

Consultation Paper:

Practical implications of Reporting Entities transacting with other Reporting Entities and the Factsheet on Managing Intermediaries

11 July 2013

About this consultation paper

In this paper FMA seeks submissions on the practical implications of the Anti-Money Laundering and Countering Financing of Terrorism Act 2009 ('**AML/CFT Act**') in situations where reporting entities are transacting with other reporting entities.

The implications of the AML/CFT Act are set out in the attached draft Factsheet on Managing Intermediaries (the '**Factsheet**'). We encourage submissions on the processes and procedures that reporting entities have adopted, or think need to be adopted, in order to comply with the AML/CFT Act obligations described in the Factsheet.

Why are we issuing this consultation paper?

The provisions of the AML/CFT Act came fully into force on 30 June 2013. FMA is aware that some reporting entities that have customers who are themselves reporting entities, are finding it difficult to determine their obligations under the AML/CFT Act in relation to aspects of their obligation to identify their customers' beneficial owners. The purpose of issuing this consultation paper is to clarify the relevant AML/CFT Act obligations, and to assist the development and adoption by the market of practical processes and procedures that ensure all reporting entities are able to meet their AML/CFT Act obligations.

Issues for comment

1. The Factsheet clarifies the AML/CFT Act obligations of reporting entities that transact with other reporting entities. We encourage submissions on whether the practical suggestions for compliance set out in the section of the Factsheet titled 'Having a CDD obligation and conducting CDD' are the most appropriate suggestions to make to reporting entities. In particular, should any further practical or alternative suggestions be made?
2. We are aware that some reporting entities are of the view that where they transact with other reporting entities the AML/CFT Act should not impose an obligation for both reporting entities to identify the '*persons on whose behalf a transaction is conducted*'. FMA is not seeking submissions on the content or interpretation of the AML/CFT Act, but if submissions are received that propose specific limits on the obligation to identify the '*persons on whose behalf*

a transaction is conducted', then these submissions will be passed on to the Ministry of Justice for consideration by the Minister.

Nothing in this consultation paper shall imply that any exemption will be granted or any change of law made. In particular, FMA notes that the Minister is only permitted to grant exemptions within the limits set out in section 157 to 159 of the AML/CFT Act, which include having regard to the overall integrity of the AML/CFT regulatory regime.

Enforcement Action

Where reporting entities have made a genuine and reasonable attempt to comply with their obligations under the AML/CFT Act, but have proceeded with their AML/CFT planning based on a misunderstanding of their obligation to identify the *'persons on whose behalf a transaction is conducted'*, FMA confirms our good faith understanding that we will not take enforcement action for non-compliance relating to that genuine misunderstanding during the period of this consultation.

Where reporting entities are supervised by either the Department of Internal Affairs (DIA) or the Reserve Bank, please refer to the enforcement policies published by those AML/CFT supervisors. Reporting entities supervised by FMA may also refer to FMA's enforcement policy available on our [website](#).

This good faith understanding should not be used as a way for reporting entities to avoid full compliance with their other AML/CFT Act obligations, or to avoid compliance with their obligation to identify the *'persons on whose behalf a transaction is conducted'* to the extent that it is reasonably possible for them to comply.

Where reporting entities are non-compliant as a result of a genuine misunderstanding of their obligation to identify the persons on whose behalf a transaction is conducted, we expect to see reasonable action being taken to achieve compliance. It will be reasonable for reporting entities to wait for the results of this consultation before taking any material steps to implement the practical suggestions set out in the section of the Factsheet titled 'Having a CDD obligation and conducting CDD'.

Following the consultation period, the AML/CFT supervisors will issue a finalised version of the Factsheet which may contain additional or alternative practical advice for achieving compliance with the obligations described in the Factsheet. There will be no obligation to implement the practical suggestions set out in the final version of the Factsheet, but reporting entities must comply with their obligation to identify the persons on whose behalf a transaction is conducted.

Consultation Period

The consultation period is three weeks.

Please send your written submissions to: Kirsty Campbell, Manager Commercial Supervision, Financial Markets Authority, Level 5, Ernst & Young Building, 2 Takutai Square, Britomart, PO Box 106-672, Auckland 1143.

