INTERNATIONAL COUNCIL of SECURITIES ASSOCIATIONS

November 15, 2009

RE: FATF Consultation Document: Joint Work on Recommendation 9

Introduction

This document, which is a response to the FATF's consultation on Recommendation 9, has been developed by the members of the International Council of Securities Associations (ICSA) Working Group on AML, which participates in the FATF's Consultative Forum as the representative of the securities industry.[1] The document sets out the views from those members of the ICSA Working Group on AML that are contributing to the FATF Expert Working Group on the review of and joint work on Recommendation 9.

Executive summary

We set out a number of common issues which although addressed in different ways within their own jurisdictions nevertheless feature as the main concerns when considering the issues set out in FATF's consultation document on Recommendation 9.

- We support the concept of reliance on third parties as set out in Recommendation 9 and recognise the efficiency this can bring to the customer "on boarding" process both for the financial institutions (FIs) and the customers . However, we recognise that there has been limited use made of it by FIs save in certain specific situations where legislation supports its use and/or through common usage, built up over time, within certain sectors, which has been generally accepted by the relevant regulatory authorities. We consider, as set out in the consultation document, that leaving the ultimate responsibility, in all circumstances, for undertaking the relevant customer due diligence (CDD) or customer identification process (CIP) with the FI relying on the third party is a significant factor contributing to the limited use of

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[1] ICSA is composed of trade associations and self-regulatory organizations that collectively represent and/or regulate the vast majority of the world's financial services firms on both a national and international basis. ICSA's objectives are: (1) to encourage the sound growth of the international capital market by promoting harmonization in the procedures and regulation of those markets; and (2) to promote mutual understanding and the exchange of information among ICSA members.

reliance. This is seen as a significant obstacle which should be addressed and work on producing “a reasonable reliance test” should be undertaken.

FIs have legal and regulatory obligations to fulfil (for example, sanctions scanning), as well as undertaking, in most cases, their own due diligence (such as credit assessments) for reputational and commercial reasons. This means that FIs should always undertake a certain level of due diligence on every customer even if not for AML purposes. Hence, we believe that the decision to rely upon a third party should be engrained within an FI’s risk-based approach. For their own reputation/commercial reasons, FIs may choose not to use reliance in certain circumstances or to limit it to certain aspects (for example, FIs may choose still to perform their own sanctions scanning on the client). The extent to which an FI would use third party reliance would, therefore, take account of all information gathered, including information on the party to be relied on.

- It is important that the CDD performed by a third party is seen as the start of a customer relationship, which is supplemented by additional KYC information obtained during the customer relationship. This is consistent with the view that CDD should be one part of an holistic approach to AML.

- The issue of reliance on other group members is not as straightforward as it might at first seem. Some groups apply a group-wide AML policy which implements the highest standards to which the group is subject and “police” its compliance within the group on an on-going basis, for example through regular internal audit reviews. Other groups, however, may identify customers according to the local requirements applying at the legal entity level, thereby leading to the application of differing standards within the group. In addition, in a number of jurisdictions the officer responsible for compliance with the money laundering requirements/regulations has a personal liability, which carries severe penalties for failure. This results in a reduced likelihood of reliance on other members of a group to have undertaken the CDD/CIP. The various interpretations of the requirements and the need to apply local regulations further complicate the ability to rely on other group members (see CESR, CEBS, CEIOPS *Compendium paper on the supervisory implementation practices across EU Member States of the Third Money Laundering Directive [2005/60/EC]* of 15th October 2009 paragraph 3.3.8 “Third party Introduction within the group compared to entities that do not belong to the same group”). Hence there is no single solution to reliance within all groups but further work should be undertaken in this area to facilitate reliance where it is appropriate.

- Even where jurisdictions permit third party reliance – usually in specified, restricted circumstances – there is often a requirement to obtain the third party’s consent (see, for example the UK’s Money Laundering Regulations 2007 which contain a consent provision in Regulation 17 that is not explicit in the European Union’s (EU’s) Third Money Laundering Directive) and possibly

additional administrative processes may be required (such as annual reconfirmation of the consent), which may make the reliance process onerous to adopt. These practical obstacles reduce the likelihood of using reliance and should be considered further.

- The third party being relied upon may be required to retain documentary evidence and produce it to the FI, usually on demand when a need arises. Alternatively, an FI may be held responsible for the availability of the third party's records. Hence, where a third party ceases to exist or is taken over, FIs are concerned that the records may, as a result, no longer be available. Reasonable responsibility for third party records should be considered in more detail.

- Generally there should be no chain of reliance: i.e. third party that is being relied upon should not 'pass on' CDD performed by another party and nor should an FI knowingly rely on such CDD. Whilst this is explicit in some countries (e.g. see Part I, Chapter 5, paragraph 5.6.11 of the UK's Joint Money Laundering Steering Group's (JMLSG's) Guidance), we believe that there should be a more uniform approach.

