Guardian Trust
THE TRUST COMPANY

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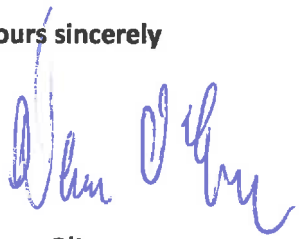
Factsheet on Managing Intermediaries Feedback

Please find attached a copy of New Zealand Guardian Trust's submission in respect of the above Factsheet.

Of course, we are happy to discuss any aspect of our submission with you if required.

Yours sincerely



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SUBMISSION – PRACTICAL IMPLICATIONS OF FACTSHEET ON MANAGING INTERMEDIARIES FEEDBACK

This is a submission made on behalf of The New Zealand Guardian Trust Company Limited (**NZGT**) in response to the consultation paper 'Practical Implications of Reporting Entities transacting with other Reporting Entities and the Factsheet' **(Consultation Paper)**.

INTRODUCTION

Thank you for the opportunity to provide feedback to the Financial Markets Authority (**FMA**) in respect of the Consultation Paper. NZGT appreciates the FMA's collaborative and consultative approach to the application of the Anti-Money Laundering and Countering Financing of Terrorism Act 2009 (**Act**).

We note that NZGT is a member of the Trustee Corporations Association (**TCA**). This submission is to be read as supplemental to and in conjunction with the submission provided by the TCA.

For the sake of consistency and to assist in a mutual understanding of the issues arising from the Consultation Paper, we have wherever possible adopted the terminology used by the FMA in the Consultation Paper.

NZGT submits that the FMA's approach in the Consultation Paper will;

- lead to onerous compliance costs disproportionate to the risks the Act attempts to address;
- result in the unnecessary imposition of legal liability when the Customer Due Diligence (**CDD**) function can be performed by the relevant managing intermediary with the underlying client relationship;
- result in unnecessary duplication of function and process;
- result in practical difficulties with the implementation without some form of further regulation;
- negate the benefits of certain exemptions for managing intermediaries of low risk underlying clients;
- result in unanticipated and unintended consequences; and
- result in the unnecessary dissemination of underlying client personal information.

FMA'S APPROACH

The FMA have outlined that generally a reporting entity will not only have CDD obligations under the Act in respect of managing intermediary as its customer but also the underlying client which constitutes a beneficial owner of the managing intermediary for the purposes of the Act.

The FMA have further stated that 'the underlying clients at the bottom of a chain of managing intermediaries will usually be beneficial owners of each managing intermediary above them, because they are individuals on whose behalf a transaction is conducted'[1].

The FMA have signalled that whilst at a practical level reporting entities will be unable to discharge, for example, CDD on an underlying client the reporting entity can rely on the managing intermediary pursuant to sections 33 or 34 of the Act[2] .

INTERPRETATION

We note in the Consultation Paper that the FMA is not seeking submissions on the content or interpretation of the Act but that the FMA is prepared to forward any such submissions to the Ministry of Justice. We respectfully request that the comments below in this section are forwarded to the Ministry of Justice.

At its simplest the FMA's approach to reporting entities' CDD obligations under the Act means that the reporting entity not only has a responsibility to conduct CDD on its customer (ie the managing intermediary) with whom it has an actual business relationship but also the underlying client on the basis that the latter is for the purposes of the Act a beneficial owner of the managing intermediary.

We set out the definition of beneficial owner.

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***

The rationale for the approach stated in the Consultation Paper is that an underlying client constitutes a beneficial owner of the managing intermediary as the underlying client is a person on whose behalf a transaction is conducted. The phrase 'or person on whose behalf a transaction is conducted' implies an agency/fiduciary relationship between the managing intermediary and underlying client. NZGT submits that an underlying investor/client contracts with a managing entity for a fee to provide a service as a customer and service provider respectively, not as principal/agent or fiduciary/ beneficiary. If a managing intermediary acted as an agent and simply invested funds as per the underlying client's instructions as principal then arguably such a relationship would mean that a reporting entity would have an obligation to conduct CDD on the underlying client. NZGT does not agree with FMA's position that transactions conducted in respect of Managed Funds are conducted for and on behalf of underlying investors of that fund but are conducted for and on behalf of the fund itself.

