By email to: FATF.Publicconsultation@fatf-gafi.org

23 August 2018

Comments on the draft risk-based approach (RBA) guidance for the securities sector

Dear Sir/Madam,

Introduction

The Association for Financial Markets in Europe (AFME), the Institute of International Finance (IIF) and the Investment Industry Association of Canada (IIAC) are pleased to provide comments on the draft FATF RBA guidance for the securities sector.

We strongly support the FATF's efforts to tackle money laundering and terrorist financing and greatly welcome the draft guidance which, we believe, will be an extremely useful resource for financial institutions engaged in the securities sector. Building on the FATF's October 2009 report on *Money Laundering and Terrorist Financing in the Securities Sector,* we think that the new guidance will greatly assist the public and private sectors to continue working together to identify those areas of the securities business that are at risk from an AML or CTF perspective, and to fight money laundering and terrorist financing. We welcome the involvement in the drafting team of both public and private sector representatives. This reflects the continuing cooperation of the securities sector with regulators and FIUs in this space.

The laws and regulations covering AML and CTF, while drafted with the same high-level principles worldwide, differ in detail from jurisdiction to jurisdiction. Harmonisation would of course be optimal. However, until we have that, any guidance of the nature of the current draft has to reconcile these differences and inevitably areas of unclarity will result. We believe that the drafting team has done an excellent job in this difficult area. That said, we have identified some areas below where we make suggestions for improved drafting.

The guidance, while stated to cover the securities sector as a whole, appears to focus more on broker-dealers than on other market participants, with some references to other activities such as custody and fund administration. In addition, it might perhaps be helpful to include an end-to-end view of the securities lifecycle from origination and issuance to trading and settlement, to custody and related activities such as fund administration and transfer agency.

There follow some specific comments of relatively minor detail. Accompanying this letter, we provide as a separate document a proposed mark-up of the draft FATF RBA guidance based on our suggestions set out below. Please note that the references to paragraphs and sections below are to those in the accompanying mark-up of the guidance.

Association for Financial Markets in Europe
London Office: 39th Floor, 25 Canada Square, London E14 5LQ, United Kingdom T: +44 (0)20 3828 2700
Brussels Office: Rue de la Loi 82, 1040 Brussels, Belgium T: +32 (0)2 788 3971
Frankfurt Office: Skyper Villa, Taunusanlage 1, 60329 Frankfurt am Main, Germany T: +49 (0)69 5050 60590
www.afme.eu

Company Registration No: 6996678 Registered Office: 39th Floor, 25 Canada Square, London E14 5LQ
AFME is registered on the EU Transparency Register, registration number 65110063986-76

Specific comments

- In Section 1.4.3, we recognise that it is helpful to provide a description of some of the differing roles of securities providers, the activities that they conduct and the parties with whom they interact. This assists securities providers to understand better the scope of the guidance, and assists other users of the guidance, who may not be familiar with the securities sector, to obtain an understanding of some of the key concepts and relationships which are critical to assessing ML/TF risk. Some of the text in this section, however, would not be regarded as describing accurately the role of certain specified types of securities providers in Europe, which could lead to confusion. We believe that this may be because terminology is used differently in different jurisdictions. Our comments on Section 1.4.3 are therefore directed at ensuring that the guidance can be more generally applicable on a global basis. We have also suggested some minor adjustments to the language to seek to clarify the way in which certain securities providers, intermediaries and customers interact.

- We set out below in more detail an explanation for the suggested revised drafting provided in Section 1.4.3.

  - In Paragraph 17, the guidance describes the meaning of a securities provider. We suggest that the following wording is added to the end of the paragraph reflecting the fact that larger securities providers may undertake a number of different activities via different group entities:

    "One characteristic particularly of larger security providers is that they may perform a diverse set of activities through different legal entities of the same group. These different group entities may be subject to very different regulatory and statutory requirements and the group's risk-based approach will need to consider this carefully."

  - In Paragraph 20, we have sought to clarify that the direct investor in a fund will be the fund's customer (and must therefore be subject to CDD).

  - In Paragraph 20, the draft guidance previously indicated that where an investor buys fund-units through an intermediary such as a broker, the fund might be required to treat the investor as a customer or might be required to treat the intermediary as the customer, depending on how the investment fund is sold and with whom the business relationship is established. Whilst we agree that CDD on the intermediary would be required if the intermediary was the investor in the fund on behalf of its underlying customers, we would not expect CDD to be conducted on the intermediary if it merely introduced customers who contracted directly with the fund. We believe that there is potential for confusion in using the word "intermediary" in two different ways (as introducer, or as investor), and we have sought to clarify the different scenarios through the introduction of the language of "direct investor".