- Where two or more FIs are involved in a relationship with a customer the overlapping responsibilities of the FIs will result in the customer having to produce documents on a number of occasions unless reliance can be placed one upon another. We believe that, given the issues in respect of reliance discussed above, it is important that authorities explore alternatives to reliance in such situations: in particular, determining whether it is appropriate for the CDD/CIP obligations to fall on both/all FIs in respect of the same customer. For example, see the FinCEN 20th April 2007, FinCEN/CFTC Guidance – *Application of the Customer Identification Program Rule to Futures Commission Merchants Operating as Executing and Clearing Brokers in Give-Up Arrangements.*

Issues subject to the Expert Group review

Preamble

The EU Third Money Laundering Directive expressly permits a FI to rely on another person to apply any or all of the CDD measures, provided the other person is, broadly, an authorised institution or other person supervised for compliance with the Directive (or equivalent) and the other person has consented to being relied upon.

In practice, though, FIs are reluctant to be relied upon and, except in some sectors where reliance is a generally accepted practice, may rarely seek to rely on third parties. Reasons for this include:

- the relying FI retains responsibility for any failure to comply with regulatory/legal requirements;
- FIs cannot delegate responsibility to satisfy their legal obligations in respect of sanctions compliance and the regulatory requirements to have in place effective systems and controls to prevent the FI being used for financial crime;
- the expectation (without clarity on what is 'reasonable') that FIs seeking to place reliance on a third party would be expected to carry out an element of due diligence on the third party to include a consideration of the third party's disciplinary record, the level of due diligence that has been carried out, the nature of the customer and information regarding the standing of the third party;
- the reliance that has to be placed on the third party to make available, on request, copies of the verification data, documents or other information;
- the belief amongst some FIs that they should be able to, in some way, ring-fence customers in respect of which CDD has been performed by a third party, so that they are able to consider whether more enhanced CDD should be undertaken if the customers' relationship with the FI changes;
- the practical obstacles required by local legislation/regulation such as obtaining consent or annual confirmations.

Reliance is frequently used in relation to 'give-up business' in the exchange-traded derivatives markets (see example 2 under Question 2 of Issue 1 (below)). However, for some/all of the reasons above, rather than formally relying on a clearing broker to have completed due diligence, many executing brokers now "*otherwise take account of the fact, in [their] risk-based approach that there is another regulated firm from an equivalent jurisdiction involved in the transaction with the customer, acting as clearing agent or providing other services in relation to the transaction.*" (UK JMLSG Guidance Notes, Part II, Sector 18, paragraph 18.47).

Many FIs believe that this risk-based approach, which avoids the need for reliance, chimes better with an FI's legal and regulatory obligations and responsibilities. It would be helpful if such 'alternative approaches' to dealing with complex areas of overlapping responsibilities could be on the agenda of policy and lawmakers. See, for example, the US FinCEN/CFTC policy in this area, referred to in the executive summary, which provides that, subject to a limited exception, executing brokers in give-up arrangements do not establish a formal relationship that would require them to apply Customer Identification Programs (CIPs) to such futures and options customers.

Issue 1 - the delineation between reliance on third parties and outsourcing or agency relationships

'Reliance on third parties' utilises work undertaken by unrelated entities (third parties) to satisfy the legal, documentary or other obligations of an FI. That said, as discussed under Issue 4, reliance is commonly used within groups, where the parties will be related.

In reliance scenarios, a customer will have a business relationship with two or more FIs. In simple, introductory scenarios (often involving retail customers), one relationship may terminate as another begins. In other (often wholesale market and/or more complex) scenarios, both FIs may have relationships with the customer in respect of the same transaction. This can be the case in both the retail market, where customers are routinely introduced by one FI to another (see Question 1, example 3 below), or deal with one FI through another, and in some wholesale markets such as syndicated lending, where several FIs may participate in a single loan to a customer (see Question 1, example 1 below) and "give-up" arrangements in respect of exchange-traded derivatives (see Question 2, example 2 below). An extract from the UK's JMLSG Guidance on reliance is included, for further information, as Appendix I to this paper.

(1) Please provide 3-5 detailed examples of what you believe are simple scenarios of third party reliance (e.g. a scenario involving single clients that are introduced to the institution by an intermediary)

Example 1: Syndicated lending

With regards to syndicated lending, the members of the syndicate typically rely on the lead manager or arranger to identify the customer the deal is being structured for and gather the necessary identification documents. There is reliance to the extent that members of the syndicate seek to rely on the due diligence performed by the lead manager/arranger to meet their own obligations instead of performing it themselves. The syndication agreement usually provides for this and includes the commitment to communicate the relevant customer data and documentation to the syndicate members upon request.

Example 2: Prime brokerage

A fund may choose a FI as its prime broker, to provide it with a full range of investment-related services. The fund will, however, still use a number of other brokers to execute its transactions in the markets. When the fund is entering into a customer relationship with an executing broker, the latter may place reliance on the prime broker who has already performed due diligence on the fund, provided it meets the conditions set in Recommendation 9. See Appendix I.

