HERBERT SMITH FREEHILLS

# REFORMING AUSTRALIA'S AML/CTF REGIME

## CLEAR COMMITMENT TO MODERNISING THE REGIME IN CONSULTATION PAPER 2

# Contents

# Reforming Australia's AML/CTF regime – clear commitment to modernising the regime in Consultation Paper 2

Following the release of the Consultation Paper on Modernising Australia's anti-money laundering and counter-terrorism financing (**AML/CTF**) regime in April 2023 (**Consultation Paper 1**), there was real excitement about the possibility for Australia's AML/CTF regime being updated for the better. Our thoughts on Consultation Paper 1 are available here.

The 142 submissions received by the Attorney General's Department on Consultation Paper 1 reflect the widespread interest from stakeholders in ensuring that the AML/CTF regime is developed in a way that addresses uncertainty, inefficiencies and ensures that Australia has a regulatory regime that is fit for the purpose of deterring money laundering (**ML**) and fighting terrorism financing (**TF**).

The wait for further materials following Consultation Paper 1 led to a concern that the opportunity to modernise and simplify the AML/CTF regime may be lost. However, the release of the second Consultation Paper on 2 May 2024 (**Consultation Paper 2**), has reiterated the Attorney General's Department's commitment to a broader reform of Australia's AML/CTF regime.

In this paper we explore the reforms that we expect to be of most importance to financial institutions. These include:

- the redesign of the legislative framework around risk assessments and AML/CTF Programs;
- the re-write of customer due diligence (**CDD**) requirements, including the introduction of a specific obligation to undertake customer by customer risk assessments before providing any designated service;
- introducing the concept of a 'value transfer service' to replace the concepts of 'electronic funds transfer instruction' and 'designated remittance arrangement,' and extending the concept of 'value' to include 'digital assets' (not just money and property);
- extending the travel rule, including so that it applies to all entities in the 'value transfer chain' and also imposes obligations on remittance service providers and digital asset service providers;
- streamlining the international funds transfer instruction (**IFTI**) reporting requirements;
- reforming the tipping off offence and the exemption mechanism that applies for supporting law enforcement with investigations of serious offences; and
- updating the definition of bearer negotiable instruments.

We have also highlighted some areas that Consultation Paper 2 has not specifically addressed. In other articles we will look at the impact on "Tranche 2" entities as well as the proposed reforms affecting digital asset service providers.

# Redesign of risk assessments and AML/CTF Programs

A reporting entity's AML/CTF Program, underpinned by the entity's money laundering and terrorism financing risk assessment, sits at the heart of an AML/CTF compliance framework. The regulatory requirements affecting AML/CTF Programs are proposed to be significantly updated including in respect of risk assessments, risk mitigation measures and internal controls. We expect that all reporting entities will need to engage with their current AML/CTF Program and risk assessments and make amendments to these as part of the reforms.

## What is currently required and what did Consultation Paper 1 propose?

Under Part 7 of the AML/CTF Act, reporting entities are required to maintain an AML/CTF Program meeting the requirements prescribed by the AML/CTF Rules. An AML/CTF Program must be made up of Part A and Part B:

- The primary purpose of Part A is to identify, manage and mitigate ML/TF risk that a reporting entity may reasonably face in relation to the provision of designated services at or through a permanent establishment in Australia.
- Part B must set out the reporting entity's applicable customer identification procedures (**ACIP**).

While an obligation to implement a risk-based approach has been successfully pursued by AUSTRAC in enforcement actions, Consultation Paper 1 acknowledged that the obligation to assess risk is not expressly contemplated in the AML/CTF regime.

Consultation Paper 1 proposed key changes in respect of:

- streamlining AML/CTF Programs to remove the concept of Part A and Part B;[1] and
- updating the regime so that reporting entities are under an express obligation to take appropriate steps to identify, assess and understand the money laundering and terrorism financing risks it faces prior to the implementation of an AML/CTF Program.

## What does Consultation Paper 2 propose?

A number of the proposals in Consultation Paper 2 go to the implementation of a reporting entity's AML/CTF Program and supporting risk assessment and internal controls.

### Entity level risk assessment

Consultation Paper 2 proposes that the AML/CTF Act would articulate an overarching obligation on reporting entities to assess the risk of ML/TF and proliferation financing in their business. Reporting entities will be required to:

- consider the nature, size and complexity of its business in determining risk level;
- incorporate relevant risks identified and communicated by AUSTRAC; and
- document its risk assessment methodology as part of its AML/CTF Program.

It is proposed that minimum considerations that the reporting entity must take into account would be set out in the Act (customer types, designated services, methods of delivery and jurisdictions) while additional risk factors could be included in the Rules.

The reporting entity would be required to review and keep its risk assessment up to date. Consultation Paper 2 proposes a minimum requirement to review the risk assessment every four years.

[1] With the exception of Special AML/CTF Programs.

## Removal of Part A and Part B concept

Consultation Paper 2 maintains the reform proposed in Consultation Paper 1 of streamlining the AML/CTF Program into a single obligation and remove the concept of Part A and Part B.

## Internal controls including Board oversight and role of AML/CTF Compliance Officer

An aspect of the reforms that is given more prominence in Consultation Paper 2 than in Consultation Paper 1 is a focus on the role and responsibilities of the AML/CTF Compliance Officer. The existing AML/CTF regime prescribes very little in connection with who may fulfil the role of AML/CTF Compliance Officer. Under the proposed reforms, it is proposed that the Act would prescribe minimum standards that the AML/CTF Compliance Officer must meet including that the reporting entity must certify that they are fit and proper. It is proposed that the Act would clarify that the AML/CTF Compliance Officer:

- must be an employee at management level;
- is responsible for overseeing and coordinating the day-today operation and effectiveness of the AML/CTF Program and compliance with the regulatory regime;
- must have sufficient authority, independence and resourcing to fulfil their function; and
- must be certified by the reporting entity as fit and proper.

