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Dear Kirsty

AML/CFT - Submission on draft Managing Intermediaries Factsheet

Thank you for the opportunity to make submissions on the draft Factsheet on Managing Intermediaries (the **Factsheet**). Our submission is set out below.

About AML Solutions

AML Solutions was established in October 2012 with the aim of being New Zealand's pre-eminent specialist AML/CFT consultancy.

Since establishment, we have assisted over 70 businesses to establish their AML/CFT programmes. These businesses represent a broad cross-section of reporting entities in terms of size and sector.

Looking forward, we have a core strategy of being the clear leader in providing high quality independent AML/CFT audits in a cost-effective manner for reporting entities.

Overview of our Submission

In summary:

(a) This submission expands on the brief submission we made when an earlier draft of the Factsheet was released to a small group of interested parties for initial consultation.

(b) We focus on the impact of the Factsheet on Collective Investment Schemes (**CIS**). However, the principles in our submission may have broader application.

(c) We consider that the requirement for reporting entities to "*look through*" CIS and have CDD obligations in respect of underlying investors will be highly onerous and probably ineffective. These outcomes are unlikely to be mitigated by the practical suggestions for compliance set out in the Factsheet.

(d) Accordingly, we propose specific limits on the obligation to identify the "*persons on whose behalf a transaction is conducted*" in the context of CIS. We hope that these proposals will be passed onto the Ministry of Justice for consideration by the Minister.

(e) We believe that our proposals will mitigate the difficulties in this area, without adversely affecting the overall integrity of the AML/CFT regulatory regime.

(f) We believe our proposals to be consistent with international practice and we provide evidence of this.

We cover each of these points in detail below.

Initial Consultation

We were fortunate to have the opportunity to provide comments on an earlier draft of the Factsheet. Due to the timing of the initial consultation (shortly before 30 June 2013) we were only able to provide brief comments.

However, we did take the opportunity to raise the issues for CIS with you. This submission significantly expands on our earlier comments and, in particular, fleshes out our thinking regarding a possible exemption.

Scope of this Submission

In this submission, we focus on the implications of the Factsheet for CIS (e.g. KiwiSaver schemes, unit trusts, superannuation schemes etc.). In part, this reflects the fact that we have been heavily involved in assisting CIS to establish their Compliance Programmes (including assisting a group of boutique fund managers working together).

We also think that focusing on CIS is likely to be a manageable way of flushing out relevant principles that may be more broadly applicable. Therefore, although we frame this submission in the context of CIS, it is likely to be relevant to other reporting entities and other managing intermediaries.

The Problem

We interpret the draft Factsheet to treat transactions conducted by a CIS as being conducted "*on behalf of*" the underlying investors in the CIS. Put another way, the entity operating the CIS is a "*managing intermediary*" and the investors are "*beneficial owners*".[1]

The implication of this is that a reporting entity dealing with a CIS has CDD obligations in respect of the underlying investors in the CIS. The Factsheet recognizes that a reporting entity may appoint another person as agent to conduct CDD and contemplates that this may offer a practical method of achieving compliance (including through the use of a "*chain*" of agents).

[1] You have specifically indicated that you are not seeking submissions on the content or interpretation of the Anti-Money Laundering and Countering Financing of Terrorism Act 2009. Accordingly, we have not sought to test or analyse this interpretation.

Our principal concern with this proposed approach is that it is likely to give rise to a very complex matrix of agency arrangements (including chains). Each arrangement would need to be identified, documented, monitored and managed. Given the legal responsibility of the reporting entity, managing the arrangements would require assurance mechanisms to be put in place.

We do not have reliable data regarding the magnitude of this exercise. However, the following might provide an indication:

(a) The Securities Commission's March 2011 Sector Risk Analysis estimated that there were approximately 65 CIS managers.[2] This does not take account of the many superannuation schemes in operation.

(b) Many CIS managers operate numerous CIS. Each of these, and the relationship it has with reporting entities, is likely to require consideration in the context of the agency arrangements contemplated by the Factsheet.

(c) It is reasonable to expect that each CIS has numerous relationships with reporting entities. These will include banks, trustee companies, brokers, custodians and other CIS.

(d) In many cases, as recognized by the Factsheet, there will be chains involving multiple CIS. For example, it is very common for a CIS to invest in another CIS, e.g. a KiwiSaver scheme or retail unit trust to invest in a wholesale unit trust.

In the light of the size and complexity of this market, we doubt that the proposed agency approach would be manageable or effective. We consider that the costs and inconvenience of implementing and maintaining this approach would significantly outweigh the benefits, to the point of being prohibitive. This in itself could adversely affect the integrity of the AML/CFT regime, through causing affected reporting entities to question the balance between regulation and benefit.

