SIA | SECURITIES INDUSTRY ASSOCIATION

1 August 2013

Kirsty Campbell,
Manager Commercial Supervision,
Financial Markets Authority,
PO Box 106-672,
Auckland 1143

E-mail: aml@fma.govt.nz

Dear Kirsty,

Practical implications of Factsheet on Managing Intermediaries feedback

I attach the submission prepared by the Securities Industry Association (SIA) in respect of the FMA Consultation paper on the "**Practical implications of Factsheet on Managing Intermediaries"** released in July 2013.

No part of this covering letter or this submission is required to be kept confidential.

Contact information:

Frank Aldridge	Chairman, SIA & Managing Director, Craigs Investment Partners
Postal Address:	C/- Craigs Investment Partners, P O Box 13 155, Tauranga
Telephone:	07 577 4734
E-mail:	frank.aldridge@craigsip.com

Alternatively, contact Rob Dowler who provides Secretariat services to the SIA

Rob Dowler	C/- Red Owl Consulting Ltd, 9 Bayview Rd, Hauraki, Auckland, 0622
Telephone:	09 486 7549
Mobile:	027 275 8770
E-mail:	red.owl@ihug.co.nz

Yours faithfully
Frank Aldridge

Chairman
SECURITIES INDUSTRY ASSOCIATION

Submission

From the Securities Industry Association

FMA Consultation paper on the "Practical implications of Factsheet on Managing Intermediaries"

1 August 2013

The Securities Industry Association is an unincorporated body established to represent the New Zealand Sharebroking Industry and provides a forum for discussing important industry issues and developments, managing industry change, and to represent the broking industry in respect of legislative management, operational and regulatory issues that impact the industry as a whole.

The Securities Industry Association members deal with a combined 200,000 New Zealand retail investors with total investment assets exceeding $40 billion. They also deal with virtually all global institutions with the ability to invest in New Zealand.

SUBMISSION

Thank you for the opportunity provided to complete a submission on the FMA Consultation paper on the "**Practical implications of Factsheet on Managing Intermediaries"**

General comments

The AML/CFT Act was expected to deliver well-defined, efficient and disciplined "Know Your Customer" ("KYC") practices to the market. Central to this is a risk-based approach. These are desirable outcomes in today's, often complex and costly, regulatory environment.

The structure of the NZ Financial Services environment effectively means that all NZ Clients will be required to contract with a financial service provider (FSP) in New Zealand to undertake a financial transaction. All FSP's in NZ will be Reporting Entities (REs) for the purposes of the AML/CFT Act and therefore have obligations to undertake Customer Due Diligence (CDD). The disciplines of performing appropriate CDD are effectively mandatory on all participants in the financial system that allow clients entry access to perform financial transactions. CDD will therefore be undertaken on all participants in the financial system and there is no susceptibility to anonymity.

Given the three key stages of money laundering are considered to be Placement, Layering and Integration, the requirement to undertake CDD at the point of entry into the financial system is the most efficient way to detect and deter ML/FT activity. Transaction monitoring and prohibitions of, or strong controls around, third party receipts and payments are the most effective controls to limit potential layering and integration of ML/FT proceeds.

Requiring all REs that undertake transactions on behalf of another RE that has underlying clients/investors to also undertake CDD on those underlying principals adds a level of duplication, complexity and inefficiency with no discernible benefit with regards to ML/FT risk reduction to any of the three stages of ML/FT activity as there is no anonymous participant. We are of the view that imposing this obligation would not reduce ML/FT risks. This is consistent with the fact that comparable requirements are not in place in other comparable jurisdictions (e.g. Australia and the UK, amongst others - We know of no others where this is required – Refer to Appendix A, attached to this submission).

Further, SIA participants predominantly have principal-to-principal or two-way relationships with the REs that they service; there is no direct relationship with the underlying clients/investors. We do **not** regard the underlying person as our clients as services are **not** being provided to them. Service is provided to the RE as a regulated party at their direction. We ought to be able to reasonably rely on the RE as having fulfilled its obligations to its client. This is also standard convention in overseas markets in dealings between regulated participants, i.e. a broker providing execution services to fund managers and other regulated financial institutions.

More broadly, we believe that the issue in NZ stems from the lack of inclusion of a broader range of other reporting entities (in accordance with the level of risk) as being subject only to simplified customer due diligence at the reporting entity level. However, that issue (and our previous submissions to the Ministry of Justice on when simplified customer due diligence can be applied - refer appendix C attached) appears to be largely beyond the scope of this current Consultation Paper, while remaining highly relevant, in our strong view. We think that this issue has to be revisited and our primary recommendation is that this be done.

Note also that we have outlined in Appendix D a suggested alternative interpretation on a person on whose behalf a transaction is conducted that, if adopted, would enable the Factsheet to be rewritten in a way that provided appropriate relief.

Potentially imposing the CDD obligations on an RE that has no direct contractual link or other connection with an underlying client/investor of its client is neither consistent with a risk-based approach nor efficient in terms of the effort required and introduces an additional layer of complexity into relationships between REs relative to the ML/FT risks faced by the system. Indeed, the manner in which the factsheet is currently drafted indicates that the operation of the market, distinction between legal and beneficial ownership and economic beneficiaries of transactions or the FATF principles relating to regulated entities, have not been well understood.

