THE LAW SOCIETY OF HONG KONG
香 港 律 師 會

Law Society's Submissions

"Proposed New Legislation on the Customer Due Diligence and Record-Keeping Requirements for Financial Institutions and the Regulation of Remittance Agents and Money Changers"

General comments

We refer to our comments on the First Consultation Paper dated 23 September 2009 and consider it worthwhile to re-iterate the same as they remain a genuine concern of the Law Society:

"....if stringent client due diligence measures are imposed, it may restrain the development of our financial sectors and have negative impact on our status as an international financial centre. It may put Hong Kong at a competitive disadvantageous position when compared with other countries.

Furthermore, extreme caution should be exercised if the Government considers introducing new criminal sanctions. If stringent criminal sanctions are imposed, it will stifle the development of the financial service industry and Hong Kong may lose its competitive edge....that proportionality is one of the important factors to be considered by the Government when it considers introducing new AML legislation. The benefit to the community must be tangible and evident if onerous duties are to be placed upon professions. To date, such evidence has not been produced."

We set out below our comments on the "Detailed Proposals Consultation Document on Proposed New Legislation on the Customer Due Diligence and Record-Keeping Requirements for Financial Institutions and the Regulation of Remittance Agents and Money Changers", published by the Financial Services and the Treasury Bureau (FSTB) on 7 December 2009 (Consultation Document).

We note that the Consultation Document does not include a draft of the proposed new legislation, nor does it specify the precise form that it is expected to take, we therefore recommend a further round of consultation when the draft legislation is ready.

As a general point, some of the requirements of the proposed legislation uses subjective terminology, such as the requirement (in relation to enhanced due diligence for PEPs) to take "*adequate measures*". We are concerned by the use of such terms in a regime which carries criminal liability, particularly when we have not had sight of any guidelines.

We also note there should be conformity in guidelines to be issued by the different authorities for this proposed regime and ideally they should be identical as it will provide not only uniform

implementation by the FIs, but also assistance with the interpretation of the regime by the relevant enforcement bodies.

In addition, we would also like to highlight potential privacy issues as we move towards a culture in which individuals and corporate entities are required to routinely establish their identity to transact in society and commerce. It is therefore important that a balance be struck between tackling the risks of facilitating money laundering or terrorism financing and an individual's right to privacy.

In this respect, any proposed legislation should be clear in giving an individual a right of access to the personal information being held by FIs, and an opportunity to provide clarifying details or correct errors. For example, where personal information is collected from "a reliable and independent source" (paragraph 5(a), Annex A), it is important that FIs keep individuals informed and in control of their personal information. This also ensures a relationship of trust between individuals and the FIs which hold personal information.

Part 1 - Coverage

Paragraph 1

1. A definition of "*long term insurance business*" is required. We note this term is defined in the Insurance Companies Ordinance ("ICO") as *"any of the classes of insurance business specified in Part 2 of the First Schedule"*. We suggest the new legislation adopts the same definition as the ICO.

2. The provisions of the Consultation Document apply to certain activities such as licensed corporations advising on corporate finance, market makers and reinsurers. Whilst comments have been made in the first consultation to this effect, the FSTB has determined it would not be appropriate to exclude them from the coverage of the proposed legislation as the Financial Action Task Force ("FATF") does not exempt them from AML regulations.

We believe the inclusion of such activities in the proposed legislation is beyond the legislative intent of the recommendations and the related definitions of FATF particularly if there is no movement of money other than for payment for the services rendered. Furthermore, we believe that a non-exemption of these activities will result in an undue burden on the industry players involved in such activities in Hong Kong and will have an impact on Hong Kong's competitiveness as an international financial centre

Part 2 - Obligations

Paragraph 3

1. We question whether the circumstances set out in 3(d) and (e) should trigger an obligation to carry out *enhanced* due diligence, rather than straightforward customer due diligence.

Paragraph 4

1. Paragraph 4(b), is unclear and thus confusing. The proposal that the verification of the identity of a beneficiary under a life insurance policy may take place after the business relationship has been established provided that it takes place at or before the time of payout or at

or before the time the beneficiary exercises a right vested under the policy seems unreasonable. For example, why would a payout to a beneficiary be withheld after the death of a policyholder when all premiums have been paid for a certain number of years as stipulated in the insurance policy?

Paragraph 5

1. It will be very important to have precise guidelines on what documents, data or information may be obtained and may be considered as a reliable and independent source. For example, will original proof of addresses be required, or will a certified copy be sufficient? Are utility bills required or will a mobile phone/internet/TV statement be sufficient? Whilst it may be difficult to set-out a list of acceptable documents in the legislation, such information should be covered with a high level of details in the general guidelines issued by the different regulators as a person who contravenes the statutory obligations under the legislation may be liable to criminal sanctions.

