BUDDLEFINDLAY
NEW ZEALAND LAWYERS

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To
Kirsty Campbell
Manager Commercial Supervision
Financial Markets Authority
Level 5, Ernst & Young Building
2 Takutai Square
Britomart
PO Box 106-672
Auckland 1143

From
Gene Turner

By Email
aml@fma.govt.nz

Dear Kirsty

Submission on Consultation Paper "Practical Implications of Reporting Entities transacting with other Reporting Entities and the Factsheet on Managing Intermediaries"

1. INTRODUCTION

1.1 Thank you for the opportunity to submit on the consultation paper released by the Financial Markets Authority (**FMA**) titled "Practical Implications of Reporting Entities transacting with other Reporting Entities and the Factsheet on Managing Intermediaries" (the **Consultation Paper**).

1.2 We act for a variety of reporting entities, a number of which have experienced significant practical difficulties and inefficiencies in satisfying their customer due diligence (**CDD**) requirements in circumstances where they are dealing with an intermediary that is also a reporting entity.

1.3 We are concerned that the interpretation of 'beneficial owner' taken in the Consultation Paper adds to these difficulties and inefficiencies, as it appears to unnecessarily extend the circumstances in which reporting entities will be required to carry out CDD on underlying clients of intermediaries.

2. BACKGROUND

2.1 Under the Anti-Money Laundering and Countering Financing of Terrorism Act 2009 (the **AML/CFT Act**), reporting entities are required to carry out customer due diligence on customers, beneficial owners of customers and any person acting on behalf of customers.

2.2 Beneficial owners are defined in section 5 of the AML/CFT Act as the individuals who:

(a) have effective control of a customer or person whose behalf a transaction is conducted; or

(b) own more than 25% of a customer or person on whose behalf a transaction is conducted.

2.3 The supervisors have determined this to be a three limbed test, capturing those persons:

(a) who own more than 25% of the customer;

(b) who have effective control of a customer; or

(c) on whose behalf a transaction is conducted.

2.4 It is the third limb that is problematic, as the supervisors have thus far interpreted it without any requirement for ownership or control or other materiality threshold. Paragraph 23 of the Consultation Paper therefore provides that:

> *"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."*

2.5 The inclusion of a third "on whose behalf a transaction is conducted" limb, as part of beneficial ownership, and with the supervisors' proposed interpretation, is both confusing and problematic in practice. It also appears inconsistent with international approaches, particularly without any reference to control or ownership or some other materiality threshold. While we are aware that AUSTRAC is currently consulting on possible amendments in Australia,[1] both in relation to requirements for beneficial ownership and control, and situations where a customer is acting on behalf of a person, it does not appear to be joining "on whose behalf a transaction is conducted" under "beneficial ownership", as in New Zealand.

2.6 Under the supervisors' interpretation of "on whose behalf a transaction is conducted" both the reporting entity and each managing intermediary (also a reporting entity) have an obligation to carry out CDD on the underlying client. In many cases, there could be hundreds, if not thousands, of underlying clients. Requiring CDD to be carried out on the same customers twice (or more frequently) by multiple reporting entities is not efficient or consistent with the risk based approach which is intended to underpin the AML/CFT Act; with the FATF recommendations; with the Wolfsberg AML Principles; nor with the FMA's regulatory framework which is aimed at fair, efficient and transparent markets.

2.7 The approach suggested in the Consultation Paper to minimise unnecessary duplication of work is that one reporting entity carries out CDD on the customer, and that other reporting entities rely on that CDD under either section 33 or 34 of the AML/CFT Act. In practice, however, we have found that this approach is not a very practical, efficient or attractive solution.

2.8 The Consultation Paper acknowledges that s 34 is unlikely to be useful in circumstances where there is not an ongoing relationship with the client, or there is a reluctance to enter into a formal

[1] AUSTRAC, *Consultation Paper: Consideration of possible enhancements to the requirements for customer due diligence* (July 2013), page 15.

agency agreement. We agree with this conclusion. Although s 34 has, because of its less prescriptive approach, been seen as the more workable mechanism where the relationship involves parties with a high degree of mutual trust and financial strength, reporting entities have not been willing to use it lightly.

