This briefing aims to provide Members with an overview of the concept of a “Politically Exposed Person” (PEP), both in the context of the current UK law and in some of the existing guidance used by UK banks and financial institutions.

The briefing also provides an overview of the Fourth Anti-Money Laundering Directive. In particular, the briefing looks at the new, broader definition of a PEP in the Directive and some of the likely implications of this for Members.
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INTRODUCTION AND BACKGROUND

WHAT IS MONEY LAUNDERING?

Money laundering is the generic term used to describe the process by which criminals disguise the original ownership and control of the proceeds of crime by making it seem like the proceeds have come from a legitimate source. They do this by exchanging money or assets that were obtained criminally for money or other assets that are ‘clean’. There are extensive ways that the proceeds of crime may be laundered, which vary in complexity and sophistication.

Banks and other financial institutions possess, manage and control money belonging to other people. Accordingly, the nature of their products and services means that banks and other financial institutions are particularly vulnerable to abuse by money launderers.

CUSTOMER DUE DILIGENCE

To aid with the prevention of money laundering, banks and other financial institutions must, among other things, carry out ‘customer due diligence’. This means taking steps to identify their customers and checking they are who they say they are.

THE CONCEPT OF A ‘POLITICALLY EXPOSED PERSON’ (PEP)

A PEP is a term which describes someone who has been entrusted with a prominent public function or a relative or known associate of that person. As explored in more detail below, precise definitions of the term vary in their scope.

A PEP is one of the categories of people who may be subject to ‘enhanced due diligence’. In essence, this means they will be subject to more rigorous checks when entering into a business relationship with a bank or other financial institution than other categories of customers.

Typically, the on-going business relationship between the bank or other financial institution and the PEP is also subject to stricter monitoring than is the case with other customers.

The rationale for these additional requirements is that PEPs are regarded as presenting a higher risk for potential involvement in bribery and corruption by virtue of their position and the influence they may hold.

THE MONEY LAUNDERING REGULATIONS 2007

Currently, the Money Laundering Regulations 2007 (SI 2007/2157) (‘the 2007 Regulations’) are an important part of the UK’s anti-money laundering statutory regime. They implemented in part the provisions of the Third EU Money Laundering Directive in the UK (2005/60/EC).

The 2007 Regulations apply to a wide range of business sectors, including banks, insurance companies, investment firms and brokers.

Regulation 14(5)(a) of the 2007 Regulations defines a PEP, for the purposes of the Regulations, as a person who is or has, at any time in the preceding year, been entrusted with a prominent public function by:
• a state other than the United Kingdom;
• an EU institution; or
• an international body.

Such a person is often referred to as a ‘foreign PEP’.¹ Foreign PEPs can be contrasted with the so-called ‘domestic PEPs’, who are entrusted with a prominent public function by the UK state or an institution in/of the UK.

Regulation 14(5)(b) and regulation 14(5)(c) expand the definition of a PEP in the 2007 Regulations to include family members and known close associates of foreign PEPs.

UK GUIDANCE ON PEPS FOR FINANCIAL INSTITUTIONS

There is guidance² on anti-money laundering measures issued by a number of bodies for use by banks and other financial institutions. Whilst this guidance is not binding, in practice it would appear that it is referred to by banks and other financial institutions in formulating their anti-money laundering procedures and practices.

This is significant because some of this guidance uses a broader definition of a PEP than that which appears in current UK law. Furthermore, it would appear that banks and other financial institutions are using this guidance in formulating their current approach to PEPs and anti-money laundering measures.

FINANCIAL CRIME: A GUIDE FOR FIRMS (APRIL 2015)

A key example is the guidance (last revised in April 2015) entitled Financial Crime: a Guide for Firms published by the Financial Conduct Authority (FCA) (FCA 2015). In Part 2, Box 12.1 (policies and procedures) good practice is said to include, for example:

“Considering the risk posed by former PEPs and ‘domestic PEPs’ on a case-by-case basis”

On the other hand, bad practice includes:

¹ Schedule 2, para 4 of the 2007 Regulations states that, for the purposes of regulation 14(5), individuals who are or have been entrusted with prominent public functions include various other categories of individuals set out in paragraph 4. These categories, in turn, include members of parliaments. However, this provision is intended to give further clarity as to the categories of individual who will fall within the definition of “an individual who is or has been entrusted with a prominent public function by a state other than the UK, a Community institution or an international body”. It is not intended to expand the definition to include members of the UK Parliament or any devolved parliament or assembly.

