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Consultation on the Transposition of 5MLD
Sanctions and Illicit Finance Team (2/27)
HM Treasury
1 Horse Guards Road
London
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London

By email: anti-moneylaunderingbranch@hmtreasury.gov.uk

14 June 2019

Dear Sir or Madam

Transposition of the Fifth Money Laundering Directive: consultation

The City of London Law Society ("**CLLS**") represents approximately 17,000 City lawyers through individual and corporate membership including some of the largest international law firms in the world. These law firms advise a variety of clients from multinational companies and financial institutions to Government departments, often in relation to complex, multi-jurisdictional legal issues. The CLLS responds to a variety of consultations on issues of importance to its members through its 19 specialist committees.

This letter has been prepared by the CLLS Regulatory Law Committee (the "**Committee**"). The Committee not only responds to consultations but also proactively raises concerns where it becomes aware of issues which it considers to be of importance in a regulatory context.

Chapter 2 - Cryptoassets

Questions 17-20 of the consultation paper seek views on whether the government should transpose only the changes required by 5MLD (that is, to extend the application of the directive to exchange services between fiat currencies and virtual currencies and custodian wallet services in relation to virtual currencies) or to bring additional services in relation to cryptoassets within the scope of the directive. We are concerned that to include additional services at the present time and on the basis of a broad definition of cryptoassets referred to in the consultation paper would risk covering types of activity that do not carry a significant risk of money laundering and creating legal uncertainty.

The consultation paper uses the definition of a "cryptoasset" proposed in the HM Treasury/ Financial Conduct Authority/ Bank of England Cryptoassets Taskforce, namely:

> *"a cryptographically secured digital representation of value or contractual rights that uses some type of distributed ledger technology and can be transferred, stored or traded electronically".*

This definition refers purely to the form of the relevant asset (that is, it is cryptographically secured, digital, uses DLT technology and can be transferred to stored electronically) rather its nature. This is in contrast to the narrower definition of "virtual currencies" used in 5MLD:

> *"a digital representation of value that is not issued or guaranteed by a central bank or a public authority, is not necessarily attached to a legally established currency and does not possess a legal status of currency or money, but is accepted by natural or legal persons as a means of exchange and which can be transferred, stored and traded electronically."*

This definition refers both to the form (digital) and nature (a means of exchange) of the relevant asset.

The government proposes using the wider definition in order to capture all three broad types of cryptoassets identified by the Cryptoassets Taskforce, namely exchange tokens, security tokens and utility tokens, since it consider that relevant activity in relation to all three types of cryptoassets should be brought within the scope of AML regulation.

However, by using a definition that focuses on the form rather than the nature of the relevant assets, the government risk bringing within the scope of AML regulation a very broad range of assets that have not traditionally been within scope, merely because those assets happen to be held in digital form. For example, it is conceivable that rights to "virtual reality" assets in computer games or government benefits could be issued or stored in digital form: the broad definition proposed would be capable of covering a service of issuing those assets where no fiat currency is involved or storing them, even though some of these, such as in-game currencies, are expressly envisaged to fall outside the regime (See Recital (10) 5MLD).

The focus on the form rather than the substance of the relevant asset is also contrary to the general approach under the money laundering directives, which require customer due diligence and related monitoring to be carried out where a "business relationship" is established. The definition of "virtual currencies" used in 5MLD is capable of involving a substantive business relationship. However, a definition that focuses on the form rather than the nature of the relevant asset involved in a service will capture many situations where there is no substantive business relationship (see the examples in the paragraph above and the discussion of open source software below).

The focus on the form rather than the nature of the relevant asset also makes it difficult to assess the potential for the relevant activity to be used for money laundering purposes and therefore to carry out a proper cost-benefit analysis to justify broadening the scope of coverage beyond the requirements of 5MLD. Although we agree with the government that services provided in relation to cryptoassets beyond virtual currencies have the potential to be used for the purposes of financial crime, we doubt that all services in relation to all cryptoassets pose such risks. If the relevant asset is defined merely by reference to its form, the nature of the relevant service provided in relation to that asset needs to be defined with enough specificity to enable the potential harm posed by the service to be evaluated. We would query the apparent assumption that all cryptoassets are inherently particularly susceptible to being used for the purposes of financial crime merely by virtue of their form.