Accordingly, we suggest an exemption which we believe would maintain the integrity of the AML/CFT regime in a manner that reduces the cost and inconvenience on reporting entities.

Proposed Exemption

In broad terms, we ask that the Minister of Justice consider exempting reporting entities from conducting CDD on investors in CIS. This exemption might be granted on the condition that a reporting entity associated with the CIS has a legal obligation to conduct CDD on the investors.

Key comments in relation to this proposed exemption are as follows:

(a) We have articulated the exemption in broad terms. If the principle was accepted, the detail would need to be worked through in consultation with industry. For example, a definition of CIS would need to be developed.

(b) We have expressed the exemption in the context of CIS. There may be other reporting entities with similar characteristics to whom it should also apply.

[2] Paragraph 75

(c) The proposed condition that the CIS have legal obligations to conduct CDD is designed to maintain the integrity of the AML/CFT regime. It ensures that a properly regulated entity has such obligations.

In proposing that this condition is adequate to maintain the integrity of the AML/CFT regime, we are conscious of the following matters:

(i) As significant financial market participants, CIS are generally well resourced and compliance focused. Therefore, they can generally be expected to meet their AML/CFT obligations in an effective manner.

(ii) We understand that, as significant financial market participants, CIS are likely to be actively monitored by FMA in the context of AML/CFT compliance.

(iii) The importance of a reporting entity "*looking through*" a CIS is arguably lower than in the case of other scenarios where an intermediary is conducting a transaction on behalf of another person. A CIS is likely to be making undirected decisions on behalf of a large and changing group of underlying investors. The independent nature of the CIS is indicated by the fact that it will have its own balance sheet.

This can be contrasted with a situation where an intermediary is acting on behalf of a specific individual on the specific instructions of that individual. In such cases, we consider the need for the reporting entity to identify the underlying individual to be more acute, especially if the intermediary is not a reporting entity.

(d) In practice, we anticipate that these protections will be supported by the CDD that the reporting entity conducts on the CIS itself. We expect that reporting entities will often be mindful of the status and reputation of the CIS, and that this will involve being satisfied as to the ability and willingness of the CIS to meet its legal obligations.

(e) We have identified some support for this type of approach from overseas literature. This is covered in the following section.

In summary, we believe that the exemption would remove a very substantive compliance cost from reporting entities, without impacting on the effectiveness of CDD or the overall integrity of the AML/CFT regime.

Overseas Material

We have not conducted a comprehensive review of overseas practice in the context of Managing Intermediaries. However, we have identified some material that supports the proposition that the integrity of an AML/CFT regime is not compromised where a reporting entity does not conduct CDD on an underlying CIS investor, in circumstances where another properly regulated reporting entity has obligations to do so.

By way of example:

(a) The Wolfsberg Group 2006 *Anti-Money Laundering Guidance for Mutual Funds and Other Pooled Investment Vehicles* states:[3]

> *"In an indirect relationship, the [Pooled Vehicle] should consider the level of due diligence that should be performed on the Intermediary … taking into account the regulatory environment in the relevant jurisdiction and the Intermediary's responsibilities in respect of AML policies, procedures and controls. Depending upon the outcome of the PV's due diligence on the Intermediary, (and also depending on the requirements of local law), the PV should determine the level of CDD (if any) that it should undertake on the investor.*"

(b) The Wolfsberg Group 2012 note on *Frequently Asked Questions with Regard to Intermediaries and Holders of Powers of Attorney/Authorised Signers in the Context of Private Banking* states:[4]

> "*However, if the Intermediary is [a CIS type Intermediary] and if the bank [is satisfied regarding the regulation of the Intermediary] 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*."

(c) *The Guidance Note on Customer Due Diligence for Banks* issued by the Basel Committee on Banking Supervision in October 2001 contains the following statement[5]:

> "*Where the funds are co-mingled, the bank should look through to the beneficial owners. There can be circumstances where the bank may not need to look beyond the intermediary, for example, when the intermediary is subject to the same regulatory and money laundering legislation and procedures, and in particular is subject to the same due diligence standards in respect of its client base as the bank. National supervisory guidance should clearly set out those circumstances in which banks need not look beyond the intermediaries.*"

In identifying these statements from international material, we have necessarily been selective and it is important to read the statements in the overall context of that material. The Wolfsberg material can be found on www.wolfsberg-principles.com. The Basel Committee material can be found on www.bis.org.

[3] Paragraph 3.2. As you will be aware, the Wolfsberg Group is an association of 11 global banks, which aims to develop financial services industry standards and related products, for Know your Customer, Anti-Money Laundering and Counter Terrorist Financing policies.
[4] Question 6.
[5] Paragraph 39

Thank you again for the opportunity to make this submission and we would be very happy to discuss it further with you.

Kind regards
Yours sincerely

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