  - The diagram in Paragraph 20 is the only diagram in the guidance; this gives it particular prominence and we were not clear what this is seeking to convey (for example, if there were particular risks associated with UCIs which it was intended to

highlight). It is also unclear whether this guidance is intended to describe and apply to fund structures more generally. In particular, hedge funds may pose different and potentially more significant ML/TF risks than mutual funds, but the guidance on UCIs appears directed to retail/mutual funds.

- In Paragraph 24, it would be useful to differentiate introducing brokers, executing brokers and clearing brokers. The roles and responsibilities of the brokers, and their visibility of the underlying customer and its activities, will vary depending on whether they are introducing, executing or clearing a trade.

  European practice is that introducing brokers typically pass customers along to full service brokers (who will conduct both executing and clearing) or executing brokers (who will only execute the trade and will then give it up a clearing broker for clearing). Introducing brokers may also be name-passing brokers only or may be involved in passing instructions to executing/full service brokers. As a result, the sections of the draft guidance stating: (a) that an introducing broker will pass orders to a clearing broker for both execution and clearing; and, (b) that the introducing broker will have the primary customer relationship and the clearing broker may have little or no visibility of the customers, will often not be an accurate description of these relationships and processes. We have suggested some amendments to this section with a view to seeking to ensure that it is more globally applicable whilst addressing the same underlying concepts. We appreciate that the relevant practice (and the measures required to address any associated AML/CTF risks) may vary by jurisdiction and we have included a reference to this in the drafting.

- Paragraph 25 states that "underlying customer transparency and due diligence obligations depend on whether the relationship is execution, custody based and/or whether there is credit exposure to the underlying customer". We believe that the words "local regulatory requirements as to" should be added after the words "depend on".

  In addition, at the end of Paragraph 25, the guidance states that "the institutional broker will perform appropriate and necessary levels of due diligence on the underlying customer(s) to mitigate any potential ML or credit risks identified". We suggest that the words "of the intermediary" should be added after the words "underlying customer(s)" and we propose that the words "potential ML or" are removed from the sentence.

- Paragraph 26 states "Regardless, customers' orders may be netted against each other by the broker-dealer's customer." It is not clear to us that this sentence is helpful here and therefore we suggest that it may be best to delete it.

- Paragraph 27 states that clearing firms "generally do not have a direct relationship with the underlying customer in some jurisdictions". In fact, clearing brokers may or may not deal directly with the trade instructing party; in Europe however, the trade instructing party *will* typically be the client of the clearing broker (although the draft guidance is correct to highlight that the clearing broker, as it performs a post-trade service, is not typically well placed to assess the intent or suitability of a given

transaction). We think the most that can be said is that clearing firms may or may not have a direct relationship with the underlying customer, which provides little positive guidance. We have therefore suggested deleting this sentence.

- The final sentence of Paragraph 27 highlights an important point which is not confined to clearing firms but is of more generally applicability; that AML/CTF responsibilities should be properly allocated between firms and intermediaries to maximise the AML/CTF efforts of each securities provider. We have suggested moving this sentence into a free-standing Paragraph 28.

- We have suggested deleting the second parenthesis in Paragraph 29 as we believe that where a prime broker conducts CDD on an investment manager acting on behalf of a fund, the prime broker will ordinarily be required to (and/or ordinarily will in practice) conduct due diligence on the general partner of the investment manager. Accordingly, we do not think it is correct to suggest that the securities provider/prime broker in this scenario would be electing to conduct additional due diligence on "associated parties" to mitigate potential risks.

- Paragraph 30 appears to us to be more of an introductory paragraph on securities providers rather than a summary of the guidance in Section 1.4.3. Therefore, we suggest that consideration is given to moving this paragraph to somewhere nearer the beginning of Section 1.4.3. In addition, in Paragraph 30, we suggest that the words "of its customers" are inserted after the words "ongoing risk assessment" as it is presently not clear who the risk assessment should relate to.

- In Paragraphs 31 to 36, the draft guidance sets out the different roles which may be played by intermediaries on behalf of securities providers. Paragraph 33 states that "all these different models and business practices may pose different ML/TF risks and require different approaches to mitigate such risks". Paragraph 36 goes on to say that "the variety of intermediary roles involved highlight that no one-size-fits-all AML/CFT approach should be applied". We welcome this flexible approach to the CDD requirements for intermediaries; securities providers should be able to apply a risk-based approach to their CDD requirements.

