TCA

TRUSTEE CORPORATIONS ASSOCIATION of NEW ZEALAND INC

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Dear Kirsty

Factsheet on Managing Intermediaries feedback

1 Thank you for the opportunity to submit on the managing Intermediaries Factsheet (**Factsheet**) released on 11 July 2013. We have reviewed the Factsheet at length and have reservations about the Financial Markets Authority's (**FMA**) interpretation of the Customer Due Diligence (**CDD**) aspects of the Anti-Money Laundering and Countering Financing of Terrorism Act (**AML Act**).

2 In short, we think that the interpretation suggested in the Factsheet would lead to the following unintended consequences:

2.1 Increased compliance costs and risks that will be passed on to investors, in the form of higher fees and lower returns;

2.2 The increase in compliance costs will have no corresponding regulatory benefit because they are a function of redundantly duplicating existing compliance obligations;

2.3 A number of practical problems implementing the compliance solution proposed in the Factsheet. In some cases compliance will be difficult because there is no incentive on contractual counterparties to take on additional liability. In other cases compliance will be almost impossible due to the statutory framework within which the reporting entity operates;

2.4 It will negate the benefits of certain exemptions for managing intermediaries of low risk underlying clients; and

2.5 It will result in the unnecessary dissemination of underlying client personal information between reporting entities.

Summary

3 The Factsheet relies on a third limb of the definition of 'beneficial owner' that does not exist in the definition of that term in the AML Act and removes any requirement for effective control or ownership of the customer. Under the AML Act, the test has two limbs. In the Factsheet, FMA has adopted a third limb following the earlier beneficial ownership

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guidelines.[1] We submit that it was not the legislature's intention to apply a three limb test, and further, the third limb is inconsistent with the policy behind the definition of beneficial owner, which is that a beneficial owner is someone who has effective control over a customer.

4 Part of the 'beneficial owner' test is the requirement to determine the 'person on whose behalf a transaction is conducted'. FMA interprets the definition broadly, stating that any underlying client who benefits from a transaction conducted by a managing intermediary will be a person on whose behalf a transaction is conducted,[2] and that this is the case whether or not the underlying client has any rights or control over the transaction. While we accept that FMA's broad interpretation is *one* of a number of possible interpretations, we submit that a narrower approach is preferable. In this context, CDD obligations should not apply in respect of every individual who benefits from a transaction, but should apply only in respect of individuals who have effective control over the reporting entity's customer, or who have appointed an agent to conduct a transaction on their behalf. We submit that the legislature did not intend the application of FMA's broad approach.

5 If FMA's interpretation of CDD obligations were accepted, we consider that it would cause a large number of unanticipated problems. Applying FMA's interpretation will cause CDD obligations to be onerous, costly and impracticable, a result which directly conflicts with the purpose of the Act, being to impose obligations which do not go further than is necessary for New Zealand to comply with international best practice standards, and which do not impose compliance costs that are out of proportion to the risk of money laundering.

'Beneficial owner' definition

Cabinet policy

6 The AML Act requires reporting entities to conduct CDD on their customers and any beneficial owner of those customers. Knowing who customers' beneficial owners are aligns with the purpose of implementing CDD obligations. In setting out the underlying policy of the AML regime, Cabinet stated that '... a key focus of CDD is ascertaining who controls corporate entities or other forms of legal entity – the 'beneficial owners''.[3]

7 Section 5 of the AML Act sets out the test to be applied by reporting entities when identifying a customer's 'beneficial owners'. It is stated as a two limb test, whereby:

> "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 [more than 25 percent] of the customer or person on whose behalf a transaction is conducted."

8 Despite the beneficial owner test appearing in section 5 of the AML Act as a two limb test, FMA have interpreted it as a three limb test.[4] FMA states that:[5]

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[1] Factsheet, page 3 at paragraph 13.

[2] Factsheet, page 4 at paragraph 23.

[3] Cabinet Paper number 2, 2 April 2009, page 2 at paragraph 10.

[4] Page 3 at paragraphs 13 to 14. This is the same approach taken in the AML Supervisors' Beneficial Ownership Guideline. We have some reservations about the approach taken in that guideline as well.

[5] Page 3 at paragraphs 13 to 14.