2.9 It is suggested in the Consultation Paper that section 33 is more appropriate for situations where the reporting entities do not have an established ongoing relationship, or are reluctant to establish a formal agency relationship. However, section 33 contains a number of additional requirements which are viewed as onerous, expensive and/or impractical, particularly the need to establish a means of providing all relevant information between the organisations (for what could be numerous underlying clients). We are not aware of any of our clients relying on section 33.

2.10 In addition, under both sections, responsibility (and therefore liability) under the AML/CFT Act remains with the reporting entity relying on the other. Consequently, reporting entities appear unwilling to rely on another reporting entity's CDD because ultimately they are responsible for any failings. Contractual indemnities and other protections are not usually regarded as sufficient, and are costly to negotiate. In addition, a managing intermediary can quite fairly be expected to be reluctant to take on responsibility, and liability, for other reporting entities, nor to be asked to agree to changes to its AML programme which are inconsistent with how they apply the AML/CFT Act requirements generally to their business.

2.11 Where our clients have been willing to consider arrangements under either section 33 or 34, the reporting entities involved have typically sought/asked to provide access to the managing intermediary's CDD policies, procedures and checks, as well as rights of review and approval in relation to the managing intermediary's CDD programme. This can be an expensive and lengthy process, and can be exacerbated by confidentiality and privacy concerns. In our opinion the cost of such an arrangement is likely to be disproportionate to the risk of money laundering and financing of terrorism risks the arrangement aims to alleviate, particularly as no agreement is capable of providing absolute certainty of compliance in any event.

2.12 It appears that this issue does not arise in the United Kingdom or Australia. In the United Kingdom,[2] reporting entities are allowed to carry out simplified CDD on other regulated reporting entities. Standard or enhanced CDD, and therefore identification of beneficial owners, is only required where the reporting entity suspects money laundering or terrorist financing. Therefore, while the United Kingdom definition of beneficial owner includes individuals on whose behalf a transaction is being conducted[3] (but then only as a residual category), where the managing intermediary is itself a reporting entity, a reporting entity dealing with the managing intermediary is not required to identify the underlying clients.

2.13 This reflects the Wolfsburg AML Principles,[4] which state that due diligence should not be required on underlying clients if the due diligence procedures of the managing intermediary are of an

[2] Money Laundering Regulations 2007 (UK), s 13
[3] Money Laundering Regulations 2007 (UK), s 13(9)
[4] The Wolfsberg Group, *The Wolfsberg AML Principles: Frequently Asked Questions with Regard to Intermediaries and Holders of Powers of Attorney/ Authorised Signers in the Context of Private Banking* (May 2012), question 5.

acceptable standard, which is presumed where the managing intermediary is sufficiently regulated by AML/CFT legislation. To comply, a reporting entity may ascertain whether the managing intermediary is adequately regulated and whether it has implemented an AML programme, on the basis of the reporting entity's familiarity with the managing intermediary's reputation and/or representations furnished by the managing intermediary to the reporting entity. A reporting entity need not obtain client specific data from a managing intermediary, nor undertakings to provide such information, unless applicable regulation otherwise requires.

2.14 The Wolfsberg Group goes on to say[5] that "if the bank can make the determination as to the adequacy of the applicable AML regulation contemplated by the answer to the prior question, it should not generally be necessary to conduct "client" due diligence with respect to the Intermediary's clients in that the Intermediary's clients in this situation should generally not be viewed as the bank's clients." Further, "The mere fact that there is a notional connection between the funds a client entrusts with a Type 2 Managing Intermediary and transactions that the Intermediary enters into with the bank, should not, from the bank's perspective, somehow result in the Intermediary's clients being treated as the clients of the bank; it is the intermediary that should be viewed as the client of the bank, and the bank's "know your client" obligations accordingly extends only to the Intermediary. In keeping with this principle, it would be inappropriate to view the bank as having an obligation, albeit one that may be delegated, to conduct client due diligence with regard to the intermediary's clients, because, as noted, the Intermediary's clients are not to be viewed as clients of the bank, and because, by definition, the obligation to conduct client due diligence extends only to clients, not to clients of clients. Consequently, the bank should not be viewed as "relying" on the Intermediary to conduct due diligence on the Intermediary's clients, given that the bank has no underlying obligation to conduct such due diligence and that "reliance," in a strict sense, presupposes such an underlying obligation. "

2.15 While the definition of "beneficial owner" in the FATF recommendations does include a reference to a natural person on whose behalf a transaction is conducted, the surrounding discussion indicates a focus on control and ownership.

