CHAPMAN TRIPP

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Dear Kirsty

**PRACTICAL IMPLICATIONS OF FACTSHEET ON MANAGING INTERMEDIARIES FEEDBACK**

**Introduction**

1 Thank you for the opportunity to submit on the Consultation Paper: Practical implications of Reporting Entities transacting with other Reporting Entities (*Consultation Paper*) and the accompanying draft Factsheet on Managing Intermediaries (*Factsheet*). We welcome FMA's proactive approach of putting guidance into the market on the areas of uncertainty under the Anti-Money Laundering and Counter Financing of Terrorism Act 2009 (*Act*).

2 For convenience, in this submission where relevant we have used the terminology in the Factsheet (e.g. "managing intermediary", "underlying client" etc.).

3 In this letter we:

3.1 summarise our key concerns on the Factsheet, followed by some more in depth analysis on those items and some specific examples where we believe the Factsheet will create significant issues for industry participants;

3.2 respond to the specific request in the Consultation Paper on whether the practical suggestions for compliance are workable; and

3.3 suggest a possible solution which we believe gives the appropriate and intended interpretation to the "third category" of beneficial owner (persons on whose behalf a transaction is conducted).

**Key concern**

4 Our key concern arises from paragraph 23 of the Factsheet:

> *"**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." (emphasis added)*

5 The consequence of this categorisation is that *every* underlying client is a "beneficial owner" of the managing intermediary, requiring any reporting entity dealing with the managing intermediary to conduct customer due diligence (*CDD*) on the underlying clients – even though those underlying clients *may have no control over the managing intermediary*.

6 This outcome essentially creates a "third category" of beneficial owner, but in doing so compromises the policy rationale for requiring CDD on beneficial owners – to identify (and verify the identity of) the individual(s) who ultimately own or control the customer.

**Summary**

7 In summary, we submit that:

7.1 ***Factsheet casts "beneficial owner" too broadly*** - The Factsheet's interpretation (summarised in paragraphs 4 to 6 above) goes well beyond the intention of the Act (and important extraneous material indicative of the intention) – that the requirement to conduct CDD on a "beneficial owner" is intended to apply to persons with control over the customer. This is at odds with what we understand to be market understanding (in the managed funds and intermediaries sector in particular), and will present operational issues which had not been anticipated.

7.2 ***"Third category" of beneficial owners is narrow*** – The third category of beneficial owner should extend only to underlying clients who have *control over the managing intermediary in the context of the arrangement in question* – which would encompass principal / agent, bare trust and other analogous arrangements. This outcome would also be consistent with regulation 24 of the Anti-Money Laundering and Countering Financing of Terrorism (Exemptions) Regulations (*Trust Account Exemption*).

7.3 ***Significant practical difficulties could arise*** - The Factsheet's interpretation will give rise to significant practical difficulties, a requirement for "duplicated" CDD with no AML benefit, an AML liability profile which is inconsistent with that which had been contemplated up to now, as well as increased compliance costs which we believe would not have been taken into account in the Regulatory Impact Statement for the Act and would be disproportionate to any benefit gained by imposing such an obligation.

7.4 ***Wider issues arise -*** At a more granular level, by way of example, the Factsheet:

(a) could dis-incentivise overseas financial institutions from dealing in the New Zealand market; and

(b) essentially renders the exemption granted for employer superannuation schemes[1] redundant.

[1] Regulation 20A of the Anti-Money Laundering and Counter Terrorism Financing (Exemptions) Regulations 2011 (*Exemptions Regulations*).

7.5 ***Proposed compliance suggestions not workable*** - The compliance suggestions in paragraphs 34 to 42 of the Factsheet – broadly that reporting entities should rely on another reporting entity under section 33 or appoint an agent under section 34 – will be impracticable and unworkable in many situations, because in practice:

(a) many reporting entities will be unable to negotiate such arrangements with managing intermediaries; and

(b) where they can, given they retain responsibility for compliance, those reporting entities will still have to implement costly and cumbersome compliance procedures in relation to a client base that in most cases "belongs" to the managing intermediary.

7.6 ***Solution –*** A simple solution would be to:

(a) clearly define the boundary which governs when an underlying client falls into the "third category" of beneficial owner – which as described in paragraph 7.2 would only cover underlying clients who have control over the managing intermediary in the context of the arrangements in question.