You can also email your written submission to aml@fma.govt.nz, clearly labelling your attached email submission 'Practical implications of Factsheet on Managing Intermediaries feedback'.

The deadline for submissions is close of business on Thursday, 1 August 2013.

Next steps

Once submissions have been received, we may share and discuss submissions with the AML/CFT supervisors and other stakeholders as appropriate. More generally, please note that we will not treat any part of your submission as confidential unless you specifically request us to do so.

Submissions will be subject to the Official Information Act 1982. We may make submissions available on our website, compile a summary of the submissions, or draw attention to individual submissions in internal or external reports.

If you would like us to withhold any commercially sensitive, confidential or proprietary information included in your submission, please clearly state this in your submission and identify the relevant extracts of information. We will consider any request to have information withheld in accordance with our obligations under the Official Information Act.

AML / CFT

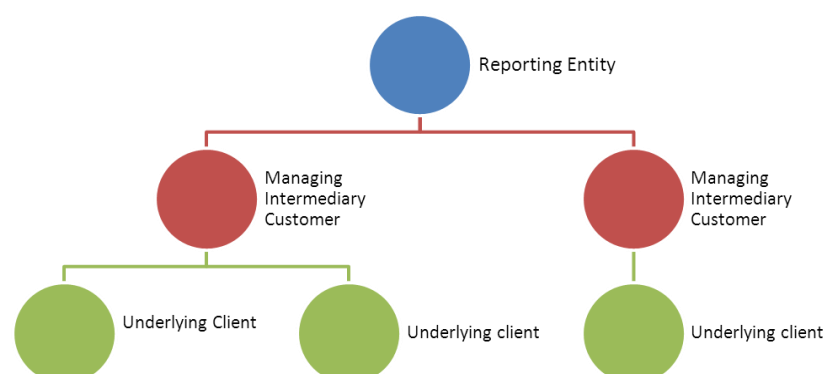
Anti-money laundering and countering financing of terrorism

Factsheet on Managing Intermediaries

1. This factsheet supplements the Beneficial Ownership Guideline (December 2012) and relates to the Anti-Money Laundering and Countering Financing of Terrorism Act 2009 (AML/CFT Act).
2. This factsheet focuses on two matters relevant to reporting entities that deal with intermediaries:
 - (i) A reporting entity has a customer due diligence (CDD) obligation to identify any beneficial owner of their customer, which includes any individual *'on whose behalf a transaction is conducted'*. This may often involve needing to look through an intermediary.
 - (ii) Where the intermediary being looked through is a reporting entity itself, the AML/CFT supervisors encourage a pragmatic approach to compliance with the CDD obligations so as to minimise unnecessary duplication of work. This may involve one reporting entity relying on another reporting entity under sections 33 or 34 of the AML/CFT Act, but it does not mean that a reporting entity dealing with a managing intermediary can turn a blind eye to the source of funds.
3. The guidance set out in this factsheet does not relieve a reporting entity from considering whether a structure has a legitimate purpose. A reporting entity is always obliged to consider the nature and purpose of a proposed business relationship and, where the level of risk involved is such that enhanced due diligence should apply, the reporting entity must obtain information on the underlying source of the funds.

What is a managing intermediary?

4. For the purposes of this factsheet, a managing intermediary means a financial institution that has a business relationship or transacts with a reporting entity in respect of products or services provided to the managing intermediary's customers. To avoid confusion, the managing intermediary's customers are referred to as 'underlying clients'.



5. A managing intermediary is likely to be a reporting entity itself. It may also have a further managing intermediary as a customer (i.e. there may often be a chain of managing intermediaries/reporting entities). Fund managers, financial advisers and trustees are examples of managing intermediaries, and the ultimate underlying client is the investor.
6. A reporting entity has CDD obligations in respect of its customers, the beneficial owners of its customers and persons acting on behalf of customers.
7. As explained in the Beneficial Ownership Guideline, in order to determine the beneficial ownership of a customer it is also necessary to consider any individual that is a *person on whose behalf a transaction is conducted*.
8. Before considering the extent to which a managing intermediary's underlying clients might be beneficial owners of the managing intermediary, we first consider who the reporting entity's customers are.