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> "13. … each time you apply the test of beneficial ownership to a customer you must apply three elements. These elements are:
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> - Who owns more than 25 percent of the customer
> - Who has effective control of the customer
> - The persons on whose behalf a transaction is conducted.
>
> 14. A beneficial owner is an individual who satisfies any one element, or any combination of the three elements."

9 We submit this interpretation is contrary to the intention of the Act. The crux of the 'beneficial ownership' definition is that the beneficial owner exercises some form of effective control over the reporting entity's customer. The point is made in the November 2010 Regulatory Impact Statement (**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'.[6]

10 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:[7]

> "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."

UK approach

11 It is of further merit to consider the policy of the beneficial ownership test as set out in United Kingdom (**UK**) legislation. Regulation 6 of the UK Money Laundering Regulations 2007 is the equivalent of New Zealand's section 5 definition of beneficial owner.[8] The regulation sets out a number of circumstances in which an underlying investor will be deemed to be a beneficial owner of a reporting entity's customer, all of which require the underlying investor to have a form of ownership in or control over the reporting entity's customer.

FMA's approach

12 FMA's interpretation removes the requirement for a beneficial owner to have effective control over the reporting entity's customer where an underlying investor is a person on whose behalf a transaction is conducted. This has the effect of causing an underlying investor to be a beneficial owner where they are a beneficiary of a transaction, whether or

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[6] RIS, November 2010, page 10 (emphasis added).

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

[8] Available here: http://www.legislation.gov.uk/uksi/2007/2157/regulation/6/made. The only amendments made to this section since it was implemented relate to Scottish succession and are not relevant to the issue at hand.

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not they have effective control over the reporting entity's customer. We do not think that this was the intended effect of the legislation.

13 For the reasons specified above, we suggest that FMA should revert to the two limb approach intended by the legislature, whereby 'effective control' remains an essential element of both limbs.

Transactions 'on behalf of' investors

FMA's approach

14 FMA has interpreted, 'a person on whose behalf a transaction is conducted', very broadly. FMA 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.[9] They further state that:[10]

> "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."

Our view

15 We take issue with FMA's broad interpretation of the meaning of 'a person on whose behalf a transaction is conducted'. We submit that while FMA's broad interpretation represents one of a number of possible interpretations, it should not be the preferred approach.

16 FMA's interpretation is so broad as to have the effect that any transaction conducted by a customer that has 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 therefore be responsible for conducting CDD on those individuals.

17 We submit that a narrower approach is more consistent with the purpose of the Act, whereby the definition of 'a person on whose behalf a transaction is conducted' is limited to agent-principal type relationships. In those cases, the requirement for CDD to be conducted will be limited only to situation where a person acts as agent for and to conduct a transaction on their behalf. This approach best aligns with the policy behind the provision, and accepted international policy.

UK approach

18 It is useful to look again at the UK Money Laundering Regulations 2007 and the approach those regulations take toward the definition of a person on whose behalf a transaction is conducted. Regulation 6(9) 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'.

19 The provision is almost identical to the first limb of the New Zealand provision. The UK Law Society sets out a simple interpretation of this section on its website, under the heading 'Agency'. The Law Society states:[11]

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[9] Factsheet, page 4 at paragraph 23.

[10] Factsheet page 4 at paragraph 21.

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

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"Agency

Regulation 6(9) says a beneficial owner generally means any individual who ultimately owns or controls the client or on whose behalf a transaction or activity is being conducted.

In these cases, it is presumed the client is himself the beneficial owner, unless the features of the transaction indicate they are acting on someone else's behalf. So you do not have to proactively search for beneficial owners, but to make enquiries when it appears the client is not the beneficial owner.

Situations where a natural person may be acting on behalf of someone else include:

- Exercising a power of attorney. The document granting the power of attorney may be sufficient to verify the beneficial owner's identity.
- Acting as the deputy, administrator or insolvency practitioner. Appointment documents may be sufficient to verify the beneficial owner's identity.
- An appointed broker or other agent to conduct a transaction. A signed letter of appointment may sufficient to verify the beneficial owner's identity.

You should be alert to the possibility that purported agency relationships are actually being utilised to facilitate a fraud. Understanding the reason for the agency, rather than simply accepting documentary evidence of such at face value, will assist to mitigate this risk. Where a client or retainer is higher risk, you may want to obtain further verification of the beneficial owner's identity in line with the suggested CDD methods to be applied to natural persons."