(b) compliment that boundary by permitting reporting entities that are required to carry out CDD on other reporting entities to conduct simplified CDD only – which avoids duplicated CDD on the same underlying client base.

This solution ensures that CDD is undertaken by the appropriate reporting entity and is not the subject of a duplicate obligation on the part of another reporting entity to conduct identical CDD on an identical client base.

**Next steps**

8 We believe it is essential for there to be an opportunity for wider debate on the policy issues raised above, as it may well be the case that a regulatory solution is preferable. We would therefore urge FMA to defer issuing the Factsheet in final form until such time as that can occur. In particular:

8.1 we believe a joint meeting with all submitting law firms and other industry stakeholders may be beneficial, so that the various concerns can be more fully articulated and a collaborative solution reached;

8.2 we strongly suggest the Ministry of Justice's (*MoJ*) policy input be sought, so that any decisions are made with the benefit of MoJ's policy perspective (particularly if there needs to be a regulatory solution implemented). With this in mind, we have had preliminary discussions with the MoJ in relation to these issues, and have copied our submission to the MoJ.

## Analysis

### *Preliminary issue - is there a third category of "beneficial owner"?*

9 We consider that there is considerable ambiguity as to whether there is a CDD obligation at all on the third category of beneficial owner. This uncertainty starts with the definition in the Act of "beneficial owner" itself:

> ***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***

10 In turn, section 11(1)(b) requires CDD to be undertaken on any beneficial owner *of a customer* but, significantly in our view, does **not** require CDD to be undertaken on *a person on whose behalf a transaction is conducted* as a distinct category in its own right.

11 Accordingly, we believe that there is a strong argument available that the words at the end of the definition of beneficial owner (*"person on whose behalf a transaction is conducted"*) are redundant, in the sense that there is no operative provision in section 11 requiring CDD to be undertaken on those persons.

12 However, we acknowledge that there is some ambiguity in this conclusion, and that an alternative argument is that these words need to be given some meaning, consistent with the purpose of the Act. This was the approach taken in the August 2010 Regulations and Code of Practice Consultation Document, which contains background discussion on the scope of (among other things) the Trust Account Exemption. Using the client / lawyer scenario as an example, paragraph 380 of that Consultation Document states that:

> *In the relationship between a client and a lawyer,* ***clearly a client does have effective control****. The lawyer is acting upon instruction from the client. But for the client's instruction, the lawyer would not act. Transactions on the account are also done at the direction of the client.*

13 This analysis appears to contemplate that the definition of "beneficial owner", at least in the context of trust accounts, is to be interpreted with regard to the control the relevant person has over the customer *in the context of the particular arrangement in question*. Clients do not have effective control of, say, a law firm in the normal sense, but the Act contemplates a contextual interpretation of beneficial ownership in these circumstances, which would take into account the control of the underlying client in relation to the intermediary account.

14 This view is consistent with the rationale for the Trust Account Exemption – because if the underlying clients were not "beneficial owners", there would be no need for this exemption in the first place – i.e. the Trust Account Exemption clearly contemplates that the underlying clients must be beneficial owners, and provides relief to reporting entities by specifically exempting them from the obligation to

identify, and verify the identity of, any *beneficial owners*. Any other view would render the Trust Account Exemption somewhat meaningless.

15 Acknowledging the scope for this broader interpretation, the key component is that the client must have *control*, which follows because the funds in the relevant trust account and client fund account "belong" to the underlying client (as required by the Trust Account Exemption). We believe that the Factsheet does not adequately take into account this component – and we describe this in further detail below.

16 In light of the considerable ambiguity in this part of the Act, and the corresponding market uncertainty it has (to our knowledge) created, particularly in the managed funds and intermediary sector, we believe that any solution may need to be implemented by regulation, to ensure there is certainty going forward.

***Factsheet casts "beneficial owner" too broadly***

*"On behalf of" does not mean "for the benefit of"*

17 The balance of our analysis proceeds on the basis that, despite the ambiguity described above, a third category of "beneficial owner" does exist.