Consultation Paper 2 highlights a focus on ensuring a culture of compliance with Board or equivalent senior management required to maintain oversight of the AML/CTF Program. However, with the move away from having an AML/CTF Program divided into Part A and Part B, there is a recognition that an AML/CTF Program must be responsive to day-to-day operationalisation and oversight. With this context, Consultation Paper 2:

- recognises that the Board should not have responsibility to approve the implementation of day-to-day operational measures;
- the AML/CTF Compliance Offers should manage the implementation of operational measures; and
- changes to the AML/CTF Program could be approved by an individual in senior management, such as the Chief Risk Officer.

## Move from “designated business group” to “business group”

The option to form a “designated business group” under the AML/CTF Act is proposed to be replaced by a concept of ‘business group’. There would be no requirement that each member of the group is a reporting entity or otherwise would be a reporting entity if resident in Australia as currently required by the AML/CTF Rules.

Unlike the current regime, there would be no option to opt-in to the group, this would be a concept that would automatically apply to entities that meet the relevant criteria. It is intended to capture traditional corporate group arrangements as well as structures such as franchise arrangements.

## Operations of foreign branches and subsidiaries

Consultation Paper 1 and Consultation Paper 2 recognise that the regulatory framework applying to foreign branches and subsidiaries of Australian entities is complex. In our experience the relevant provisions of the AML/CTF regime are opaque and create regulatory and compliance uncertainty. The expectations of AUSTRAC in respect of these regimes is also unclear.

Consultation Paper 1 proposed that the Act could be amended so that the overseas operations should apply measures consistent with Australian AML/CTF Programs. This was met with significant industry concern that the reforms would require the Australian AML/CTF Program to apply overseas, without regard to the nuance of doing business in the other jurisdiction or the existing regulatory frameworks which, although not identical, implemented the expectations of FATF.

Consultation Paper 2 appears to take a more adaptable approach to the proposed reforms affecting overseas operations. Consultation Paper 2 contemplates providing reporting entities with flexibility in meeting the general obligations under the Australian AML/CTF regime, rather than prescribing that reporting entities must apply the AML/CTF Program to those operations. It will be important to keep this aspect of the reforms under review to ensure that entities operating in comparable jurisdictions do not need to unnecessarily apply multiple regulatory regimes to their operations.

# Key considerations in implementing changes to AML/CTF Programs and risk assessments

Based on the proposals in Consultation Paper 2, we expect key considerations for reporting entities in implementing the changes will include the following.

| Implementation consideration | Insights |
|---|---|
| **Redrafting AML/CTF Program** | While there will be structural changes to AML/CTF Programs as a result of the change to Part A and Part B, reporting entities are likely to need to undertake a more considered review of the proposed obligations on risk mitigation measures and specific internal controls. The extent of these changes will become clearer once there is legislative drafting available. However, it is likely that all AML/CTF Programs will need to be revisited. |
| **Allocation of roles and responsibilities between Board, senior management and AML/CTF Compliance Officer** | We expect that reporting entities and their Boards will be interested in defining an appropriate allocation of responsibility between the Board, an appropriate member of senior management and the AML/CTF Officer in a manner that is responsive to the risks of the particular business. We expect that Directors will continue to be interested in ensuring that the Board maintains sufficient oversight to have comfort that the reporting's approach is working effectively.<br><br>With ASIC's pursuit of individual directors currently before the courts, AUSTRAC stating that it may join individuals to proceedings and the attention of ASIC and APRA under the Financial Accountability Regime, we expect that this allocation of responsibilities will be a key focus of reporting entities in the implementation of the reforms. |
| **Identifying the right person to act as AML/CTF Compliance Officer** | While we expect that reporting entities will have taken care in the selection of their AML/CTF Compliance Officer to date, the increased focus on this role, including the legislative standards, means that we expect that this will be an area that comes into sharper focus. We expect that there will be a greater attention paid to selecting the right person and providing them with the right support in the implementation of the appropriate compliance framework. |
| **Business groups** | The change to a 'business group' is a positive step towards removing administrative hurdles in the efficient implementation of an AML/CTF compliance framework.<br><br>However, while the purpose of the changes is to make the implementation of AML/CTF compliance frameworks more flexible, consideration will need to be given to potential adverse or unintended consequences. For example:<br><br>• the head of the business group is responsible for ensuring that the AML/CTF Program applies to all business group members that provide designated services in Australia. As there is no option to opt-in, this may create the unintended outcome of requiring all entities to maintain an AML/CTF Program that is not preferred (where group members want to maintain tailored Programs, for example). This could include where a "Special AML/CTF Program" is maintained by group members or may affect franchisees that wish to maintain their own Program; and<br><br>• the industry consultation levy (which is subject to a separate review) should not take into account income of entities not obtained from designated services. |
| **Overseas operations** | The scope of changes required to the controls placed on foreign branches and subsidiaries will be impacted by the extent to which the reforms streamline or lift the current regulatory framework. Reporting entities with overseas operations should keep the proposed reforms under review. |

# Re-write of CDD requirements

Submissions in response to Consultation Paper 1 pointed to the prescriptive CDD requirements under the current regime with many asking for a move to principles-based obligations. Consultation Paper 2 recognises that feedback, stating that the proposals are intended to move from prescriptive procedures to an outcomes-focussed one. Despite this, the reforms contemplate measures that appear to retain prescriptive approaches to CDD, in particular where a customer is rated as medium risk.

## What is currently required and what did Consultation Paper 1 propose?

As described above, Part B of an AML/CTF Program must set out the ACIP of a reporting entity. Chapter 4 of the AML/CTF Rules prescribes ACIP that must be included in an AML/CTF Program for different customer types. The current regime is prescriptive but also difficult to navigate. While CDD requirements must be included in Part B of an AML/CTF Program, Part A of the Program must include enhanced CDD and a transaction monitoring program.