Example 3: Introductions

A customer may be introduced to an executing broker by another FI, which is responsible for the reception and transmission of the customer's orders. Provided the FI meets the conditions set in Recommendation 9, the executing broker may place reliance upon it.

(2) Please provide 3-5 detailed examples of what you believe are complex scenarios of third party reliance (especially scenarios where the relying financial institution may not know who is the ultimate client of the business relationship as well as examples of implicit reliance)

Example 1: Funds

An FI is entering into a customer relationship with a fund that is not regulated or not incorporated in the EEA or an equivalent country. The FI may need to identify the beneficial owners of the fund: in particular, the persons, if any, holding an interest of at least 25% in the fund (relevant investors). To do so, it may, in certain circumstances, rely on a third party that performs one of the key roles in relation to the fund (for example, the investment manager or the fund administrator) providing it meets the conditions set in Recommendation 9.

In France reliance could typically be in the form of a certificate signed by the third party ascertaining that there are no relevant investors or, more infrequently, stating that the identities of these persons has been ascertained and verified and committing to provide any supporting documentation upon request. In other jurisdictions, a FI may undertake due diligence on the third party who controls entry of investors into a fund (including assessing their customer identification and verification procedures) and, taking into account the nature of the fund (e.g. a private wealth management vehicle or a publicly traded fund), determine whether it may place reliance on that third party.

Example 2: Give-up business

Customers wishing to execute transactions in exchange-traded derivatives on certain regulated markets may do so through a "give-up agreement" whereby the customer elects to execute transactions through one or more executing brokers and to clear the transaction through a separate clearing broker. Once the transaction is executed, the executing broker will then "give-up" that transaction to the clearing broker for it to be cleared through the relevant exchange or clearing house.

Both the executing broker and the clearing broker have a relationship with the customer (e.g. both may be agents), for whom they perform separate functions but the executing broker, unlike the clearing broker, will not hold or control the customer's assets or see the totality of their investment activity. Outside the US, both executing and clearing regulated entities have CDD obligations in respect of their joint customer, but an executing broker may wish to rely upon the clearing broker (if the clearing broker meets the third-party qualifying criteria). An extract from the (consultation draft) UK JMLSG Guidance is included, for further information, as Appendix II.

Implicit reliance

In our view, implicit reliance refers to situations that are within the scope of Recommendation 9 but that do not require consent from the third party. "Implicit" refers to the documental evidence of the reliance, not to other, more complex reliance scenarios. Such situations occur when, for example, the third party is regulated in a jurisdiction that the FI considers as being truly equivalent because it understands and knows the applicable regulation (to which it can confirm the third party is submitted to). Requiring a certification in such cases would be assuming

that the third party is in breach of its obligations and is not properly supervised, hence the use of "implicit" reliance.

Conversely, implicit reliance does <u>not</u> refer to situations where an FI (FI1) has a customer relationship with another regulated FI (FI2), whose customers are not known to FI1. As FI2 is the customer of FI1, due diligence should be performed on FI2. Similarly, the beneficial owner of the relationship is the beneficial owner of the FI2, not its customers. Such situation is therefore out of scope of Recommendation 9 and does <u>not</u> constitute implicit reliance (see also our response to Question 4 below).

(3) Could the CBFA explain in details the approach is has developed to delineate the different concepts of reliance and outsourcing in Belgium?

N/A

(4) The views of members are sought on any differences (legal or factual) that may exist between the concepts of agency and outsourcing in this context.

<u>Outsourcing</u>

Outsourcing is a term given to certain contractual arrangements and is very well defined. For example, Article 2(6) of the EU Markets in Financial Instruments Directive (MiFID) Implementing Directive defines outsourcing as: "*an arrangement of any form between an investment firm and a service provider by which that service provider performs a process, a service or an activity which would otherwise be undertaken by the investment firm itself*."

In outsourcing, a service provider is engaged to perform a function and but for the engagement they would not have an independent obligation to perform the function. Outsourcing is, therefore, based on the existence of a service whose execution is entrusted on a permanent and regular basis to a third party who commits itself to executing the service on behalf of the FI and according to the FI's requirements and performance criteria.

Outsourcing is governed by contract, and usually subject to service level agreements and the outsourcer will be required to adhere to the processes of the FI for which it is performing the service. Hence, customer identification and verification performed by an outsourced function will be performed as if by the FI itself (i.e. there is <u>no</u> reliance).

<u>Agency</u>

The concept of agency arises under common law but is not defined in many legal systems (e.g. France). An agency relationship can arise in a number of different ways and does not have to be formalised in writing. An agent is, however, generally understood as standing 'in the shoes' of the party for whom it acts (its principal) in respect of liability.