To demonstrate the issues that arise, there are also a range of structures that can be considered, such as mutual organisations e.g. co-operatives /mutually owned building societies or insurance companies, that are beneficially owned by multiple underlying "shareholders," i.e. farmers, depositors or policy holders.

Consider a depositor opening a mutual building society share account where the depositor effectively becomes a beneficial owner. The building society, through its treasury department, undertakes a transaction with a bank, which transaction would be expected to include funds contributed to it by all depositors. Applying the FMA Fact Sheet in this situation would potentially require the bank to undertake DD on each of the mutual building society's depositor/shareholders.

The two options in the AML/CFT Act to ensure compliance with the current drafting are to:

1. Rely on another RE to undertake CDD on its underlying principals and to obtain the information; or
2. Appoint the other RE as its agent to conduct CDD and obtain information.

1. Undertaking CDD and obtaining information

Where an RE is relying on the other RE to undertake CDD as required by the Act it permits the client facing RE to provide the information. (Section 33 also permits the RE to obtain the CDD information from the other RE/regulated person in an acceptable jurisdiction.) It would be expected that all necessary information has already been obtained and held by the client facing (and regulated) RE as expected under the AML/CFT Act. Providing this information further up the chain (i.e. to the RE as service provider for the other RE) will not reduce the ML/FT risks, adds overheads in terms of additional processes, data storage and reduces efficiency in the NZ financial markets. The only benefit would appear to be that the client facing RE has in effect had its CDD processes subject to scrutiny and review by another RE.

2. Appointing an RE as Agent

Requiring the RE to appoint the client facing RE it is transacting with as its agent for CDD purposes for underlying principals has no material impact on reducing the risks of entry of ML/FT activity in to the financial system because CDD has already been undertaken (by the client facing RE or another agent, where involved). As with section 33 requirements, arguably the only benefit may be add to the level of scrutiny/commercial due diligence an RE undertakes prior to appointing another RE as its agent. There may be expected to be some due diligence of the other RE's Compliance Programme. Sharing client information can be highly business sensitive and REs would be reluctant to share it with competitors. Further, breach of privacy requirements should also be considered and express client consent may be required. Reliance on the fact that the RE being dealt with is regulated by an approved regulator should be deemed sufficient.

Other jurisdictions with well-defined and established AML/CFT regimes do not require NZ entities to either pass on this kind of information or appoint them as agents under their regulations.

Whilst acknowledging that the FMA's Consultation Paper has been formulated on the basis of what would appear to be a late change of interpretation by FMA of the legislation as drafted, the proposals contained in the Consultation Paper, while seeking to be pragmatic where possible, are likely to have some significant unintended consequences that may extend as far as limiting the amount of international investment into NZ. International investment plays a significant in the NZ market. For example, why would a US fund manager go through the burden of providing the CDD contemplated in respect of its underlying investors just to invest in the NZ market, when it would not have to go through that process in Australia? In our view, the simple answer is that they won't. Furthermore, consider for a moment the challenges of a NZ broker acting as NZ execution agent on the NZ market for a global investment bank in terms of CDD of that institution's underlying clients.

Other fundamental basics such as consideration of the fact that, for example, REs such as fund managers (including in respect of Kiwisaver funds) will in many cases have tens of thousands of underlying unit holders are not addressed in the consultation paper.

Requirements as set out in the Fact Sheet

The Consultation Paper sets out that where a transaction is executed for a "Managing Intermediary" which may include the likes of:

- Fund managers (international and domestic (including Kiwisaver))
- Brokers (domestic or international)
- DMA clients
- Financial advisers
- Trustees

Where those Managing Intermediaries have underlying investors, each and every one of those underlying investors are likely to be persons "on whose behalf the transaction is conducted" (see paragraph 23):

> *"If a primary purpose of a transaction conducted by a managing intermediary is to invest funds for the benefit of (any number of) underlying clients, then even if a defined profit is taken by the managing intermediary, those underlying clients would usually be persons on whose behalf the transaction is conducted. This is the case whether or not the underlying clients have any direct rights or control over any part of the transaction conducted by the managing intermediary."*

Prima facie, as a person on whose behalf the transaction is conducted (e.g. an investor in an investment trust), the implication is that CDD needs to be carried out on each of the underlying investors by the person providing the financial service, whether or not those underlying clients have any direct rights or control over any part of the transaction (as would be the case where the underlying client is an investor in another vehicle e.g. investment funds).

The Consultation Paper goes on to note that the Reporting Entity may not necessarily need to conduct CDD on the underlying clients itself as it can rely on others in the chain to perform the CDD obligations as those obligations will "match" the reporting entities (paragraph 26):

"This means that where a reporting entity deals with a managing intermediary, the reporting entity will usually have a CDD obligation to look through any managing intermediaries to the beneficial owners of the underlying clients. This does not necessarily mean that a reporting entity needs to complete the CDD itself, as its obligations will match those of any managing intermediary down the chain."