We note that in the Consultation Paper the phrase 'person on whose behalf a transaction is conducted' is at paragraph 13 separated into a separate limb and element of the definition of beneficial ownership in its own right. NZGT believes that this construction ignores that it should be read in the context of the phrase that precedes it in the Act namely, '*beneficial owner means the individual who has effective control of a customer* or person on whose behalf the transaction is conducted'. We believe Parliament's intention as outlined in TCA's submission was to ensure that CDD was conducted on the customer and on those individuals who either have an ownership interest and/or exert effective control over the customer.

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[1] Paragraph 16 of the Consultation Paper.
[2] Paragraph 34 of the Consultation Paper.

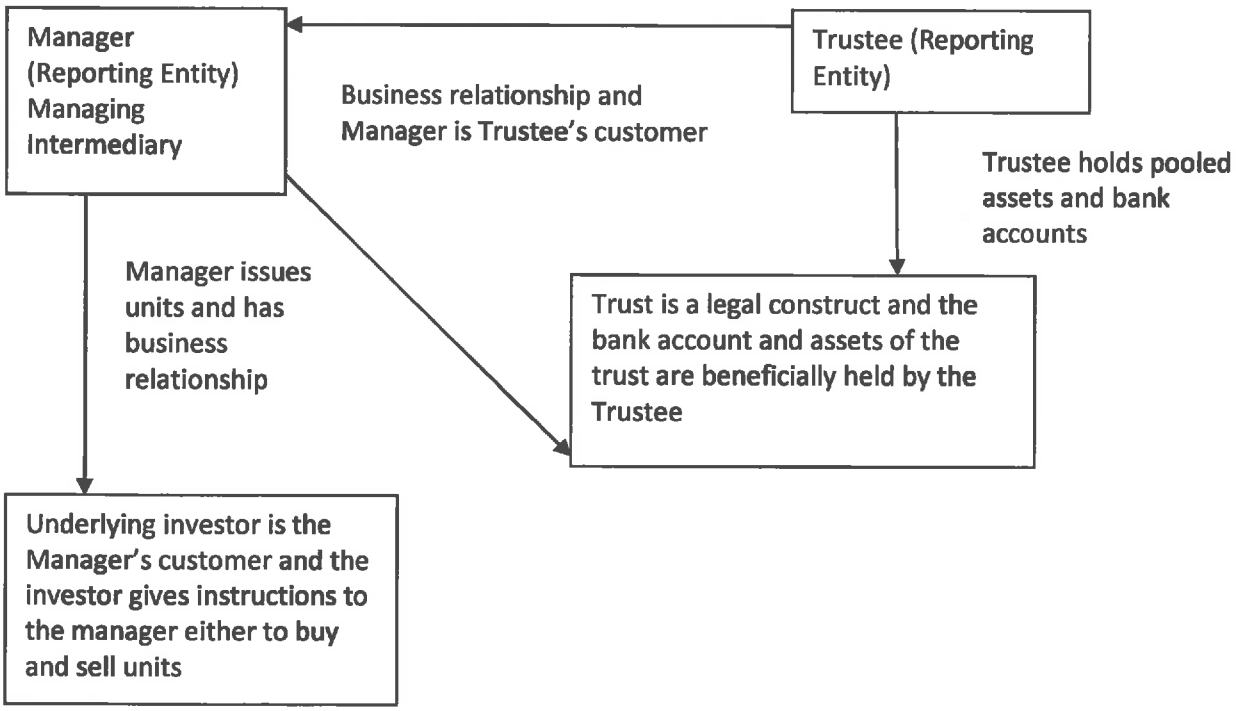
The broad interpretation of the phrase means that beneficial ownership is no longer associated with its legal or common sense meaning where the underlying client has an ownership interest in the customer.

MANAGED FUNDS (KIWISAVER/UNIT TRUSTS/SUPERANNUNATION SCHEMES)

In the context of Managed Funds, the rationale for the approach stated in the Consultation Paper is that an underlying client constitutes a beneficial owner of the managing intermediary as the underlying client is a person on whose behalf a transaction is conducted. As such the Consultation Paper states that a reporting entity is required to conduct CDD on the underlying client. This approach raises considerable difficulties for NZGT in its capacity as a Corporate Trustee of Managed Funds.

We set out below a structural diagram of a typical Managed Fund structure from the perspective of the Corporate Trustee and the roles of the various participants.

Managed Fund Structure



As recorded in the above example the Managed Fund operates through a Trust which is treated as a separate entity for tax and accounting purposes and no underlying client/ investor has a direct holding in any security held by the Trustee on the Trust's behalf. The Trust is a legal pooling of the assets and underlying investors only have a share of the asset pool.

