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Dear Kirsty

Consultation Paper: Practical implications of Reporting Entities transacting with other Reporting Entities and the Factsheet on Managing Intermediaries

1 Thank you for the opportunity to submit on the Consultation Paper discussing practical implications of the Anti-Money Laundering and Countering Financing of Terrorism Act 2009 ('AML/CFT Act') in situations where reporting entities are transacting with other reporting entities ('Consultation Paper'), and its accompanying draft fact sheet on managing intermediaries ('Factsheet').

2 We commend FMA and the other AML/CFT supervisors for the pro-active approach taken in communicating their interpretation of the requirements of the AML/CFT Act in the complex commercial dynamic discussed in the Factsheet. We appreciate the opportunity to provide input before the Factsheet is finalised.

3 We have assisted a variety of reporting entities to prepare for the AML/CFT Act coming into effect. Many of those will interact with managing intermediaries in the ordinary course of their business, and others will be categorised as managing intermediaries in terms of the Factsheet. Most will operate on both sides of that equation at different times. It would be fair to say that for many reporting entities, the full extent of the practical difficulties that the AML/CFT regime will create for them in dealing with each other has only now been highlighted through the release of the Consultation Paper and Factsheet.

4 We have very real concerns as to the practical consequences for reporting entities, and in particular those reporting entities dealing with managing intermediaries based in an off-shore jurisdiction.

5 We realise that many of the practical difficulties arise by virtue of the wording of the AML/CFT Act itself, and the policy decisions made in promulgating regulations under the AML/CFT Act. To that extent, we recognise that supervisors' powers are limited. However, some of the approaches outlined in the Factsheet are unlikely to be workable in practice. In our view, there are alternative options available that would reduce the extent of the practical challenges of the regime and the inefficiencies and duplication of processes arising.

Submission

6 In our view, a regulatory change is required to allow reporting entities appropriate relief in relation to their customer due diligence ('CDD') obligations when dealing with managing intermediaries and verifying the identity of the beneficial owners of those managing intermediaries. We believe the best solution is something that needs to be referred back to the policy makers for further consideration, having had the impracticalities of the current provisions identified for them. The solution would most appropriately involve some form of conditional permission for reporting entities to apply simplified CDD-type principles when dealing with managing intermediaries.

7 In the interests of timing and the targeting of our response to the Consultation Paper, and recognising the regulatory limits on the supervisors' powers, we have not discussed the desired legislative and regulatory changes further in this submission.

8 Pending a regulatory solution to the practical difficulties faced, we submit as follows:

a The wide interpretive view taken to the phrase 'on behalf of' is unhelpful, and should be narrowed to an interpretation more consistent with international practice. The concept of beneficial ownership should not extend beyond persons who control or have an agency-type relationship with a reporting entity. Extending the concept to transactions carried out 'for the benefit of' customers is not legally supported. We do not believe that adopting the narrower interpretation proposed would be inconsistent with FATF recommendations.

b Reporting entities should not be encouraged to audit or second guess the AML CDD processes of another reporting entity (or of persons resident in another jurisdiction with sufficient AML systems and measures in place who are supervised or regulated for AML/CFT purposes). This is highly inefficient, and creates a significant layer of avoidable commercial tension. Instead, reporting entities should be encouraged to rely upon those AML CDD processes without further enquiry, unless they have reason to believe the other entity's processes are deficient. We recommend the supervisors expressly recognise the reasonableness of such reliance.

Beneficial owner definition

9 Paragraph 23 of the Factsheet significantly expands the class of persons commonly understood to be beneficial owners. Transactions with a primary purpose of benefiting clients are introduced into the concept of transactions entered into 'on behalf of' clients. This point is emphasised further in this paragraph where it is stipulated that such clients will be regarded as beneficial owners 'whether or not the underlying clients have any direct rights or control over any part of the transaction conducted by the managing intermediary'.

10 Adopting such a wide interpretation of the concept of 'on behalf of' is inappropriate and unnecessary. We do not believe there is any legal basis for such a wide interpretation, which is inconsistent with the wider provisions of the AML/CFT Act and Regulations. The interpretation is also at odds with FATF's focus on persons 'exercising ultimate effective control'. Our view is that a much stronger connection is required than a mere beneficial interest.

11 In particular, this wide interpretation would have a catastrophic impact upon the common practice of funds investing into other funds.

12 For example, requiring a wholesale master trust to conduct CDD on every underlying investor into a retail managed fund (being a managing intermediary) would be unworkable. Section 37 of the AML/CFT Act would then prohibit the master trust from accepting investments from the managing intermediary retail fund, unless the requisite information was forthcoming or agency relationships were confirmed to an appropriate level (which is not a given). Whilst the investments in the master trust would be conducted with the primary purpose of benefiting the underlying investors in the retail fund, they are equally quite clearly not conducted 'on behalf of' the underlying investors, but instead are conducted 'on behalf of' the retail fund itself. These investments are made in order to discharge the relevant fund manager's obligations under the governing provisions of that fund. Adopting the wider interpretation put forward in the Factsheet would be entirely disproportionate in this scenario.