The Consultation Paper then suggests how section 33 and 34 may be used to meet those obligations (paragraph 34):

> *"Having a CDD obligation in respect of an underlying client does not mean that you personally have to conduct CDD on that individual. Where a number of connected reporting entities/managing intermediaries have CDD obligations in respect of the same underlying client in a transaction chain, not every reporting entity/managing intermediary in the chain needs to separately conduct CDD on the underlying client. Sections 33 and 34 of the AML/CFT Act allow CDD to be performed on the underlying client by just* ***one person*** *in a chain of reporting entities/managing intermediaries. Subject to the terms of the AML/CFT Act, other reporting entities may rely on that third party to discharge their CDD obligations."*

As noted in Appendix 3 in the consultation paper, the corollary of this is that the FMA considers it "likely" that the Broker would include provisions in its terms and conditions requiring fund managers to act as agent of the RE in relation to conducting CDD. This significantly understates what would be required in arranging such an agency agreement as various aspects would need to be addressed. As noted at paragraph 39 of the Consultation Paper, where the reporting entity uses a third party to conduct CDD, the reporting entity will nonetheless always be responsible for ensuring that the CDD is carried out in accordance with the AML/CFT Act. It is therefore in the reporting entity's interest to ensure the arrangements under the agency agreement are sufficient to meet their AML/CFT requirements and this is likely to include provisions other than simply stating the agent is responsible for carrying out CDD.

It is important to note that in relation to the scenarios provided in Appendix B attached to this submission, a broker/financial adviser/fund manager can only realistically be expected to observe what is happening through its business – i.e. the trading activity that actually occurs through its systems. For example, a broker has no sight of the activities of the underlying investors of a third party broker or a fund e.g.:

1. buying and selling units in funds or individual shares
2. introducing or withdrawing funds to the managing intermediary
3. new clients joining or leaving the managing intermediary
4. the financial circumstances and changes thereto of those clients

Essentially any activity that would enable someone to enter and withdraw funds from the financial system is the responsibility of the client facing RE even if the broker were to have an agency arrangement in place with that RE.

It is relevant to note that NZX Participant Rules prohibit cash handling by NZX Participants. Further, the Securities Commission Risk Assessment (page 16) itself notes that "The industry generally does not accept cash from customers for the sale and purchase of securities listed on the NZX. Sharebrokers that do not accept cash are much less likely to be used by money launders to place funds into the financial system. Sharebrokers are typically used to layer funds by moving funds between various sharebroking accounts."

Some additional comments on Agency arrangements

As the international scenarios in Appendix B highlight, on an international scale, Agency arrangements with other financial service participants (particularly where those participants are subject to their own AML regime) are likely to be impractical or ineffectual.

Looking at the matter from a domestic point of view, implementing a vast number of agency agreements has the potential to impose a significant duplication of costs across industry for very little, if any, benefit. As noted in scenario 4 (see Appendix B), there is the possibility that agency paperwork may go full circle, when the primary responsibility for CDD rests with only one RE in the chain.

Furthermore, in order for REs to be comfortable with agency agreements, it is inherent that there will be a certain amount of on-going DD. The REs will end up having to spend significant resources on managing agency relationships and reviewing each other. The guidance significantly underestimates the work involved in maintenance of agency relationships if these were to be done right – e.g. with routine reviews and audits. So it has a high risk of becoming form over substance, paper over quality. In addition, we contend that the current interpretation of "on whose behalf the transaction is being carried out" is unworkable as it is possible that an entity may be held liable for breaches regardless of how far removed the underlying investor down the chain may be from them. Apart from concerns around efficiency and cost, it has potential to turn draconian in its application.

Simplified Customer Due Diligence and the Factsheet

It is clear that allowing simplified due diligence to be conducted on financial institutions subject to equivalent money laundering and terrorist financing legislation, and who are supervised to ensure compliance with that legislation, would resolve the impracticality of the proposed requirements where your customer is a managing intermediary. By conducting simplified due diligence, you are not required to identify beneficial owners and would therefore not need to look through to the individual customers of the intermediary. This would be consistent with the jurisdictions referred to above, all of which are global financial centres. The volume and value of transactions that take place in the financial markets within these countries are significantly higher than in New Zealand.

Allowing simplified due diligence on regulated financial institutions is also consistent with the FATF Recommendations. The Recommendations state that it could be reasonable to allow financial institutions to apply simplified due diligence to customers who are financial institutions subject to requirements to combat money laundering and terrorist financing, and that are supervised to ensure compliance with those requirements.

Paragraph 39 of the draft FMA Fact sheet states that:

> *"Where a reporting entity uses a third party (under either section 33 or 34) to conduct CDD, the reporting entity will always be responsible for ensuring that the CDD is carried out in accordance with the AML/CFT Act."*

Where the intermediary is another RE, that intermediary is already required to comply with the AML/CFT Act and undertake CDD on their customers. A RE undertaking a transaction with an intermediary should not be required to ensure the intermediary is complying with the AML/CFT Act. That is the role of the AML/CFT supervisor. The RE transacting with the intermediary should be able to rely on the fact that the intermediary is required to comply with the AML/CFT Act and is supervised to ensure compliance with the Act, and therefore not be required to look through to the beneficial owners of the intermediary.

Primary Recommendation

We submit that REs should be able to conduct simplified customer due diligence on other REs or similarly regulated entities in other jurisdictions. To restate, this is consistent with well-established international convention in other FATF member countries. If this was put in place, then it would not be necessary to look through to the beneficial owners of that financial institution, so the factsheet would effectively be redundant for those situations. This would also be consistent with the customer due diligence obligations in other jurisdictions (Refer to Appendix A, referencing the provisions applicable in other selected jurisdictions.) Whatever is necessary to achieve this, including urgent legislative change, if required, should be progressed as quickly as possible.