20 Each of the examples of circumstances where a person is 'acting on behalf of' another person for under Regulation 6 relate to agent-principal type relationships. They are not broader and do not refer to the person on whose behalf a transaction is conducted. We believe the UK's narrow, 'agent-principal type' approach is preferable to that which FMA has adopted. It should be applied to the New Zealand regime.

21 Neither fund managers nor the funds they manage are agents for underlying investors. 'Persons on whose behalf' should be limited to agent-principal relationships. We submit that in the fund manager context fund managers are not agents because they conduct transaction on behalf of the fund and not underlying investors. Therefore underlying investors should not be considered 'beneficial owners' of the fund manager on that basis.

CDD obligations unworkable

Objectives of AML regime

22 The objectives of New Zealand's AML regime are set out on page 3 of the first RIS issued on the regime in April 2009. They are to:

22.1 Detect and deter money laundering and terrorist financing;

22.2 Maintain and enhance New Zealand's international reputation;

22.3 Contribute to public confidence in the financial system; and

22.4 Realise these objectives with minimum cost to industry.

23 The same RIS discussed the need to comply with New Zealand's obligations under the Financial Action Task Force (**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

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excessive compliance burdens' and implementing measures that are 'appropriate to New Zealand circumstances'.[12]

Oppressive compliance costs

24 We submit that FMA's interpretation of CDD obligations imposed on reporting entities will create oppressive compliance burdens that are disproportionate to the money laundering risk posed by their customers. We further submit that these excessive reporting burdens, while discharging New Zealand's obligations under the FATF Recommendations, are not appropriate to New Zealand's circumstances. The objectives set out at 22 above are sufficiently met without requiring reporting entities to be responsible for CDD on underlying investors – particularly in situations where they have no direct relationship with that investor.

25 The Factsheet's approach has the effect that every entity involved in bringing a financial product to market is responsible for conducting CDD on the underlying investors. This is not practical or workable and the compliance costs would be out of all proportion to the marginal regulatory benefit (if any) gained.

26 For example, 'Bonus Bonds' is a unit trust product with over a million investors. The Factsheet's approach would mean the Trustee (along with the manager, distributing financial advisers, the bank and others) would be responsible for conducting CDD on each of those investors. Most entities simply do not have the resources to discharge this kind of obligation. Building those resources by employing new staff and implementing new systems would come at significant cost. That cost would be passed onto investors in the form of higher costs, lower returns or the product being removed from the market entirely because the new obligations have rendered it financially unviable.

Onerous CDD obligations

27 We also question what regulatory benefit comes from requiring the Trustee to conduct CDD on the underlying investor. One or more other reporting entities in the investment chain, typically the fund manager or financial adviser, will already have conducted CDD on the underlying investor as their 'customer'. Given that CDD has already taken place, requiring the Trustee to go through this process again is redundant and duplicative.

28 The Factsheet suggests one or more of sections 33 or 34 of the AML Act or clause 24 of the Anti-Money Laundering and Countering Financing of Terrorism (Exemptions) Regulations 2011 (**Exemptions Regulations**) could be used to 'contract out' the CDD obligation to other parties in the investment chain.

29 While this may appear to be a solution in theory, in practice, it will be highly problematic.

30 Entities further up the investment chain, such as Trustees, are unlikely to have commercial or contractual relationship with those entities at the 'coal face', such as distributing financial advisers, who are best placed to conduct CDD. Without this pre-existing relationship there is no incentive for those at the 'coal face' to assume the new contractual obligations and potential liabilities sought to be imposed pursuant to sections 33 or 34, or clause 24. Where such 'coal face' entities are not reporting entities under the AML Act, they have no statutory obligation to undertake CDD. Therefore, reporting entities should not have an obligation to do CDD on the underlying customer of such entities.

31 Unlike statutory obligations, contractual obligations cannot be unilaterally imposed on a person; they must be freely entered into. Many 'coal face' entities may simply refuse to

[12] RIS, April 2009, page 1.

