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BY EMAIL:

Attention Kirsty Campbell

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Dear Kirsty

Practical implications of Factsheet on Managing Intermediaries feedback

Introduction

1. We refer to FMA's Consultation Paper dated 11 July 2013 seeking comments on the draft Factsheet on Managing Intermediaries (the **Draft Factsheet**). We support clear guidance on the treatment of beneficial owners and managing intermediaries and we appreciate the opportunity to comment.

Summary

2. In summary, our submissions are as follows:
 - (a) The definition of "beneficial owner" at section 5 of the Anti-Money Laundering and Countering Financing of Terrorism Act 2009 (**AML/CFT Act**) as a "person on whose behalf a transaction is conducted" should be read to require a relationship of control or agency between the beneficial owner and the customer. We consider the broader interpretation taken in the Draft Factsheet is not legally correct, does not align with the policy behind the AML/CFT Act and will give rise to practical difficulties.
 - (b) Suggested solutions to the problems created by the wide interpretation of "beneficial owner" in the Draft Factsheet and the requirement to conduct customer due diligence (**CDD**) on all beneficial owners of a customer are:
 - (i) to revise the Draft Factsheet so that the phrase "person on whose behalf a transaction is conducted" requires that person to be able to exercise direction or control over a customer; and
 - (ii) to confirm that the treatment of participatory securities is comparable to the treatment of debt and equity securities outlined at paragraph 24 of the Draft Factsheet; and
 - (iii) to amend section 33 of the AML/CFT Act to enable reliance without the prospect of liability by one reporting entity under the AML/CFT Act on the

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CDD of another and to allow CDD undertaken under section 33 to be performed by an entity from another jurisdiction where that entity is compliant with an AML/CFT regime which is FATF-compliant; and

- (iv) as an interim measure (given the complications associated with amending legislation) to amend regulation 24 of the Anti-Money Laundering and Countering Financing of Terrorism (Exemptions) Regulations 2011 (**Exemptions Regulations**) so that CDD does not need to be conducted on the beneficial owners of foreign entities which are compliant with FATF-compliant AML/CFT regimes.

Explanation

3. ***The definition of “beneficial owner” at section 5 of the Anti-Money Laundering and Countering Financing of Terrorism Act 2009 (AML/CFT Act) as a “person on whose behalf a transaction is conducted” should be read to require a relationship of control or agency between the beneficial owner and the customer. We consider the broader interpretation taken in the Draft Factsheet is not legally correct, does not align with the policy behind the AML/CFT Act and will give rise to practical difficulties.***

3.1 “Beneficial owner” is defined in the AML/CFT Act to mean an individual who:

- (a) has effective control of a customer or person on whose behalf a transaction is conducted; or
- (b) owns a prescribed threshold of the customer or person on whose behalf a transaction is conducted.

3.2 The Draft Factsheet states that “it is...possible for a person to be acting on behalf of another person without an agency relationship” and that an underlying client will be a “person on whose behalf a transaction is conducted” whether or not the underlying client has any direct rights or control over any part of the transaction conducted by the managing intermediary. The Draft Factsheet recommends looking at whether the underlying client participates in the risks and/or benefits of a managing intermediary’s transactions.

3.3 In our view, the approach taken in the Draft Factsheet to the phrase “person on whose behalf a transaction is conducted” is too broad. We do not consider it appropriate to equate beneficial ownership with benefit, i.e. to suggest that if a person stands to benefit from a transaction they will, probably, be a beneficial owner for the purposes of the AML/CFT Act. We are of the view that the proper construction of the phrase “person on whose behalf a transaction is conducted” requires a relationship of control or agency. In our view this approach would achieve the following:

- (a) efficiency for reporting entities by avoiding duplication of CDD or multiple monitoring;
- (b) consistency with the FATF Recommendations;
- (c) consistency with the Wolfsberg principles; and
- (d) consistency with the case law; and
- (e) internal consistency in the AML/CFT Act.

Efficiency for reporting entities by avoiding duplication of CDD or multiple monitoring