Who are the reporting entity's customers?

9. In the context of an investment structure involving one or more managing intermediaries, a reporting entity's customer will be the facility holder with whom the reporting entity has, or seeks to have, a business relationship, or the person seeking to conduct an occasional transaction through the reporting entity.
10. Consider the example of a fund manager providing investments to an investor. Investments may be provided either directly or indirectly. The fund manager's *facility holder* is the person whose name their account or arrangement is in. This could be the investor, a nominee/custodian or a trustee depending on the structure.
11. If the facility holder is an intermediary conducting a transaction on behalf of another person, that other person is *not* a customer of the reporting entity unless the account or arrangement is in their name. Care should be taken to avoid confusion with the situation where a person is *acting on behalf of a customer*, i.e. acting on behalf of the person who is the facility holder. A reporting entity has CDD obligations in respect of a person acting on behalf of a customer (as described in the Beneficial Ownership Guideline) but this is separate from the category of beneficial ownership.

Who are the beneficial owners?

12. Under the AML/CFT Act, a beneficial owner means an individual who:
 - has effective control of the customer or person on whose behalf a transaction is conducted; or
 - owns more than 25 percent of the customer or person on whose behalf a transaction is conducted.

13. A reporting entity should use the Beneficial Ownership Guideline to determine the individuals who are beneficial owners of the managing intermediary/customer. As described in the Beneficial Ownership Guideline, each time you apply the test of beneficial ownership to a customer you must apply three elements. These elements are:
 - 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.
15. For AML/CFT Act purposes, the beneficial owner of an entity may be different in relation to different transactions because in each case it includes the individual on whose behalf a transaction is conducted or any individual who owns more than 25 percent or has effective control over the person on whose behalf a transaction is conducted. It should be noted however, that a reporting entity does not need to identify beneficial owners in relation to every transaction within an existing business relationship. The section below titled 'Timing of CDD obligations' considers the practical effect of this changing group of beneficial owners of managing intermediaries.

Are underlying clients beneficial owners?

16. For the reasons explained in this section, the underlying clients at the bottom of a chain of managing intermediaries will usually be beneficial owners of each managing intermediary above them, because they are individuals on whose behalf a transaction is conducted.
17. In order to identify any person that falls within paragraph (a) of the definition of 'beneficial owner' in section 5 of the AML/CFT Act, a reporting entity must look through any legal structure to identify any '*individual*' who has effective control of a customer or effective control of '*a person on whose behalf a transaction is conducted*'.
18. Where the '*person on whose behalf a transaction is conducted*' is themselves an individual, that individual is considered to have '*effective control*' of themselves, unless there are reasonable grounds to suspect that they are acting on behalf of another person. For this reason, that individual will be a person who has '*effective control*' of a '*person on whose behalf a transaction is conducted*'. This means that the '*person on whose behalf a transaction is conducted*' is themselves a 'beneficial owner'.
19. For the reason set out in paragraph 18 above, a managing intermediary's underlying clients that are individuals¹ will be beneficial owners of the managing intermediary where they are '*the person on whose behalf a transaction is conducted*'.

¹ If the underlying client is not an individual, then any individual that has effective control, or owns more than 25 percent, of that underlying client will be a beneficial owner.

