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1 August 2013

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Dear Kirsty

Practical implications of Factsheet on Managing Intermediaries feedback

1 Thank you for the opportunity to submit on the managing Intermediaries Factsheet (**Factsheet**) dated 11 July 2013. DLA Phillips Fox acts for a number of managing intermediaries who have expressed concerns in respect of the practical implications of this Factsheet. Our submission is made primarily from the perspective of our managed funds practice. We are concerned that reporting entities will have an obligation under the Anti-money Laundering and Countering Financing of Terrorism Act 2009 (**AML Act**) to essentially look through other reporting entities and also carry out customer due diligence (**CDD**) on underlying clients. These requirements will result in unnecessary duplicated/replicated CDD of investors and additional, unnecessary compliance costs.

Summary of submission

2 The interpretation of 'beneficial owner' to include a third limb which includes 'a person on whose behalf a transaction is conducted', in our opinion broadens obligations under the AML Act beyond the intention behind the AML Act and the Financial Action Task Force (**FATF**) recommendations and is inconsistent with overseas practice.

3 While FMA has suggested that sections 33 and 34 of the AML Act provide a solution to the issue of CDD duplication, the sections do not remove the compliance costs involved as reporting entities will still be responsible and liable under these sections for the acts of other reporting entities or agents in a chain of managing intermediaries.

4 We believe the issues highlighted above can be resolved and we submit as follows:

4.1 The broad interpretation of 'beneficial owner' under the Factsheet is impractical, costly, and serves no regulatory purpose.

4.2 A narrower interpretation of 'beneficial owner' is available (and policy supports this) so that there is no *separate* limb for 'persons on whose behalf a transaction is conducted'.

4.3 If the broad interpretation to the definition of 'beneficial owner' under the Factsheet is maintained, the AML Act should be amended or (more likely) exemptions granted to enable one reporting entity to rely on the CDD of another reporting entity without being liable for that CDD. An alternative would be to allow reporting entities transacting with other reporting entities to be designated as suitable for simplified CDD.

Practical implications of the Factsheet interpretation of 'beneficial owner' and reliance on sections 33 and 34 of the AML Act

5 Beneficial owner is defined under section 5 of the AML Act as follows:

> **beneficial owner** means the 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

6 The interpretation of this definition in the Factsheet is that a beneficial owner of a customer is a person who satisfies any one, or a combination of the following three elements:

6.1 Who owns more than 25 percent of the customer

6.2 Who has effective control of the customer

6.3 The persons on whose behalf a transaction is conducted.

7 This adds to the definition of 'beneficial owner' a third limb not present in section 5 of the AML Act.

8 In addition, the 'a person on whose behalf a transaction is conducted' element has been interpreted very broadly. The Factsheet states that any underlying client who benefits from a transaction conducted by a managing intermediary will be 'a person on whose behalf the transaction is conducted', and that this is the case whether or the underlying client has any rights or control over the transaction.[1] The Factsheet further states that:[2]

> An example of a transaction conducted on behalf of another person is an agent conducting a transaction on behalf of a principal, but it is also possible for a person to be acting on behalf of another person without an agency relationship.

9 This interpretation is too broad and has the effect that when any transaction is conducted by a customer for the primary purpose of investing funds for the benefit of (any number of) underlying investors, those underlying investors will be beneficial owners of the customer, and a reporting entity will be responsible for conducting CDD on those individuals. For example, in the case of a financial product such as a unit trust, this would mean that every reporting entity dealing with the unit trust would be required to conduct CDD on any person who will or may benefit from the investment

[1] Factsheet, page 4 at paragraph 23.

[2] Ibid, at paragraph 21.

into that unit trust. In this circumstance reporting entities who will be responsible for conducting CDD on the underlying investor may include the trustee, manager, wrap platform, custodian trustee and financial adviser.

10 This approach will result in duplicate/replicated CDD. The Factsheet suggests that sections 33 and 34 of the AML Act are a solution. While these sections allow an agent or another reporting entity to conduct CDD on behalf of another reporting entity (subject to certain conditions in the case of another reporting entity), a reporting entity relying on section 33 or section 34 of the AML Act still retains responsibility for ensuring CDD is carried out in accordance with the AML Act. While we can understand the reasoning behind a reporting entity being required to retain responsibility under an agency relationship (as this is a consequence of agency law), we do not consider that a reporting entity should retain responsibility and liability for the CDD conducted by another reporting entity.

11 If reporting entities retain responsibility and liability for CDD conducted by another reporting entity under the AML Act, section 33 provides little relief from the compliance burdens of having to conduct CDD on underlying customers. To be satisfied that another reporting entity is carrying out CDD in accordance with the AML Act, reporting entities will require access to policies, procedures, systems and checks and will need additional resources to review these. Rights of review and approval of that other reporting entity's AML/CFT programme would also be required. This would be impractical, expensive, time-consuming and unnecessary and there are also privacy and confidentiality concerns involved. In the example of the chain of managing intermediaries involved in a unit trust provided in paragraph 9 above:

11.1 all involved would bear this additional cost;

11.2 some may require contractual arrangements with the reporting entities they do not deal with directly to ensure that further down the chain CDD is being conducted in accordance with the AML Act; and

11.3 it is likely additional costs would ultimately be passed onto investors.