18 However, as a matter of statutory interpretation we submit that the scope of the third category needs to be considered in the context of the definition of "beneficial owner" and the wider purpose of the Act. More specifically:

18.1 the scope is necessarily informed by the words in paragraphs (a) and (b) of the definition – which require an individual to hold the prescribed threshold or have effective control of a customer to be a "beneficial owner" – both of which contemplate an element of *control* by the beneficial owner;

18.2 any extension of the definition to underlying clients on whose behalf a transaction is conducted must be analogous to those categories – i.e. those underlying clients must have control over the customer *in the context of the particular arrangement in question;*

18.3 to give a practical example, a single investor in a managed fund would never be considered to "control" the managed fund, nor does industry treat transactions undertaken by persons dealing with the managed fund to be undertaken on behalf of each underlying investor (rather, they are undertaken for the benefit of the fund, represented by the manager / trustee);

18.4 in our view this approach aligns with the rationale for requiring CDD on beneficial owners – to identify (and verify the identity of) the individual(s) who ultimately control the reporting entity; and

18.5 the interpretation in paragraph 23 of the Factsheet – that "beneficial ownership" arises 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 – does not align with the definition or the wider purpose of the Act.

*This interpretation is consistent with other important indicators*

19 This interpretation is consistent with the wider context of the Act and other important indicators:

19.1 ***Trust Account Exemption*** – As discussed in paragraphs 12-14 above, the Trust Account Exemption (and the policy underpinning it) clearly contemplate that "beneficial ownership" should only arise where the beneficial owner *controls* the customer, in the context of the arrangement in question.

19.2 ***Wider provisions of the Act*** - There are various other parts of the Act (e.g. the definition of "financial institution" paragraphs (x) and (xi)) which uses the "on behalf of" formulation. Construing those words to mean that a transaction carried out "for benefit of" a third party means that a party is a reporting entity could extend the coverage of financial institution to a large number of entities that were not otherwise contemplated to be within the Act.

19.3 ***FATF Recommendation 10*** - Recommendation 10 of the Financial Action Task Force (*FATF*) Recommendations also indicates that, in respect of beneficial owners, the focus should be on those persons exercising control of the legal person or arrangement. The following passages from the Interpretive Notes to Recommendation 10 are relevant:

> *"For legal persons:*
>
> *(i.i) The identity of the natural persons ...who **ultimately have a controlling ownership interest** in a legal person; and...*
>
> *For legal arrangements:*
>
> *(ii.i) Trusts – ... any other natural person **exercising ultimate effective control** over the trust (including through a chain of control/ownership);*
>
> *(ii.ii) Other types of legal arrangements – the identity of persons in equivalent or similar positions."*

19.4 ***Wolfsberg Principles*** - The Wolfsberg Group is an association of large global banks that has developed a body of good practice standards in relation to anti-money laundering and counter terrorist financing (the so-called "Wolfsberg Principles"). The Wolfsberg Principles indicate:

> *"for the purposes of the Wolfsberg principles, it would be inappropriate to equate "beneficial ownership" with the "beneficiary" or "holder of beneficial interest"*[2]

and also recommend that a bank should satisfy itself as the managing intermediary's reputation and integrity, and whether it is adequately

[2] The Wolfsberg AML Principles: Frequently Asked Questions with Regard to Beneficial Ownership in the Context of Private Banking, 2012, Question 1.

regulated, and if it is satisfied, rely on the CDD that the managing intermediary has conducted on its clients."[3]

19.5 ***Australian position*** – We are aware that Austrac is currently consulting on possible amendments to CDD requirements in Australia.[4] However, the scope of this consultation does not appear to contemplate adding a category of persons who are beneficial owners in the same way that the Factsheet contemplates (so if the Factsheet formulation is adopted, it will put us out of step with Australia).

*Practical examples of issue if Factsheet interpretation preferred*

20 We set out below some examples of problematic outcomes if the Factsheet interpretation is preferred:

20.1 ***Service providers to managed funds caught*** – One of the starkest examples can be drawn from in Appendix 3 of the Guidance Note. That Appendix indicates that a broker undertaking an investment function for a managed fund would actually be considered to be undertaking those transactions on behalf of the *underlying investors*. Those underlying investors would, therefore, be "beneficial owners" of the fund manager in this context, requiring CDD to be undertaken by the service provider.

