INVESTMENT SAVINGS & INSURANCE ASSOCIATION OF NZ INC

SUBMISSION

ON THE

MINISTRY OF JUSTICE DISCUSSION DOCUMENT

Anti-Money Laundering and Countering the Financing of Terrorism

31 July 2006

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Investment Savings and Insurance Association of NZ Inc.

Introduction

The Investment Savings and Insurance Association ("ISI") welcomes the opportunity to comment on the Ministry's discussion document *Anti-Money Laundering and Countering the Financing of Terrorism.*

ISI represents the companies that issue and manage life insurance, superannuation and managed funds in New Zealand. Reserve Bank financial statistics for the quarter ending 31 March 2006 indicate that this industry is responsible for assets in excess of $60 billion. A list of our member companies appears at the end of this document.

ISI members have an obvious interest in legislation that affects the relationship between financial services companies and their customers. The nature of that relationship will vary considerably depending on the type of financial product the customer holds.

We accept that NZ is not immune to money-laundering and the financing of terrorism and that effective measures should be put in place to reduce the opportunities for these activities to occur. We made a submission on the Ministry's earlier discussion document, *Money Laundering and New Zealand's Compliance with FATF Recommendations,* acknowledging that New Zealand needs to comply with international obligations in this area but noting also that the application of those obligations should reflect the risk presented by the business of different financial institutions and their various products.

We are pleased to see that the discussion document acknowledges that a risk sensitive approach would mean different sectors may be required to comply to a greater or lesser extent with different parts of the regime.

This paper will address some of the key issues for the financial services industry first, then respond to some of the preliminary proposals in Part 2.

Key Issues

Cost of Compliance

With any new regulation the first priority is for it to be effective in achieving its objectives. Then it is essential to ensure that the costs of complying with the new regime are neither excessive nor distributed inequitably.

We note that the discussion document claims to follow the principles of proportionality, partnership and effective compliance. We endorse these principles and fully support them forming the basis of policy development. Our submission in response to the first discussion document recommended a risk-sensitive approach and we were pleased to see the Ministry's statement that it favours that approach. We do have some concerns that the discussion document appears to focus more on additional legislation to achieve compliance with the FATF recommendations rather than the development of specific proposals appropriate for the NZ environment.

We do not agree completely with the assumption that compliance costs would have been incurred any way by those of our members with an overseas parent company. While they will have some procedural directives from overseas, the bigger driver is the local regulatory environment and their need to comply with NZ legislative requirements and practices. Although some compliance costs would have been incurred by entities with parents in overseas FATF-member states, they will incur additional costs in ensuring that they also comply with the requirements of a new regime in New Zealand.

We agree that the regime design should endeavour to harmonise compliance requirements, but the New Zealand regime should be designed first and foremost for the New Zealand environment, rather than to harmonise with Australian obligations. In accordance with the Australia/New Zealand Memorandum of Understanding on Coordination of Business Law, we would expect entities that operate on both sides of the Tasman to be required to comply with the legislation of either Australia or New Zealand but not both. We would not expect the obligations of New Zealand-only companies to be less onerous than those of companies with offshore parents.

Legislative framework and implementation

In principle, option 3 would be our preference for a legislative framework as we consider a risk-based regime would work most effectively with sector-specific guidelines that can be easily implemented and shown to be effective. We acknowledge, however, that it would be difficult for sectors of the financial services industry other than banking and the legal fraternity to undertake development and enforcement of industry guidelines required under option 3 as it is currently drafted. Consequently, we support option 2 and recommend that the rules are developed as a joint venture between a government agency and industry.

This would allow industry to give input on a practical level, and then help to ensure that any subsequent changes required could be changed more easily than if required to be set in legislation.

A transitional period will be required. It is hard to say how long it should be until the scope of the changes is known, but a minimum of two years should be expected. Once the policy is finalised, consultation at that stage would be helpful.

Our preference would be to phase in the new legislation on the basis of a service rather than an entity or some other basis.

Coverage

In principle our preference would be for coverage to be on a functional basis, however we accept that the proposed combination institutional and functional basis may work better on a practical level.

We are happy with the proposal to widen the definition of financial institution to include a wider range of entities, in order to avoid competitive disadvantage and ensure that those who are providing comparable services are subject to the same regulatory requirements. For reasons relating to their functions, we do not support the inclusion of trustees or statutory supervisors in the definition. This is explained further in the next section. We note also that the definition specifically includes investment broker as defined under the Investment Adviser (Disclosure) Act, but is silent on investment adviser. Unless the reasoning for this is clear, this may cause uncertainty.