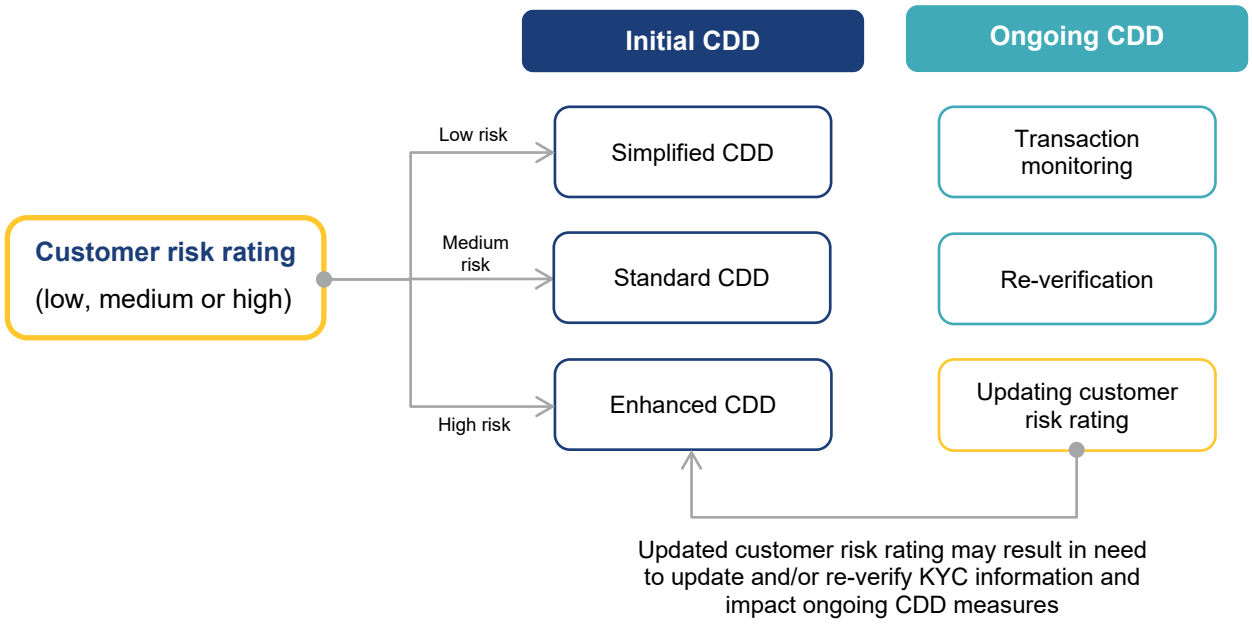
Consultation Paper 1 proposed updates to the CDD regime, including revisiting the "safe harbour" provisions identified in Australia's 2015 FATF Mutual Evaluation as being insufficiently risk-based.

The response of the financial services industry to Consultation Paper 1 was overwhelmingly supportive of updates to the CDD framework and a move away from the prescriptive requirements in Chapter 4 of the AML/CTF Rules. However, some concerns were raised on the proposed imposition of an obligation to risk rate each customer individually.

## What does Consultation Paper 2 propose?

Consultation Paper 2 proposes a significant re-write of the CDD framework. These range from the more superficial (including the removal of the phrase "ACIP") to substantive reframing of the provisions.

Importantly, Consultation Paper 2 is clear that the proposal is to prescribe an obligation to individually risk rate each customer prior to providing the customer with a designated service. Reporting entities would be required to implement a risk rating scale that clearly shows whether a customer is high, medium or low risk. The reporting entity must undertake "Initial CDD" based on the customer risk rating. This would then feed into the ongoing CDD that is undertaken through the customer relationship.



We have described each of the Initial CDD types below.

| CDD type | Overview and impact |
|---|---|
| **Simplified CDD** | The introduction of simplified CDD appears most consistent with the intention of moving away from a prescriptive CDD approach and to a principles-based regulatory regime. Simplified CDD, available only where the customer is "low risk", would provide the reporting entity with discretion to determine what measures should be used and the extent to which the CDD measures should be simplified. |
| **Standard CDD** | Standard CDD would need to be applied where simplified and enhanced CDD do not apply. Consultation Paper 2 states that "*CDD obligations are overly detailed, complex and substantively contained in the Rules despite being a core pillar of the AML/CTF regime*". Notably Consultation Paper 2 states that "*reporting entities may conduct standard CDD in line with requirements set out in the Rules*".<br><br>It is unclear how the approach to CDD where the standard approach is applicable will have a different outcome to what is currently under the AML/CTF Rules. With the recognition of the complexity and prescriptive nature of the CDD requirements, it would be disappointing if this aspect of the reforms was a case of everything old is new again for standard CDD. |
| **Enhanced CDD** | Consistent with current expectations, reporting entities would need to conduct enhanced CDD where the customer is rated as higher risk. This would include some specified relationships. Consultation Paper 2 contemplates that enhanced CDD measures must be applied proportionate to the risk where:<br>• the risk associated with providing the designated service to the customer is high;<br>• there is a suspicion of ML/TF or identify fraud and the reporting entity proposes to continue the business relationship;<br>• the customer or its beneficial owner is a foreign PEP; or<br>• the customer or its beneficial owner is physically present in or is a legal entity formed in, a high-risk jurisdiction for which the FATF has called for enhanced due diligence to be applied. |

# Key considerations in implementing CDD updates

Consultation Paper 2 suggests that the CDD reforms would "*seek to focus on outcomes, with reporting entities being empowered to mitigate, manage and respond to risks in a way that best reflect their unique risks and customers*". While we expect that this intention will be welcome by industry, the proposals potentially have the result of continuing to require a prescriptive framework to be followed.

