Proposal for a Third Money Laundering Directive ("**MLD3**")[1]. The issues we raise in relation to POCA will also need to be addressed in MLD3 to ensure a clear enforceable pan-European anti-money laundering regime.

Summary

2. We conclude that there is legal uncertainty in relation to Part 7 of the Act[2]. The uncertainty lies in the definition of "criminal conduct" and manifests itself in two respects.

   2.1 It is uncertain in what circumstances conduct outside England and Wales is criminal conduct within the meaning of POCA (and hence it is uncertain as to who has to be reported to the UK authorities as a suspected money-launderer and which transactions need consent).

   2.2 It is uncertain whether every offence in English law can be an offence predicate to money laundering.

3. The concerns raised in relation to POCA are inherent in and equally applicable to MLD3. Since it is unrealistic to imagine any amendment to POCA other than in conformity with MLD3, the European Commission's proposal for MLD3, codifying and building on the first two directives, may be considered to offer a very valuable opportunity to resolve the uncertainties raised in this paper.

[1] Published by the Commission on 30 June 2004.

[2] The FMLC has confined its consideration to Part 7 of the Act (Money Laundering) ("Part 7"). We conclude in paragraphs 13 and 18, below, that there are inconsistencies between Part 7 POCA and European fundamental freedoms. It seems likely that other parts of the Act might also be inconsistent with the fundamental freedoms.

Background

4. Part 7 consolidates and extends the pre-existing legislation in the UK[3] which applied to money laundering.

5. The Act received Royal Assent on 24 July 2002. Part 7 came into force on 24 February 2003 and applied from that date to firms authorised and regulated by the Financial Services Authority, amongst others. The Proceeds of Crime Act 2002 (Business in the Regulated Sector and Supervisory Authorities) Order 2003 came into force on 1 March 2004. It changed the scope of Part 7 substantially, by amending Schedule 9 of the Act. From 1 March 2004, all solicitors and accountants, tax advisors and other professionals have been part of the regulated sector for the purposes of Part 7.

6. Central to the offences in Part 7 are the definitions of "criminal conduct" and "criminal property", which are set out in section 340. Criminal property flows from criminal conduct. Thus, in most cases, where there is criminal conduct, there will be criminal property.

A person commits a money laundering offence if, inter alia, he acquires, uses, possesses, transfers or conceals criminal property or is concerned in an arrangement which he knows or suspects facilitates the acquisition, retention, use or control of criminal property. Persons who work in the regulated sector must report suspected money launderers (within the meaning of POCA) and obtain consent to dealing with them.

> *"340(2) Criminal conduct is conduct which-*
>
> *(a) constitutes an offence in any part of the United Kingdom, or*
>
> *(b) would constitute an offence in any part of the United Kingdom if it were to occur there.*
>
> *340(3) Property is criminal property if-*
>
> *(a) it constitutes a person's benefit from criminal conduct or it represents such a benefit (in whole or in part and whether directly or indirectly), and*
>
> *(b) the alleged offender knows or suspects that it constitutes or represents such a benefit."*

The Act has no other provisions about the type of offences which are predicate to money laundering.

7. Part 7 creates substantive offences, for example of concealing, acquiring, using and possessing the proceeds of crime; it also creates inchoate[4] offences in relation to them. (These offences, which are defined collectively as "money laundering", all turn on a degree of involvement with criminal property.) A third category of offence is that of omission, which can be committed by failing, in certain circumstances, to make a disclosure to the appropriate authorities in prescribed manner. Finally, there are offences of "tipping off" and prejudicing an investigation into suspected money laundering.

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[3] We refer to the UK because the Act frames the law in substantively the same terms in relation to England and Wales, Scotland and Northern Ireland. (This can, of itself, give rise to difficulties where conduct which is criminal in one part of the United Kingdom is not in another.) However, this paper addresses only the law of England and Wales, including the law of the European Community as it applies in England and Wales.

[4] Inchoate offences include attempt to commit, as well as aiding, abetting, counselling or procuring another to commit, an offence.

8. This paper concentrates on two offences for the purposes of illustrating the nature of the uncertainty with which we are concerned:

   8.1 the offence in section 330 POCA: a person commits an offence if he fails to disclose that he knows or suspects (or has reasonable grounds for knowing or suspecting) that another person is engaged in money laundering, where he formed that knowledge or suspicion in the course of business in the regulated sector[5]; and

   8.2 the offence in section 328 POCA: a person commits an offence if he enters into or becomes concerned in an arrangement which he knows or suspects facilitates (by whatever means) the acquisition, retention, use or control of criminal property by or on behalf of another person. He has a defence if he can show that he made the appropriate disclosure to the authorities before doing the act and either: (a) he received the appropriate consent from the authorities; or (b) (i) he did not receive a refusal within a seven day notice period; or (ii) he did receive a refusal within the notice period, but then no further action was taken by the authorities within a further 31-day moratorium period.