In financial services, a "tied agent" is, for example, defined in MiFID (Article 4(1)(25)) as: "*a natural or legal person who, under the full and unconditional responsibility of only one investment firm on whose behalf it acts, promotes investment and/or ancillary services to customers or prospective customers, receives and transmits instructions or orders from the customer in respect of investment services or financial instruments, places financial instruments and/or provides advice to customers or prospective customers in respect of those financial instruments or services.*"

An agent is often understood to be an introducer. An example of this would be a broker that introduces business to a FI or sells (directly or 'white labeled') an FI's products and as part of the introducing broker's activity with the customer they undertake CDD on behalf of the FI to whom the business is introduced and who owns the product and therefore the customer relationship and compliance obligations.

Unlike outsourcing, however, whilst the agent acts in the name of the FI, it does not have to follow the FI's own AML procedures (although it may be required to do so by contract).

Relationship to reliance

In the UK, Part I, Chapter 5, sections 5.6.35 and 5.6.36 of the JMSLG Guidance includes the scenario "where the intermediary is the agent of the product/service provider" as one of the situations that does not constitute reliance.

"5.6.35 If the intermediary is an agent or appointed representative of the product or service provider, it is an extension of that firm. The intermediary may actually obtain the appropriate verification evidence in respect of the customer, but the product/service provider is responsible for specifying what should be obtained, and for ensuring that records of the appropriate verification evidence taken in respect of the customer are retained.

5.6.36 Similarly, where the product/service provider has a direct sales force, they are part of the firm, whether or not they operate under a separate group legal entity. The firm is responsible for specifying what is required, and for ensuring that records of the appropriate verification evidence taken in respect of the customer are retained." [this scenario is, of course, also relevant to outsourcing arrangements].

In our view, outsourcing and agency are clearly distinct from the reliance scenario, as in reliance each of the parties has a legal obligation to undertake customer diligence and one FI utilises the work undertaken by another party to satisfy its documentary or other obligations. The third party being relied upon performs a service in virtue of its own relationships with the customer and decides (or commits) to provide the benefits/results of this work to the relying party.

It is also important to distinguish between reliance scenarios and situations where the FI is able to apply simplified due diligence to other FIs which are subject to the

equivalent regulation (e.g. the EU Third Money Laundering Directive) when those other FIs are acting as intermediaries/agents for their underlying customers. In those situations, when the other FI is the customer for AML purposes (and there is no direct relationship with its underlying customers), there is no requirement to complete CDD on the underlying customer (unless the underlying customer is also a customer (in a prime brokerage relationship, for example)). This does not, however, constitute "reliance" and should also be clearly distinguished (as per "*Simplified or reduced CDD measures*" in the Interpretative Note to Recommendation 5).

Issue 2 - Ultimate responsibility (C.9.5)

Ultimate responsibility in the United States

We are aware that the US Department of the Treasury and the Wolfsberg Group have submitted responses that address this question in some detail and, hence, we have chosen not to repeat the detailed points. We would, however, make the following, more general, comments:

In the US, reliance (and the benefit of the 'safe harbour') is very limited - and therefore not useful - as it is limited to CIP and does not extend to CDD generally. CIP requires a customer's name, address, ID number and date of birth: information that an FI needs to obtain to perform the rest of its diligence obligations. FI's have noted that it is almost harder to use a reliance agreement than to automate the process.

Turning to the specific questions addressed to US industry practitioners, the responses of our US colleagues are as follows:

(1) The conditions under which the third party reliance is permitted in the US are very narrow which may provide very little incentive to financial institutions to adopt this approach. Could US industry's practitioners and US delegates to the FATF comment on this and provide examples of such reliance arrangements?

As noted above, reliance is not often used because: (a) it is limited to CIP; (b) the other party does not want the liability; and, (c) the administration can be difficult (e.g. the need to re-execute agreements annually).

The most prevalent place reliance is used is in the introducing/executing/clearing context where the two parties "split" up the functions.

(2) Could you also comment on the scope of the reliance provisions in the US and on the delineation between the reliance scenario and the contractual delegation as described above? (in relation to Issue 1)

As noted above, the scope is limited to CIP and does not cover CDD.

(3) In what circumstances the reliance is judged to be "reasonable" (for instance in the case Bank A relies on Bank B to verify the customer's identity)?

Reasonableness has not been tested with the regulators. Many FIs have processes in place to do an annual review of the other financial institution looking for enforcement actions, asking about issues in annual audits, confirming there have been no major/material changes to their programmes, SAS 70s etc. It would be less for an affiliate but that might be a function of the information being easier to obtain.

The principle of ultimate responsibility and its scope

The simple tenet in reliance and outsourcing/agency relationships is that an FI can outsource the activity/functions but not the responsibility for compliance with its obligations. As such an FI has a responsibility to ensure that the third party is undertaking CDD to a level that will comply with the FI's obligations before placing reliance. If reliance is to be placed for a period of time, in respect of a number of customers, it is equally important to ensure that the third party continues to operate at a level that meets the FI's obligations. This will require a degree of initial and on-going due diligence on, and engagement with, the third party.