20. When determining whether the underlying clients of a managing intermediary are the persons on whose behalf the managing intermediary is conducting transactions, a reporting entity should consider whether the managing intermediary's transactions are conducted on its own behalf or ultimately on behalf of the underlying clients².
21. 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.
22. In each case, when considering whether an underlying client is a person on whose behalf the managing intermediary's transactions are conducted, it is necessary to consider the closeness of the connection between the managing intermediary's transactions and the risks and/or benefits imparted to the underlying client.
23. If a primary purpose of a transaction conducted by a managing intermediary is to invest funds for the benefit of (any number of) underlying clients, then even if a defined profit is taken by the managing intermediary, those underlying clients would usually be *persons on whose behalf the transaction is conducted*. This is the case whether or not the underlying clients have any direct rights or control over any part of the transaction conducted by the managing intermediary.
24. Where a company issues debt securities, or issues equity securities for the purpose of funding its business (where the primary purpose of that business is not simply investing funds from the underlying clients), then any transactions conducted by that company would not usually be entered into on behalf of the underlying clients, because there is no close connection between the transaction and the risks/benefits passed on to the investors. In these circumstances the company would not usually be considered to be a managing intermediary and reporting entities entering into a business relationship with the company would not need to look through the company to its investors³.
25. The purpose of the requirement to identify the people *on whose behalf a transaction is conducted*, is to ensure that reporting entities identify the individuals that effectively benefit from transactions. This is so that these individuals can be identified by authorities, if necessary, in relation to any investigation of a suspicious transaction or prosecution of criminal activity. .
26. This means that where a reporting entity deals with a managing intermediary, the reporting entity will usually have a CDD obligation to look through any managing intermediaries to the beneficial owners of the underlying clients. This does not necessarily mean that a reporting entity needs to complete the CDD itself, as its obligations will match those of any managing intermediary down the chain. Practical suggestions of how reporting entities can rely on each other to discharge these obligations are described below in the section titled '*Having a CDD obligation and conducting CDD*'. There may also be exemptions as described

² If an underlying client has effective control, or owns more than 25 percent, of a managing intermediary/customer, then this would also cause the underlying client to be a beneficial owner, but this is not a result of their status as an underlying client.

³ Reporting entities entering into a business relationship with this type of company would still need to identify any individuals that have effective control or own over 25 percent of the company.

below in the section titled '*Exemption from beneficial ownership identification and verification*'.

27. The appendices contain a typical funds flow transaction scenario for a straightforward fund (**Appendix 1**) and another for a wrap platform (**Appendix 2**). **Appendix 3** shows a typical transaction between a fund manager and a broker. These examples show how a fund or wrap platform may operate. Even if your business model differs from these, you should be able to extract useful pointers on your CDD obligation to identify your customers' beneficial owners.
28. Please note that this guideline focuses on the circumstances in which a reporting entity may have to look through one or more managing intermediaries to the underlying clients because the underlying clients are the beneficial owners of the managing intermediary. A managing intermediary may also have other beneficial owners, such as its directors or shareholders holding more than 25 percent, but these other beneficial owners are not considered in this guideline.

Timing of CDD obligations

29. A reporting entity is required to complete standard CDD in the circumstances described in section 14 of the AML/CFT Act. The most common circumstance that will give rise to the obligation to complete CDD will be at the establishment of a business relationship.
30. When a reporting entity establishes a business relationship with a managing intermediary, the managing intermediary may not have any underlying clients, which will limit the class of beneficial owners that need to be identified at that time.
31. Under section 31 of the AML/CFT Act, all reporting entities have an ongoing obligation to regularly review their CDD information obtained in relation to existing customers to ensure it is up to date. This does not mean that reporting entities need to review CDD information before every transaction within an existing business relationship, but the regularity of review should be based upon the reporting entity's risk assessment.
32. Please note that the wording in section 31(1) saying that this section '*applies to a business relationship between a reporting entity and a customer*' should not be interpreted to mean that a reporting entity need not regularly review information about the beneficial owners of a customer: The identity of a customer's beneficial owners is relevant information about the customer for the purposes of section 31.
33. Reporting entities, therefore, have an obligation to ensure that they regularly review the information they hold about the identity of beneficial owners of their customers. Where a reporting entity deals with a managing intermediary, it has a CDD obligation to regularly update information about that managing intermediary's beneficial owners.