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sign. It should also be appreciated that, even in respect of a single product, there could be a large number of 'coal face' entities with whom contracts would be required. For example, in respect of a unit trust distributed by advisers, a contract would be required between the Trustee and every financial adviser distributing the product. Even in the extremely unlikely event that the Trustee could convince all of those adviser groups to take on new contractual obligations (and potential liabilities) under the section 33, 34 or clause 24 contracts, there would be a large number of contracts to enter into and monitor. The legal and business costs associated with establishing and monitoring these contracts on an ongoing basis would be sizeable.

32 It might be suggested that those entities further up the investment chain could indirectly impose these obligations by building a 'viral' obligation (that is, an obligation to contract with the next person down the investment chain on the same terms). However, in these cases, the Trustee becomes reliant on persons with whom it has no direct contractual relationship to discharge and monitor CDD obligations for which it has primary responsibility. With each level from which the Trustee is removed from the actual undertaking of the CDD, the risk of non-compliance increases. It is unfair to impose these responsibilities and liability for breach where the entity has little or no method of ensuring compliance.

Disproportionate response to risk

33 The Factsheet suggests that where an entity is uncomfortable with contracting with other entities to do CDD, it should refuse to deal with those entities. As managed funds are the fund manager's products, in the case of a Trustee, this suggests the Trustee should resign from its appointment. This is not practicable. In some cases this would simply not be allowed by law. In other cases, it would be a massively disproportionate response to the concern. The AML Act was introduced as a risk based regime. Extending the scope of the AML Act by broadening the definition of beneficial owner removes the benefit of a risk based regime.

34 For example, the Factsheet would require that the Trustee should have arrangements with each distributing adviser to conduct CDD on underlying investors. If the Trustee has concerns about those, for example, if some of those advisers refused to enter those arrangements, it is suggested the Trustee should resign its appointment. However, in the case of a debt security, unit trust or KiwiSaver Scheme the Trustee may not be allowed to do this. The KiwiSaver Act 2006, Unit Trusts Act 1960 and Securities Act 1978 prohibit the trustee from resigning until its obligations are fully discharged, it is replaced by another licensed trustee or the High Court consents.[13] If there are compliance concerns causing the one Trustee to want to resign, is seems unlikely that another would be easily found to take its place. High Court consent is untested and likely to be costly, if an option at all.

35 In other cases, resignation in the circumstances proposed by the Factsheet may not be permitted under the trust deed, court appointment or other contractual arrangements. Even if it were permitted, requiring the Trustee to step down from its position because of concerns about a third party is a massively disproportionate response to one or more distributing advisers refusing to enter section 33, 34 or clause 24 type contracts.

36 The practical problems described above are only a summary of the most significant problems we have been able to discern in the short time permitted to analyse and comment on the Factsheet's proposals. Reporting entities in other areas, such as banks, brokers,

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[13] Section 116E of the KiwiSaver Act 2006, section 10 of the Unit Trusts Act 1960 and section 48 of the Securities Act 1978

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custodians and the like, will no doubt identify their own specific problems which add to those set out above. As with any proposal, further issues are likely to be discovered if it is decided to implement the proposals in their current form.

Nullifies certain exemptions

37 The Factsheet will nullify the effect of exemptions granted in respect of managing intermediaries, for example, the Superannuation exemptions provided for under the Anti-money Laundering and Countering Financing of Terrorism (Exemption) Regulations 2011 (**Exemption Regulations**).

38 Regulations 20 and 20A of the Exemption Regulations exempt certain managing intermediaries such as trustees and other relevant service providers involved in promoting employee superannuation schemes from the requirement to conduct CDD on their members.

39 FMA's Factsheet interpretation of CDD requirements will have the effect that any party that those managing intermediaries' contracts with, such as third party investment managers, administration managers, custodians and the like, will be required to conduct CDD on the scheme's members.

40 This will nullify the effect of the exemption granted by regulations 20 and 20A of the Exemption Regulations. This is because, in order to meet their CDD requirements, these third parties will have to rely on the trustee(s) to conduct CDD on their behalf reimposing the obligation from which they are exempt.

41 This same issue arises in respect of the regulatory exemption for administrators and executors of deceased estates or trustees of family trusts. Trustee Corporations and others are currently exempt from the AML Act in respect of these appointments.[14] However, where third party reporting entities (such as investment managers and administration managers) are contracted to provide services to these trusts, the exemption does not extend to them. Again, this nullifies the benefit of the exemption because the third party reporting entity will have to rely on the trustee, administrator or executor to conduct CDD on the beneficiaries of the trust on its behalf.