The use of Recommendation 9 by the financial industry is, however, currently impaired by the provision that full responsibility lies with the FI relying on the third party, as it imposes a very strong requirement on the relying party with no counterbalancing obligations on the third party. The concept of the risk-based approach supports the argument that liability be shifted, as to do so would allow the FI to use its resources more efficiently, since it would not have to duplicate the work of another FI. In this respect, the concept of "reasonable reliance" discussed at the June 2009 FATF Expert Group meeting is appealing because it would provide for a more balanced division of responsibilities.

1) What would be a "reasonable reliance"?

Reasonable reliance would be based on a proper due diligence process executed by the FI on the third party, when the latter is based in a jurisdiction that the FI considers to be equivalent. Hence reliance would only be reasonable on the basis that FI has taken the necessary steps to ascertain that the third party's customer due diligence practices do meet the conditions set in Recommendation 9. This would enable a clear distinction between the responsibilities of the FI (to rely on a "fit and proper" third party) and the third party (to perform its CDD process in accordance with the laws and regulations to which it is subject).

The FI should (1) document its assessment of the quality of the AML controls of the third party to be relied upon and be prepared to justify their conclusion to their regulator; (2) give notice to the other FI that they intend to rely upon them; and (3) obtain consent.

2) **What would be the conditions under which there would be limited liability of the relying financial institution?**

   The relying FI should be held liable for the decision to rely on a third party and the process it followed to make that decision. The relied upon party should have the choice to be relied upon or not.

3) **To what extent can financial institutions rely on a risk-based approach when using reliance scenarios (especially when selecting the relied-upon financial institution)?**

   The risk-based approach allows FIs to address their regulatory commitment by allowing enhanced diligence where the risk is higher and simplified diligence where the risk is lower. As discussed above, this approach is also applicable to the decision to rely on a third party.

   For example, if the third party is subject to the EU Third Money Laundering Directive, the relying FI should be in a position to assume that the EU legal framework is adhered to and shall not have to proceed with further due diligence. Any breach by the third party of its national legislation transposing the Directive shall fall under its responsibility and shall not affect the relying FI.

   On the contrary, if the third party is not subject to the requirements of the Third EU Directive, the FI should perform proper due diligence (unless the third party is subject to requirements deemed to be equivalent) to assess the quality of its CDD process. Again, if the third party does not meet its requirements, this should constitute a breach of its responsibilities.

4) **What are the assurances the regulator in Jersey provides to financial institutions about circumstances in which it will not take regulatory action (in case the institution has done everything that could reasonably be expected)? Please provide any feedback you believe important for the discussion of ultimate responsibility of the relying financial institution.**

   N/A.

Issue 3 – Sectoral coverage

<u>Questions to Expert Group members</u>: please provide any input you deem relevant to the discussion on sectoral coverage in the light of the comments above.

No comment.

Issue 4 – Reliance within a group scenario

Whilst few FIs outside certain industry sectors – e.g. introducing/executing/clearing brokers and investment advisors - have engaged in reliance with third parties, reliance on affiliates is more common.

Outside of France, though, views within the industry appear mixed, with some FIs placing reliance on affiliates and others not.

1) **Should reliance within a group be treated in the same way or differently to reliance with arms-length third parties?**

   AMAFI, our expert group representatives from France, strongly supports a specific approach to reliance within a group. The EU Third Money Laundering Directive, Article 31-1 provides that "*Member States shall require the credit and financial institutions covered by this Directive to apply, where applicable, in their branches and majority-owned subsidiaries located in third countries measures at least equivalent to those laid down in this Directive with regard to customer due diligence and record keeping*". FIs have implemented this Article by ensuring that all entities of their groups comply with their group's CDD policies. To the French financial industry, this is a strong argument to support the proposal that branches and subsidiaries of a group be not considered as third parties but rather as parts of a single entity. Differences in local legislations that may hinder the application of the group's policies by certain entities would however require a different approach (see response to Question 2) below.

   The views of other trade associations were, however, mixed as some groups may elect to comply with local regulations while others set a group-wide policy at the level of the highest standards. However, even if there is a group standard covering all group entities, it is possible that entities within the group may deploy those controls differently because of local obligations or cultural variations. In relying on intra-group activity the FI should understand the differences and make conscious decisions as to the extent the activity undertaken by the entity they are relying upon fully or only partly meets the receiving entities obligations. Hence, whilst reliance within groups should be facilitated, unless local legislation creates a uniform approach, the decision

to utilise any simplified group-reliance provisions would need to be applied on a case by case basis.

2) How should the "group" concept be defined for this purpose?

A starting point could be the definition of group for the purposes of the preparation of consolidated accounts.

When the local legislation a country prevents full application of the group's policies, a pragmatic solution would be to use a case by case approach, whereby one could consider the entity concerned and assess its CDD process, considering any additional measures that may have to be taken to mitigate the risk. As a result, branches, subsidiaries or entities which are controlled by the parent company and apply its AML group principles, could be considered as part of the group.