- Paragraph 34 states that "financial institutions are sometimes appointed by a securities provider to perform some aspects of CDD". We suggest that the words "are generally" are replaced by the words "may be" here. We understand that practices can vary by jurisdiction and believe this should be reflected here.

- Paragraph 57 states "on the other hand, securities providers should understand that a flexible RBA does not exempt them from applying effective AML/CFT controls and that they must demonstrate to their competent authorities the effectiveness of the AML/CFT controls implemented, which should be commensurate with the risks identified." We suggest that the wording "must demonstrate" is too rigid for a risk-based approach and should be replaced by "need to be able to explain". In addition, we suggest that words "which they have" are inserted between the words "controls" and implemented".

- Paragraph 61 states that "a securities provider's risk assessment should be commensurate with the nature and complexity of the business, type of products and services offered, the conditions of the proposed transactions…" We suggest that it would be appropriate to replace the word "conditions" with "characteristics".

- Bullet point 1 of Paragraph 62 states that one risk factor which a securities provider should consider is "the nature, diversity and complexity of its business and target markets". We believe that the products of a business should be considered here as well and therefore suggest that the word "products" is inserted into the sentence in the following way: "business, products and target markets".

- Paragraph 69 provides a list of categories of customers whose business or activities may indicate a higher risk. In relation to Paragraph 69, we have the following comments:

    - The fourth bullet point includes the words "customer [which] resides in countries considered to be uncooperative with respect to tax transparency, or refusing international cooperation due to their secrecy or offshore status". We believe that the words "offshore status" should be removed here. The fact that a customer is based "offshore" does not seem relevant and should not be used as a factor to determine a customer as being uncooperative. The same change should be made to the last bullet point in Paragraph 67 in relation to country/geographic risk.

    - The sixth bullet point is that the "Customer has been mentioned in negative news reports". We believe that this is too broad and that it would be more accurate to replace this with "Customers that have been subject to negative attention from credible media and in a context that is relevant for AML/CFT purposes".

    - The penultimate bullet point includes a "customer is also a securities provider, acting as an intermediary or otherwise, but is either unregistered or registered in a jurisdiction with weak AML/CFT oversight". We suggest that the word "unregulated" should replace the word "unregistered" and the word "registered" should be replaced by the word "regulated".

    - The last bullet point includes a situation where a "customer is engaged in or derives wealth or revenues from a potentially high-risk cash intensive business". We believe that the words "and where the relationship is indicative of personal wealth" should be added to the end of this sentence. Otherwise the requirements for an investigation of source of wealth/funds appears to be too broad.

    - We suggest that other factors possible which could be added to this list are: (1) the number of STRs and their potential concentration on particular client groups; and, (2) where a customer is incorporated in the form of bearer shares (we understand that this is still possible in certain jurisdictions, for example, in Latin America). We recommend that these are included here.

- Paragraph 70 states that "transactional operations are either undertaken on a regulated exchange (e.g. NASDAQ) or other market…" Given the global nature of the guidance, we

suggest that the words "(e.g. NASDAQ)" are removed from this sentence. We believe that it should be clear what is meant here in any event.

- Paragraph 71 identifies products and services that may indicate a higher risk. In relation to Paragraph 71, we have the following comments:

    - One of the factors included is the offering of "bank-like products, such as check cashing and automated cash withdrawal cards". We suggest that the words "bank-like" should be replaced by the words "cash-based" which, we believe, provide a more accurate description of the services that would indicate a higher risk here.

    - Another of the factors included is "products with unusual complexity and/or structure and with no obvious economic purpose (securities providers may offer this as an ancillary service or they may earn fees from the transactions), which may also make pricing the product difficult." We suggest that the words "(securities providers may offer this as an ancillary service or they may earn fees from the transactions), which may also make pricing the product difficult" be deleted from the sentence as it is not clear that they add any helpful explanation.

- Paragraph 72 provides a list of higher risk transaction indicators. The final bullet point states "transactions involve penny/microcap stocks". We believe that this is already covered in Paragraph 71 which provides a list of higher risk products and services, one of which is "products that have been particularly subject to fraud and market abuse, such as low-priced securities". We suggest that the indicator "transactions involve penny/microcap stocks" Paragraph 72 should be deleted.

- Paragraph 75 states that "a securities provider should analyse the specific factors which arise from the use of intermediaries as a business model". We suggest that the words "as a business model" are removed. It is not clear what these words add.

- Paragraph 82 states that "securities providers should take measures to comply with national and international sanctions legislation; sanction screening is mandatory and is not discretionary". We think the word "mandatory" is too strong (albeit we would be surprised if any securities providers were to choose not to carry out sanctions screening) and suggest that this would better read "securities providers should take measures to comply with national and international sanctions legislation; sanctions screening is expected".