The Manager issues units on behalf of the Trust to the investors. Investors pay over the relevant funds to the Manager in consideration for the issue of units in the Managed Fund. This gives rise to a business relationship with the underlying investor. The Trustee does not have a direct relationship with the underlying investor. The Trustee's function is to manage the pooled assets and act on the direction of the Manager. At no point does the Trustee have any relationship or communication with the underlying client. Similarly, it has no knowledge of the identity of the underlying clients.

At a practical level the Trustee as a reporting entity will be unable to discharge CDD on an underlying client itself given that it has no relationship and contact with the underlying client nor any knowledge of the underlying client's identity. FMA have suggested in this situation that the reporting entity can rely on the managing intermediary to conduct CDD on the underlying client pursuant to either sections 33 or 34 of the Act. What this approach does not address is that, assuming a managing entity agrees to enter into such arrangements, the reporting entity will be potentially liable for the failure of the managing intermediary to discharge its CDD obligation on the underlying client under either section 33 or 34 arrangements. This leaves NZGT with a legal risk outside of its immediate control which it is unable to mitigate completely.

There is no requirement in the Act for a managing intermediary Fund Manager to enter into a section 33 or 34 arrangement. A response to a managing intermediary Fund Manager unwilling to enter into either a section 33 or 34 arrangement is that NZGT simply resigns or refuses to do business with that managing intermediary. NZGT submits that this ignores commercial reality and the entrenched nature of the Corporate Trustee's role under legislation. Resignation as a Corporate Trustee in a Managed Fund context is a complicated process which would require that NZGT complete all obligations under the Trust Deed and ensure an orderly transfer of the Fund's assets to a new licensed Corporate Trustee under the Securities Trustee and Statutory Supervisors Act 2011[3]. If a managing intermediary is not prepared to enter into a either a section 33 or 34 arrangement then any licensed Corporate Trustee is going to be faced with the same issue.

SECTION 33 AND 34

Sections 33 and 34 are the means by which the Consultation Paper suggests a reporting entity can ensure that its CDD obligation in respect of the underlying client is discharged. However, both arrangements require the agreement of the managing intermediary. Section 33 requires that the third party consents to conducting CDD on underlying customers on behalf of reporting entities[4]. The FMA has stated that section 33 is 'to be more appropriate for situations where the reporting entity does not have an established ongoing relationship with the person on whom it is relying to perform CDD obligations or where there is a reluctance to enter into a formal agency arrangement'. An appointment under section 33 will require the consent of the managing intermediary and will still require a degree of formality particularly where there is no ongoing relationship between the parties. The reporting entity will want to be assured that the managing intermediary will take the obligations seriously and accordingly it will want some form of written agreement acknowledging the performance of such obligations.

If the managing intermediary has entered into either a section 33 or 34 arrangement and fails to perform those CDD obligations on behalf of reporting entities/managing entities up the investment chain then the managing intermediary is potentially liable to those entities up the investment chain. The reporting entity will want certainty, assurance and a protection from the managing intermediaries' failure to perform the CDD obligations whereas the managing intermediary, if it agrees to such obligations, will want to minimise any potential liability for failure.

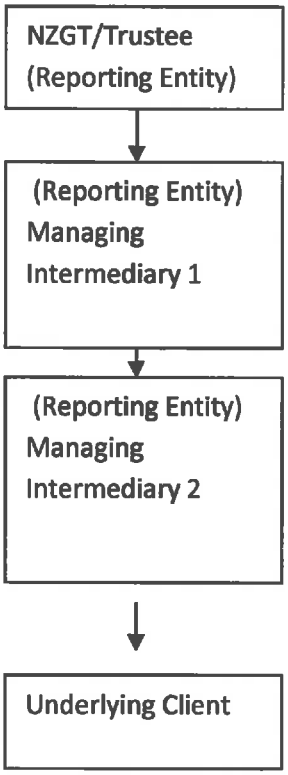
NZGT as a reporting entity has encountered resistance by some managing intermediaries in the context of certain securitisation structures where NZGT have sought to enter into agency arrangements with those managing intermediaries to perform CDD on its behalf. Certain managing intermediaries have been reluctant to enter into any such agency relationships contending they have no obligation to do so nor should they assume any obligation with respect of the underlying client insofar as NZGT is concerned. Those managing

[3] Section 116E of the KiwiSaver Act 2006, section 10 of the Unit Trusts Act 1960 and section 48 of the Securities Act 1978
[4] Section 33(2)(d) of the Act

intermediaries that have entered into such arrangements have not been prepared to indemnify NZGT for any loss that it may suffer where the managing intermediary has failed to fulfil its obligations without any fault or contribution by NZGT to such failure.