Considering in more detail some of the services that the government is considering bringing within the scope of AML regulation:

- ***crypto-to-crypto exchange services***: because there is no connection to a fiat currency, the inclusion of these services (particularly in the context of a broad definition of "cryptoassets" rather than the narrower "virtual currencies" definition used in 5MLD) is likely to bring a broad

range of assets of low or no value within the scope of regulation that seem unlikely to pose money laundering risks;

- ***issuance of new cryptoassets***: far more specificity, informed by a study of the operational processes used in ICOs, would be necessary in order to achieve an accurately targeted regime. For example, it would need to be considered whether the regime should apply only to certain types of intermediaries (as under the current regime for securities issuance) or to coin issuers themselves. Furthermore, activities relating to the issuance of security tokens will already be within the scope of the existing regulatory perimeter (and thereby also within the UK AML regime) by virtue of their being securities;

- ***publication of open source software***: again, this activity would need to be carefully limited to situations involving substantive business relationships in order to be suitable to be brought within the scope of AML regulation. For example, it may be appropriate in relation to software where full functionality is only available on payment or software performing specific types of activity in relation to cryptoassets. It seems unlikely to be appropriate in relation to widely used and freely available open source computer operating systems such as Linux. We also query why open rather than closed source software is particularly susceptible to money laundering risk –for example, it is not clear that open source software will inevitably involve a distribution model capable of giving rise to a "business relationship" which pose potential harm from a money laundering perspective as opposed to free (in both senses) public access.

More generally it is not clear how requiring the activity of publishing open-source software to become subject to CDD requirements would work in practice, or when the users of that software (or integrated versions of it) would become customers for this purpose, or would be entering into a business relationship with the publishers of different versions, or how these relationships could be easily tracked. Its impracticability could dis-incentivise the publication and use of open-source software, a facility whose many advantages are recognised globally.

We note that the final report of the Cryptoassets Taskforce indicates that the government proposes to consult on whether the regulatory perimeter requires extension in relation to cryptoassets that have comparable features to specified investments but that currently fall outside the perimeter. Although we recognise and agree with the government's concern that services in relation to a broader range of cryptoassets than the virtual currencies specified in 5MLD may be used for the purposes of financial crime, we suggest that it would be more appropriate to implement this aspect of the regime in an incremental manner. We would suggest that the regime first be transposed only to exchange services between fiat currencies and virtual currencies (as defined in 5MLD) and custodian wallet services in relation to virtual currencies, and that consideration of the cost benefit analysis for a broader extension take place only following the outcome of the consultation on the extension of the regulatory perimeter to other types of cryptoasset. The analysis undertaken to determine which types of services in relation to cryptoassets should be brought within the regulatory perimeter more generally should help to inform the related discussion of which types of cryptoassets, and which services in relation to them, should be brought within the scope of AML regulation.

Chapter 9 - Registration of express trusts

Chapter 9 refers to the expansion effected by 5MLD of the current requirement to register certain trusts.

HM Treasury produced guidance in respect of 4MLD confirming that the trust registration process was not intended to apply to statutory, resulting or constructive trusts. It would be helpful for the UK's implementation of 5MLD to confirm this limitation of scope of the registration requirement. In particular, it would be helpful to exclude trusts formed to comply with statutory or regulatory requirements (such as the statutory trust created in respect of client money held by authorised persons).

We also note that it is common in the asset management industry for general partners to hold fund assets on trust. This is usually expressly provided for in the fund documentation. The arrangement reflects the legal reality of the way in which the fund holds property (through the general partner) and also serves the purpose of confirming that the manager of the fund does not perform the regulated activity of safeguarding investments. To the extent that the express trust relating to the general partner's holding of fund assets is subject to 5MLD registration requirements, it would be helpful to confirm the extent of the resulting data collection and sharing obligation, particularly in respect of investors in the relevant fund. Managers of relevant funds will need to be clear on the extent of the general partner's disclosure requirement, so that such disclosure can be explained to investors.

Separately, it is common for contractual documentation of commercial arrangements expressly to provide that a specific party shall hold certain property on trust in particular "default" circumstances, e.g. in the event of a failure in a process of transferring the property. In other words, to avoid uncertainty, the contractual documentation provides for the creation of the trust as a safety net, even though the parties do not expect the trust to be formed in the ordinary course of the commercial arrangements. As the parties expressly create this default trust arrangement, it is unlikely to be a resulting or constructive trust, and so is likely to be in scope of the 5MLD registration requirements. Parties will need to identify the point in time at which this trust is created (i.e. when the contract is executed, or in the "default" circumstances?) It is likely to be operationally difficult for parties to comply with 5MLD registration requirements if the registration requirement is triggered in "default" circumstances (i.e. will parties have processes in place to comply with the registration requirement at the time that the express trust arrangements come into effect, in the "default" circumstances.)

If you would find it helpful to discuss any of these comments then we would be happy to do so. Please contact Karen Anderson by telephone on +44 (0) 20 7466 2404 or by email at Karen.Anderson@hsf.com in the first instance.

Yours faithfully

Karen Anderson
Chair, CLLS Regulatory Law Committee

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