9. During the course of our consideration of these issues, the European Commission issued a formal proposal for MLD3. MLD3 is intended to codify the first two money laundering directives and bring them into line with the latest international standards adopted by the Financial Action Task Force on Money Laundering. As POCA can be amended only to the extent consistent with MLD3 as adopted, this legislative exercise offers the chance to review and address the existing uncertainties which are manifest in Part 7.

   It is also important to ensure that MLD 3 does not give rise to the same or similar uncertainties, as this will produce the risk of uneven and less effective implementation and enforcement across the Community. This is both undesirable of itself but also liable to lead to the adoption of measures which could be inconsistent with the functioning of the internal market.

10. The aim of MLD3 is the combating of organised crime by vigorous anti-money laundering measures (Article 1), thus preserving the integrity and stability of financial institutions and confidence in the financial system, but in a way consistent with the functioning of the internal market (Recital 2). There is no suggestion in the Proposal that, so far as the territories comprised in the EU are concerned at any rate, money laundering (except in the case of terrorist financing) can extend to the proceeds of lawful activity merely because what is lawful in one EU state is criminal in another. However, these issues could be addressed more usefully and in more detail in the body of the directive. The only significant deviation from the existing position in this regard is in the definition of "serious crime" in MLD3, which is unhelpful for the reasons set out in paragraph 28.

[5] The "regulated sector" for these purposes is widely defined but, since 1 March 2004, it has included all those who work in any firm authorised and regulated by the Financial Services Authority (such as banks, insurers, stockbrokers, fund managers, etc.) as well as accountants, barristers and solicitors, for example.

The nature of the uncertainty

Conduct outside England and Wales

11. Criminal conduct includes conduct which would constitute an offence in any part of the United Kingdom if it were to occur there. This is the "**single criminality test**" in section 340(2)(b) POCA. It has been suggested that, on one construction, it is necessary to transpose to the UK only the facts in issue. Since it would be a criminal offence to drive on the right-hand side of the road in England, when a person drives on the right-hand side in France, that is criminal conduct within the meaning of POCA - any benefits derived from such activity are therefore criminal property. This would apply for example to a road haulage operator. This is the "**literal interpretation"** of the single criminality test.

12. The FMLC rejects the literal interpretation. We have identified Cox v Army Council[6] as helpful authority: in that case, the House of Lords considered the meaning of a similar single criminality test in section 70(2) Army Act 1955.

    12.1 Lord Radcliffe observed that:

    > *"the occurrence that is said to constitute the offence is always the actual occurrence itself as it took place outside England and that means importing into the hypothetical English occurrence the circumstances and conditions that prevailed at the place where and at the time when the thing that is complained of was done or omitted."*

    12.2 On this basis, one may have regard to compliance with local law requirements applicable to the overseas conduct in question. So, a motorist driving in France on the right will be driving lawfully. One transposes lawful driving to the UK, not merely the literal fact of being on the right-hand side of the road.

    12.3 The most certain comfort to be drawn from Cox derives from the observations in this case concerning criminal acts which necessarily can only be committed in the UK and the impossibility of transposition in such circumstances. If, for example, the UK offence is carrying on a regulated activity in the UK without a UK authorisation then, according to Cox principles, an activity lawfully carried on abroad, necessarily without a UK authorisation, does not become "criminal" under POCA just because of the absence of such authorisation.

    12.4 This Cox approach can work where one is dealing with comparable legal regimes (activities attracting a local licensing requirement in both the overseas and UK jurisdictions; laws relating to dangerous driving) but becomes more difficult to apply in those cases, which are likely to be common, where particular conduct would be criminal in the UK but is either unregulated in another jurisdiction or is regulated very differently there. For example, the Spanish matador who buys a house in London is, under POCA, laundering the proceeds of criminal conduct.

13. Furthermore, the literal interpretation would be inconsistent with the directly effective European internal market freedoms: in particular, those which provide for the free movement of capital and the free movement of services (the "**fundamental freedoms**").

6 Cox v Army Council [1963] AC 48.

13.1 The failure of the UK, without objective justification, to recognise circumstances or events occurring in another Member State as equivalent to comparable circumstances or events occurring in the UK, is likely to amount to indirect discrimination on the grounds of nationality.