3) If reliance within a group is treated differently, please provide examples of how and under what conditions reliance takes place?

FIs should deploy appropriate checks and balances to confirm to what a group company (in the same jurisdiction or overseas) is performing CDD which is commensurate with that required by FI's obligations.

Where an FI is satisfied, reliance within a group could be implicit, as there would be no need for an agreement between the parties, based on the assumption that they all have the same CDD process. The group's policy could provide for a set of principles related to reliance within the group, to ensure each entity is prepared to be relied upon.

Reliance intra-group should mean that there is more certain access to supporting documents and clarity on what activity is done and intra-group it may be appropriate to rely on introduction certificates and have the ability to request supporting documents as needed. That said, it is important that data protection and privacy issues do not impede the ability to use reliance. An FI should, obtain adequate information to make its own determination as to the level of compliance with its obligations (e.g. through an assessment report, or introductory certificates).

Appendix I

Extract from the UK JMLSG Guidance - Part I, Chapter 5, section 5.6: Multipartite relationships, including reliance on third parties

Reliance on third parties

"5.6.4 The ML Regulations expressly permit a firm to rely on another person to apply any or all of the CDD measures, provided that the other person is listed in Regulation 17(2), and that consent to being relied on has been given (see paragraph 5.6.7). The relying firm, however, retains responsibility for any failure to comply with a requirement of the Regulations, as this responsibility cannot be delegated.

5.6.5 For example:

- where a firm (firm A) enters into a business relationship with, or undertakes an occasional transaction for, the underlying customer of another firm (firm B), for example by accepting instructions from the customer (given through Firm B); or
- firm A and firm B both act for the same customer in respect of a transaction (e.g., firm A as executing broker and firm B as clearing broker),

firm A may rely on firm B to carry out CDD measures, while remaining ultimately liable for compliance with the ML Regulations.

5.6.6 In this context, Firm B must be:

(1) a person who carries on business in the UK who is
  (a) an FSA-authorised credit or financial institution (excluding a money service business); or
  (b) an auditor, insolvency practitioner, external accountant, tax adviser or independent legal professional, who is supervised for the purposes of the Regulations by one of the bodies listed in Part 1 of Schedule 3 to the ML Regulations;

(2) a person who carries on business in another EEA State who is:
  (a) a credit or financial institution (excluding a money service business), an auditor, insolvency practitioner, external accountant, tax adviser or other independent legal professional;
  (b) subject to mandatory professional registration recognised by law; and
  (c) supervised for compliance with the requirements laid down in the Money Laundering Directive in accordance with section 2 of Chapter V of that directive;

(3) a person carrying on business in a non-EEA State who is

(a) a credit or financial institution (excluding a money service business), an auditor, insolvency practitioner, external accountant, tax adviser or other independent legal professional;
(b) subject to mandatory professional registration recognised by law; and
(c) subject to requirements equivalent to those laid down in the Money Laundering Directive; and
(d) supervised for compliance with those requirements in a manner equivalent to section 2 of Chapter V of the Money Laundering Directive.

Consent to be relied upon

5.6.7 The ML Regulations do not define how consent must be evidenced. Ordinarily, 'consent' means an acceptance of some form of proposal by one party from another – this may be written or oral, express or implied. Written acknowledgement that a firm is being relied on makes its relationship with the firm relying on it clear. On the other hand, it is not necessary for a firm to give an express indication that it is being relied on, and it may be inferred from their conduct; for example - dealing with a firm after receipt of that firm's terms of business which indicate reliance; silence where it has been indicated that this would be taken as acknowledgement of reliance; participation in a tri-partite arrangement, based on a market practice that has reliance as an integral part of its framework.

5.6.8 In order to satisfy the purpose behind Regulation 17(1)(a), a firm may wish to consider providing a firm being relied on with notification of the reliance. The notification should specify that the firm intends to rely on the third party firm for the purposes of Regulation 17(1)(a). Such a notification can be delivered in a number of ways. For example, where one firm is introducing a client to another firm, the issue of reliance can be raised during the introduction process, and may form part of the formal agreement with the intermediary. Similarly, where the relying and relied upon firms are party to tripartite agreement with a client, the notification may be communicated during exchange of documents. Where a relationship exists between the parties it is likely that such a notification plus some form of acceptance (see paragraph 5.6.7) should be sufficient for the purposes of establishing consent.

5.6.9 Where there is no contractual or commercial relationship between the relying and relied on firms it is less likely that consent can be assumed from the silence of the firm being relied on. In such circumstances firms may wish to seek an

express agreement to reliance. This does not need to take the form of a legal agreement and a simple indication of consent (e.g., by e-mail) should suffice.

Basis of reliance

5.6.10 For one firm to rely on verification carried out by another firm, the verification that the firm being relied upon has carried out must have been based at least on the standard level of customer verification. It is not permissible to rely on SDD carried out, or any other exceptional form of verification, such as the use of source of funds as evidence of identity.