Key considerations in implementing the CDD updates include the following:

| Implementation consideration | Insights |
|---|---|
| **How will the requirement to undertake customer risk ratings prior to the provision of designated services be operationalised?** | Consultation Paper 2 is clear that a customer risk rating must be attributed to each customer before providing the customer with a designated service. The customer risk rating will then inform what type of Initial CDD must be carried out.<br><br>We would expect that the customer risk rating would take into account factors such as the beneficial owners, politically exposed persons and other information collected about a customer.<br><br>Rule 4.13.1 of the AML/CTF Rules currently allows a reporting entity to determine whether a customer or beneficial owner is a PEP before providing a designated service or as soon as practicable after the designated service has been provided. This means that steps flowing from this determination can also be undertaken at this point.<br><br>If implemented as proposed, any reporting entity that has implemented a process to undertake this screening and these additional steps after the designated service has commenced will need to consider alternative operational measures to meet the requirements.<br><br>This may be an area that industry considers it appropriate to make submissions on allowing flexibility with these requirements, equivalent to the delayed CIP contemplated in Chapter 79 of the AML/CTF Rules. |
| **Incorporating sanctions in CDD processes** | Consultation Paper 2 contemplates that the AUSTRAC CEO could make rules prescribing certain circumstances that would mandate a high risk for certain customer risk ratings. This could include where customers are connected with a country subject to sanctions.<br><br>Consultation Paper 2 would also require that the reporting entity must be reasonably satisfied that it knows that the customer is not the subject of sanctions under Australian sanctions laws.<br><br>These changes are significant as, in our experience, many reporting entities have not expressly contemplated sanctions screening processes as part of their AML/CTF compliance processes. |

# New ‘value transfer’ designated services – EFTIs and designated remittance arrangements to go

Consultation Paper 2’s introduction of the concept of ‘value transfer services’, and collapsing the distinction between electronic funds transfer instructions (or ‘EFTIs’) and designated remittance arrangements, should be welcome – it is a proposal that exemplifies the spirit of modernising and simplifying the regime. We expect that this will be a proposal that is welcomed by financial institutions. The detail of the drafting will be important, including ensuring that the new definition of what amounts to a value transfer service does not introduce new uncertainty in the introduction of “core” and “incidental” concepts.

## Current approach and proposals in Consultation Paper 1

The current framework for the regulation of transfers of value across borders distinguishes between electronic funds transfer instructions (or **EFTIs**), which are undertaken by financial institutions, and remittances by remittance services providers. EFTIs are the focus of designated services 29 and 30. Remittance arrangements are the focus of designated services 31 and 32 and also, in the right circumstances, require the providers of registrable designated remittance services to be registered with AUSTRAC. The registration obligation, as opposed to enrolment, reflects the heighted ML/TF vulnerability associated with remittance services. However, the definition of ‘remittance arrangement’ under the AML/CTF Act has been identified as being framed broadly, causing concern that the concept does not reflect the scope of activities intended to be caught by the regulatory framework, particularly where transfers are incidental to the provision of another service.

Consultation Paper 1 did not propose reform to the designated services relating to EFTIs or remittance arrangements subject to AML/CTF regulation, or the introduction of an overarching concept of ‘value transfer services’ which would also encompass digital assets. However, based on the published submissions, it appears that the Attorney General’s Department has taken note of the concerns that have been raised on response given the opportunity for reform.

## What is proposed in Consultation Paper 2?

Consultation Paper 2 proposes removing the definitions of ‘EFTI’ and ‘designated remittance arrangement’ in sections 8, 9 and 10 of the AML/CTF Act. The concept would be replaced with a streamlined concept of ‘value transfer service’”. This would be a concept that would apply to remittance providers, digital asset service providers and financial institutions.

## Key considerations in implementing the concept of ‘value transfer services’ and changes to the obligations of institutions in the ‘value transfer chain’

| Implementation consideration | Insights |
|---|---|
| **Definition of ‘value transfer services’ and ‘value transfer chain’** | Consultation Paper 2 proposes that the streamlined concept of a ‘value transfer service’ simplifies the current arrangement which identifies four different value transfer services while failing to provide for the transfer of digital assets. The new concept is designed to “*ensure that businesses that do not provide remittance services as part of their core business would not be incidentally captured by the AML/CTF regime*”. The updated concept of a ‘value transfer chain’, which would define the roles of ‘ordering institution’, ‘intermediary institution’ and ‘beneficiary institution’ by reference to their role in the chain, would not apply to “*non-financial institutions that transfer value incidentally, such as entities that provide car fleet management services or other services in which value is passed on behalf of a customer incidentally to another service*”. We expect that this policy position will |

| Implementation consideration | Insights |
|---|---|
| | be welcome by the market however the drafting should be kept under review as the reforms progress. |
| **AUSTRAC oversight of fit and proper persons** | Consultation Paper 2 proposes the introduction of an ability for AUSTRAC to make a 'fit and proper' assessment of key personnel connected with the applicable entity to be registered as a remittance service provider or digital asset service provider.<br><br>Given the proposal that certain remittance service providers and digital asset facility providers will be required to hold an AFSL (see our article here), it would be appropriate that a coordinated approach is taken to these reforms to ensure consistency and avoid duplication of effort. |
| **Introduction of a new limited designated service for intermediary institutions** | While the updated concept of a 'value transfer chain' is intended to simplify the regulatory oversight of payments, Consultation Paper 2 also suggests the introduction of a limited designated service for intermediary institutions that pass on messages in a value transfer chain. At present, businesses that only operate as intermediary institutions are unable to enrol with AUSTRAC (by virtue only of their role as an intermediary) because in those circumstances they do not provide designated services. Under this proposal, the obligations of intermediary institutions would be limited to those related to their role in the funds transfer chain while, recognising that they do not have a direct relationship with either the payer or payee, they would be exempted from other AML/CTF obligations including those relating to CDD for the payer and the payee.<br><br>Consultation Paper 2 proposes to define an 'intermediary institution' as a business which receives and passes on a message on behalf of the ordering institution or beneficiary institution. While it is suggested that this definition would exclude businesses that solely provide the messaging infrastructure through which messages in the value transfer chain are transmitted, the framing of the definition will be important to review. We consider that this is another area where it is appropriate for these AML/CTF reforms to have regard to the proposed scope of the payment service provider reforms. |

# Updates to the travel rule

The reforms proposed to the travel rule focus on bringing the AML/CTF regime into line with FATF standards, increasing the end-to-end transparency of transactions. Although they expand the scope of the obligation to collect, keep, screen and pass on information, the reforms propose some practical exceptions that attempt to mitigate the impact of any additional regulatory burden.

