

THE
INVESTMENT
ASSOCIATION

MARKET PRACTICE PAPER REAL ESTATE TRANSACTIONS AND AML PRACTICE

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ABOUT THE INVESTMENT ASSOCIATION (IA):

The Investment Association is the trade body that represents the interests of UK investment managers. Our 250 full members manage in excess of £8.8 trillion of assets and the investment management industry supports 126,400 jobs across the UK.

Just under half of total assets managed in the UK are for overseas customers, making us a leading global centre for our industry.

The IA network lets our members share strategic thinking about the future of the investment management industry, especially as we embark on significant change in European and international trade. The investment Association ensures that our industry's voice is heard at both national and international level.

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PURPOSE

This document has been prepared for the benefit of the Investment Association's membership, thereby covering a wide range of firm types and sizes. It is intended to inform, rather than prescribe. It is not binding, nor is it intended to be exhaustive, and firms will need to consider its application having regard to the nature, size and complexity of their business. Firms should also consider taking a risk based approach to the issues raised.

This market practice paper is intended to provide a comprehensive guide to anti-money laundering (AML) practices in real estate transactions. It aims to inform investment managers about the financial crime risks associated with managing real estate and offers guidance on due diligence processes for various parties involved in such transactions. It covers the following essential areas:

1. The potential for money laundering within the real estate sector, outlining the risks arising from geographic, customer, and transactional factors.
2. Conducting customer due diligence (CDD) for purchasers, vendors and other counterparties, including tenants and auction participants.
3. Addressing the specific financial crime risks in infrastructure investment and the importance of understanding ownership structures.



INTRODUCTION

The management of real estate by investment management firms is widely perceived to be one of the higher financial crime risks faced by firms. The impact of money laundering in the property sector is far reaching, with possible implications across many financial crime risks. As the *Financial Action Task Force's (FATF) new Guidance paper* on the risk-based approach to the real estate sector notes, real estate as an asset creates the ideal conditions for the movement of large amounts of funds, across different jurisdictions.

Risks, in this context, can arise from a combination of Geographic Risk, Customer Risk (including any additional parties to a transaction and any underlying beneficial owners) and Transactional Risk (including the methods of financing and delivery channels).

Property can attract criminals for many reasons; it is widely available, can give illegitimate transactions legitimacy and provide avenues to conceal large sums of illicit funds, either through purchases and sales or rental income. Further, property prices tend to remain fairly stable and appreciate over time, during which money can be generated by leasing out the property.

It is noted that the JMLSG Guidance has only two paragraphs on real estate, in Chapter 9 of Part II, on 'Discretionary and advisory investment management':

9.39 Some portfolios will include direct holdings in real assets. Unlike securities, the counterparties¹ involved in the purchase and sale of direct holdings may not be other regulated financial institutions. Those purchases and sales will often involve special purpose vehicles, and in some cases will be owned via trusts and a wide variety of structures in a wide variety of jurisdictions which by their nature may increase the risk of coming into contact with the proceeds of crime.*

Some portfolios will make direct investments in construction and development projects. The nature of these projects, and especially the risks of fraud, bribery and corruption and tax evasion may also increase the likelihood of coming into contact with the proceeds of crime.

40 The counterparty(s) would not normally be regarded as a customer of the investment firm and consequently the firm would not be obliged to verify the identity of the counterparty(s) itself. Nevertheless, and as part of their risk-based approach, the investment firm may take account of the risk profile of the transaction and of the counterparty(s) involved. This may include reviewing the nature of the transaction, ascertaining the counterparty's legal form (taking into account the jurisdiction in which the counterparty(s) is based and whether or not it is a regulated financial institution within another equivalently regulated jurisdiction), checking for adverse information, PEPs and sanctions-related screening (prior to execution and thereafter on an ongoing basis).

** Note: Real assets is an investment asset class that covers investments in physical assets such as real estate, energy, and infrastructure.*

Many Government bodies hold property, or engage in lending and supporting the property market, creating political involvement (e.g. National Asset Management Agency (**NAMA**) in Ireland). Conflicts of interest arise from the relationship between: partners and investors in real estate; banks or similar entities set up to hold bad debt; and planning authorities. There are also Gifts and Hospitality (G&H) and inducements issues. As noted in the JMLSG Guidance, while some firms are regulated, many of the counterparties they interact with are not regulated by the FCA. Property deals also often involve multi-million pound deals and SPVs.

It should be noted that the Money Laundering Regulations 2017 are silent in relation to real estate transactions by funds. They do, however, apply to financial institutions and legal professionals (as well as to estate agents and letting agents) acting 'in the course of business'. They also apply to solicitors when participating in real estate transactions.

¹ The term counterparty(s) reflects the involvement of other third parties in the sale or purchase of a piece of real estate e.g., chartered surveyors, agents etc. and should not be confused with the purchaser or vendor of the real estate who will be considered the customer of the investment management firm either as part of an ongoing business relationship or via an occasional transaction.