Transactions with Overseas Intermediaries

The Ministry of Justice's Regulatory Impact Statement published in October 2010 states:

> *"Key considerations have been to comply with the FATF standards, ensure the response is proportionate, ensure costs to industry are minimised, and harmonise New Zealand's AML/CFT regime with Australia's wherever possible and appropriate."*

In our view, the proposals under the Consultation Paper do not fundamentally align with Australian, or indeed international regimes (Refer to Appendix A attached to this submission). As noted (see scenario 1 in Appendix B attached to this submission), the NZ regime does not specifically have a mechanism making it permissible to recognise CDD carried out under an equivalent AML regime. As such, the proposals under the fact sheet are unduly onerous when dealing with a foreign jurisdiction, as the NZ regime prima facie requires "agents" to adhere to NZ CDD standards.

The draft Factsheet does not appear to take into consideration transactions with intermediaries located outside New Zealand. If the transaction described in Appendix 3 of the Factsheet took place with a UK regulated fund manager, it is difficult to see in practice how either section 33 or 34 of the AML/CFT Act could apply. Both sections require the UK fund manager to conduct customer due diligence in accordance with the procedures required by the AML/CFT Act in order for the NZ broker to place reliance on them. If the underlying clients of the UK fund manager are other regulated financial institutions, the UK fund manager would have only conducted simplified due diligence on those clients and therefore would not have conducted customer due diligence in accordance with the AML/CFT Act. The NZ broker would then be required to look through the intermediary to the intermediary's underlying clients. This is an increased burden on NZ financial institutions and is likely to restrict their ability to do business with overseas regulated financial institutions.

It is unclear what the benefit is to NZ financial institutions of having a more restrictive AML/CFT regime than that of other larger jurisdictions. It is also unclear what money laundering risk is being mitigated by requiring financial institutions to look through to the underlying clients of intermediaries who are already required to comply with the AML/CFT Act. By allowing simplified due diligence to be conducted on regulated financial institutions, which is consistent with the FATF Recommendations and other jurisdictions, the impracticalities of the draft Fact sheet would be easily resolved.

Some Additional Comments on Specific Paragraphs in the Factsheet

1. Para 2(ii) and Para 3 caused some confusion; it appeared to be a duplication. So we would suggest the sentence in paragraph 2(ii) *"but it does not mean that a reporting entity dealing with a managing intermediary can turn a blind eye to the source of funds"* is deleted. Para 3 is then expanded to explain the necessity to establish the source of funds when considering nature and purpose as opposed to the obligation to obtain source of funds or wealth of customer when considering enhanced due diligence.

2. We disagree with the references in appendix 2 (fund manager) to the investors in managed funds being *"likely to be"* the beneficial owner of the fund manager. This places a CDD obligation on the custodian of the managed fund's assets.

3. Paragraphs 43 to 47 refer to the Regulation 24 exemption. When that exemption was proposed to be amended, the Minister of Justice expressly stated that the purpose of the exemption was to allow persons dealing with **custodians** to gain the benefit of the exemption. Refer to the Minister's Cabinet Paper dated 7 February 2013. The example given in the guidance note refers to banks gaining the benefit of this exception. It would be helpful if the guidance note could include another example whereby a broker that is dealing with a custodian had the benefit of the exemption. Quoting only the bank example implies that custodians are not caught if they provide more than just a cash deposit facility (Minter Ellison has suggested this in a publicly available newsletter dated 15 July 2013). Custodians offer more than just a cash deposit facility. The interpretation suggested by the note contradicts the Minister's stated intention and we request that clarification is given to show that persons dealing with custodians have the benefit of the exemption.

4. Paragraphs 43-46. Taking the paragraph 45 example given of a wrap provider or fund manager's account with a registered bank. Ultimately a broker would be settling the money side of transactions in securities (as execution broker) into that wrap provider or fund manager account (or an account of a settlement agent or custodian appointed by them), or conversely they would be paying the broker from that account (or that of an appointed settlement agent or custodian). The bank as the holder of the trust account is exempt from end customer/investor CDD obligations and yet a broker as a RE would not be. This is despite that both the bank and broker are only directly facing the RE client (being the wrap provider or fund manager, as the case may be), and both know that the RE has underlying customers and has AML/CFT obligations.

5. This does in our view raise the very real question of inconsistency of approach. In other words, a bank provides a facility to a RE and does not have CDD obligations down the chain, yet a broker provides a facility to a RE and would be expected to complete CDD on the underlying clients/investors.

Factsheet Consultation Timing & Timeframe

We note that this consultation appears to represent a late change of interpretation by FMA and is taking place after full implementation of the regime has come into effect, that advice of the release of the consultation paper by the FMA was relatively limited (with the RSS feed initially failing to list the new consultation document, the other two supervisor's websites do not appear to reference or promote the consultation - raising a question as to whether their supervised REs are even aware of the consultation and, for example, the document still not appearing on the standard FMA webpage listing consultation papers). Finally, only three weeks were provided for consultation.