42 This outcome is contrary to the legislative intent, which was to avoid the application of onerous and expensive CDD obligations on low-risk situations, such as employer-based superannuation schemes, deceased estates and family trusts. In order to remedy this situation, amendments would need to be made to these exemptions, resulting in more work for the Ministry, the Regulators, and industry and adding further confusion to the plethora of existing regulations.

Unnecessary dissemination of investors' personal information

43 FMA's approach to CDD obligations will result in each reporting entity in an investment chain being responsible for conducting CDD on underlying investors. One practical implication of this is that once CDD has been conducted on an individual underlying investor, the information acquired through that CDD will be passed onto each reporting entity in the investment chain.

44 We consider that such widespread sharing of clients' personal information was not intended by the legislature. The underlying purpose of conducting CDD is so that reporting entities

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[14] Regulation 20 of the Anti-Money Laundering and Countering Financing of Terrorism (Definitions) Regulations 2011

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have knowledge of their customers in the hope that money-launderers will be deterred from investing. Where one reporting entity has obtained sufficient information about a client to discharge their CDD obligations, it is unnecessary for that information to be shared amongst numerous corporate entities, particularly where the client is unaware that their information is being shared.

45 Not only does this information sharing requirement go beyond what is required for New Zealand to meet its FATF obligations, but it also raises serious concerns surrounding the potential for information leaks, misuse of information by corporates for unsolicited purposes such as cross-selling, and exacerbates distrust many members of the public already have for entities holding their personal information. New Zealand should not have a legislative regime in place that actively encourages the widespread sharing of individuals' private information.

Conclusion

46 In summary, our points are:

46.1 FMA's three limb interpretation of the definition of 'beneficial ownership' departs from the underlying policy of the provision, which requires an element of effective control over the customer;

46.2 FMA's interpretation of the meaning of 'a person on whose behalf a transaction is conducted' is too broad and creates the possibility that reporting entities will have to conduct CDD on any individual who will benefit from a transaction. We do not believe that this is the best practical interpretation and submit that a narrower interpretation should be adopted, whereby a 'person on whose behalf a transaction is conducted' refers to an agent-principal type relationship; and

46.3 Finally, if FMA's interpretation is to be accepted, it is our belief that it will create a myriad of unintended outcomes, including increasing compliance costs in a way that Cabinet intended to avoid and subjecting reporting entities to onerous CDD obligations that exceed those required to satisfy New Zealand's FATF obligations.

47 We therefore respectfully seek that the position is clarified as follows:

47.1 Effective control is a necessary element of 'beneficial ownership'; acting 'on behalf of' alone is not sufficient;

47.2 Acting 'on behalf of' refers to agent-principal type relationships; it does not extend to include any relationship where the actions of one party may benefit the other.

48 We are aware that others who have submitted on the Factsheet have raised the possibility of 'simplified CDD' as a solution to the problem of reporting entities being required to conduct CDD on underlying investors. It is our view that simplified CDD is not the preferred solution. We submit that while simplified CDD does provide some relief to reporting entities, it does not resolve the core issue of the interpretation of 'person on whose behalf a transaction is conducted', and further, implementing simplified CDD in relation to underlying investors will mean further cost and time spent on implementing an exemption. Our strong preference is that FMA should revisit its interpretation of 'person on whose behalf a transaction is conducted'.

49 Our members and other industry participants have spent significant time and money over the last two years developing CDD systems and processes in line with our understanding of the manner in which the AML regime would be implemented. The view at the time was based on public commentary from FMA (including road-shows, workshops and other public

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and private communications with the responsible FMA staff) and was premised on the basis that only the reporting entity with the most direct relationship with the underlying investor would have CDD obligations in respect of that investor. The Factsheet changes this approach, at a very late stage, some time after the AML regime has 'gone live' and after significant time and money has already been expended complying with what industry understood were the requirements. If the Factsheet's proposals are adopted, this will necessitate further changes to those systems and processes, resulting in further costs (and risk), which will be ultimately be passed onto investors in the form of higher fees and lower returns.

50 We would be pleased to discuss any aspects of this submission with you as and when convenient.

Yours Sincerely

David Brown Douglas

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