## Current approach and proposals in Consultation Paper 1

The AML/CTF Act contains obligations to pass on information about the origin of the funds to be transferred that are known as the 'travel rule'. Currently, those obligations are limited to financial institutions and only require information about the payer to be passed on with transfer instructions.

Consultation Paper 1 proposed to update the travel rule for financial institutions in line with the FATF Standards by requiring payer information to be verified and extending the obligation to include payee information. It also suggested that the regime should encompass remitters and digital currency exchange providers in order to reduce the risk that Australian businesses are assessed by overseas counterparts as presenting higher ML/TF risks as the travel rule is subject to increasing take up by jurisdictions around the world.

## What is proposed in Consultation Paper 2?

Consultation Paper 2 elaborates upon the reforms that were proposed in the first round of consultation with industry. In particular, the proposed streamlined 'value transfer services' would trigger the travel rule for remittance service providers and digital asset service providers, in addition to financial institutions (as provided by the current regime), for both domestic and cross-border transfers.

Further, Consultation Paper 2 proposes to require information about the payee to be included in value transfer instructions while currently the obligation is confined to information about the origin of the transferred funds.

Although the scope of the travel rule is expanded under the proposed reforms, Consultation Paper 2 also suggests that the full travel rule information would not be required to be included with:

- for domestic value transfers where the ordering institution would be able to provide full information to the beneficiary institution or law enforcement upon request; or
- incoming cross-border value transfers where the full information is unable to be included in the message due to the technical limitations in existing payment systems (most notably the Bulk Electronic Clearing System).

To align with FATF Standards, the travel rule will apply to all digital asset transfers where digital assets are transferred from one financial institution or digital asset service provider to another, without the application of the above exceptions proposed in relation to transfers of money or property.

There is also a focus on reviewing whether the exemptions currently contained in section 67 of the AML/CTF Act should continue to apply. Notably, Consultation Paper 2 suggests that any exemptions from the travel rule would be aligned with exemptions from IFTI reporting, in keeping with the reforms' emphasis on simplifying and streamlining the regulatory regime.

## Key considerations in implementing travel rule updates

As with other aspects of Consultation Paper 2, the detail of the proposed reforms will require careful review to assess their impact on reporting entities' travel rule compliance obligations. Key considerations are as follows:

| Implementation consideration | Insights |
|---|---|
| **Increased scope of the travel rule** | The changes proposed in Consultation Paper 2, if legislated, will increase the regulatory burden on financial institutions in that they require additional steps to be taken to collect, and verify, travel rule information for the payer and also to include information about the payee (for ordering institutions), additional record-keeping and screening to ensure completeness of travel rule information (for all institutions) while retaining existing obligations in relation to passing on the travel rule information (for ordering and intermediary institutions). The reforms seek to ensure that Australia keeps pace with the expectations set by the FATF Standards and avoids negative impacts including potential 'grey-listing'.<br><br>In any case, various accommodations are proposed that may ameliorate the increased regulation. These include allowing an ordering institution with an existing relationship with a payer to simply include the travel rule information in the value transfer; ie, not requiring information about the payer to be re-collected and re-verified. They also include the exceptions to the requirement to include full travel rule information mentioned above. Close review of the detail of these proposed exceptions will be needed in order to accurately operationalise the requirements. |
| **Systems and controls to address the 'sunrise issue'** | It is proposed that beneficiary institutions (and also remittance providers and digital asset service providers), when receiving a value transfer from a country that has not implemented the travel rule and may therefore be faced with missing or incorrect travel rule information (this is known as the 'sunrise issue'), will need to take a risk-based approach to determining whether to make value available to the payee.<br><br>As with other proposed reforms, the detail of what would constitute a sufficient risk-based approach, and the design of appropriate systems and controls for the conduct of such assessments, will be issues that will require further scrutiny as the reforms progress. |
| **New ambit to include digital asset transfers and remittances** | Consultation Paper 2 contemplates that full travel rule obligations would apply to all digital asset transfers, save for one important qualification relating to transfer of digital assets to a self-hosted wallet. In those circumstances, the financial institution or digital asset service provider would be required to collect, and keep records of, travel rule information from their own customer, but there would be no requirement to transmit, receive or screen for missing travel rule information.<br><br>Where the paper refers to the need for the financial institution or digital asset service provider to "*undertake counterparty due diligence*" in relation to the destination custodial wallet, it will be critical for the legislated reforms to make it very clear what that would entail. Otherwise, it may be difficult for financial institutions and digital asset service providers to satisfy the limited travel rule obligation that is proposed for value transfers to self-hosted digital wallets.<br><br>Another issue that is yet to be clearly addressed as part of the travel rule reforms is whether the travel rule will extend to providers of foreign exchange or gambling services (which are not remittance service providers) where there is an incidental value transfer. This question is one of the matters that Consultation Paper 2 raises expressly for submissions from industry. In light of the paper's emphasis on simplification and consistency, it seems likely that the travel rule will be updated to apply in those circumstances, consistent with the proposal that such incidental value transfers will be subject to IFTI reporting obligations, as addressed below. |

# International funds transfer instructions (IFTI) re-write

The regulatory regime in the AML/CTF Act for the reporting of IFTIs is complex and does not necessarily serve the information gathering purpose it is designed to address. In a move that we expect will be welcome by industry, the IFTI reporting regime is proposed to be streamlined with a new focus on the movement of value rather than instructions, and a change in the entity in the value transfer chain subject to the IFTI reporting obligation.