Having a CDD obligation and conducting CDD

34. Having a CDD obligation in respect of an underlying client⁴ does not mean that you personally have to conduct CDD on that individual. Where a number of connected reporting entities/managing intermediaries have CDD obligations in respect of the same underlying client in a transaction chain, not every reporting entity/managing intermediary in the chain needs to separately conduct CDD on the underlying client. Sections 33 and 34 of the AML/CFT Act allow CDD to be performed on the underlying client by just one person in a chain of reporting entities/managing intermediaries. Subject to the terms of the AML/CFT Act, other reporting entities may rely on that third party to discharge their CDD obligations.
35. Reporting entities may consider which reporting entity in a chain of managing intermediaries is best placed to identify the beneficial owners of underlying clients, and may then implement arrangements as envisaged by sections 33 or 34.
36. We would expect section 33 of the AML/CFT Act, to be more appropriate for situations where the reporting entity does not have an established ongoing relationship with the person on whom it is relying to perform the CDD obligations or where there is a reluctance to establish a formal agency relationship. In this case it is necessary, as envisaged by sections 33(2)(c) and 33(2)(d), that the reporting entity/managing intermediary conducting CDD for another reporting entity up the chain, provides all relevant information to that other reporting entity. Section 33 can only be used where the person conducting the CDD is itself a reporting entity or is similarly supervised or regulated in another jurisdiction in accordance with section 33(2)(a)(ii).
37. Where there is an established ongoing relationship, a reporting entity may choose to appoint a managing intermediary as their agent under section 34 where that managing intermediary is better placed to identify the beneficial owners of underlying clients.
38. A person may be appointed as an agent under section 34 whether or not they are a reporting entity themselves. One way to do this is for each person in the chain ('A') to include clauses in their existing agreements or terms and conditions with the next person down the chain ('B') to the following effect:
- B acknowledges that A has CDD obligations in respect of certain underlying clients or the beneficial owners of underlying clients.
 - If B has a direct relationship with the underlying clients, that A authorises B, and B agrees, as agent of A to:
 - conduct CDD on the underlying clients;
 - hold the CDD information; and
 - on request from A, provide the CDD information to A.
 - Or, if B does not have a direct relationship with the underlying clients, that A authorises B, and B agrees, as agent of A to appoint a third person ('C') as agent of A (and of B, as applicable) to attend to the matters referred to above, or to appoint a further person ('D') as agent of those back up the chain to attend to those matters.

⁴ Or in respect of an underlying client's beneficial owners where the underlying client is not an individual.

39. Where a reporting entity uses a third party (under either section 33 or 34) to conduct CDD, the reporting entity will always be responsible for ensuring that the CDD is carried out in accordance with the AML/CFT Act.
40. In particular, where a reporting entity has appointed an agent under section 34, we would expect the reporting entity to have processes to enable the reporting entity to have confidence that the agent is fully complying with the AML/CFT Act. Reporting entities should treat the outsourcing of CDD to a third party with the same care as the outsourcing of any other material business function.
41. Where a reporting entity relies on another entity to complete CDD under section 33 or 34 of the AML/CFT Act, the person completing the CDD will need to ensure that they comply with the Privacy Act 1993 to the extent applicable. We would expect the entity with the direct relationship with the underlying client to ensure that CDD information can be shared with third party reporting entities where appropriate. We would also expect appropriate restrictions to be placed on the use of personal information by reporting entities up the chain, but even where an agent is appointed under section 34, the reporting entities up the chain must have the ability to promptly obtain the CDD information where necessary for AML/CFT purposes.
42. For the avoidance of doubt the above should not be taken as legal advice. It is merely an example of the kind of arrangement that the AML/CFT Supervisors would be comfortable with. Reporting entities are advised to seek legal advice (that fully takes into account their particular circumstances) on the arrangements they need to put in place to discharge their CDD obligations.

Exemption from beneficial ownership identification and verification

43. One exemption that will often be relevant in the context of managing intermediaries is Regulation 24 of the Anti-Money Laundering and Countering Financing of Terrorism (Exemptions) Regulations 2011, as amended. This exempts a reporting entity ('A') from the obligation to perform CDD on the beneficial owners of its customer where the obligation arises from the provision of a certain type of trust account or client funds account to that customer.
44. In order to qualify for the exemption, the trust account or client funds account must meet all of the following requirements:
 - It is held by a customer ('B') who is another reporting entity or a person subject to the Financial Transactions Reporting Act 1996;
 - 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;
 - 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 trust account and the means of verifying that information.

45. An example of an account that could qualify for this exemption is a law firm's trust account or a wrap provider's or fund manager's client funds account with a registered bank.
46. Subject to the requirements of Regulation 24(1), a registered bank will not need to perform CDD on its customer's underlying clients, even though these underlying clients may be the beneficial owners in relation to the banking transactions conducted through the trust account or client funds account.
47. Without this exemption, a customer's underlying clients would be subject to CDD as beneficial owners of the customer because any transactions relating to the account would be entered into on behalf of those underlying clients.