12 There will also be additional consequences when dealing with offshore counterparties. As a result of the additional compliance burdens, it is likely that overseas financial institutions such as custodians that offer global services will have concerns with entering into arrangements with New Zealand reporting entities.

13 Further implications arise from use of section 33 of the AML Act where the reporting entity carrying out the CDD (A) is required to provide to the reporting entity relying on them (B):

13.1 relevant identity information before the reporting entity establishes a business relationship or an occasional transaction is conducted; and

13.2 relevant verification information as soon as practicable, but no later than 5 working days, after the business relationship is established or the occasional transaction is conducted.

14 This means that both A and B will have obligations and compliance costs in reviewing and checking the information, and in a chain of intermediaries, so will others. We believe these compliance burdens and additional costs are disproportionate to the money laundering risk involved. The practical solution would be for one reporting entity to have responsibility for CDD under the AML Act.

15 We submit that a narrower approach is more consistent with the policy of the AML Act, FATF recommendations, and the approach in other jurisdictions. While the broad interpretation represents one of a number of possible interpretations, it should not be the preferred approach.

16 Some stark examples of how the broad interpretation under the Factsheet is impractical and unworkable include:

16.1 The suggestion in Appendix 3 that brokers would be responsible for conducting CDD on investors or customers of a fund manager who instructs that broker.

16.2 Superannuation exemptions provided under the Anti-money Laundering and Countering Financing of Terrorism (Exemption) Regulations 2011 become effectively unusable, for example:

16.2.1 Regulation 20 applies to relevant services provided in respect of "promoting, facilitating, or effective the membership of a person in a superannuation scheme if the person's membership is facilitated, or to be facilitated, through his or her employer". The effect of the broad interpretation is that other third party providers such as investment managers will have an obligation to conduct CDD on the underlying investors as required under the AML Act (not the exemption).

16.2.2 Regulation 20A exempts relevant services provided in respect of "promoting or operating" limited employer superannuation schemes or a specified restricted scheme Again, the effect of the broad interpretation of 'beneficial owner' in these circumstances is that other third parties involved in the operation of the superannuation scheme, such as external investment managers, will still be required to conduct CDD on the underlying investors - even though the promoter or operator has no obligations under the Act. This contradicts the policy behind the exemption which was to exempt these schemes from all AML Act requirements due to their restricted membership base.

16.2.3 This will restrict the effect of the exemptions because in both circumstances the third party who has no direct access to underlying investors, will have no reporting entity or agent to rely on under sections 33 or 34 of the AML Act to obtain the CDD information unless they appoint the superannuation trustee(s) as their agent to conduct the CDD on their behalf;

Consistency of a narrow interpretation of 'beneficial owner' with FATF recommendations and the policy of the AML Act

17 The FATF recommendations which led to the implementation of the AML Act state that conducting CDD on a beneficial owner of a customer includes "understanding the ownership and control structure"[3] of the customer. This is essentially a control test. The interpretive note to this FATF recommendation states that the purpose of identifying beneficial owners is:[4]

> to prevent the unlawful use of legal persons and arrangements, by gaining a sufficient understand of the customer to be able to properly assess the potential money laundering and terrorist financing risks associated with the business relationship; and second, to take appropriate steps to mitigate the risk.

18 This policy is not consistent with the current broad interpretation of the 'beneficial owner' definition in the Factsheet. The FATF interpretative note goes on to state that CDD on a beneficial owner where it is a legal person will be satisfied where information is obtained in respect of:[5]

18.1 'The identity of the natural persons … who ultimately have a controlling ownership interest in a legal person'; and

18.2 To the extent there is doubt (under paragraph 18.1) above, 'as to whether the persons(s) with the controlling ownership interest are the beneficial owner(s) or where no natural person exerts control through ownership interest, the identity of the natural person (if any) exercising control of the legal person or arrangement through any other means'; and

18.3 Where no natural person is identified under paragraphs 18.1 and 18.2 above, 'financial institutions should identify and take reasonable measures to verify the identity and take reasonable measures to verify the identity of the relevant natural person who holds the position of senior managing official'.

19 There is nothing in the above explanation which reflects that any underlying customer who merely benefits from a transaction would be considered to be a beneficial owner of (for example) a unit trust.

20 The objectives of the AML Act are set out on page 3 of the first Regulatory Impact Statement (**RIS**) issued on the regime in April 2009. They are to:

20.1 Detect and deter money laundering and terrorist financing;

20.2 Maintain and enhance New Zealand's international reputation;

20.3 Contribute to public confidence in the financial system; and

20.4 Realise these objectives with minimum cost to industry.

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[3] The FATF Recommendations 2013, Recommendation 10, at page 4.

[4] Ibid, at page 60.

[5] Ibid, at pages 60,61.