IDENTIFICATION OF PURCHASER AND VENDOR

The purchaser or vendor will have a relationship with the firm, with the nature of this relationship being determined by whether the purchaser or vendor has an existing business relationship with that firm (in which case ongoing monitoring obligations will already apply to that business relationship). Where no such existing business relationship exists, the purchaser or vendor must be subject to customer due diligence (CDD) measures as the transaction will be considered an occasional transaction under Regulation 27(1)(b) of MLR 2017.

For business relationships or occasional transactions with non-UK entity(s) that involve the purchase, sale or transfer of physical UK land or property (e.g., within a real estate fund), investment management firms must obtain an excerpt of the Register of Overseas Entities from UK Companies House (MLR 30A(f)). Should the investment management firm identify a material discrepancy between the beneficial ownership information collected as part of its CDD process and the registrable beneficial ownership information held at UK Companies House, the discrepancy must be reported to UK Companies House as soon as possible.

PURCHASER

Purchasers include individuals, private companies (including trusts), regulated entities, funds. An example would be where a fund is selling a real estate property from a portfolio owned on behalf of a client to a third party.

When dealing with purchasers, firms should consider the following:

- Regulations apply directly to transactions with purchasers, such as: MLR s27(2) which requires that a relevant person must apply CDD measures if they carry out an occasional transaction that amounts to 15,000 euros or more.
- CDD must be completed to an appropriate level, based on the risk of financial crime.
- Other issues specific to the transaction should be taken into account by the firm, e.g. criminal allegations regarding the purchaser found via open-source searches.
- Identification and mitigation of specific financial crime risks by way of appropriate CDD covering source of wealth, source of funds, transparency/complex ownership structures, adverse media, high risk jurisdictions, sanctions, presence of PEPs, etc.

VENDOR

The vendor is the person selling the real estate to an investment firm.

When dealing with vendors, firms should consider the following:

- General MLR obligations that apply to any customer transaction.
- Other specific issues, e.g., criminal allegations regarding the vendor found via open-source searches.
- Completion of CDD proportionate to the level of financial crime risk.
- Identification of any specific financial crime risks, such as lack of transparency, complex ownership structures, adverse media, high risk jurisdictions, sanctions, presence of PEPs, etc.

OTHER COUNTERPARTIES

The term counterparty(s) reflects the involvement of other third parties in the sale or purchase of a piece of real estate e.g., chartered surveyors, agents etc. and should not be confused with the purchaser or vendor of the real estate. While the purchaser or vendor will be considered the customer of the investment management firm, either as part of an ongoing business relationship or via an occasional transaction, other counterparties are unlikely to be customers of the firm. Firms should consider the degree to which they need to:

- Understand the role of these various parties in the real estate transaction (including if they have control over any flow of money).
- Understand whether the counterparty is involved on a one-off basis or whether it will be ongoing after completion of the transaction.
- Ensure that any agreed payment to these counterparties is aligned with the market rate and fully documented via a contract/legal agreement.
- Ensure that adequate financial crime clauses are included in any legal agreement to hold the relevant parties accountable for providing all required information to allow for the completion of due diligence requirements, which may include payment screening against applicable sanctions lists.
- Complete due diligence proportionate to the level of financial crime risk. For on-going relationships, this shall include on-going due diligence at defined intervals.
- Assess specific financial crime risks, such as lack of transparency, complex ownership structures, adverse media, high risk jurisdictions, sanctions, presence of PEPs, etc.

TENANTS

- Firms should consider whether they should complete due diligence on the tenants (and guarantors, if any exist) proportionate to the level of financial crime risk and in line with the financial thresholds. MLR s27(7A) requires that letting agents conduct CDD on both parties to all tenancy agreements longer than one month, with a monthly rental value exceeding 10,000 EUR.
- For properties with existing tenants, firms should assess any CDD undertaken by the current landlord.
- Firms may wish to consider completing due diligence on property managers.
- Ensuring that there is a legal agreement/contract in place between the tenant/landlord and landlord/property manager (which includes financial crime clauses and what the obligations of each party are).
- Unless a letting agent or real estate broker confirms that they perform the screening of the tenants, firms may wish to screen any tenants representing a substantial rental revenue (e.g. 25% of the total rental revenue for low/medium risk – 10% for the high-risk cases)
- The financial crime risk of a tenant relationship is not just onboarding them, but monitoring what it is they do with the property and how they generate the income to pay for the tenancy agreement.
- Identification and appropriate escalation of suspicious activity is a regulatory requirement (MLR s21(5) and POCA s330).

AUCTIONS

Firms should consider the following, on a risk based approach:

- Completion of due diligence (on the auction house or auctioneer) proportionate to the level of financial crime risk.
- Ensuring that there is a legal agreement or contract in place between the buyer/seller and the auctioneer, which includes suitable financial crime clauses and what the obligations of each party are – including that the transaction is not final until all involved parties are satisfied with the level of due diligence completed and that this doesn't put them at unnecessary risk of financial crime.