13 The inappropriateness of the interpretation placed on the concept of 'on behalf of' is highlighted in the example put forward at Appendix 3 of the Factsheet. Investors/underlying clients in a fund may well be the beneficiaries of a transaction implemented by a reporting entity on the instruction of the relevant fund manager. However, it is unreasonable to regard those investors as being individuals on whose behalf the transaction is being conducted. There is a separate legal entity between them and the transaction, taking ownership of the funds invested at the retail level for its own purposes. The retail investors also have no ability to control or direct or even influence the transactions in question. The retail fund managers have CDD obligations in relation to any investor who invests in the relevant fund. The broker should only need to conduct CDD on the fund manager itself, and any beneficial owner of the fund manager. The classes of individuals that make up the beneficial owners of the fund manager should not be extended to non-controlling underlying investors. Such an extension would give rise to inefficiencies and duplication, and in our view is not supported as a matter of law.

14 The above submission reflects our interpretation of the law, and is consistent with our understanding of the advice many of our competitor law firms have given to their clients when advising on their compliance obligations under the AML/CFT Act. In our view, an amendment to the AML/CFT Act itself would be required in order to support the wide interpretation of beneficial ownership expressed in the Factsheet.

Reliance on the managing intermediary

15 Section 34 of the AML/CFT Act permits reporting entities to authorise other persons to be their agent. It enables them to rely on such agents to conduct CDD and obtain any information required. Section 33 allows reliance on non-agent reporting entities (or offshore equivalents) to undertake CDD, subject to certain conditions. The fact that most overseas jurisdictions do not impose CDD obligations to the same level as New Zealand means that use of section 33 when dealing with offshore managing intermediaries is generally not possible.

16 One of the main practical difficulties posed by the sections referred to above is that the reporting entity will remain responsible for AML/CFT Act compliance regardless of that reliance. In the case of section 33 this is explicit, in the case of section 34 this arises by virtue

of the principal-agent relationship required. As a consequence, reporting entities are reluctant to rely upon third party CDD without first satisfying themselves as to the robustness of the processes in place. This gives rise to concerns over commercial sensitivity. It also results in entities that are in a weak negotiating position being potentially precluded from doing business, as they have no direct relationship to be able to conduct CDD on the managing intermediaries' clients.

17 In our view, a more proportionate approach to addressing a reporting entity's AML/CFT Act obligations in relation to the clients of a managing intermediary, within the current wording of the AML/CFT Act, is available. That approach would be for the supervisors to expressly recognise that it is reasonable for a reporting entity to rely upon the robustness of the AML CDD processes adopted by another reporting entity, or upon an overseas resident falling within section 33(2)(a)(i), without further enquiry.

18 The proposed relief would be limited to reliance upon reporting entities in the position of a managing intermediary, who have been authorised to act as the first reporting entity's agent in accordance with section 34. Unfortunately, we believe the wording of section 33 of the AML/CFT Act makes the proposal ineffective in a non-agency situation, as the express statutory imposition of responsibility set out at section 33(3) means that reporting entities would be unable to fully rely upon the proposed relief. That statutory restriction is not present with section 34.

19 The 'no enquiry' relief proposed above would be denied where the first reporting entity has reason to believe that the AML CDD processes of the managing intermediary are deficient. Such reason could exist where a supervisor has signalled an issue of concern with the reporting entity, but would not necessarily be limited to official signalling. The key is that a reporting entity should not be required to initiate any investigation itself in the absence of any external signs that it would be inappropriate to rely upon another entity that is similarly supervised for AML purposes, or that is supervised or regulated for AML/CFT purposes in an acceptable overseas jurisdiction.

20 If the approach proposed above were to be adopted by the supervisors, the inefficiency and impracticality of effectively forcing reporting entity's to second-guess the processes of managing intermediaries could be overcome, or at least reduced. This is not an absolute solution to the difficulties faced, but could provide a pragmatic interim level of comfort for reporting entities whilst a more comprehensive regulatory solution is developed. On that basis, we believe incorporating such an approach into the Factsheet has merit.

Conclusion

21 We have limited the content of our submission to the two key areas where we believe the supervisors have some flexibility to mitigate the regulatory burden imposed by the AML/CFT Act in the circumstances covered by the Factsheet.

22 Irrespective of the adoption of our proposals, we urge the supervisors to defer implementation of the proposed requirements in relation to managing intermediary arrangements until there has been opportunity for the practical implications of the new regime in this area to be further considered. Hopefully a regulatory solution can be developed. If not, we see the practical application of the AML/CFT Act, as outlined in the Factsheet, as carrying a high risk of

impairing the ability of New Zealand financial institutions to do business with their offshore equivalents, and causing significant inefficiencies in our domestic markets.

23 We would be happy to discuss any of the contents of our submission or the practical difficulties identified if that would be of assistance, or to meet with you to further explore options for pursuing a legislative amendment to address those difficulties.

24 We are conscious that a number of other law firms share similar concerns to those we have raised. We are happy to work collaboratively with them, the supervisors, and the team at the Ministry to devise a solution that provides an appropriate balance to the challenges involved.

Yours faithfully
Kensington Swan

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