Further, the consultation paper states:

> *Nothing in this consultation paper shall imply that any exemption will be granted or any change of law made.*

The "good faith" provision that the FMA references in the document relating to relief from potential enforcement action is stated as only extending so far as the consultation period.

Noting that the legislation was enacted in 2011, we query whether this is an appropriate way to progress regulatory development and implementation.

Particularly taking account of the timing of the release of this substantive draft guidance, we submit that the FMA approach is unrealistic and unreasonable, as it is simply not practical to expect that all affected REs in NZ have the opportunity or hope of putting in place the arrangements now outlined (or confirmed) in this guidance for the first time as being required to be negotiated and implemented with other NZ REs and overseas entities.

As noted earlier, we therefore suggest that further consultation be undertaken or that the Factsheet release be delayed pending legislative consideration of broader issues and that greater relief from enforcement action be provided in the interim.

We also comment that the limited timeframe for consultation may be evident in this submission. If some of the material appears to be disjointed or duplicated in parts, this reflects the limited time available (especially two weeks over school holidays) to properly canvas, collate, review and provide to you the views received from SIA member NZX Firms. In this circumstance, we request that you overlook any such deficiencies when considering the submission.

Supervisory coverage

While noting that the draft Guidance Note includes the logos of the three AML/CFT supervisors, it is unclear in the draft note and covering information as to whether the proposed approach to interpretation is intended to be adopted by all supervisors.

However, we do note that the covering information under the heading "Enforcement Action" states, "…., *please refer to the enforcement policies published by those AML/CFT supervisors.*", thereby referencing the RBNZ and the Department of Internal Affairs. This appears to open up the possibility that either the policy or enforcement may be applied differently to the same types of entities subject to the oversight of a different supervisor. For example, an NZX Firm that is a subsidiary of a bank may be subject to RBNZ supervision for AML/CFT rather than being subject to FMA supervision in contrast to other NZX Firms.

We regard any such divergence of policy or enforcement action as inappropriate and we would welcome receiving confirmation that the statutory and regulatory mechanisms put in place to ensure consistency across the supervisors will ensure that the policy decisions contained in the final guidance will be uniformly applied to all supervised REs.

Concluding Comments

We recognise that each participant in the financial industry has their part to play in the fight against financial crime. The regime is cognisant of this fact and imposes that obligation on each financial institution by designating them as an RE. As an RE, financial service providers accept that they have a range of obligations to the supervisors and the FIU that they are required to fulfil. Potentially imposing obligations on REs of a nature that fundamentally do not further mitigate or reduce ML/TF risk but would have the effect of introducing duplication of effort, unnecessary complexity, significant practical issues, and also resulting in increased costs, would appear to be inconsistent with the aim of the AML/CFT Act (section 3(1)). Further, the proposal has the potential to make it unnecessarily difficult for offshore financial institutions investing/transacting in the NZ market.

Finally, in line with the comments contained in the discussion paper, we also request that the views contained in this submission be passed to the Justice Department and to the other supervisors. We would then welcome the opportunity to discuss our reservations and observations, including from an international perspective, with both the Supervisors and the Ministry of Justice.

We are also in the process of drafting a letter to the Minister of Justice, among others, outlining some of the key concerns that we have with the approach being taken in relation to the limited number of entities able to be subjected to simplified customer due diligence, as well as deficiencies that we have identified in relation to the development and implementation of the AML/CFT regulation that we believe carry lessons important to the development and implementation of government regulation more generally.

Appendix A – Practices in Other Jurisdictions & Other Industry Guidance

It is worth comparing the practice in the United Kingdom, Singapore and Hong Kong. All three of these countries are global financial centres and full FATF members.

United Kingdom

Regulation 13 of the Money Laundering Regulations 2007 provides that:

> *"(1) A relevant person is not required to apply customer due diligence measures…where he has reasonable grounds for believing that the customer…falls within any of the following paragraphs.*
>
> *(2) The customer is-*
> *(a) a credit or financial institution which is subject to the requirements of the money laundering directive; or*
>
> *(b) a credit or financial institution (or equivalent institution) which-*
> *(i) is situated in a non-EEA state which imposes requirements equivalent to those laid down in the money laundering directive; and*
> *(ii) is supervised for compliance with those requirements."*

This means there is no requirement to identify the beneficial owners of financial institutions who are subject to the requirements of the EU directive on the prevention of the use of the financial system for the purpose of money laundering and terrorist financing, or financial institutions who are supervised in jurisdictions with equivalent requirements to prevent money laundering and terrorist financing.

Further guidance on customer due diligence requirements for intermediary relationships is provided by the Joint Money Laundering Steering Group (JMLSG). The JMLSG is made up of the leading UK Trade Associations in the financial services industry and has been producing money laundering guidance for the UK financial sector since 1990.

Paragraph 5.6.39 of the JMLSG Guidance for the UK Financial Sector Part I relates to an intermediary, as agent of a customer, undertaking business with a product/service provider. It states:

> *"Depending on jurisdiction, where the customer is an intermediary carrying on an appropriately regulated business, and is acting on behalf of another, there is no obligation on the product provider to carry out CDD measures on the customer, or on the underlying party"*

The guidance goes on to say that there is an obligation to carry out due diligence on the intermediary and the underlying customer where the intermediary is not appropriately regulated. In addition, there is an obligation to carry out due diligence on the underlying customer if you take instructions directly from them.