INFRASTRUCTURE

Investment transactions to build infrastructure, or lending to fund the building of infrastructure, should take into account the risks associated with the construction industry. Specifications, tendering arrangements, architects' instructions, specialists' reports, stock and payments can all be manipulated for the purposes of fraud. The high level of regulation and approvals required, also make this an area where bribery and corruption can occur regularly.

Many Infrastructure projects have public sector involvement. This can help to reduce financial crime risk as public authorities and public officials, and the nature and purpose of their business are straightforward to identify and verify. On the other hand, dealing with public authorities means a higher likelihood of dealing with entities under the control of politically exposed persons (PEPs) and therefore, a greater risk of public sector corruption when dealing with public authorities in high risk jurisdictions with opaque anti-corruption regimes, and being used as vehicles for the laundering of proceeds of crime, and therefore a need to ensure that public funds are being used correctly. Dealing with State-Owned Companies (SOCs) based in higher risk jurisdictions can pose similar risks as dealing with PEPs.

Infrastructure projects can make use of special purpose vehicles with complex ownership structures. Although there are often good reasons for this, it is important to understand the ownership structure right back to the ultimate beneficial owner. SPVs, trusts and foundations are often necessary investment vehicles, but they are not transparent: this means that they can be abused to hide the true identity of the owner and the origin of their money.

Some infrastructure investment transactions are one-off purchases and/or sales of companies or debt. CDD should be carried out on the vendor/purchaser as it is incumbent on firms to ensure that they do not accept the proceeds of crime as payment for an asset, but also do not purchase an asset that was obtained by the vendor with proceeds of crime.

One of the strategies used is to bring co-investors into transactions alongside the internal client. It is important that co-investors are subject to due diligence as per a counterparty, to ensure the firm understands who it is dealing with. Completing risk based CDD on investors is normally the responsibility of business development teams, however, in some instances, infrastructure investment teams may be involved in the process.

The different types of infrastructure investments that firms manage raise different levels of inherent financial crime risk, which depend on the type of relationships with the investment:

- In one-off purchases and sales, whether for equity or secondary debt investments, CDD on the vendor or the purchaser, i.e. "One-off counterparty" and their beneficial owners should be performed.
- In longer term relationships, e.g. with borrowers, tenants, or other providers of income, risk based ongoing monitoring obligations should be undertaken.
- Risk-based financial crime due diligence is also performed on service suppliers, contractors, developers and other suppliers, "Third Parties", which are contracting, on a one-off or on-going basis, with the firm-managed infrastructure entities.



Counterparties parties with which there is a one-off or ongoing contractual relationship to the ownership of the investment asset, and the long term income from the asset	Examples
One-off Counterparties	Vendors, like banks or project developers Purchasers
On-going Counterparties	Borrowers Tenants ² Companies invested in, but not controlled by, the firm Co-investors – joint owners or partners in investment transactions
Third Parties other parties for which there is a contractual relationship in relation to the investment	Examples
Construction management and EPC contractors	On-going equipment Suppliers
Operations and Maintenance providers	Manufacturers
Project Managers, Asset Managers	Advisers or Consultants
Insurance service providers	Accountant, administration services, Depositories

The firm should review the Initial Consideration Form and other information and will need to establish all relationships on which due diligence will be required and these will include the following as appropriate:

- One-off counterparties
- Long term counterparty
- Third Parties

² Firms' responsibilities will depend on how they are arranged. The tenant relationship may be managed by an agent, with whom firms will have a vendor relationship. Estate Agents are now subject to the MLRs, and firms may wish to ensure that they are aware of their obligations.

ANNEX

SOURCES THAT MAY BE USEFUL

- MLRs: *The Money Laundering, Terrorist Financing and Transfer of Funds (Information on the Payer) Regulations 2017*
- *Economic Crime (Transparency and Enforcement) Act 2022*
- POCA – *Proceeds of Crime Act 2002*
- FCA *Rules* – particularly the *Financial Crime Guide* and the *Financial Crime Thematic Reviews*
- JMLSG *Guidance*
- HMRC Guidance designed for estate agency and property-related businesses: *AML Supervision for Estate Agency and Letting Agency Business*: <https://www.gov.uk/government/publications/money-laundering-regulations-2007-supervision-of-estate-agency-businesses>
- RICS *reminder* to members and firms
- NECC Understanding how the property market is used to facilitate money laundering – April 2023
- Kroll – *AML Due Diligence*
- Dun & Bradstreet: *Regulatory Compliance and Financial Crime*
- ICIJ – *Offshore Leaks Database*, includes the Panama Papers, Pandora Paper, Paradise Papers etc.
- AREF position paper on the use of non-UK domiciles for funds – AREF members only
- FATF
 - *Recommendations* – particularly referenced in Recommendation 22(b), (d)
 - *Report on* Money Laundering and Terrorist Financing Through the Real Estate Sector (2007)
 - *Risk-based Approach Guidance* for the Real Estate Sector (2022).
- SRA *fine of a Solicitor for AML failings* in three real estate transactions, all involving a property investment company.



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