In our view, this fails to recognise the commercial realities of that particular arrangement:

(a) In this context, the investment manager is acting for the trustee or manager of the fund, as principal. In turn, the trustee or manager has duties to the underlying investors, under the relevant governing documents. The same logic would apply to other service providers to a fund, including banks or custodians of the fund's assets.

(b) The broker has no linkage to each underlying investor, so cannot be said to be conducting a transaction on their behalf.

(c) This accords with the liability structure of this arrangement – the underlying clients would ordinarily have no direct right of recourse against the investment manager; rather those rights of recourse would have to be undertaken by the manager or the trustee, on behalf of the fund and its investors.

(d) This could potentially catch a variety of service providers to a managed fund – which in our view is not the intention of the Act.

20.2 ***Overseas entities*** - More generally, we have had direct feedback from at least one client that this interpretation could discourage overseas

[3] Frequently Asked Questions with Regard to Intermediaries and Holders of Powers of Attorneys/Authorised Signers in the Context of Private Banking, 2012, Question 5.

[4] Austrac, Consultation Paper: Consideration of possible enhancements to the requirements for customer due diligence (July 2013).

intermediates from dealing in the New Zealand market if New Zealand entities are required to "look through" to the underlying client base of those intermediaries, when entities in other jurisdictions are not.

20.3 ***Employer Superannuation Scheme's exemption*** – This interpretation would essentially render the existing exemption under regulation 20A of the Exemptions Regulation redundant. That exemption provides a complete exemption from the provisions of the Act for persons "promoting or operating" a limited employer superannuation scheme. However, if the interpretation in the factsheet is adopted then other parties involved or dealing with that scheme will have to do CDD on investors in the scheme, when the principal parties involved in the scheme do not. This is a strange outcome, given the policy decision made to exempt those types of schemes.

21 More fundamentally, it will create an obligation to undertake identical CDD on an identical client base, for no discernible AML benefit. And while agency arrangements can seek to minimise duplication, they do not remove the fundamental issue of duplicated obligations existing in the first place (and the liability profile that goes with it).

*"Third category" of beneficial owners is narrower than Factsheet interpretation*

22 Drawing this material together, we believe that the third category should be considerably narrower than the scope contemplated by the Factsheet. In particular:

22.1 Only underlying clients with "control" over the managing intermediary in the context of the arrangements in question should be caught by the third category.

22.2 This type of control would exist for a reporting entity, in our view, where:

(a) the managing intermediary has a business relationship with the reporting entity (so that the managing intermediary is the customer of the reporting entity); and

(b) the managing intermediary holds assets on "bare trust" for the underlying client (so that the underlying client is able to control their disposition) or the managing intermediary is acting purely as agent for the underlying client (the principal).

22.3 Applying this to the examples used in the Appendices to the Factsheet[5]:

(a) ***Appendix 1*** – The fund manager's obligation to conduct CDD on the investors would only arise if those investors invested directly in the managed fund (as they would be customers of the fund manager in any event) or if the financial adviser was investing as agent or bare trustee of the investor. The trustee's position is effectively the same, as unit holders in the managed fund are customers of the trustee under the

[5] These instances are used as examples only by reference to the Appendices to the Factsheet – but the principle of requiring "control" would be of universal application.

Act in any event[6] – i.e. the obligation is not "created" by the investors being considered to be beneficial owners of the fund manager (because transactions undertaken by the fund manager are not undertaken by the fund manager on behalf of investors).[7]

(b) ***Appendix 2 –*** We see wrap platforms as potentially in a different category, given that they often involve the wrap provider holding asserts on bare trust for customers of the wrap. This would mean that reporting entities whose customer is the wrap provider would have to undertake CDD on the wrap provider's customers. So, for example, a manager of a managed fund offer through a wrap platform may well have to undertake CDD on the wrap platform's customers who invest (through the wrap) in the fund. But the investors (as labelled in Appendix 2) will not be beneficial owners of the wrap provider, the fund manager, or any other entity, unless the relationship is where the investor is principal and the other party is agent or bare trustee.[8]

(c) ***Appendix 3 –*** For the reasons already outlined in paragraphs 18.3 and 20.1 above, service providers to managed funds would not in any circumstances be considered to be conducting transactions on behalf of the underlying client, so the investors would not be considered "beneficial owners" in that context.