Singapore

The Monetary Authority of Singapore Notice SFA04-N02 applies to all holders of a capital markets services licence. Paragraph 4.17 of the Notice states that there is no requirement to identify a beneficial owner of a customer that is:

> *"(e) a financial institution supervised by the Authority…;*
> *(f) a financial institution incorporated or established outside Singapore that is subject to and supervised for compliance with AML/CFT requirements consistent with standards set by the FATF; or*
> *(g) an investment vehicle where the managers are financial institutions-*
> > *(i) supervised by the Authority; or*
> > *(ii) incorporated or established outside Singapore but are subject to and supervised for compliance with AML/CFT requirements consistent with standards set by the FATF…"*

The same wording is used in the Notice that applies to licenced financial advisers (FAA-N06).

Hong Kong

Pursuant to section 4, Schedule 2 of the Anti-Money Laundering and Counter-Terrorist Financing (Financial Institutions) Ordinance, simplified customer due diligence may be carried out when:

> *"(3) The customer is-*
> > *(a) a financial institution;*
> > *(b) an institution that-*
> > > *(i) is incorporated or established in an equivalent jurisdiction;*
> > > *(ii) carries on business similar to that carried on by a financial institution;*
> > > *(iii) has measures in place to ensure compliance with requirements similar to those imposed under this Schedule; and*
> > > *(iv) is supervised for compliance with those requirements by an authority in that jurisdiction that performs functions similar to those of any of the relevant authorities;*
> >
> > *…*
> > *(d) an investment vehicle where the person responsible for carrying out measures that are similar to the customer due diligence measures in relation to all the investors of the investment vehicle is-*
> > > *(i) a financial institution;*
> > > *(ii) an institution that-*
> > > > *(A) is incorporated or established in Hong Kong;*
> > > > *(B) has measures in place to ensure compliance with requirements similar to those imposed under this Schedule; and*
> > > > *(C) is supervised from compliance with those requirements; or*
> > >
> > > *(iii) an institution that-*
> > > > *(A) is incorporated or established in an equivalent jurisdiction;*
> > > > *(B) has measures in place to ensure compliance with requirements similar to those imposed under this Schedule; and*
> > > > *(C) is supervised for compliance with those requirements;…"*

When simplified due diligence applies, financial institutions are not required to identify and verify beneficial owners.

The Guideline on Anti-Money Laundering and Counter-Terrorist Financing published by the Securities and Futures Commission makes it clear that simplified due diligence can be applied to a customer when it is a financial institution opening an account in the name of an investment vehicle in the capacity of a service provider (such as a manager) to the investment vehicle and the underlying investors have no control over the management of the investment vehicle's assets. This is provided the manager has conducted due diligence on the investment vehicle pursuant to the money laundering legislation. In order to ascertain whether the institution is complying with the relevant legislation, it will generally be sufficient to verify that the institution is on a list of authorised (and supervised) financial institutions in the jurisdiction concerned (see paragraphs 4.10.6 and 4.10.7 of the Guideline).

Other Industry Guidance

The Wolfsberg Group is an association of 11 global banks formed in 2000 with the aim of developing financial services industry standards for anti-money laundering and counter terrorist financing policies. They have published global anti-money laundering guidance, statements and principles with regard to private banking, investment banking, correspondent banking, terrorist financing, monitoring pooled vehicles and the risk based approach.

In their FAQ on Selected Anti-Money Laundering Issues in the Context of Investment and Commercial Banking, the Wolfsberg Group use the term "institutional intermediary" to refer to financial institutions (i.e. institutional counterparties) that act on behalf of their clients.

The view of the Wolfsberg Group is that when a financial institution, applying its risk based approach, determines that an institutional intermediary is subject to adequate AML regulation and is supervised for compliance with such regulation, the obligation is only to conduct due diligence on the institutional intermediary. There is no need to conduct due diligence on the institutional intermediary's customers. The Wolfsberg Group go on to state that:

> *"Similarly, it would be inappropriate to view an institutional intermediary's customer as having a beneficial ownership interest with respect to transactions entered into between the institutional intermediary and the Financial Institution."*

Appendix B – Application to some Typical Scenarios

For the reasons set out in the submission, applying the requirements of the Fact Sheet to the following scenarios has the potential to have serious adverse economic consequences in our view:

Scenario 1

An internationally located fund manager wishes to trade TEL on the NZX. The fund manager is not listed on an exchange. The international fund manager is located in a jurisdiction that has its own AML regime and the fund manager is regulated (and/or authorised) by their home regulator for the purposes of AML. The fund manager carries out CDD to the standard required by its home jurisdiction AML regulator. The fund manager approaches an NZX firm to execute the trade.

As set out in the Consultation Paper, the NZX broker, on identifying that the fund manager is a "managing intermediary" is faced with two options:

1. Collect CDD on all underlying clients of the international fund seeking to execute the TEL trade; or
2. Appoint the international fund manager as its agent for AML/CFT purposes.

As the number of investors that comprise the makeup of underlying clients in the international fund can be quite substantial, it is wildly impractical for the NZX broker to request and check that information. As such, the only practical solution would be to appoint the fund manager as their agent.