- 3.4 The consequences of extending the meaning of “person on whose behalf a transaction is conducted” are likely to be wide ranging. Subject to our comments below on the appropriate obligations where one reporting entity is conducting CDD on another, the implication of the Draft Factsheet’s interpretation is that many reporting entities will be responsible for conducting duplicate CDD on customers who have already been subject to CDD.
- 3.5 The Draft Factsheet suggests that one reporting entity may rely on another reporting entity under either section 33 or section 34 of the AML/CFT Act. However, neither of these sections is likely to offer a satisfactory solution to the problem of duplicated CDD brought about by the wide interpretation of “beneficial owner”.
- 3.6 We believe that section 33 is unlikely, in its present form, to offer sufficient comfort to many reporting entities and that few will be willing to rely on it. The key issue with the section is that responsibility remains with a reporting entity that is relying on the CDD of another reporting entity. The uncertainty created by this means reporting entities will feel obliged to undertake the CDD themselves, or to exercise close supervision over other reporting entities.
- 3.7 We note also that there may be practical business complications with this. It is possible that some reporting entities may be reluctant to pass on information about clients because of concerns about how their clients would perceive this and potentially running into conflict with privacy concerns. Where one reporting entity is relied on by several others, each of them may seek to exercise close supervision in a manner which is ineffective and may involve conflicting standards. Consequently, one reporting entity may not, in some circumstances, be able to rely on another reporting entity’s CDD as section 33 envisages. In such a case, RE2 will, in practice, have to conduct CDD on all underlying clients of RE1.
- 3.8 We believe section 34 will be subject to similar limitations in many cases. A reporting entity under the AML/CFT Act (RE1) may be willing to contract another reporting entity under the AML/CFT Act (RE2) to perform its CDD on the basis that RE2, as reporting entity under the AML/CFT Act was capable of meeting New Zealand AML/CFT standards and was monitored by RE1. However, if RE2 has multiple relationships with other reporting entities they may all seek to monitor performance, which would be inefficient and involve conflicting standards.
- 3.9 There is an additional difficulty where RE2 in the above situation is a foreign entity, and where RE1 is obliged to conduct CDD on RE2’s beneficial owners. RE2 must complete CDD to the standard required in the AML/CFT Act. Given the standards of the New Zealand regime are different and, in some cases potentially more onerous than the standards of other FATF-compliant jurisdictions, this would involve RE2 putting place a new AML/CFT procedure specifically designed to comply with New Zealand law. This would involve considerable expense and risk for both RE1 and RE2. Consequently, RE1 would be left needing to conduct CDD on all “beneficial owners” of RE2, which would often be prohibitively costly.

Consistency with the FATF Recommendations

- 3.10 The AML/CFT Act is intended to implement the FATF Recommendations, and in our view there is benefit in maintaining consistency with the FATF Recommendations.

- 3.11 The FATF Recommendations essentially equate “beneficial ownership” with “control”. Recommendation 10 of the FATF Recommendations says that conducting CDD on a beneficial owner of a customer includes “understanding the ownership and control structure” of the customer.
- 3.12 The interpretive note to Recommendation 10 says that CDD on a “beneficial owner” in accordance with recommendation 10 will be satisfied where a financial institution obtains information on:
- (a) “the identity of the natural persons...who ultimately have a controlling ownership interest in a legal person”; or
 - (b) “the identity of the natural persons...exercising control of the legal person or arrangement by any other means” (emphasis added).
- 3.13 The interpretive note says that the purpose of the requirement to identify and verify the identity of any beneficial owners is to gain a sufficient understanding of a customer in order to prevent the unlawful use of legal persons and arrangements. The implication is that the FATF Recommendations state quite clearly that identifying those natural persons with something akin to a controlling interest in a customer will suffice in terms of targeting people who could present a money laundering or financing of terrorism risk.
- 3.14 At no point do the FATF Recommendations go so far as to define a “beneficial owner” as anyone who stands to benefit from a customer’s activities. There is therefore a clear inconsistency in relation to “beneficial owners” between the FATF position and that of the Draft Factsheet. Whereas the FATF Recommendations require a relationship of control, paragraph 23 of the Draft Factsheet says that a beneficial owner will be someone on whose behalf a transaction is conducted “whether or not the underlying clients have any direct rights or control over any part of the transaction conducted by the managing intermediary”.

Consistency with the Wolfsberg Principles

- 3.15 The Wolfsberg Group is a respected association of large global banks that has developed a body of good practice standards in relation to anti-money laundering and counter terrorist financing. The Wolfsberg Group has produced two papers entitled *The Wolfsberg AML Principles: Frequently Asked Questions with Regard to Intermediaries and Holders of Powers of Attorney / Authorised Signers in the Context of Private Banking (Managing Intermediaries Paper)* and *The Wolfsberg AML Principles: Frequently Asked Questions with Regard to Beneficial Ownership in the Context of Private Banking (Beneficial Ownership Paper)*. Each paper is a valuable source of guidance on the treatment of managing intermediaries and their clients by reporting entities in other FATF-compliant jurisdictions.
- 3.16 In the Beneficial Ownership Paper, the Wolfsberg group states that:
- for purposes of the [Wolfsberg] Principles, it would be inappropriate to equate “beneficial owner” with “beneficiary” or “holder of beneficial interest”. To define the term “beneficial ownership” in this manner would yield a result that is too inclusive.
- 3.17 In the Managing Intermediaries Paper, the Wolfsberg Group recommends that a bank should attempt to satisfy itself as to the reputation and integrity of a managing

intermediary and, if can do so¹, should rely on the CDD that managing intermediary has conducted on its clients.