5.6.11 Firms may also only rely on verification actually carried out by the firm being relied upon. A firm that has been relied on to verify a customer's identity may not 'pass on' verification carried out for it by another firm. "

5.6.13 Whether a firm wishes to place reliance on a third party will be part of the firm's risk-based assessment, which, in addition to confirming the third party's regulated status, may include consideration of matters such as:

- its public disciplinary record, to the extent that this is available;
- the nature of the customer, the product/service sought and the sums involved;
- any adverse experience of the other firm's general efficiency in business dealings;
- any other knowledge, whether obtained at the outset of the relationship or subsequently, that the firm has regarding the standing of the firm to be relied upon.

5.6.14 The assessment as to whether or not a firm should accept confirmation from a third party that appropriate CDD measures have been carried out on a customer will be risk-based, and cannot be based simply on a single factor.

5.6.15 In practice, the firm relying on the confirmation of a third party needs to know:

- the identity of the customer or beneficial owner whose identity is being verified;
- the level of CDD that has been carried out; and
- confirmation of the third party's understanding of his obligation to make available, on request, copies of the verification data, documents or other information.

5.6.18 A firm which carries on business in the UK and is relied on by another person must, within the period of five years beginning on the date on which it is relied on, if requested by the firm relying on it

- as soon as reasonably practicable make available to the firm which is relying on it any information about the customer (and any beneficial owner) which the third party obtained when applying CDD measures; and
- as soon as reasonably practicable forward to the firm which is relying on it relevant copies of any identification and verification data and other relevant documents on the identity of the customer (and any beneficial owner) which the third party obtained when applying those measures

5.6.19 A firm which relies on a firm situated outside the UK to apply CDD measures must take steps to ensure that the firm on which it relies will, within the period of five years beginning on the date on which the third party is relied on, if requested, comply with the obligations set out in paragraph 5.6.18.

5.6.20 The personal information supplied by the customer as part of a third party's customer identification procedures will generally be set out in the form that the relying firm will require to be completed, and this information will therefore be provided to that firm.

5.6.21 A request to forward copies of any identification and verification data and other relevant documents on the identity of the customer or beneficial owner obtained when applying CDD measures, if made, would normally be as part of a firm's risk-based customer acceptance procedures. However, the firm giving the confirmation must be prepared to provide these data or other relevant documents throughout the five year period for which it has an obligation under the Regulations to retain them.

5.6.22 Where a firm makes such a request, and it is not met, the firm will need to take account of that fact in its assessment of the third party in question, and of the ability to rely on the third party in the future.

5.6.23 A firm must also document the steps taken to confirm that the firm relied upon satisfies the requirements in Regulation 17(2). This is particularly important where the firm relied upon is situated outside the EEA.

5.6.24 Part" of the firm's AML/CTF policy statement should address the circumstances where reliance may be placed on other firms and how the firm will assess whether the other firm satisfies the definition of third party in Regulation 17(2) (see paragraph 5.6.6)."

Appendix II

Reliance and give-up business: extract from the UK JMLSG Part II Sectoral Guidance [consultation draft]

(c) 'Give-up business'

"18.41 Customers wishing to execute transactions on certain regulated markets may do so through a "give-up agreement" whereby the customer elects to execute transactions through one or more executing brokers and to clear the transaction through a separate clearing broker. Once the transaction is executed, the executing broker will then "give-up" that transaction to the clearing broker for it to be cleared through the relevant exchange or clearing house.

18.42 Both the executing broker and the clearing broker have a relationship with the customer (e.g. both may be agents), for whom they perform separate functions.

18.43 It is usually (but not always) the customer that elects to execute transactions through one or more brokers and to clear such transactions through another broker and, to that end, selects both the clearing broker and executing broker(s).

18.44 Where a firm acts as executing broker, the party placing the order is the customer for AML/CTF purposes. Where the party placing the order is acting as agent for underlying customers, they, too, may be customers for AML/CTF purposes (see paragraphs 18.32 – 18.34). It is important to note that when acting as an executing broker, a firm executes customer orders only and does not receive or hold their funds. Transactions are settled by the customers' clearing broker, who also pays brokerage commission to the executing broker.

18.45 Where a firm acts as clearing broker, the customer on whose behalf the transaction is cleared is the customer for AML/CTF purposes. A clearing broker typically has a more extensive relationship with the customer as a result of holding their funds.

18.46 A customer may choose to use one or more executing brokers because:

- the customer may prefer, for reasons of functionality or cost, the executing broker's frontend
- electronic order routing;
- certain brokers develop a reputation for being able to execute transactions very efficiently
- in certain contracts, while the clearing broker provides superior post-trade clearing and
- settlement services;
- the customer may feel more comfortable with the credit risk of the clearing broker;

- the executing broker may provide access to certain value-added services linked to the
- execution of the customer's transactions; or
- the customer does not wish to disclose its trading strategy to other market participants; or
- for other reasons relevant to the customer's business.