Managing risks

48. The main money laundering and terrorist financing risks occur at placement and integration. Placement risks are controlled by completing adequate CDD on a customer and their beneficial owner. Integration risks in the context of pooled investment products/services are controlled by limiting payments to the account that the funds originally came from, and not allowing third party payments or investment in financial products provided by unknown third parties. Reporting entities with managing intermediaries as customers should therefore consider their procedures for such transactions, the source of the instructions and ask whether they are for a legitimate purpose.

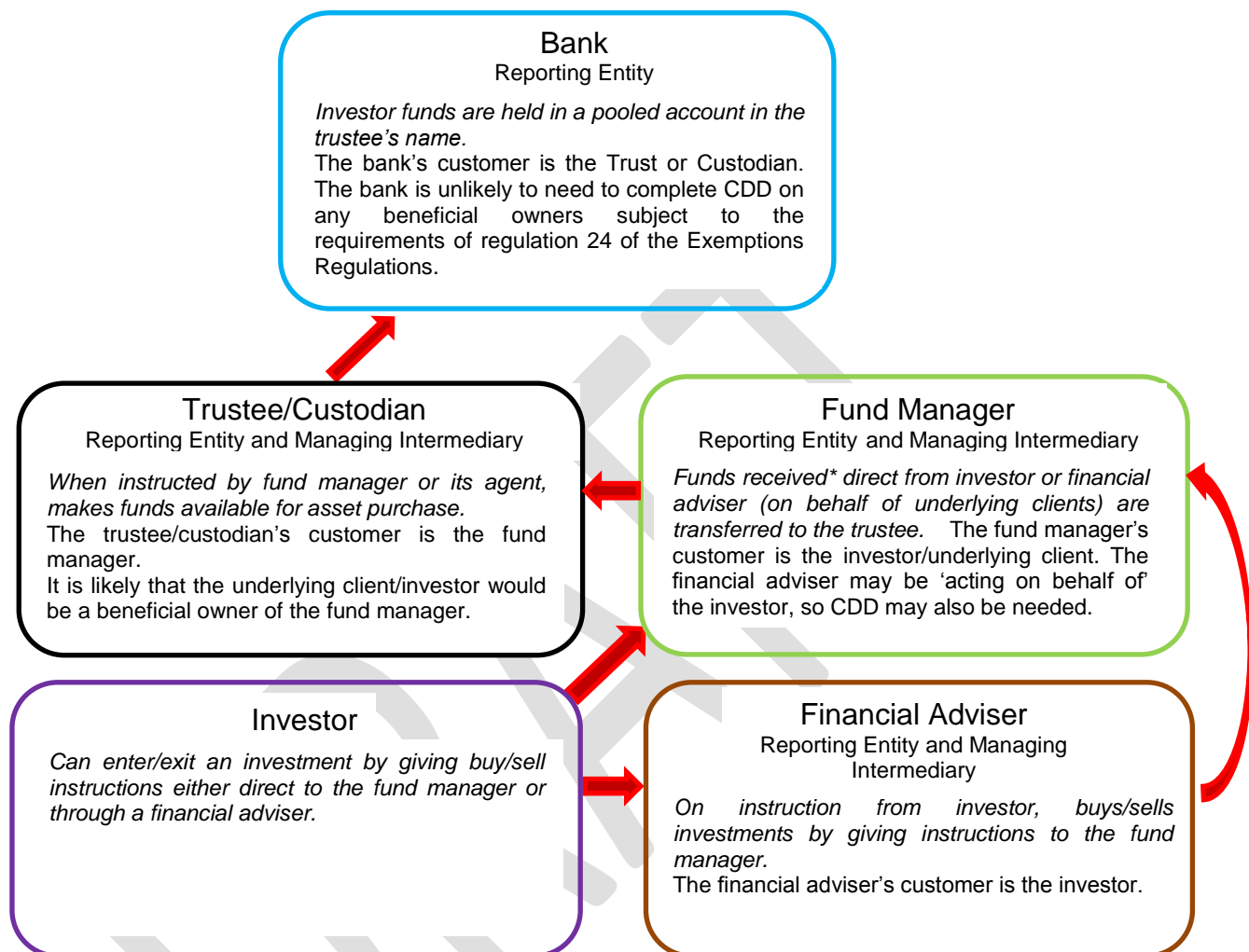
How we can help

49. If you are still unsure about your obligations after reading this factsheet, please contact your AML/CFT Supervisor or take legal advice.