13.2 The requirements to notify and obtain consent to conduct which is tainted only by virtue of the single criminality test (as interpreted literally) is also likely to be disproportionate: it might be sufficient for the authorities to receive simple prior notification or to have the benefit of a much shorter stay[7] and/or to set out objective criteria for the exercise of the discretion.

13.3 We have considered whether the restrictions might otherwise be objectively justified on the grounds of public policy or public security. The two EC Money Laundering Directives in force[8], which POCA is intended to implement, acknowledge that their implementation will create such restrictions but proceed on the basis that these are justified. However, rather than implementing the Directives[9] strictly, the Act extends their principles to a level of super-equivalence and the effects identified cannot be justified on public policy grounds. (There is also a separate question as to whether the Money Laundering Directives have been implemented properly, since, as a matter of Community law, implementation must itself be achieved in a way which is consistent with the fundamental freedoms.)

14. Even without the literal interpretation there remains substantial uncertainty.

14.1 Arguments based on the fundamental freedoms might be advanced before an English court in an attempt to ensure either (a) a reading of Part 7 which is consistent with those freedoms, or (b) disapplication of Part 7. However, a defendant to a charge under Part 7 would have standing to raise those arguments only if he were exercising fundamental freedoms, in cross-border business, in the context in which the prosecution was brought[10]. It is unsatisfactory, and is itself a source of uncertainty, if Part 7 would apply differently to UK persons in the regulated sector depending upon whether their client (doing business in the UK) is British or, say, French.

14.2 The overarching point from the previous paragraphs is that there is not a clear choice between the "literal interpretation" and some other consistent but sensible interpretation which one can apply in all circumstances. Indeed, the "fundamental freedom" argument is opposed not only to the literal interpretation but also to those cases where there is on any interpretation a clear conflict between UK notions of legality and very different notions of legality in other member states.

Further difficulty with "criminal conduct" definition

15. The fact that "criminal conduct" includes conduct which is a crime in any one, but not every, part of the United Kingdom itself presents problems. For example, foxhunting is unlawful in Scotland but is not unlawful in England and Wales. Are persons who foxhunt in England and Wales involved in criminal conduct within the meaning of POCA?

[7] The ECJ considered prior notification regimes in joined Cases C-163/94, C-165/94 and C-250/94 Lucas Emilio Sanz de Lera [1995] ECR I-4821 and Case C-54/99 Association Eglise de Scientologie de Paris and the Prime Minister [2000] ECR I-1335.

[8] Council Directive 91/308/EEC as amended by European Parliament and Council Directive 2001/97/EC.

[9] It seems that the Act will also be super-equivalent to the Third EC Money Laundering Directive, now in draft.

[10] Case C-264/96 ICI v Colmer [1998] ECR I-4695.

The absence of a de minimis *threshold in domestic cases*

16. It is clear from the second limb of the definition of "criminal conduct", in section 340(2)(b) POCA, that conduct which constitutes *any UK offence* is predicate to money laundering, not only a serious crime or a terrorist or drugs offence. This is the conclusion reached in P v P[11] (although it is understood that arguments based on the fundamental freedoms were not put to the court in that case).

17. In the domestic context, this means that a person is under the same onerous duties both to report and, more importantly, to suspend transactions pending consent from the authorities, in circumstances where the criminal conduct does not raise the same public interest issues as serious crime involving matters like fraud, corruption, drugs, pornography, such as:

    (a) a breach of intellectual property laws;

    (b) regulatory or technical breaches (e.g. some offences under the Financial Services and Markets Act 2000 and Part X of the Companies Act 1985);

    (c) events in the past which are so stale as to be of no practical interest or use to law enforcement agencies (e.g. unlawful confiscations during the Second World War).

18. On this basis, each of the seven-day notice period and the 31-day moratorium are also inconsistent with the fundamental freedoms. Both restrictions are disproportionate; in addition, since there is no publicly available list of criteria by reference to which the authorities will (a) decide to respond more quickly than seven days, or (b) decide whether to impose the further 31-day moratorium, they are inconsistent with the principle of legal certainty[12].

19. In assessing the proportionality of a restriction as a matter of Community law, it is necessary to have regard to the application of the restriction in context. The problem identified in paragraph 18 is compounded by the difficulties faced in practice.

    19.1 For example, in the context of a corporate transaction where something comes to the attention of a professional adviser which prompts him to make a report, the professional advisor in question may not take any steps in relation to the transaction for fear of committing the offence under section 328 POCA[13]. Nor may he explain the situation to his client for fear either of tipping off or prejudicing an investigation: if the professional advisor is a lawyer, English law principles of client confidentiality and legal professional privilege are modified in this context. These points emerge from P v P[14]. It is disproportionate to deny the client access to his advisors at the very point at which he needs them: it might not even be the client, but a counterparty, who is implicated in a crime.