Assuming for the moment that the international fund manager is prepared act as an agent of their NZX broker for AML purposes (which is a somewhat odd relationship given that the fund manager is appointing the broker to act as their agent in executing the trade on the NZX), it is likely that the international fund managers customer due diligence programme would not be fully aligned with the requirements of the NZ regime where they are subject to their own overseas AML regime.

Furthermore, as the NZ regime makes no provision to recognise equivalent CDD requirements under a comparable AML regime (i.e. regimes in Australia, UK, Canada, US etc) it is not practically possible for the NZ RE to appoint and rely on the fund manager to meet AML/CFT requirements at any rate.

Practically, we do not see how an NZ firm in this scenario could comply with the proposals in the Consultation Paper.

Scenario 2

An overseas broker (who is not an NZX participant) that is acting in respect of its own underlying client, seeks to execute a trade on the NZX through their NZ broker. The broker is acting as agent for its own underlying client. The broker is subject to an AML regime (whether in NZ or elsewhere) and carries out its obligations to the standard required in its own jurisdiction.

The same issues as those outlined above apply. In addition however, where a broker has a relationship with a client, they are very protective of their client relationship and are very reluctant to provide any information to a competitor that would enable that competitor to potentially poach that business. As such, the process of appointing the broker as an agent for CDD purposes is likely to be more of a protracted discussion, including non-solicitation issues.

As there is the potential for a number of brokers to be involved in the chain, this process can very quickly become very complicated. Where the process is too difficult to execute, NZ will simply be overlooked as a destination for international investment.

Scenario 3

DMA clients that access the NZX market via a NZX participant will enter into a relationship with the NZX participant for those services. Typically, DMA clients are brokers or fund managers in their own right who are subject to AML requirements.

Similar issues as above apply, as DMA clients have their own underlying client relationship and the reason for them to have DMA access to the NZ market may include reasons such as providing a full international service to their clients. When they execute a trade, while we know who the trader is, we have no knowledge of the underlying client or fund that the trade is for and this is typically recognised in the DMA agreements.

Scenario 4

An investor advised by investment adviser invests in retail PIE fund managed by asset manager X. Retail PIE invests in wholesale PIE. Both PIEs holdings are via custody platform/nominee company. Wholesale PIE invests in fund manager Y with Nominee Company listed as holder. Fund manager Y executes trades through multiple Brokers.

Each broker is viewed as responsible for:

1. CDD on fund manager Y, including its authorised parties, beneficial owners, etc.
2. Nominee company
3. Ascertaining wholesale PIE is the first investor
4. Ascertaining there is another retail PIE underneath
5. Asset manager as authorised person on the accounts
6. Underlying adviser if any, along with its authorised parties, beneficial owners, etc.
7. Original investor, its beneficial owners
8. Transaction monitoring having no visibility over trades

See also comments under the section Agency Agreements below for further comments about the practical implications of this proposed requirement.

Scenario 5

NZ based broker facilitates a float, placement etc. In such situations, the broker is appointed as the agent of the company for the purposes of facilitating the corporate event. The brokers facilitating the corporate activity on behalf of the company etc will meet their own AML requirements with regard to their client (i.e. the company undertaking the corporate action).
Typically, where a broker is facilitating a float, they will co-ordinate with other third party brokers for the placement of stock to the third parties underlying clients and the collation of the requisite funds. Under the Consultation Paper, a possible construction is that the broker facilitating the corporate action would be obligated to collect CDD on the underlying investors of the third party or appoint the third party broker as their agent.

As with other scenarios, commercial sensitivities appear to have been overlooked. It cannot be understated how highly valued and coveted broker relationships with their clients are. They are the basis upon which the broker is able to run their business. The requirement (or even the potential requirement) to hand over those details will be strongly resisted on commercial grounds as well as on the practical basis that each RE has its own AML

obligations to fulfil (whether they be domestic or another jurisdictions requirements), which the proposals merely seek to duplicate.

Scenario 6

Investment adviser provides investment advice services to Trustees of an employer pension fund. As per the Consultation Paper the customer is the pension fund with trustees as authorised parties. According to the interpretation under the Consultation Paper, the investment adviser is responsible for CDD on beneficial owners of the pension fund e.g. the employees investing in it.

This is a very broad compliance obligation. It is our view that fund managers (and those executing the trades – i.e. brokers) transact on behalf of the fund and not for the underlying investor.

Scenario 7

NZX Trading Participant (TP) – places trades on the market for CAP
NZX Client Advising Participant (CAP) – Places order with TP for the FM
Fund Manager (FM) - instructs the CAP to trade on behalf of the fund
Trustee Company (TC) – accepts investors of the fund's money
Bank – transfers underlying investors' money to the TC
Underlying Investor – invests in a large fund with no effective control of the fund

Theoretically, under the Factsheet, an NZX Trading Participant could ultimately be responsible for CDD of the underlying client of the fund.