As discussed above, NZGT's submission is that it is fundamentally inequitable to impose a legal obligation to conduct CDD on underlying clients (ie as beneficial owners of NZGT's customer) as a reporting entity when it is unable to discharge this obligation itself and is reliant on the voluntary cooperation of a managing intermediary to assist in discharging this obligation.

Multiple Managing Intermediaries



The FMA states in scenarios where there are multiple reporting entities/managing intermediaries that not every reporting entity/managing intermediary needs to conduct CDD on the underlying client. The Consultation Paper suggests that the Trustee in this scenario must assess which entity is best placed to identify the beneficial owners of underlying clients[5].

If NZGT determines that managing intermediary 2 has the best prospect of completing CDD on the underlying client then the Consultation Paper suggests that NZGT can implement either a section 33 or 34 arrangement. Assuming that managing intermediary 2 is prepared to enter into such an arrangement with a reporting entity up the investment chain with whom it has no direct or contractual relationship, then NZGT is reliant on an entity with whom it has no relationship to discharge its legal obligation. Practically this will not only be difficult but unduly onerous from a legal perspective. At least with NZGT's customer (ie managing intermediary 1) it has an established relationship and is able to monitor as best it can the customer's compliance with such CDD obligations.

A number of Managed Fund products use independent Financial Advisers (ie managing intermediary 2) as part of the distribution channel to underlying clients/investors. These Financial Advisers have the direct relationship with the underlying client. These Financial Advisers are potentially numerous for any given product. This would require NZGT to enter into multiple arrangements with such Financial Advisers. NZGT would need to go through the time consuming process of establishing which financial advisor acted for which underlying client. It would then need to establish contact with each Financial Adviser to request that the Financial Adviser would assume CDD obligations on NZGT's behalf.

The Financial Advisers will be faced with multiple agreements to different reporting entities/managing intermediaries up the investment chain requiring the Financial Advisers to conduct CDD obligations for those reporting entities/managing intermediaries. Those arrangements are likely to differ markedly in nature and require extensive negotiation and allocation of risk. Large corporate reporting entities/managing intermediaries up the investment chain are likely to seek to protect themselves against the Financial Advisers' failure to conduct CDD on behalf of the reporting entities/managing intermediaries. Such Financial Advisers will wish

[5] Paragraph 35 of the Consultation Paper

to avoid any such obligations to large reporting entities/managing intermediaries up the investment chain given the potential liability associated with failure to perform such obligations.

NZGT may wish to enter into either a section 33 or 34 arrangement with managing intermediary 1 and rely in turn on a further section 33 or 34 arrangement between managing intermediary 1 and managing intermediary 2 to conduct CDD on the underlying client. This possibility may be preferable in practice to NZGT as it will have an existing relationship with managing intermediary 1 as its customer. However, to ensure that NZGT discharges its obligation in this scenario it is reliant on other third parties voluntarily entering into back to back section 33/34 arrangements.

PRIVACY CONSIDERATIONS

The Consultation Paper suggests that managing intermediaries/reporting entities will need to be mindful of their privacy obligations in respect of the personal information of underlying client[6]. Given the number of reporting entities and managing intermediaries that will require such identity information to discharge their obligations under either section 33 or 34 arrangements, NZGT question whether underlying investors will be comfortable with their personal information being distributed up the investment chain to reporting entities/managing intermediaries with whom they have no relationship. Managing intermediaries will need to ensure that their customer facing documentation provides that their underlying clients agree to the distribution of their personal information to various entities up the investment chain with whom they will have no relationship. NZGT submits that this will be an unnecessary distribution of personal information when the purposes of the Act can be discharged by the managing intermediary that has the relationship with the underlying client.

REGULATION

If the FMA insists on interpreting the Act in the manner set out in the Consultation Paper then NZGT strongly urges that it regulate the industry to ensure that managing intermediaries must enter into either section 33 or 34 arrangements. Without any such compulsion managing intermediaries are under no obligation to enter into an agreement with the reporting entity. Similarly, managing intermediaries are unlikely to be willing to assume obligations voluntarily to reporting entities up the investment chain where there is no business relationship. We suggest that some form of standardised agreement would need to be drafted and endorsed by the Financial Services industry for reporting entities and managing intermediaries setting out specific responsibilities and allocation of risk.