## Current approach and proposals in Consultation Paper 1

The AML/CTF Act contains reporting obligations attaching to international funds transfer instructions (**IFTIs**). If a person sends the 'instruction' out of Australia or receives an instruction into Australia the reporting obligation applies. IFTI reporting obligations attach to financial institutions as well as those involved in designated remittance arrangements, though the 'sender' and the 'receiver' of an IFTI are not defined by reference to those institutions.

As well as the Act being complex and difficult to navigate, it has not kept step with the emergence of new payment services and innovative technologies. In recent years, AUSTRAC has engaged with the industry in respect of proposed draft guidance to the IFTI regime. While the draft guidance was not finalised, the consultation process created debate in respect of the industry's approach to IFTIs and AUSTRAC's expectations.

While Consultation Paper 1 flagged that the Attorney General's Department was considering streamlining IFTI reporting requirements, it did not go into detail on this focus area. However, the compliance burden associated with IFTIs is an issue that financial institutions are well aware of and the issue formed the basis of numerous submissions to Consultation Paper 1. This included a focus on ensuring that the regime is simplified and that reporting obligations are triggered by transfers, rather than instructions.

## What is proposed in Consultation Paper 2?

According to Consultation Paper 2, the data from IFTIs makes up 98% of AUSTRAC's intelligence. They are therefore a key part of AUSTRAC's capability in identifying ML and TF activity and taking action accordingly. Consultation Paper 2 does not step away from the importance of this data. However, it recognises that the regulatory regime itself is outdated, increasingly complex and not reflective of modern payment arrangements.

Consultation Paper 2 proposes focusing on the movement of value, rather than the movement of instructions. Unlike the current reporting obligation, which is imposed on the sender of the IFTI out of Australia (which may not necessarily be the ordering institution) and the receiver of the IFTI into Australia (which may not necessarily be the beneficiary institution), under the proposed reforms the reporting obligation would be triggered by:

- an ordering institution initiating a transfer of value under an instruction by a payer; and
- a beneficiary institution making the transferred value available to the payee.

The distinction between IFTIs constituted by cross-border EFTIs ('IFTI-Es') and IFTIs under cross-border designated remittance arrangements ('IFTI-DRAs') would be collapsed under the reforms addressed above in relation to the introduction of the concept of 'value transfer services'. This would also mean the replacement of the current framework, where different information is reported in different formats leading to complexity and inconsistency, with a single, streamlined report. In addition, the IFTI reporting obligation would be extended to transfers of digital assets.

## Key considerations in implementing IFTI reforms

As with Consultation Paper 2 more generally, the detail will be important in identifying the impact of the updated IFTI reporting regime. Key considerations are set out below.

| Implementation consideration | Insights |
|---|---|
| **Reporting obligation to fall on Australian institution closest to the customer** | Consultation Paper 2 proposes to shift the IFTI reporting obligation from the 'last out' institution (or 'sender') to the ordering institution, and from the 'first in' institution (or 'receiver') to the beneficiary institution, i.e. in each case the institution with the closest relationship with the payer or payee. This represents a significant change to the IFTI reporting framework and has the potential to resolve many of the issues that have plagued the process of reporting, particularly in respect of data quality where, for example, the receiver of an IFTI into Australia can be constrained in the information it is able to report about the payee when that person is not its customer.<br><br>As the proposed reform would impose a new regulatory compliance burden on smaller businesses which have until now relied on correspondent banks or remittance network providers to submit IFTI reports, Consultation Paper 2 proposes to allow such businesses to continue to rely on their larger counterparts in the value transfer chain with developed infrastructure for IFTI reporting to submit reports on their behalf. This reliance would be subject to the initiating or receiving institution having in place appropriate policies, systems and controls to ensure the accuracy and completeness of IFTI reports, and a due diligence defence would be available. The detail of the reforms in respect of how the smaller business and the intermediary institutions work together to ensure that the intermediary institution to which the IFTI reporting obligation is delegated is given the information it needs to submit an accurate and complete IFTI report will need to be closely reviewed. |
| **Trigger for reporting to change from the transfer of an instruction to the transfer of value** | Consultation Paper 2 proposes another significant change in the IFTI reporting framework in shifting the focus from the transfer of instructions to the transfer of value. The current regime, which invokes an IFTI reporting obligation whenever an instruction is transferred on the basis that the transferred money "is, *or is to be*" made available in another jurisdiction, has given rise to much confusion, for example in circumstances when an instruction is subsequently aborted, or cancelled, before the funds have been transferred. Debate has arisen as to whether an IFTI report that has already been submitted should be withdrawn or whether multiple reports should be submitted that relate to the same transaction. Now, there will only be an obligation to report when an ordering institution has initiated the process of transferring value in accordance with an instruction, or when a beneficiary institution has made the transferred value available to its customer. For reporting entities that have needed to commit considerable resources to manual and time-consuming processes in order to comply with their obligation to submit timely, accurate and complete data in their IFTI reports, this will be a welcome change.<br><br>One thing to monitor as the proposed reforms are legislated will be what constitutes 'initiating' the transfer of value, as that question has the potential to give rise to regulatory uncertainty. |
| **Explicit IFTI reporting obligation to apply to certain incidental remittances** | As described above, Consultation Paper 2 proposes to remove the concept of a 'designated remittance arrangement' from the Act, replacing it with an overarching concept of a 'value transfer service' that would apply to remittance providers, digital asset service providers and financial institutions alike. The current definition of 'designated remittance arrangement' is so broad that it arguably captures transfers of money or property that are incidental to provision of another service, leading to significant, and unintended, regulatory burden.<br><br>Although the reforms broadly propose to confine the IFTI reporting obligation to remittance service providers, Consultation Paper 2 contemplates that certain |