Appendix C – Extract from SIA submission dated 14 August 2012 on Ministry of Justice AML regulations consultation

Simplified CDD (paragraphs 43 to 48)

We support the expansion of the types of entities in respect of which simplified CDD can be undertaken, particularly the recognition of entities that are regulated to a 'fit and proper' standard under the legislation named in paragraph 47, namely "reporting entities that are supervised or regulated under the New Zealand AML/CFT Act and that are licenced or regulated in accordance with the Insurance (Prudential Supervision) Act 2010, the Reserve Bank of New Zealand Act 1989 or the Non-bank Deposit Takers Bill." However, as far as we are aware, there is no centralised register or other mechanism for all such reporting entities to identify whether the customer is regulated to this standard under any of the three pieces of legislation (while noting the separate lists of registered banks and insurers available via RBNZ webpages). We request that the AML regulation clarifies how a reporting entity is expected to meet this, noting that it would be unworkable for the reporting entity to have to assess for itself whether or not the customer is regulated by that legislation.

It is unclear whether the list of three pieces of legislation is an exclusive list (the use of the word "including" in paragraph 47 implies that it is not). Note that NZX Firms, for example, would not generally fall within the proposed regulatory relief description as they are not generally licenced or regulated under the specified legislation. Another reporting entity entering into a relationship with an NZX Firm would therefore need to undertake standard due diligence and look to beneficial ownership even though an NZX Firm is supervised by NZX under the Securities Markets Act provisions. In some cases, an NZX Firm may also be licenced by the FMA as a QFE.

We would support a more dynamic approach whereby new legislation could be added to the list without new regulations being promulgated, if possible. For instance, the Financial Markets Conduct Bill proposes a fit and proper person test for providers of financial services. A possible approach would be to make the Simplified CDD exemption apply to any reporting entity that is licenced by any one of the three AML/CFT supervisors and thereby subject to a "fit and proper person" test. Again, it would then be useful to have a central register publicly available listing all such licenced entities.

Also, as is standard practice in other jurisdictions (e.g. see UK Money Laundering Regulations), simplified CDD should also be applied to financial services firms which are subject to equivalent money laundering legislation in their home jurisdiction and which are regulated/supervised to ensure compliance with that legislation. Thus simplified CDD can be undertaken when establishing relationships with regulated financial services firms in equivalent jurisdictions, for example, Goldman Sachs in London or Morgan Stanley in New York. This is also consistent with FATF guidance that financial institutions that are subject to requirements to combat money laundering and terrorist financing consistent with the FATF Recommendations, and are effectively supervised, are potentially lower risk and it could therefore be reasonable for a country to allow its financial institutions to apply simplified CDD to such customers.

The aim, in our view, should be to simplify the CDD required to be conducted on regulated financial institutions in jurisdictions with a sufficient AML/CFT legal and regulatory framework in place.

Appendix D – Suggested alternative interpretation on a person on whose behalf a transaction is conducted.

We suggest that the following be considered as an appropriate alternative interpretation on a person on whose behalf a transaction is conducted.

The AML/CFT Act is customer centric.

Section 11 states that CDD has to be completed on
(1)

a) A customer
b) Any beneficial owner of a customer
c) Any person acting on behalf of a customer

(2) for the purpose of (1) (b) a customer who is an individual and who the reporting entity believes on reasonable grounds is not acting on behalf of another person is to be treated as if he or she were also the BO unless the reporting entity has reasonable grounds to suspect that that customer is not the beneficial owner.

The interpretation of a customer covers four points the one that is of interest is

- A facility holder.

So REs have to complete CDD on the beneficial owners (BO) of their customers.

The interpretation of a BO is,

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

Fact sheet para 13 splits this into three

(a) has effective control of a customer
(b) owns a prescribed threshold of the customer (more than 25%)
(c) or person on whose behalf a transaction is conducted

Para 16 suggests that the underlying clients (investor) at the bottom of the chain will be the BO of each intermediary. This is the point that needs to be addressed and, if proven, implies that the fact sheet has to be rewritten.

In our view, there is no argument that as it is currently written the fact sheet is not workable. In the absence of any change to the Act, it is appropriate to look at how the FMA is interpreting the Act, specifically the BO interpretation.

Instead of looking at the BO interpretation as above, consider splitting into three points,

(a) has effective control of a customer
(b) owns a prescribed threshold of the customer (more than 25%)
(c) has effective control or owns a prescribed threshold of a person on whose behalf a transaction is conducted. (specifically looking at an individual)

Para 18 of the fact sheet goes a step too far. Section 11 (2) of the Act suggests that an individual who is a customer is the BO unless there are grounds to suspect that the

individual is acting for another person. This means that they are a BO of themselves as a customer. They are not the BO of the person who is undertaking a transaction on their behalf (the intermediary)

A sensible and possibly an alternative interpretation that we suggest could work is:

If a managing intermediary (MI) is conducting a transaction on behalf of a customer that is an individual. The MI establishes if the customer is acting for themselves; if they are then the individual is a BO of him/herself so CDD is completed on that individual. If it is noted that the individual is doing the transaction at a friend's direction or the funds are partly/wholly owned by a friend or business associate then the MI completes CDD on the third parties as well as the individual who is the customer. The individual will have CDD completed on them irrespective of whether they are in effective control of themselves, being in effective control of themselves does not make them a BO of anyone other than themselves.

If the RE is twice removed from the investor. The RE completes CDD on its customer, the MI below them. That includes the BO's of the MI. Unless the investor owns 25%+ or controls the MI or is a facility holder with the RE then the Act does not require the RE to complete CDD on the investor.

With this interpretation, the Act is not asking RE's to undertake CDD on the individual investor who originally asked for the transaction to be conducted.