    19.2 It is anticipated that the relevant authorities could be swamped, or even overwhelmed, by reports; if so, irrespective of how serious is the crime reported, one should expect a longer, rather than a short, stay. More importantly, the UK law enforcement authorities have already acknowledged the danger that "defensive reporting" - reports of dubious merit which are made out of a sense of uncertainty and self-protection on the part of the reporter - could flood the system and, the higher the volume of reports that the authorities have to process within the timelines, the higher the risk that valid reports will slip through the net.

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[11] P v P (Ancillary Relief: Proceeds of Crime) [2003] EWHC 2260 (Fam).
[12] Eglise de Scientologie, fn 7 ante.
[13] P v P, fn 11 ante: a legal advisor negotiating an arrangement is concerned in an arrangement, para. 48.
[14] P v P, fn 11 ante. We consider it questionable whether, in view of the fundamental importance attributed by the House of Lords to client confidentiality and legal professional privilege (Morgan Grenfell & Co. Ltd v Special Commissioner of Income Tax [2003] 1 AC 563), P v P correctly establishes that Part 7 abrogates or modifies these principles.

19.3 The ambiguities of the legislation make it particularly difficult for large financial institutions to develop clear and consistent guidelines for their myriad customer-facing staff. The fact that the Home Office has declined to issue material guidance on the legislation's interpretation, despite calls from many corners of the regulated sector, only worsens the sense of unease. Some global institutions have considered avoiding the pressures which difficulties in interpreting POCA have placed on certain areas of their business, by simply transferring whole teams of staff into a different jurisdiction. Even if this has not occurred in any particular case, the fact that it has been considered makes this an influential factor in determining where to locate or whether to relocate a business, and could be detrimental to the UK economy.

19.4 Many employees in the regulated sector are, quite naturally, very concerned at the prospect that they could personally face criminal sanctions under legislation which is a source of so much uncertainty for their employers. Regulated sector firms have reported that eligible candidates are often reluctant to accept the role of money laundering reporting officer, in light of the extra obligations that this role imposes and the underlying uncertainty. Firms are coming to terms with the additional training costs that anti-money laundering requirements have brought to their business, but the increasing cost of recruiting money laundering officers seems to include an element of "danger money" because of the problems in interpreting the legislation.

19.5 The consequences of making a report are extremely difficult to reconcile with the ongoing duties that a financial institution such as a bank normally owes to its customers. When a client seeks to recover what they consider to be their money from an account, only to be told that this is not currently available to them (because a report has been filed without their knowing), conflict is inevitable; there have been cases of customers making threats of physical violence to bank staff. When consent is subsequently given to the transaction, it is very difficult to explain to a client why their account is functioning normally, without revealing why it did not do so previously (as this could be tipping off). It has even been known for customers to claim damages from the bank for the loss of a business opportunity during the period of the account's suspension pending NCIS response.

19.6 The duty on the regulated sector to freeze their services to clients is exceptionally onerous, damaging to client relationships and potentially costly in many ways - it must therefore be ensured that this obligation arises only in cases where it is strictly necessary and that the personnel of regulated sector firms do not feel compelled, under pain of criminal sanctions, to make reports in circumstances arising purely from uncertainties in the legislation's interpretation.

20. The point made in paragraph 14.2, above, applies equally in this context, to demonstrate why uncertainty remains despite the fact that the European law arguments, advanced above, are sound.

This is a new problem, not an old one

21. It has often been noted by Government representatives that the single criminality test appeared in the provisions framing the substantive money laundering offences in the predecessor legislation, raising the question as to why the issue is drawing such increased attention now.

21.1 Previously, in practice, the onus was on the prosecuting authorities to decide what conduct merited prosecution under the single criminality test. It could reasonably be assumed that they would not waste resources in pursuing unmeritorious cases merely because a literal application of the test resulted in lawful overseas activity being characterised as “criminal conduct”. That presumably remains the position with the substantive offences under POCA.

21.2 The real difference is the new reporting obligation placed on the regulated sector, which allows institutions no discretion to distinguish between the meritorious and unmeritorious. An institution is, on pain of criminal sanction, under a positive and continuing duty to report suspected money laundering applying the single criminality test – a situation which raises huge issues of client confidentiality and the possibility of needlessly disrupted transactions (as considered in paragraph 19 above).