Paragraph 6

1. Whilst this paragraph is consistent with the FATF recommendations, we believe that precise guidelines should be issued by the relevant regulators regarding their interpretation of "*ongoing due diligence*" as such a provision may have a substantial commercial impact on FIs, and as a person who contravenes the statutory obligations under the legislation may be liable to criminal sanctions.

Paragraph 7

1. We agree that for business relationships entered prior to the commencement of the legislation, on-going due diligence must be conducted upon the occurrence of one of the triggering events, including transactions of significance, substantial changes to customer documentation standards, material changes in the way the account is operated, or the FI becomes aware that it lacks sufficient information about an existing customer. However, we believe the requirement for FIs to apply CDD requirements to *all existing accounts* within 2 years upon the commencement of the legislation may be unnecessary and will result in an undue burden on these FIs. There seems to be little point in conducting CDD on an account that has been dormant for several years.

Paragraph 9

1. It is notable that in some lines of business (e.g. insurance), very few customer relationships will be established face-to-face and so in such business areas, the enhanced due diligence requirements will be very burdensome. We note the FSTB does not propose to relax the legislation. We therefore recommend that very specific guidelines be provided by the relevant regulators as to what steps need to be taken in relation to enhanced due diligence requirements in those business areas

2. We do not understand what is intended by the proposal in paragraph 9(a)(iii). We believe that compliance with paragraph 9(a)(i) or (ii) should be sufficient.

3. We would argue that where a correspondent banking relationship is to be established with a regulated FI from an equivalent jurisdiction, enhanced due diligence is not necessary. The other FI will be carrying out its own CDD procedures and those procedures will be regulated locally in accordance with FATF requirements. In particular, we do not believe it is the Hong Kong FI's responsibility to assess the respondent's AML and CFT controls (as required by paragraph 9(b)(iii)), nor to conduct the checks described in paragraph 9(b)(vi). We recommend the FI that will have a correspondent banking relationship must be from a jurisdiction that is a member of FATF.

4. Previous consultation responses have already focused on the practical difficulties of recognizing and verifying PEPs. We are particularly concerned by paragraph 9(c)(ii), which requires "*adequate measures*" to be taken to establish the source of wealth and source of funds which are involved in the transaction or business relationship. We would expect to see detailed guidelines on steps which should be taken to satisfy this test on an objective basis.

Paragraph 10

1. We do not understand what is required by paragraph 10(b).

2. We suggest that, other than in relation to FIs, the people specified in paragraph 10(e)(iii)(A) should be the same as those in paragraph 10(e)(ii)(A).

3. We are unsure, when reading paragraph 10 together with paragraphs 3.12 - 3.15 of the commentary, what is being proposed in relation to third party reliance. The last part of paragraph 10 suggests an FI may outsource the CDD procedures to any agent, but if it does so, it will remain liable for the failure to apply those procedures. The main part of paragraph 10 appears to restrict the ability to outsource to a restricted group of professionals, again on the basis that the FI remains liable.

4. Clarification is required as to the meaning of "*requirements*" in paragraphs 10(e)(ii)(C) and 10(e)(iii)(C). In Hong Kong, we are only aware of regulatory requirements e.g. for solicitors, Law Society Practice Direction P, which cover similar ground to the proposed FI legislation, but which are not statutory and do not carry criminal sanctions.

5. We proposed that the FIs should require such third parties obtain the consent of the client to release confidential information to the FI, in order to meet CDD requirements.

Paragraph 11

1. A definition of "*shell bank*" is required.

Paragraph 18

1. We are of the view that where an FI has complied with a guideline, this should be sufficient to protect the FI and its officers from liability. In other respects, we agree with the proposal in paragraph 18.

Paragraph 19

1. We are of the view that where an FI has complied with a guideline, this should be sufficient to protect the FI and its officers from liability. In other respects, we agree with the proposal in paragraph 19

Part 3 - Powers of the Relevant Authority

Under the proposed legislation the regulatory authorities will have considerable powers to supervise FIs compliance with obligations under the new legislation. These have been modelled on powers available to the SFC under Part VIII of SFO.

We note investigations under Part VIII of the SFO are designed to assist in detecting a wide range of offences including complex offences such as: market misconduct (including insider

trading), fraud and defalcation (which often involve an element of conspiracy etc). Under the proposed legislation, the regulatory authorities need to have sufficient investigatory powers to ascertain whether an FI is or has been complying with its CDD and record keeping requirements.

It appears these proposed powers are too broad in scope for this limited purpose and currently *only* the SFC currently enjoys such powers.