- Paragraph 87 states that a securities provider must use a risk-based approach when determining the type and extent of CDD to apply. In particular, the securities provider "may obtain information about the intermediary's AML/CFT controls including the intermediary's risk assessment of its underlying customer base". Obtaining information about the intermediary's risk assessment of the underlying customer base is not, we think, necessary and therefore we believe that the words "including the intermediary's risk assessment of its underlying customer base" should be removed. On the third line of Paragraph 87, we note a typo "on behalf of its r underlying customers". The "r" should be removed.

- Paragraph 91 states that for source of wealth and funds "under the RBA, a securities provider should take reasonable measures to establish the source of wealth and source of funds of relevant parties, where necessary". We believe that the inclusion of the word "necessary" is too broad and that a source of wealth or source of funds investigation is required in circumstances only where the relationship is indicative of personal wealth. Accordingly, we believe that the words "the relationship is indicative of personal wealth" should replace the word "necessary" in this sentence.

- In relation to Section 7.1.6, we have the following comments:

    - We suggest that it would be helpful to rename the section "Correspondent Relationships", which is what it covers.

    - The guidance should clarify that the relationship between a securities provider and intermediary is considered analogous to a correspondent/respondent relationship in that the securities provider is generally not expected to know the intermediary's customers. The CDD requirements for securities providers with respect to intermediaries set out in Paragraph 88 should be consistent with those set out in Paragraphs 95 to 100, and the circumstances when CDD is required to be undertaken by a securities provider on the underlying clients of an intermediary should be clear.

- In Box 1 (at the end of section 7.1.5), there is a list of examples of measures to be taken for the purposes of EDD. Bullet point 1 (which reads "Obtaining additional customer information, such as the customer's reputation and background from a wide variety of sources before the establishment of the business relationship and using the information to inform the customer risk profile") is effectively the same as bullet point 5 (which reads "Obtaining additional customer information, such as the customer's reputation and background from a wide variety of sources before the establishment of the business relationship"). One of these (we suggest preferably bullet point 5) should be removed. The last bullet point with respect to measures to be taken for the purposes of SDD is "Reducing the degree and extent of on-going monitoring and scrutiny of transactions, for example based on a reasonable monetary threshold". We suggest that "on reasonable monetary thresholds" should replace "on a reasonable monetary threshold".

- In relation to reliance on intermediaries, Paragraph 101 states that "it may not rely on such parties to perform ongoing monitoring, ongoing due diligence and scrutiny of transactions". We believe that this is not necessarily automatically the case and should depend on the circumstances involved. Therefore, we propose that the words "be appropriate to" should be inserted in between "not" and "rely" and the words "although this will depend on the circumstances involved" should be added to the end of the sentence.

- Paragraph 102 states that "the securities provider should immediately obtain the necessary information concerning elements (a)-(c) of the CDD measures set out in R.10, and also take adequate steps to confirm that copies of identification data and other relevant documentation relating to CDD requirements will be made available by the third

party upon request and without delay". We suggest that the word "confirm" should be replaced by the words "satisfy themselves". In addition, we suggest that the word third party should be replaced by the word "intermediary".

- Paragraph 104 states that "the reliance model above can be contrasted with an outsourcing agency scenario, in which the outsourced entity applies the CDD measures on behalf of the securities provider, in accordance with its procedures, and is subject to the securities provider's overall control of the effective implementation of those procedures". The word "control" is inappropriate in our view and should be replaced by the word "review".

- Paragraph 114 states that "transaction monitoring should be carried out on a continuous basis and may also be triggered by specific, unusual transactions". We believe that it would be very helpful if the FATF guidance would include here some examples of suspicious activity in the securities sector which would require enhanced monitoring beyond that which would be carried out on a routine basis.

- Paragraph 117 states that "Securities providers should document and state clearly the criteria and parameters used for customer segmentation and for the allocation of a risk level for each of the clusters of customers." We believe that it would be clearer to start this sentence by saying "If securities providers establish different customer segments for monitoring, the providers should document and state clearly…".

- Paragraph 126 states that "ML/TF risks will be managed before entering into, or maintaining, business relationships or offering services that are associated with excessive ML/TF risks". We suggest that the word "significant" should replace "excessive" and would be more appropriate in this context. In addition, the last bullet point reads "indicate adequate resources for the securities provider's AML/CFT function". We suggest that the word "allocate" should replace "indicate" and would be more appropriate in this context.