21.3 Therefore, the new uncertainty derives principally from the combination of the new reporting requirement and the effects of the single criminality test. The test has always been a potentially difficult one to apply, but the new reporting requirement shifts this assessment from the prosecuting authorities to the regulated sector which is itself potentially subject to prosecution if it makes a wrong assessment. As a result, the test has far more potency to cause unnecessary and widespread harm to ordinary economic activity and thus requires institutions to have a clear and workable idea of its application in practice.

MLD3 and Conduct in another EEA Member State or third country

22. We have considered how the problems exposed in this paper might be addressed by the relevant authorities. One possible approach open to the Community legislator is suggested here.

23. MLD3 refers to the effect of conduct outside a member state in the last paragraph of Article 1:

"Money laundering shall 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."

"Activities" refers to the term "criminal activity" used elsewhere in Article 1.

24. In order to avoid the uncertainties that have arisen with the UK legislation, and to ensure coherent implementation across the Community, MLD3 needs to adopt a clear approach as to the tests to be applied in one Member State when determining if conduct in another Member State or a third country is a "serious crime" within the meaning of the Directive.

The principal options are:

- a single "criminality" test based on the law of the jurisdiction of the reporting institution - this would mean that a firm based, say, in the United Kingdom would have to consider if, for example, conduct in Spain would be a serious crime under UK legislation. This raises the difficulties which have been identified with the UK legislation where an activity is not regarded as a crime in the Member State where it is carried out - for example bull-fighting.

- a single criminality test based on the law of the jurisdiction in which the activity takes place - this would raise the difficulty that persons subject to MLD3 would have to have a detailed knowledge of the criminal codes in each other jurisdiction.

- a dual criminality test - this would require conduct to be criminal in both the jurisdiction of the reporting institution and in the jurisdiction where it takes place - but this could cause difficulties in relation to third countries if they have or would be regarded by Member States as having an inadequate criminal code.

25. We suggest that the European Commission consider a tiered approach which combines an assessment of the seriousness of the offence with a proportional approach to implementation.

We therefore propose the following:

(a) that for serious crime of the kind referred to in Article 3(7)(a) - (e) of MLD 3 there is a single criminality test based on the law of the jurisdiction of the reporting institution. Thus a firm based in, say, France would have to report an activity that involved fraud as defined in French law, wherever in the world it is committed. This avoids the difficulty, where major crime is concerned, of having to take into account inadequate criminal codes in third countries.

(b) the dual criminality test should be applied to all other alleged criminal activities. This would require the reporting institution first to ask itself whether the activity would be an offence in its own jurisdiction, and if the answer is in the affirmative it would have to consider the law of the local jurisdiction.

A variation of this element would be to have a dual criminality test for such crimes where the conduct concerned has occurred in another FATF country but retain a single criminality test for all other jurisdictions.

In any event, whatever approach is adopted in the MLD3, it needs to be clear as to how the territorial issues are to be dealt with by the Member States to avoid the difficulties that have arisen with the UK legislation.

The de minimis exception

26. Article 3(7) of the proposal for MLD3 carries a definition of "serious crime" which includes,

" ... (f) all offences which are punishable by deprivation of liberty or a detention order for a maximum of more than one year or, as regards those States which have a minimum threshold for offences in their legal system, all offences punishable by deprivation of liberty or a detention order for a minimum of more than six months".

It is suggested that, just because a serious version of an offence, for example theft, may be triable on indictment and the defendant face a potential jail term of more than six months (thus qualifying as a predicate offender), it does not follow that MLD3 should catch as "serious crime" the trivial shoplifter dealt with summarily in the Magistrates' Court.

27. This last paragraph of the definition of "serious crime" will cover a vast number of offences which are triable on indictment, yet which are not typically "criminal" and which are extremely unlikely to have any relation to the serious crime which the directive is targeting. Common examples are offences relating to food standards or environmental law.

27.1 Concerted efforts to draw up a proposed list as to which UK indictable offences should and should not fall within the remit of POCA have repeatedly ended in a failure due to the inevitable arbitrariness of such distinctions in the face of the vast permutations involved.

27.2 The variations between national criminal codes make it impossible for the EU to draw such a distinction in MLD3 itself and this is likely to pose serious problems to national authorities when implementing the directive.

28. Article 37 of MLD3 allows the Commission to adopt implementing measures to take account of technical developments and ensure the uniform application of the directive; we suggest this power could be valuably used to implement a *de minimis* level within the Article 3(8) definition of "serious crime" through secondary legislation. Given the likely complexities of applying such a principle to varying national codes, this process may be more efficient and effective if the Commission delegated power to issue such delegated legislation to a centralised body with a specific focus on the issue. The Committee on the Prevention of Money Laundering, created under Article 38(1), could be just such a body.

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