Paragraph 20

1. The proposal that the relevant authority may at "*any reasonable time appoint authorized persons to conduct inspections...*"

Is the "*reasonable time*" referable to the time of inspection rather than the time of appointment of the authorized person? If so, the draft legislation should reflect this in due course.

2. The proposal in paragraph 20 requires qualification - that the inspections will be for the purposes of ascertaining whether the FI is complying (or has complied /is likely to be able to comply) with the CDD and record keeping requirements under the new legislation.

3. Paragraph 20(b): the authorized persons may inspect and make copies or record details of "*any records or document relating to the business, transaction or activity conducted by the FI*". This is very broad in scope given that the powers are afforded to the relevant authority (and authorized person) for the purposes of ensuring FI's compliance with CDD and record keeping requirements under the proposed legislation. We consider such powers should be restricted accordingly to inspection and copying of books and records relating to CDD and record keeping only.

4. Paragraph 20(c): the scope of inquiries to be made by authorized persons should be restricted to issues relating to compliance with the CDD and record keeping requirements under the new legislation.

Paragraph 21

1. This paragraph refers to "*the person under investigation*". Please clarify this refers to the FI, rather than individuals, which will be subject to investigation at first instance, thereafter, the mechanism by which the investigation and obligations will in practice be extended to individual management and officers of the FI and then to third parties should be set out with particularity. This is especially important given the considerable powers afforded under this paragraph for investigators to summon individuals to be questioned and to provide explanations and statements verified by statutory declarations and in the context of the proposed abrogation of the right to silence.

Paragraph 22

1. There is no definition of the "*requirements imposed by the relevant authority*" in paragraph 22 (a). If it is intended these are requirements to be imposed under paragraph 21, again it is important to set out with particularity the mechanism by which obligations are extended to individual managers and officers of the FI and then also to third parties.

2. The three criminal offences are modelled on s.184 of the SFO. In addition to the highest tier criminal offence (c), the *mens rea* of "*intent to defraud*", there could also be added in the alternative, a formula encompassing intent to hide, disguise or conceal money laundering activity or avoid the reporting requirements with regard to the same.

3. The proposed offence under paragraph 28 could be added to the offences under paragraph 22.

Paragraph 24

1. We strongly oppose the abrogation of the right of silence as set-out in paragraph 24 as this is a major infringement of an individual's constitutional rights and is not justified in the context of enforcement of CDD and record keeping requirements under the new legislation. We consider the proposal not only breaches Article 14(3)(g) of the *International Covenant of Civil and Political Rights* but also Article 11(2)(g) of the *Hong Kong Bill of Rights Ordinance* which states:

In the determination of any criminal charge against him, everyone shall be entitled to the following minimum guarantees, in full equality:

(g) Not to be compelled to testify against himself or to confess guilt.

Paragraph 31

There is a need to consider whether there will be consistency between investigations conducted by the SFC and those conducted by the other regulators in view of the differences in the provisions which may be applicable under the proposed legislation (see comments above).

Part 4 – Sanctions

Paragraph 33

We question the proposal to impose fines based on "*three times the profit made or loss avoided*" as it may not be an appropriate measure for a fine when an FI fails to observe the CDD and record keeping obligations under the proposed legislation.

Paragraph 32 and 34

1. Clear guidance is needed in the legislation on the circumstances in which liability for a fine should be borne by the officer of an FI or the FI itself or if this is in the discretion of the regulatory body and how such discretion should be exercised.

2. Details of whether it is proposed that the FI/person should have the right to be heard and the form of such hearing should be provided.

Paragraph 37

1. The criminal sanction is presumably targeted at FI's officers and staff (including former officers and staff). This should be clarified in the proposed legislation.

2. We agree with the higher threshold of *mens rea* in the words "*knowingly contravenes*".

3. In addition to the *mens rea* of "*intent to defraud*", there could also be added in the alternative a formula encompassing an intent to hide, disguise or conceal money laundering activity, or avoiding reporting requirements with regard to the same which is the chief mischief the legislation seeks to cover.

Part 5 - RAMCs

We have no comments.

Part 6 – Appeals

1. Whilst there may be certain advantages in setting-up a single appeals tribunal, this may cause numerous difficulties in practice. For example, a person involved in a regulatory breach may need to appear in front of the Securities and Futures Appeals Tribunal ("SFAT") and simultaneously appear in front of this new independent appeals tribunal for a breach of KYC requirements.

List of proposed definitions

1. "*remittance agent*" - the definition should be amended so that the words "*a place outside Hong Kong*" apply to (a), (b) and (c).

The Law Society of Hong Kong
Company and Financial Law Committee
Securities Law Committee
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