2.16 Australia currently only requires identification of beneficial owners in circumstances where the customer is a company (where beneficial owner means ownership of 25%, or effective control, of the company). Therefore, Australian reporting entities are not currently required to look through managing intermediaries to indentify underlying clients.

2.17 AUSTRAC acknowledges[6] that Australia's current beneficial owner requirements do not meet the standard required by the FATF principles and has proposed to extend the requirement to identify beneficial owners to circumstances where the customer is any type of legal person. Correspondingly, it is proposed that the definition of beneficial owner will be altered to mean the natural person(s) who ultimately owns or controls the customer (regardless of type). While

[5] The Wolfsberg Group, *The Wolfsberg AML Principles: Frequently Asked Questions with Regard to Intermediaries and Holders of Powers of Attorney/ Authorised Signers in the Context of Private Banking* (May 2012), question 6
[6] AUSTRAC, *Consultation Paper: Consideration of possible enhancements to the requirements for customer due diligence* (July 2013), page 15.

AUSTRAC explicitly acknowledges the FATF definition of beneficial ownership and control, and its inclusion of reference to "the natural person on whose behalf a transaction is being conducted", the proposed Australian definition of "beneficial owner" does not include that limb. "A person on whose behalf the transaction is conducted" would only be a "beneficial owner" to the extent that they have control or ownership of the customer.

2.18 AUSTRAC believe their reform would bring the Australian CDD requirements in line with the FATF recommendations, which require reporting entities to identify the natural persons that have beneficial ownership or control of customers, as part of a general requirement to understand the control structures of the customer.

2.19 While AUSTRAC also proposes to separately require reporting entities to determine and identify the person on whose behalf the transaction is conducted, it appears[7] that this is still aimed at identifying the "true owner of the transaction" where the customer is "attempting to disguise or conceal ownership or control of an account or transaction" i.e. ownership or control is still required.

3. SUBMISSION

3.1 There are clearly significant issues which need to be addressed as part of a long-term solution, including to ensure consistency with Australia and to maintain New Zealand's international competitiveness. We understand it will take time to put that long-term solution in place. In the interim, we recommend that the Fact Sheet is reissued clarifying a revised interpretation that "person on whose behalf the transaction is conducted" requires some degree of control or ownership.

3.2 We believe any long-term approach should be:

(a) Consistent with our key financial trading partners, a point noted in the Anti-Money Laundering and Countering Financing of Terrorism Regulations: thresholds, simplified due diligence and regulatory exemptions (paper two) paper (the **November 2010 Cabinet Paper**).[8] In particular, paragraph 20 of the November 2010 Cabinet Paper notes that the Trans-Tasman Outcomes framework contains an outcome statement that seeks harmonisation between AML/CFT obligations between Australia and New Zealand.

(b) Consistent with the risk based approach that should underpin the AML/CFT Act, the FATF recommendations, the Wolfsberg AML Principles, and the FMA's aims of fair, efficient and transparent markets.

3.3 In particular, given that AUSTRAC is currently consulting on these same issues, we believe that consistent with the Trans-Tasman Outcomes framework, effort should be made to harmonise with Australia.

[7] AUSTRAC, *Consultation Paper: Consideration of possible enhancements to the requirements for customer due diligence* (July 2013), page 22.
[8] Cabinet Domestic Policy Committee, *Anti-Money Laundering and Countering Financing of Terrorism Regulations: thresholds, simplified due diligence and regulatory exemptions (paper two) paper* (November 2010).