18.47 In all give-up arrangements the customer, the executing broker, and the clearing broker are participants. Although this type of tri-partite arrangement is most common, give-up arrangements can extend to cover many types of relationships, and may extend through a number of parties with differing roles and responsibilities including advising, managing clearing or executing, for or on behalf of the underlying customer, before the trade reaches the ultimate clearing broker.

18.48 A common additional participant in a give-up arrangement is the customer's investment adviser or manager, who in the give-up agreement is usually referred to as a trader, to whom the customer has granted discretionary trading authority, including the authority to enter into give-up arrangements on the customer's behalf.

18.49 Typically, an adviser or manager acting for a client may only wish to disclosure a reference code, rather than their client's name, to the executing broker, particularly where the adviser or manager has multiple underlying accounts over which they exercise discretionary authority; hence, the clearing broker is likely to be the only party that knows the underlying customer's identity. Where a give-up agreement includes such an arrangement, firms should ensure that their risk-based approach addresses the risks posed, which may include the risk associated with the investment manager as appropriate, the type of fund and possibly the underlying investors. Hence, where a firm is acting as executing broker and there is an adviser or manager acting for an underlying customer, the customer due diligence performed, and whether there is an obligation to identify the underlying customer, will depend upon the regulatory status and location of the adviser or manager. For further guidance, see Part I, section 5.3.

18.50 Where simplified due diligence cannot be applied to the adviser or manager and there is an obligation to verify the identity of the adviser or manager and their underlying customers, the firm should take a risk-based approach (see Part I, Chapter 5, section 5.3), which may include consideration of whether it is appropriate, subject to satisfying the ML Regulations, to take into account any verification evidence obtained by, a clearing broker in the UK, EU or an equivalent jurisdiction or the involvement of the clearing broker in the transaction.

18.51 To avoid unnecessary duplication, where an executing broker and a clearing broker are undertaking elements of the same exchange transaction on behalf of the same

customer (which is not itself a regulated firm from an equivalent jurisdiction), subject to a give-up arrangement, the executing broker may, where as part of its risk-based assessment it feels it is appropriate to do so:

- place reliance on the clearing broker, provided the clearing broker is regulated in the UK, another EU Member State or an equivalent jurisdiction and the requirements for third party reliance in the ML Regulations are satisfied. Guidance on reliance on third parties and on the factors to consider, as part of a firm's risk-based approach, when seeking to rely on another firm to apply the CDD measures (but not monitoring or sanction checking) is given in Part I, Chapter 5, paragraphs 5.6.4ff.; or
- take account of the fact, in its risk-based approach to customer identification and verification (see Part I, Chapter 5, paragraph 5.3.28), that there is another regulated firm from the UK/EU or an equivalent jurisdiction acting as the customer's clearing broker in respect of the transaction, which will handle all flows of funds. This may reduce the identity information or evidence requested from the client and what the firm verifies.

18.52 It is important to recognise that even if a clearing broker can, in principle, be relied upon under the ML Regulations, there are a number of exceptions that relate to the type of CDD carried out by the clearing broker in respect of the customer (see Part I, Chapter 5, paragraph 5.6.16ff). Firms also need to satisfy themselves (and evidence) that the clearing broker has give

18.53 In addition, as firms cannot delegate their responsibility to satisfy their legal obligations in respect of sanctions and the FSA's requirements to have in place effective systems and controls to prevent the firm being used for financial crime, executing brokers wishing to place reliance should take steps to satisfy themselves re the clearing broker's procedures for screening clients against relevant sanctions lists.

18.54 Thus, firms considering placing reliance on clearing brokers to identify give-up customers should also ensure that they can satisfy other legal and regulatory requirements such as sanction list screening, which cannot be delegated. Whether a firm wishes to place reliance on the clearing broker will be part of its risk-based assessment but as firms cannot delegate their responsibilities for CDD, the assessment should include due diligence in respect of the clearing broker (Part I, Chapter 5, paragraph 5.6.13).

18.55 Given the risks and issues outlined above, most firms now take the relationship with the clearing broker into account in their own CDD on customers, rather than place reliance on the clearing broker.

18.56 Where an executing broker also provides other services to its 'give-up' customers, it should, check - where it has placed reliance on a clearing broker or has assessed a give-up relationship to be lower risk - that it can 'ring fence' the accounts of give-up customers (or has over controls in place), such that their

relationships with the firm cannot be extended (e.g. dealing in different product types, receiving collateral) without triggering additional CDD requirements. Firms that are not able to ring-fence services provided to such customers should carry out CDD to the highest standard.

18.57 Finally, given the information asymmetries likely to exist between an executing broker and clearing broker, when a firm is acting as clearing broker, it would not be appropriate, from a risk-based perspective, to rely on an executing broker, even if this would be permitted under the ML Regulations. Clearing firms should undertake the CDD measures as set out in Part I, Chapter 5."