NZGT also suggests that the following issues would still need to be considered and addressed in relation to any such practical concerns;

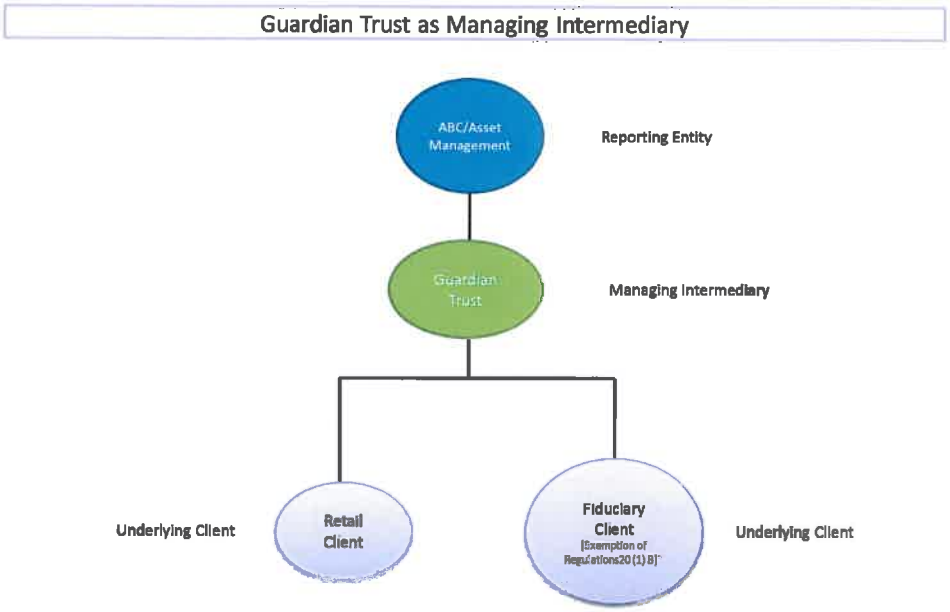
- If a managing intermediary who has a direct customer relationship with the underlying client fails to conduct CDD on the underlying client resulting in the placement of funds in breach of the Act would the FMA seek a civil penalty on the reporting entity for a failure which the reporting entity could not control or contribute to?
- If the FMA determines to impose a civil penalty on the reporting entity despite the reporting entity not contributing to the managing intermediary's failure then what

[6] Paragraph 41 of the Consultation Paper

recourse should the reporting entity have against the managing entity for any such loss?

NZGT AS MANAGING INTERMEDIARY

On the personal client side of NZGT's business NZGT will have a customer relationship with the underlying clients as presented in the diagram immediately below. It will also act on behalf of the underlying clients to invest those funds with ABC Asset Management. Of course, NZGT as a Managing Intermediary/Reporting Entity is obliged under the Act to conduct CDD on its underlying clients. Off the back of the anticipated approach contained in the Consultation Paper ABC Asset Management sought to enter into a Agency Agreement pursuant to section 34 with NZGT. Difficulties arose when ABC Asset Management required NZGT to conduct CDD on our Fiduciary Clients where we act as a Trustee of a family trust or an executor of an estate pursuant to the Trustee Companies Act 1967.



*Anti-Money Laundering & Countering Financial Terrorism (Definitions) Amendment Regulations 2013

NZGT's role as Trustee/Executor in our fiduciary capacity is exempted under the Act for good policy reasons by virtue of Regulation 20 of the Anti-Money Laundering and Countering Financing of Terrorism (Definitions) Regulations 2011. However, ABC Asset Management maintained that NZGT's exemption did not extend to ABC Management Limited and accordingly sought to have NZGT conduct CDD on its fiduciary clients despite the fact that NZGT had an exemption in this respect. We suggest that if the FMA proceeds with the interpretation contained in the Consultation Paper then it will need to clarify that a Reporting Entity will not have CDD obligations if the managing intermediary with the customer relationship is exempt under the Act.

SUMMARY

For the reason stated above NZGT submits that the approach contained in the Consultation Paper is impracticable and will result in disproportionate compliance costs insofar as the risks the Consultation Paper seeks to address. We further submit that the broad

interpretation of the definition of 'beneficial owner' will result in the unnecessary extension of legal obligations which reporting entities will be unable to discharge themselves or mitigate completely even with reliance on third parties.