21 The same RIS discussed the need to comply with New Zealand's obligations under the FATF Recommendations. The RIS also stated that while complying with the FATF Recommendations was an essential purpose of implementing New Zealand's AML regime, this should also be balanced against the need to 'avoid excessive compliance burdens' and implementing measures that are 'appropriate to New Zealand circumstances'.[6]

22 The narrow interpretation of the 'beneficial owner' definition is supported in the November 2010 RIS on the AML regime which stated that 'knowing who holds beneficial ownership, *insofar as they are able to exercise some effective control of a legal entity*, is critical to judging the legitimacy of activities undertaken by a legal entity'.[7]

23 Further, policy documents produced on the AML regime since its implementation have consistently expressed the provision as a two limb test. In the Consultation document released in August 2010, the test is set out as follows:[8]

> A reporting entity also has obligations in respect of a beneficial owner. The AML/CFT Act defines a beneficial owner as the individual who either:
>
> - Has effective control of a customer or person on whose behalf a transaction is conducted
> - Owns a prescribed threshold of the customer or person on whose behalf a transaction is conducted.
>
> Assuming a client of a lawyer (for example) does not own a prescribed threshold of a lawyer (or law firm) then the second test in the definition is unlikely to be met. The first test is whether a client can be said to have 'effective control' over the lawyer.

24 Not only do the above extracts support a narrow interpretation of the 'beneficial ownership' test, but they also support the need to adopt a narrow interpretation to avoid unnecessary compliance costs on reporting entities that transact with other reporting entities.

Consistency with overseas practice

25 The following jurisdictions adopt a narrow approach to the test for 'beneficial ownership' and support the principle that there should be some level of control involved.

25.1 The United Kingdom adopts a narrow interpretation of 'beneficial owner'. Regulation 6(9) of the UK Money Laundering Regulations 2007 states that a beneficial owner is (in any other case not already described in that provision) 'the individual who ultimately owns or controls the customer or on whose behalf a transaction is being conducted'. This provision is similar to the first limb of the AML Act definition of beneficial owner. The interpretation of this section however, as set out on the UK Law Society website through its examples, is that 'on whose behalf a transaction is

[6] Regulatory Impact Statement, April 2009, page 1.

[7] Regulatory Impact Statement, November 2010, page 10 (emphasis added).

[8] Consultation Document, August 2010, page 64 at paragraphs 378 to 379.

conducted' applies where a person is acting on behalf of another person. This relates to an agent-principal type relationship.[9]

25.2 Under Australian legislation, CDD is required on beneficial owners of a company where a person owns more than 25% of the company or has effective control of the company.[10]

25.3 A discussion paper has been released in respect of the Australian legislation to extend the definition of beneficial owner to apply not just to companies, to also apply to the natural person(s) (individuals) who ultimately owns or controls a customer.

26 Wolfsberg AML Principles

26.1 The Wolfsberg AML Principles were developed by the Wolfsberg Group, an association of large global banks that has developed a body of good practice standards in relation to Anti-money laundering and countering financing of terrorism.

26.2 The Wolfsberg principle relevant to managing intermediaries recommends that if a bank can satisfy itself that the due diligence procedures of the managing intermediary are of an acceptable standard, then it can rely on the CDD that a managing intermediary has conducted.[11] It is assumed that due diligence procedures are of acceptable standard if they comply with the standard of the relevant jurisdiction where that intermediary is based.

26.3 This supports the proposition that a reporting entity should be able to rely on the CDD of another reporting entity.

Suggested approach

27 An objective of the AML regime was to avoid excessive compliance burdens. A broad interpretation of 'beneficial owner' does not support this objective. A broad interpretation is also not consistent with extracts taken from the 2010 RIS, 2010 Consultation Document and overseas practice.

28 To avoid the impracticalities that will result from the approach set out in the Factsheet, together with the additional compliance costs, we submit that:

28.1 The beneficial ownership test outlined in section 5 of the AML Act should be interpreted narrowly so that there are only two limbs to the test. That interpretation is available. While we accept that FMA's interpretation of this definition is *one* of a number of possible interpretations, we believe a narrower approach is preferable and is also consistent with the intention of the Act and overseas practice. Compliance with the broad interpretation is

[9] At http://www.lawsociety.org.uk/advice/practice-notes/aml/customer-due-diligence/.

[10] Regulation 1.2.1, Anti-money Laundering and Counter Terrorism Financing Rules Instrument 2007.

[11] 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.

in practice, not possible, and additional steps to comply would be disruptive and expensive.

28.2 If a broad interpretation is maintained we would support any approach to the Ministry of Justice for legislative (or more likely) regulatory relief through the form of exemptions to enable reporting entities to reply on other reporting entities to conduct CDD, or to permit simplified CDD where one reporting entity is relying on standard CDD conducted by another reporting entity (removing the requirement that CDD obligations extend to beneficial owners).

Thank you for the opportunity to provide feedback on the Factsheet. We look forward to working with you further.

DLA Phillips Fox