3.4 *Proposal 1: As an interim solution, the FMA re-release the Fact Sheet with a narrower interpretation of the phrase "person on whose behalf the transaction is conducted" so as to require some degree of control or ownership*

We believe the supervisors' current interpretation of the phrase "person on whose behalf the transaction is conducted" is too broad. The phrase should be interpreted to require some level of control or ownership, as to interpret it more broadly than that imposes an undue cost on reporting entities and their customers, and may disincentivise international organisations from dealing in the New Zealand market.

3.5 *Proposal 2: For the longer term, align with Australia*

(a) We noted above in paragraphs 2.17 to 2.19 that Australia is currently considering reform to its 'beneficial owner' requirements so that its AML/CFT Act better complies with FATF requirements. It is desirable to align our approach to beneficial owner with their proposed approach, including to meet the outcome statement in the Trans-Tasman Outcomes framework.

(b) AUSTRAC's proposed definition of beneficial owner will extend the current definition to all customers, so that any person who ultimately owns or controls the customer is considered a beneficial owner. AUSTRAC considers that this definition will bring the Australian legislation in line with the FATF recommendations on identification of beneficial owners, because it requires the reporting entity to determine the ownership and control structure of the customer which is the apparent intention of the FATF requirement.

(c) AUSTRAC are proposing to deal with any "person on whose behalf the transaction is conducted" issues separately from beneficial ownership, and still appear to be looking at some level of ownership or control. Consistency between the jurisdictions is desirable.

Until such time as the Fact Sheet is re-released, the FMA should provide assurance to the reporting entities affected by its unexpectedly broad interpretation of beneficial owner, that the FMA will not consider them to be in breach of their CDD obligations, if they fail to carry out CDD on underlying clients that do not meet the control and ownership limbs of the beneficial owner definition.

3.6 *Proposal 3: That the Ministry of Justice, using its authority under s 18(2)(f) of the AML/CFT Act, permit reporting entities to carry out simplified CDD on their customers who are identified as reporting entities and are regulated under the AML/CFT Act.*

(a) Under the AML/CFT Act, in situations where simplified CDD applies, a reporting entity does not need to identify or verify the identity of a beneficial owner of a customer.[9]

(b) We believe that it would be reasonable to allow a reporting entity to carry out simplified CDD on other reporting entities. Other reporting entities are regulated under the AML/CFT Act, and should therefore be in compliance with their AML/CFT obligations. Pursuant to section 131(d) of the AML/CFT Act, one of the functions of an AML/CFT supervisor is to investigate

[9] Anti-Money Laundering and Countering Financing of Terrorism Act, s 18(4)

the reporting entities it supervises and enforce compliance with the AML/CFT Act and regulations.

(c) This approach would be consistent with the approach taken in the United Kingdom where reporting entities are permitted to carry out simplified, rather than standard, due diligence on other regulated reporting entities. This approach reflects the level of risk in the circumstances, particularly considering the high, and relatively unnecessary, cost of carrying out standard CDD on other reporting entities and specifically on underlying clients, of which there might be hundreds or thousands, none of whom is individually material or exercises any significant rights of ownership or control.

(d) This approach is also consistent with The Wolfsberg AML Principles and published guidelines,[10] which recommend allowing reporting entities to be exempt from identifying underlying clients of managing intermediaries that are reporting entities where they have ascertained that a managing intermediary is adequately regulated and has implemented an AML/CFT Programme, on the basis of the reporting entities' reputation and/or the reporting entities' representations.

(e) If a full entitlement to conduct simplified CDD (and therefore no obligation to identify and verify beneficial owners) would be seen as too permissive, we suggest that:

(i) At least the requirement to identify and verify "beneficial owners" under the "third limb" should be waived, where there is no beneficial ownership under either of the ownership or control limbs; and/or

(ii) A concept, similar to s 18 of the Companies Act 1993, could be adopted such that a reporting entity should only be required to carry out standard CDD on customers that are reporting entities, where the reporting entity has, or ought to have, by virtue of its position with or relationship to the reporting entity customer, knowledge that the reporting entity customer is not meeting its CDD obligations.