² This non-binding guidance is not to be confused with ‘relevant guidance’. Relevant guidance has been approved by HM Treasury (as well as satisfying certain other requirements). Courts and other decision-makers must have regard to relevant guidance when deciding whether there has been a breach of the 2007 Regulations. The relevant guidance also emphasises that the definition of a PEP in the 2007 Regulations only includes a foreign PEP. An example of relevant guidance is the guidance produced by the Joint Money Laundering Steering Group (JMLSG)(JMLSG 2014). This makes it clear at (para 5.5.19) that the definition of a PEP in the 2007 Regulations only includes foreign PEPs.
“Failure to carry out enhanced due diligence on customers with political connections who, although they do not meet the legal definition of a PEP [emphasis added], still represent a high risk of money laundering”

FINANCIAL ACTION TASK FORCE (JUNE 2013)

Another piece of guidance of potential significance in relation to UK banks is produced by an inter-governmental organisation called the Financial Action Task Force (FATF), of which the UK is a member. The guidance in question is entitled Politically Exposed Persons (Recommendations 12 and 22) (FATF 2013).

A PEP is defined in this guidance much more broadly than in the 2007 Regulations and specifically includes ‘domestic PEPs’, i.e. individuals who are or have been entrusted domestically with prominent public functions (chapter I, para 11). The recommendations in this guidance apply to family members and close associates of the PEP (chapter IV, paras 46, 48 and 49).

Under the guidance it is suggested that banks should carry out a series of steps in relation to individuals potentially falling within the definition of a PEP. These include determining whether the individual is a domestic PEP and, if they are, assessing the level of risk of the business relationship in the particular instance (chapter III, para 16).

In relation to those business relationships classified as higher risk, the recommendation is that “enhanced risk mitigation measures” be applied. Normal or low risk relationships do not require such measures (chapter III, para 16).

THE FOURTH ANTI-MONEY LAUNDERING DIRECTIVE

The EU’s Fourth Anti-Money Laundering Directive came into force on 26 June 2015. EU member states are expected to bring into force the domestic legislation necessary to comply with the new Directive by mid-2017.

NO DISTINCTION BETWEEN DOMESTIC AND FOREIGN PEPS

The new Directive does not make a distinction between domestic and foreign PEPs. It treats all PEPs as potentially high risk individuals. Specifically, a PEP is defined as a person “who is or has been entrusted with prominent public functions” (art. 3(9)). Such a person includes “members of parliament or similar legislative bodies” (art. 3(9)(b)).

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3 Chapter 1, para 1 states “in February 2012, the FATF expanded the mandatory requirements to domestic PEPs… in line with Article 52 of the United Nations Convention against Corruption… which includes both domestic and foreign PEPs.”

4 Article 3(9) then goes on to say that “no public function referred to in points (a) to (h) shall be understood as covering middle-ranking or more junior officials.” No further guidance is given in the Directive as to how such officials are identified. “[M]embers of parliament or similar legislative bodies” appears as point (b) and so, on the face of it, seems to be affected by this statement. However, we think it unlikely that the role of an MSP could be demonstrated to be that of a middle-ranking or junior official. In any event, it is not known what effect (if any) this will have in practice when banks and financial institutions are formulating their approach to members of parliament and assemblies. We think it more likely that financial institutions would take a cautious approach and apply the enhanced measures to all MSPs than that they would take upon themselves the task of trying to identify whether a particular MSP is “middle-ranking” or “junior”. For completeness, SPICe notes that similar wording appears in the 2007 Regulations (Sch 2, para 4(1)(a)(ii) and (b) and in the non-binding FATF Guidance Politically Exposed Persons (Recommendations 12 and 22) (FATF 2013) referred to earlier in this briefing. See chapter I, para 11 and chapter IV, para 38 of that guidance.
Family members and “persons known to be close associates” of that person are also made subject to the enhanced due diligence measures (arts 20, 21 and 23).\(^5\) These terms are further defined in the Directive (art 3 (10) and (11)).

**ENHANCED DUE DILIGENCE MEASURES WILL APPLY**

With respect to transactions or *any* business relationships with PEPs, banks and financial institutions will have to apply “enhanced customer due diligence measures to manage and mitigate those risks appropriately” (arts. 18 and 20). As mentioned above, this applies equally to transactions or any business relationships with PEPs’ family members and close known associates.

This is a more rigorous approach than the FAFT guidance described above, which focuses only on business relationships which can be classified as high risk (see paras 21 and 22 above).\(^6\)

In the case of business relationships with PEPs (and their family/close associates) required measures under the Directive will include (art. 20):

- obtaining senior management approval for establishing or continuing business relationships with such persons;
- taking adequate measures to establish the source of wealth and source of funds that are involved in business relationships or transactions with such persons;
- conducting enhanced, ongoing monitoring of those business relationships.\(^7\)

It seems likely that the recent approach of some banks and financial institutions to due diligence checking is motivated, at least in part, by an awareness of these forthcoming legislative changes.

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\(^5\) By virtue of article 23, articles 20 and 21 also apply to a PEP’s family members and close known associates.

\(^6\) The original proposed Directive also focused only on high risk business relationships with PEPs.

\(^7\) The Directive will also apply to those providing life insurance and other investment-related insurance to PEPs (and to PEPs’ family members and close known associates), and will require them, where higher risks are identified, (i) to involve senior management before paying out policy proceeds and (ii) to conduct enhanced scrutiny of the entire business relationship with the policyholder (article 21).
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