- 3.18 Subject to contextual issues, such as whether or not the managing intermediary is from a jurisdiction with comparable AML laws, the Wolfsberg Group suggests that CDD will not need to be conducted on a managing intermediary's clients. (Clients, in the Wolfsberg Group scenario, would include beneficial owners in the case of a New Zealand reporting entity.)
- 3.19 This, in our view, would be the correct setting for a reporting entity's CDD obligations with respect to beneficial owners of customers and any customers other than "direct" customers of the reporting entity.

Consistency with case law

- 3.20 We note that the narrow construction of the phrase "person on whose behalf a transaction is conducted" would accord with the limited case law on the meaning of the phrase "on behalf of". We have not identified New Zealand authority on this point. However, we refer to the English Court of Appeal case of *Gaspert Ltd. v Elliss*². The case related to the deductibility of expenses incurred in relation to research undertaken "on behalf of" an entity and confirmed that a form of agency was required for the expenses to be deductible, rather than merely that the expenses were incurred for the benefit of the taxpayer.

Internal consistency in the AML/CFT Act

- 3.21 A further concern we have with the interpretation given in the Draft Factsheet is that references to "on behalf of" elsewhere in the AML/CFT Act will inevitably be coloured by the Draft Factsheet's approach.
- 3.22 One instance of the phrase "on behalf of" or similar is at the definition of "financial institution". Paragraphs (x) and (xi) define financial institution as including persons who, in the ordinary course of business, carry on:
- (a) safe keeping or administering of cash or liquid securities on behalf of other persons; and
 - (b) investing, administering, or managing funds on behalf of other persons.
- 3.23 If the concept of acting "on behalf of" is interpreted widely in relation to the definition of "financial institution" as it is in the Draft Factsheet, we see a significant practical complication being a potentially very large number of additional reporting entities. For example, it may be argued that the trustee of every trust may be regarded as investing for the benefit of and therefore, on the wide interpretation, on behalf of its beneficiaries, so that every trust is a "financial institution" and therefore a reporting entity (unless exempted by regulation). To our knowledge that intention was not articulated at any point in the legislative process leading to the AML/CFT Act. In our view, such an expansive definition of "financial institution" has not been reflected in Supervisor guidance and is not in line with the market's understanding of how the AML/CFT Act will be applied.

¹ The Wolfsberg Group writes that this can be achieved by the bank looking at whether the managing intermediary has AML procedures of an acceptable standard based on the level of regulatory supervision to which the intermediary is subject and the jurisdiction in which the intermediary is situated.

² *Gaspert Ltd. v Elliss (Inspector of Taxes)* [1987] 1 WLR 769, CA.

- 3.24 Another instance of a wide interpretation of “on behalf of” being problematic is at section 19 of the AML/CFT Act. Section 19 says that under simplified CDD, information must be gathered on persons “acting on behalf of the customer”. If a wide interpretation is given to this section, we think the scope of simplified CDD will again be broader than anything reflected in guidance or the market’s understanding. We comment further on this at paragraph 4.8.
4. **Solution 1: revise the Draft Factsheet so that the phrase “person on whose behalf a transaction is conducted” requires that person to be able to exercise direction or control over a customer**
- 4.1 We urge a revision of the Draft Factsheet which aligns the concept of beneficial ownership with the approach taken in the FATF Recommendations and the Wolfsberg Principles. As outlined above, we believe this would give clear guidance to the New Zealand market that the New Zealand regime was aligned with international practice.
5. **Solution 2: confirm that the treatment of participatory securities is comparable to the treatment of debt and equity securities outlined at paragraph 24 of the Draft Factsheet.**
- 5.1 Paragraph 24 of the Draft Factsheet states:
- where a company issues debt or equity securities for the purpose of funding its business (where the primary purpose of that business is not simply investing funds from, the underlying clients), than any transactions conducted by the company would not usually be entered into on behalf of the underlying clients, because there is no close connection between the transaction and the risks/benefits passed on to the investors.
- 5.2 Further to our proposal under paragraph 4 above, we would like confirmation from the Supervisors that, where an underlying client does not direct or control the activities of a managing intermediary, the treatment of transactions in relation to participatory securities (as defined in the Securities Act 1978), including units in unit trusts and memberships of superannuation and KiwiSaver schemes will follow the treatment of transaction relating to debt securities or equity securities. We do not believe there is a difference between the two from a money laundering or financing of terrorism perspective where the underlying client has no ability to direct the investment activities of the managing intermediary.
6. **Solution 3: amend section 33 of the AML/CFT Act to enable reliance without the prospect of liability by one reporting entity under the AML/CFT Act on the CDD of another reporting entity and to allow CDD undertaken under section 33 to be performed by an entity from another jurisdiction where that entity is compliant with an AML/CFT regime which is FATF-compliant.**
- 6.1 Section 33 of the AML/CFT Act provides that one reporting entity (RE1) is entitled to rely on the CDD of another reporting entity (RE2) but that RE1 must take responsibility for ensuring that RE2’s CDD is conducted in accordance with the AML/CFT Act. As noted above at paragraph 3.6, the practical implication of this is that RE1 will gain little comfort that it is in compliance with the AML/CFT Act unless it conducts its own CDD on all beneficial owners of RE2. RE2 will also have conducted CDD on those beneficial owners.
- 6.2 As we have noted above, there will be significant duplication involved where all entities must satisfy themselves as to the CDD of the other entities. The result of each reporting