(iii) As another alternative, for persons on whose behalf a transaction is conducted (which do not have an ownership or control element), a similar approach could be taken to regulation 24 of the Anti-Money Laundering and Countering Financing of Terrorism (Exemptions) Regulations 2011, which provides:

24 Relevant services provided in respect of trust accounts [or client funds accounts]

(1) This regulation applies to the provision by a reporting entity (A) of an account that is used as a trust account [or client funds account] in respect of which all of the following apply:

[10] The Wolfsberg Group, *The Wolfsberg AML Principles: Frequently Asked Questions with Regard to Intermediaries and Holders of Powers of Attorney/ Authorised Signers in the Context of Private Banking* (May 2012), question 5.

(a) the account is held by a customer (B) who is another reporting entity or a person subject to the Financial Transactions Reporting Act 1996:

(b) A has taken reasonable steps to satisfy itself that the account is being operated for legitimate and professional purposes and not to obscure the beneficial ownership of the account:

(c) A has a written agreement with B that B will, on request, produce to A the information relating to the names and dates of birth of the clients whose funds are held in the trust account [or client funds account] (the clients) and the means of verifying that information.

(2) A is, in relation to those clients, exempt from sections 11(1)(b) and 16(1)(b) of the Act.

(3) For the purposes of this regulation, [trust account or client funds account] means an account or other arrangement for the purpose of holding funds that belong to more than 1 client of a reporting entity or person subject to the Financial Transactions Reporting Act 1996.

(f) Removing the need to look through to underlying clients would also be consistent with the apparent intent behind the November 2010 Cabinet Paper. At paragraph 47 of the November 2010 Cabinet Paper, a beneficial ownership threshold of 25% was proposed. It was stated that "This means that reporting entities will not have to carry out CDD on any individual who owns less than 25% of a customer (if they do not otherwise exercise effective control)".

3.7 *Proposal 3 (as an alternative to Proposal 2): That reporting entities be permitted to rely on CDD carried out by other reporting entities for the purposes of section 33 of the AML/CFT Act and that the entity carrying out the CDD be the entity responsible for ensuring CDD is carried out in accordance with the AML/CFT Act.*

(a) As discussed above in paragraphs 2.9 to 2.11, relying on sections 33 of the AML/CFT Act has proved impractical for our clients because responsibility for ensuring CDD is carried out in accordance with the AML/CFT Act remains with the relying reporting entity. Section 33(3) should be removed or amended so that it is the managing intermediary which carries out the CDD that is responsible for ensuring the CDD complies with the AML/CFT Act and not the other reporting entity.

(b) The current effect of section 33 is that reporting entities wanting to rely on CDD conducted by managing intermediaries feel obliged to carry out CDD themselves if they are to satisfy themselves that they are meeting their obligations under the AML/CFT Act.

(c) The requirement in section 33 requiring the identity information to be provided every time should be relaxed to an "on request" basis as in regulation 24 of the Anti-Money Laundering and Countering Financing of Terrorism (Exemptions) Regulations 2011 referred to above. The relying reporting entity should, in the absence of reason to believe otherwise, be entitled

to presume that an appropriately supervised managing intermediary, which represents it is complying with its obligations under the AML/CFT Act, is in fact complying with its obligations under the AML/CFT Act.

(d) We note that we do not prefer this proposal 3 over proposal 2, because it is less desirable to retain an obligation to identify and verify the identity of non-owning/controlling "beneficial owners" at all. Exempting a reporting entity from penalty, but not the obligation, will still result in many reporting entities feeling obliged to undertake additional CDD at unnecessary cost and inefficiency. See also the comments by the Wolfsberg Group referred to in paragraph 2.14 above.

4. CONCLUSION

4.1 Thank you again for the opportunity to provide this submission. We look forward to your response and would be happy to discuss any of our comments with you further.

Yours sincerely

Gene Turner
Partner

Direct: 64 4 462 0446
Mobile: 64 21 339 527
Email: gene.turner@buddlefindlay.com