| Implementation consideration | Insights |
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| | 'incidental' remittances should continue to be caught by the IFTI reporting requirements due to the higher ML/TF risks associated with them. Specifically, Consultation Paper 2 refers to foreign currency conversion services or gambling services where there is a relevant transfer into or out of Australia in connection with these services.<br><br>Care will need to be taken to ensure that the reforms to IFTI reporting in respect of the provision of incidental remittance services is done in a manner that is consistent with addressing the uncertainty associated with the current regulatory approach. |

# ‘Tipping off’ reforms

The ‘tipping off’ reforms will be welcomed by reporting entities who currently face many practical difficulties when applying and seeking to navigate the existing regime. However, the extent of relief from the proposed amendments will depend on whether, and if so how, the Government seeks to address other closely related issues, crucial mention and details of which remain missing from Consultation Paper 2.

## Current approach and proposals in Consultation Paper 1

Broadly speaking, the current ‘tipping off’ prohibition contained in section 123 of the AML/CTF Act makes it an offence, subject to limited statutory exceptions, to disclose to someone other than AUSTRAC, that a SMR or a response to a section 49 Notice has been submitted (or is required to be submitted), or to disclose any information from which this could reasonably be inferred.

Consultation Paper 1 proposed amending the way the offence operated to one that is ‘outcomes-focused’, rather than prescriptive. That is to say, it would instead make it an offence to disclose where there is conduct or an intention to compromise a law enforcement investigation. This would be more akin to the approach taken in the UK and Canada. Such an approach was expressed as better supporting industry compliance with AML/CTF obligations, while also reducing the burden on AUSTRAC caused by the increasing number of requests, through the mechanism provided by section 248 of the AML/CTF Act, for an exemption from the offence.

## What is proposed in Consultation Paper 2?

Consultation Paper 2 provides further detail on how this ‘outcomes-focused’ mechanism will likely operate and suggests it will focus on preventing the disclosure of information where it is “likely to prejudice an investigation or potential investigation”.

The updated paper also indicates that:

- the amendments would permit the disclosure of such information for “legitimate” purposes, which would include sharing within business groups to manage and mitigate risks in accordance with the controls and processes outlined in a group’s AML/CTF program;
- in addition to intentional and reckless disclosures, negligent disclosures would also be an offence and would include situations where reporting entities fail to develop, implement or maintain adequate measures to prevent that occurring;
- the offence would apply to reporting entities, officers, employees and agents of reporting entities, and anyone else required to give information or documents in response to a section 49 Notice;
- reporting entities would be subject to a positive duty to adopt controls and processes to prevent improper disclosures; and
- the Government’s desire is that, in the future, the reframed offence may ultimately help facilitate private-to-private information sharing, subject to appropriate protections.

## Key considerations with the tipping off amendments

| Implementation consideration | Insights |
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| **Uncertainty in proposed scope and definitions** | While the reframed offence is better aligned to the underlying policy goals, and should alleviate AUSTRAC's own administrative burden, the updated paper leaves unanswered important questions about how the new offence is to apply in practice. For example, it neither outlines what may fall within the definition of "SMR information", nor whether information from which there is a "reasonable inference" that a suspicious matter reporting obligation has arisen, will continue to be captured.<br><br>In practice, it is the obligation not to disclose information from which a suspicion can be inferred that is particularly fraught with potential risks, and can hinder reporting entities in seeking to end relationships with customers or employees as well as in defending the positions they have taken when private action is brought against them. As a result, a large degree of uncertainty may remain for reporting entities, particularly from difficulties with interpreting and applying the relevant elements of the offence in practice. |
| **Interaction with section 235 of the AML/CTF Act** | A related issue is the interplay between the 'tipping off' offence and the defence from liability provided by section 235 of the AML/CTF Act. That defence provides, broadly speaking, that an action, suit or proceeding "does not lie" against a person for something done or omitted to be done in good faith where that occurs in compliance or purported compliance with requirements under the AML/CTF Act, Rules or regulations. In practice, reporting entities wishing to rely on this defence will be hindered by the inference limb of section 123, which in turn requires an AUSTRAC exemption to be obtained. |

These challenges may be alleviated by the 'outcomes focussed' proposed amendments, but this will depend on precise drafting. For example, it would be helpful if 'legitimate purposes' for disclosure expressly included the purposes of (a) understanding and managing ML/TF risk and (b) mounting a defence in civil proceedings. It will also be important for legitimate *purposes* to permit disclosure notwithstanding that the disclosure may have unintended prejudicial *effects*.

# Assisting an investigation of a serious offence

This reform focuses primarily on the easing of AUSTRAC's administrative burden, albeit reporting entities will benefit from the proposed clarification that CDD need not occur where there is a reasonable belief that it would tip off the customer. It is hoped that the Government provides future guidance on how this change will interact with the reframed 'tipping off' offence to ensure that unintended consequences do not arise for reporting entities.

## Current approach and proposals in Consultation Paper 1

Currently, following the formation of a suspicion for the purposes of section 41 of the AML/CTF Act, reporting entities are required to undertake enhanced customer due diligence which may compel them to consider, and seek senior management approval for, maintaining a business relationship with the relevant customer and whether to continue to provide a designated service to them. However, any decision by the reporting entity to terminate the relationship or stop providing the designated service, may be detrimental to law enforcement agencies who could benefit from the relationship / service continuing in order to gather greater evidence of the underlying misconduct.