entity having to satisfy itself is an inefficiency that we do not believe will be counterbalanced and justified by an increase in quality of CDD.

- 6.3 In our view, section 33 should be amended to provide explicitly that provided one reporting entity (RE1) has taken reasonable steps to confirm that another reporting entity (RE2) on which it is relying for CDD is a reporting entity under the AML/CFT Act or is a reporting entity that is in compliance with the AML/CFT regime in another jurisdiction which is FATF-compliant, then:
- (a) RE1 is able to rely on RE2's CDD; and
 - (b) where RE1 does rely on RE2's CDD, RE1 has no responsibility to ensure that RE2's CDD complies with the AML/CFT Act.
- 6.4 We are of the view that RE1 should be able to rely on section 131 of the AML/CFT Act, which provides that the Supervisors have a responsibility to monitor reporting entities for compliance with the AML/CFT Act and any regulations made under it. In other FATF-compliant jurisdictions we expect similar supervision to apply.
7. **Solution 4: as an interim measure (given the complications associated with amending legislation) amend regulation 24 of the Anti-Money Laundering and Countering Financing of Terrorism (Exemptions) Regulations 2011 (Exemptions Regulations) so that CDD does not need to be conducted on the beneficial owners of foreign entities which are compliant with FATF-compliant AML/CFT regimes.**
- 7.1 Recognising that amending legislation to implement Solution 3 will take time, an interim solution to the obligations placed on one reporting entity transacting with another reporting entity would be to amend the regulations to designate reporting entities or foreign reporting entities that are treated as reporting entities in their home jurisdictions as suitable for simplified CDD when they are customers.
- 7.2 Under the AML/CFT Act at present, where one reporting entity (RE1) transacts with a "customer" which is also a reporting entity (RE2) RE1 will have to conduct CDD on RE2 and RE2's "beneficial owners" upon the establishment of the business relationship, in accordance with section 14(a) of the AML/CFT Act. The CDD required will be "standard" CDD unless RE1 falls within section 18, in which case "simplified" CDD is allowed. Very few, if any, managing intermediaries will come within the scope of section 18. Section 18(f) does, however, allow for "any other entity or class of entities" to be specified as suitable for simplified CDD in the regulations.
- 7.3 Designating a reporting entity under the AML/CFT Act as suitable for simplified CDD would not fully address the concerns we note above. It would, however, address the requirement on RE2 to conduct CDD on every person with a beneficial interest in RE1, because simplified CDD does not carry the requirement to conduct CDD on "beneficial owners".
- 7.4 The suitability of designating reporting entities as suitable for simplified CDD in part depends on the interpretation given to section 19. The number of persons who reporting entities must conduct CDD on will vary greatly depending on who the Supervisors consider to be "acting on behalf of the customer". We seek a narrow construction of this phrase from the Supervisors that accords with our submission above in relation to beneficial ownership.
- 7.5 In our view, designating reporting entities as suitable for simplified CDD will be more efficient without compromising CDD quality. All reporting entities are required to have

procedures in place under the AML/CFT Act and are already open to Supervisor scrutiny. We do, however, see this as an interim measure only. As per paragraph 4.1 to 4.4, we would ultimately like to see a reporting entity be able to rely on the CDD of another reporting in all respects, and not just in relation to beneficial owners.

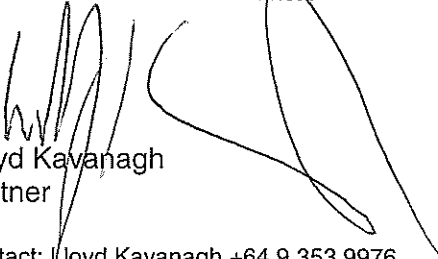
7.6 In the case of managing intermediaries which are reporting entities under the AML/CFT Act, Supervisors are in a position to be sure that those managing intermediaries are at a high standard of compliance as the Supervisors will themselves be monitoring the reporting entities.

8. Conclusion

8.1 Thank you for taking the time to consider our submissions on the Draft Factsheet. We look forward to receiving the FMA's response and to working with you further.

Yours faithfully

Minter Ellison Rudd Watts



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