Appendix 1

Typical retail managed funds structure

This shows a typical transaction scenario where there may be one or more managing intermediaries.



Notes:

*The fund manager may use an agent for key functions such as registry, including receipt of funds.



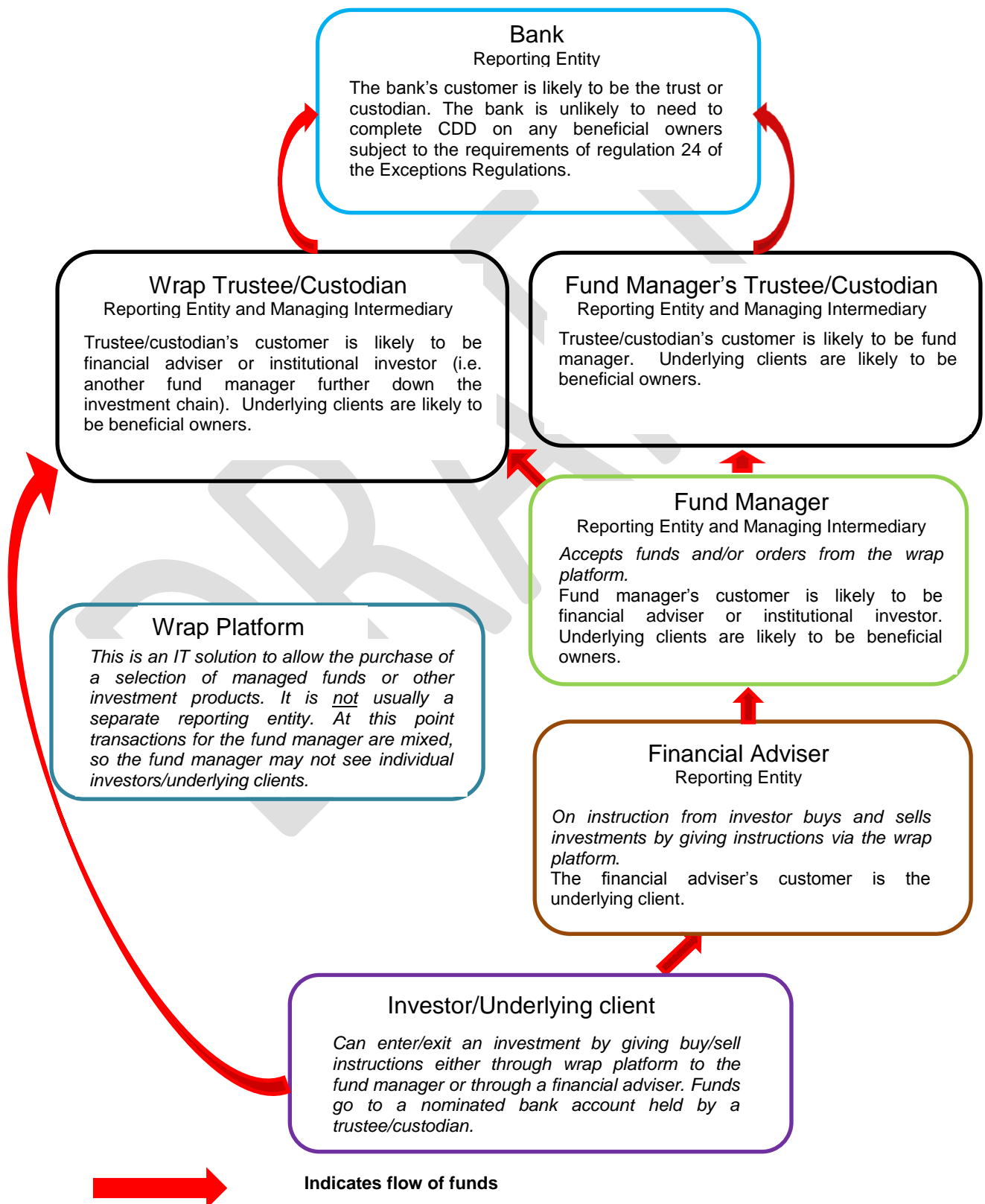
Indicates flow of funds

Appendix 2

Typical wrap platforms/accounts and funds flow scenario

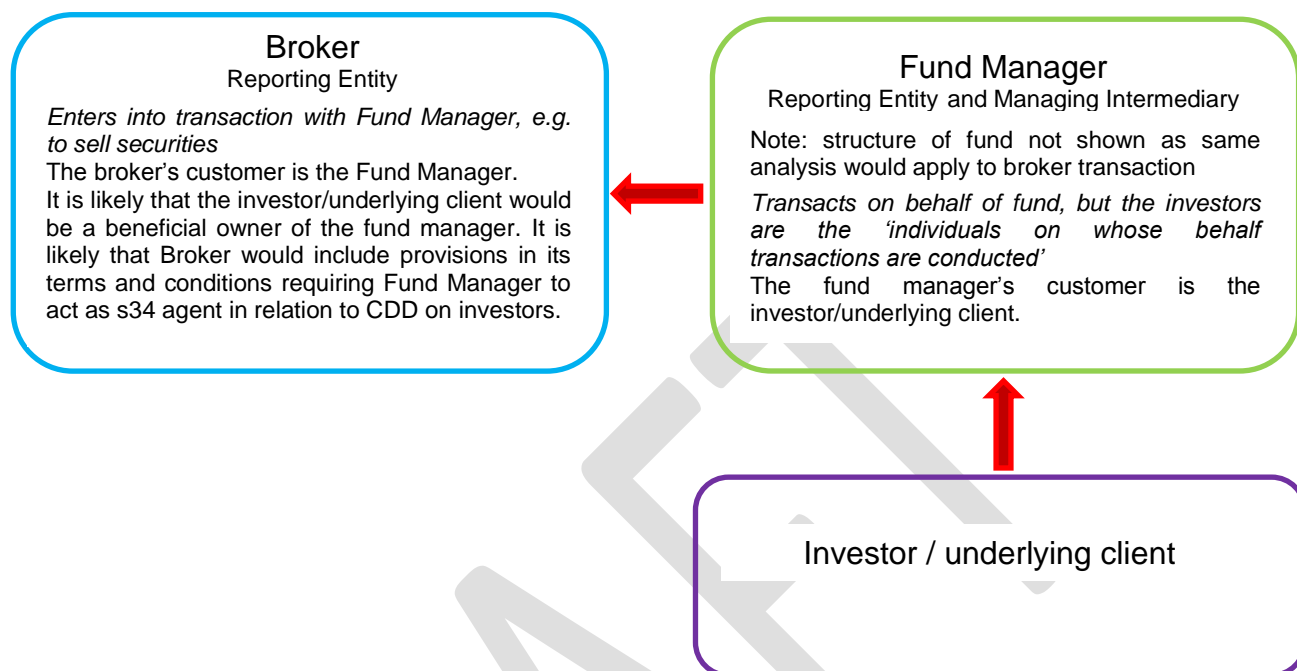
Wrap platforms are promoted as tools that give investors better visibility and control over their investments/composition of their investment portfolio. They are able to switch between their investments and buy or sell them with lower transfer fees.

Because wraps are attractive for investors with large sums of money to invest, they present increased risks. Also, being a one-stop shop, they are potentially efficient vehicles for layering and integration stage of money laundering and terrorism financing.



Appendix 3

Typical transaction between a fund manager and a broker



DRAFT

Disclaimer: This factsheet is intended to be read in conjunction with the AML/CFT guidelines from the AML/CFT supervisors. While reasonable measures have been taken to ensure the quality and accuracy of the information contained in this factsheet, it does not replace information contained in the Act or related provisions and regulations. This factsheet is for general information only and is not a substitute for independent, professional legal advice.



INTERNAL AFFAIRS

Te Tari Taiwhenua