To address this, and to ensure that the carrying out by the reporting entity of other obligations imposed upon them under the regime (such as customer due diligence) does not 'tip off' the customer to the criminal investigation, there is a mechanism provided under the current Chapter 75 of the AML/CTF Rules. This provides for a process by which law enforcement may seek and obtain certain exemptions from AUSTRAC to enable a reporting entity to continue providing a designated service where that would assist the agency's investigation of a serious offence.

Given the volume of these Chapter 75 exemption requests received by AUSTRAC, Consultation Paper 1 proposed streamlining the operation of the current mechanism by amending it so that eligible agencies could themselves issue a 'keep open notice directly to reporting entities (but copied to AUSTRAC)', and which would consequently act as a relevant exemption for reporting entities. This would be available where the reporting entity held a "reasonable belief that" otherwise complying with the relevant AML/CTF obligation would alert the customer the existence of the criminal investigation.

## What is proposed in Consultation Paper 2?

Consultation Paper 2 continues with, and builds further upon, the earlier proposal. It specifies that the 'keep open notice' could only be issued where "a senior delegate" of the relevant agency believes that maintaining the provision of the designated service would assist the investigation of a serious offence. The updated paper also elaborates that reporting entities would not in these circumstances be exempt from the requirement to undertake other customer due diligence measures where they can be carried out without alerting the customer.

It also clarifies that:

- receipt of a 'keep open notice' would not *compel* the reporting entity to continue providing the designated services to the customer and that it would only operate as a safe-harbour from liability if it continues to provide the service;
- reporting entities would not have to file a SMR merely due to the receipt of a 'keep open notice' (although if they separately form their own suspicion their obligation to lodge an SMR remains unchanged);
- one of the proposed changes to the existing regime will be to outline expressly that customer due diligence need not be undertaken where a reporting entity reasonably believes that doing so would 'tip off' the customer; and
- the form of the 'keep open notice' would be outlined in the Rules, AUSTRAC will have the power to revoke such notices where they are considered to be invalid or non-compliant with the AML/CTF Act or Rules, and notices would be valid for 6 months, albeit able to be extended up to two time for a total period of 18 months (or more with approval from AUSTRAC).

## Key considerations with these changes

Given the similarities between the current and proposed mechanism, reporting entities should already be familiar with, and developed processes for, these scenarios. However, it is currently unclear how this proposed change will interact with the suggested reframing of the 'tipping off' offence under section 123 of the AML/CTF Act.

It remains to be seen, for example, whether a reporting entity will be told by the relevant law enforcement agency that the expiry or withdrawal of any 'keep open notice' will entitle the relationship to be terminated or service provision ended, and that doing so will no longer likely prejudice an investigation or potential investigation. If the reporting entity will not be told about this, it is not obvious that the reporting entity would be entitled to make that presumption (and it may understandably have difficulty in making the relevant assessment itself in these circumstances).

# Bearer negotiable instruments

## Current approach and proposals in Consultation Paper 1

The AML/CTF Act provides that a person commits an offence if they move one or more monetary instruments with a value of $10,000 or more into or out of Australia without reporting this to AUSTRAC. Monetary instruments includes bearer negotiable instruments (**BNI**) and the definition of BNI includes "a cheque".

This has caused a significant compliance burden as, while "cheque" is included in the definition of BNI, that does not appear to be limited to cheques in bearer form. Accordingly, the definition has wide application to all cheque types requiring any person sending a cheque outside of Australia with a value of $10,000 or more to implement a process to report this to AUSTRAC in accordance with the AML/CTF Act.

Like IFTIs, the issue was flagged in Consultation Paper 1 but was not expanded upon.

## What is proposed in Consultation Paper 2?

The definition of BNI is proposed to be updated to clarify that only truly bearer negotiable instruments will be in scope – named and crossed cheques would not need to be reported as BNIs.

## Key considerations in implementing updated definition of BNI

We expect that this reform will be supported across the industry, which has been endeavouring to comply with reporting obligations outside the apparent policy purpose of the BNI regime.

# What is not included in Consultation Paper 2?

As reflected in the large number of submissions, Consultation Paper 1 generated enormous interest in the modernisation and simplification of Australia's AML/CTF regime. While Consultation Paper 1 looked at specific issues, submissions from industry took the opportunity to highlight more general areas that would benefit from review and update as part of the reform. Areas that Consultation Paper 2 has not picked up include:

- Reforming the concept of designated services – designated services will remain and will be added to as part of the proposed reforms.
- Reliance arrangements have not been contemplated as an area that will be reformed, although the ability to implement reliance arrangements has been flagged as part of the CDD measures that real estate agents may leverage.
- Submissions focussed on the need to ensure record-keeping obligations under the AML/CTF regime are implemented consistently with privacy policy objectives and cybersecurity reforms. Privacy considerations are briefly mentioned in Consultation Paper 2 but not extensively.
- In addition to the tipping off considerations outlined above, industry has also been concerned with the ability to make a determination that it is appropriate to terminate a customer relationship without exposure to liability from that customer (other than by way of the defence under section 235 of the AML/CTF Act). See our article here. While industry has submitted for protection in these scenarios, this has not been expressly addressed in Consultation Paper 2.

# What can we expect on timing and next steps?

The opportunity to provide submissions on Consultation Paper 2 close on Thursday 13 June 2024.

The proposed reforms under Consultation Paper 2 are significant and wide ranging. They will require the AML/CTF Rules to be repealed and replaced and substantial updates will need to be made the AML/CTF Act. AUSTRAC is also expected to release targeted guidance material. There is much to be done.

For reforms to be enacted in the current Government's parliamentary term, we expect that exposure legislation will need to be released by the end of this year. There is much to do between now and then. However, the release of Consultation Paper 2 and the Attorney General's engagement with industry to date suggests that there is momentum to meet the challenge.

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