- Paragraph 128 states that "responsibility for the consistency and effectiveness of AML/CFT controls should be clearly allocated to an individual of sufficient seniority within the securities provider…". We suggest the words "consistency and" be omitted as they do not add clarity.

- Paragraph 129 states that "this independent testing and reporting should be conducted by, for example, the internal audit department, external auditors, specialist consultants or other qualified parties who are not involved in the implementation or operation of the securities provider's AML/CFT compliance programme". We suggest that the word "design," is included before the word "implementation" in the above sentence.

- Similarly, in the second sentence of Paragraph 131 the words "the measures relevant to AML/CFT controls should be consistent with the broader set of controls in place to address business, financial and operating risks generally" do not add clarity and suggest they be omitted.

- In relation to Paragraph 133, we have the following comments:

- The fourth bullet point states "verify that adequate risk assessment and controls are in place before new products are offered". We suggest that the words "or services" are added after "products".

- The seventh bullet point states "focus on meeting all appropriate regulatory record keeping and reporting requirements and requirements for AML/CFT compliance and provide for timely updates in response to changes in regulations". We suggest that the word "applicable" replaces the word "appropriate".

- Paragraph 142 states that "supervisors should also look at the controls in place, including the quality of the risk management policy, the functioning of the internal oversight functions, the history of the securities provider's compliance with regulations, STR reporting history (including quality, timing and volume of STRs submitted) and other open source information." We suggest that the word "effectiveness" should replace the word "functioning" in the above sentence.

- Section 9.1 of the guidance states that "supervisors should draw on a variety of sources to identify and assess ML/TF risks, including information from stock exchanges and self-regulatory organisations". Paragraph 143, in relation to how information may be obtained, states that "in some jurisdictions, this may involve information-sharing and collaboration between prudential and AML/CTF supervisors, especially when the responsibilities belong to two or more separate agencies". We suggest that in Paragraph 143, the Guidance should also refer to information sharing and collaboration between AML/CTF supervisors. This is an important means by which cross-border information may be gathered on the risks posed by certain securities providers.

- Paragraph 164 states that "Supervisors should consider communicating with other relevant domestic regulatory and supervisory authorities". We believe that this should read "Supervisors should communicate with other relevant domestic regulatory and supervisory authorities".

- In Paragraphs 138 onwards (Section III: Guidance for supervisors), we believe that the guidance should make the following points:

    - Encourage supervisors to update their list of suspicious transaction indicators/red flags at regular intervals, taking into account developments in their respective jurisdictions, for example, by analysing the STRs that have been generated.

    - Encourage cooperation between supervisors that allows for the exchange of best practices in the field of AML/CFT supervision.

    - Encourage the provision of regular feedback from supervisors to securities providers (and other parties) in the financial services sector to enable better targeting of procedures by securities providers.

- In relation to Annex B, we have the following comments:

- The introductory paragraph states that "this is not an exhaustive list, and may not be relevant in all countries or circumstances". We suggest that the word "circumstances" is replaced by the words "for all business activities described in this document".

- Paragraph 5, Section I of Annex B includes a "Sudden spike in transaction volumes which deviates from previous transactional activity". Paragraph 1, Section II of Annex B (Suspicious activity indicators in relation to securities) includes "intermediaries whose transaction volume is inconsistent with past transaction volume". In both cases, we believe that the words "absent any commercial rationale or related corporate action event" should be added to the end of the sentence. There may be a reasonable commercial explanation for a change in transaction volume (e.g. as part of a wider change in investment strategy) and we believe that this is material to whether this should be considered a risk factor in the first place. In other suspicious activity indicators (e.g. Paragraph 11, Section I of Annex B), the FATF has included a reference to there being no reasonable business explanation and we believe the same should be included here.

- Paragraph 13, Section 4 of Annex B includes a "Customer is reluctant to provide information needed to file reports to proceed with the transaction". We suggest that the following words are added to the end of this sentence "or request an inordinate amount of secrecy around a transaction".

- Paragraph 14, Section 4 of Annex B includes a "Customer exhibits unusual concern with the firm's compliance with government reporting requirements and the firm's AML/CFT policies. We recommend that the words ", the firm's systems" are added after the word "requirements" and the words "and controls" are added after the word "policies".

We would reiterate that these comments should be seen as detail in a draft which, in general, we welcome and like. We would be happy to discuss our comments in more detail and to meet to do so if that would be helpful.

Yours faithfully,

Adam Willman
Director, Policy, AFME
+44 203 828 2740

Andrés Portilla
Managing Director, Regulatory Affairs, IIF
+1 202 857 3645

Michelle Alexander
Vice President, IIAC
+1 416 687 5471