(d) ***Banks –*** In passing, we note that a bank would not have to conduct CDD unless it has a business relationship with an intermediary acting as agent or bare trustee for investors. This is unlikely to occur except in the case of trust accounts or custody accounts – in which event the Trust Account Exemption will apply to relieve banks from the obligations (subject to compliance with the conditions).

Importantly, banks would **not** be required to conduct CDD on investors in a managed fund – because the assets of a unit trust do not "belong" to (and are therefore not controlled by) investors,[9] nor would transactions undertaken by the bank be considered to be carried out on behalf of those investors (rather, they are carried out on behalf of the manager or trustee).

***Proposed compliance solutions not workable***

23 The Factsheet directs entities to section 33 (reliance on other reporting entities) and section 34 (appointment of an agent) as solutions to the obligations reporting entities will face in relation to the third category of beneficial owners.

[6] For example, a trustee would be "administering assets on behalf of those investors", bringing trustees within the definition of "reporting entity" for that activity.

[7] We understand that this is the accepted position of trustees of managed funds, and the approach has been to appoint fund managers to conduct CDD as the trustee's agent.

[8] We believe a more general reconsideration of Appendix 2 would be useful, particularly from wrap providers, as we have some reservations as to whether it adequately portrays how a wrap platform operates in practice.

[9] Unless of course the investor owns 25% or more of the units in the Fund or otherwise has effective control – which would be unusual for most retail managed funds.

24 However, we do not consider that these solutions will be workable, for a variety of reasons:

24.1 It will require reporting entities to assume liability for a set of obligations in relation to a group of clients for which another reporting entity has the "primary" obligation (and this liability cannot be "laid off" to third parties, as the reporting entity will remain liable for compliance under the Act). Amongst other things, this will have insurance and indemnity impacts on those reporting entities – which is an inefficient regulatory outcome.

24.2 In some cases it simply will not be possible to agree agency arrangements with the relevant reporting entities "in the chain" – leaving the reporting entity with a compliance failure (for which it will be liable).

24.3 Agency arrangements are only a partial solution, as the reporting entity will still need to undertake a risk assessment and design a compliance programme in relation to the underlying clients, when the reality is that those reporting entities will not be in a position to undertake those actions without co-operation from the managing intermediary.

24.4 All of these elements contemplate significant actions being required of the relevant reporting entities. We question whether the cost of these impacts was contemplated in the Regulatory Impact Statement for the Act, given that they have the potential to be hugely significant across the managed funds and intermediary industry.

24.5 More fundamentally, it ignores the commercial reality that, in many intermediary situations, the underlying clients of an intermediary represent the outcome of years of goodwill generated by the intermediary, and should not be required to be shared with rivals or other entities without a compelling regulatory reason (and we submit that no such reason exists in these circumstances).

***Solution***

25 The solution in our view is relatively straightforward:

25.1 clearly define the boundary which governs when an underlying client falls into the "third category" of beneficial owner – which would only cover underlying clients who have material control over the managing intermediary in the context of the arrangements in question; and

25.2 compliment that boundary by permitting reporting entities that are required to carry out CDD on other reporting entities to conduct simplified CDD only – which avoids a need for duplicated CDD on the same underlying client base. In addition, if the first reporting entity is not satisfied that the other reporting entity is conducting adequate due diligence, then the first entity could be

required to undertake CDD on the underlying client base (to ensure CDD is performed to the requisite standards).[10]

26 There is an argument that if the first element (the "boundary" for when an underlying client is a beneficial owner) is properly calibrated, then there should be no need for the second element (simplified CDD on other reporting entities). However, this second element is still essential because it recognises that, where there is an element of duplication in terms of CDD on the same client base (e.g. where there is a principal / agent or bare trust relationship), a reporting entity which does not have direct "visibility" to that client base should be able to assume that the other reporting entity has conducted CDD in compliance with its obligations (and therefore only be required to conduct simplified CDD on that other reporting entity).

27 We look forward to progressing these issues in a constructive and collaborative way with FMA.

Yours sincerely

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[10] We understand this is similar to the approach under the UK AML regime.