The over-riding requirement must be to ensure that obligations are applied in the areas where there is a significant risk of criminal activity, rather than incurring extra costs for all users of financial services by increasing regulation across the board.

Suspicious Transaction Reporting

Our preference would be to retain the current transactions-based reporting, pending further details of what would be involved in activity-based reporting. We believe that the current system adequately enables identification of suspicious transactions but this is an area that would be best covered by sector-specific rules rather than legislation. That will enable the most effective measures to be applied.

Part 2 – Preliminary Proposals

As noted above, we recognise the need for New Zealand to comply with its international obligations but believe that can be achieved with a risk-sensitive approach to the FATF Recommendations. We are concerned at the extent of legislation foreshadowed in the preliminary proposals without sufficient detail to allow adequate depth of comment at this stage. We strongly recommend industry involvement in the development of rules in order that they may be effective without incurring excessive compliance costs.

We have responded to the proposals of most concern for ISI members.

FATF Recommendation 5:

Identification and verification of identity of all facility holders – no matter the number of facility holders involved with any account and no matter the type of account

Particular issues arise in respect of the verification of identity for collective investments, wrap platforms and discretionary trusts.

FATF Recommendation 5 states that customer due diligence (CDD) is to include *identifying the beneficial owner, and taking reasonable measures to verify the identity of the beneficial owner such that the financial institution knows who the beneficial owner is*.

The FATF Recommendations define a beneficial owner as:

> *the natural person(s) who ultimately owns or controls a customer and/or the person on whose behalf a transaction is being conducted. It also incorporates those persons who exercise ultimate effective control over a legal person or arrangement.*

ISI agrees that:

- the requirement that a financial institution should identify and take reasonable measures to verify the identity of beneficial owners should be included in legislation; and
- the "reasonable measures" should be contained in enforceable Rules promulgated by the responsible agency in consultation with industry (i.e. in accordance with our preferred legislative model: Option 2).

Our comments on this aspect of Recommendation 5 relate to its application to:

- Wrap platforms
- Collective investment schemes
- Discretionary trusts

Wrap/Administration Platforms, **Beneficial Owners and Reliance on Third Parties.**
Wrap/administration platforms providing custodial services are common in the industry.

In this situation, the custodian acts as a bare trustee for underlying beneficial owners. The trustee/issuer has no direct relationship or knowledge of the underlying beneficial owners. Any obligation to "look through" the bare trustee to identify the underlying investors would fundamentally change the current business model for these arrangements.

In relation to the obligation to verify beneficial owners, under the Securities Act s51 (4) no notice of trusts may be entered on the register in respect of equities, debt securities such as bonds, debentures, notes, CDs and convertible notes, participatory securities (eg GIFs) and life insurance policies. In addition, the trust deeds of some unit trusts provide that trusts must not be entered on the register. Accordingly, issuers often do not and/or should not have notice that the legal owners of units are holding them on trust. Accordingly, we consider that issuers should not be required to make any inquiry as to what lies behind the legal owners of the securities. This inquiry could be made by those involved in establishing the trusts and, where bank accounts are used, those financial institutions involved in that.

It is not uncommon for trustees/issuers to have no physical relationship with the investors. Often the securities are distributed through investment adviser networks, employers etc and issuers are reliant upon these intermediaries identifying the investors. Accordingly, it is important that issuers continue to be able to rely on other financial institutions and intermediaries and that there is consultation on any measures required when relying on third parties. In this regard it would be useful to have reliance deemed as reasonable and appropriate in certain instances. Examples might be:

- where the financial institution is a registered bank or subsidiary of a registered bank, or
- where the third party is a registered member of an APB under the new financial intermediaries regime.

The solution might be as simple as allowing the financial institution to rely on the identification and verification undertaken by the manager or on behalf of the manager by an acceptable financial intermediary in accordance with the same or equivalent CDD obligations. The wrap manager would seem to be caught by the proposed scope on page 21/22 of the Discussion Document.

Collective Investment Schemes

Collective investment schemes for this purpose include unit trusts, superannuation schemes and participatory securities where assets are held by a person in trust for one or more beneficiaries. ISI considers that:

- a trustee of a collective investment scheme should not have to identify and verify beneficiaries of the scheme where the trustee reasonably is able to rely on the identification and verification of beneficiaries carried out by a manager of the scheme in accordance with the same or equivalent CDD obligations; and

- where a financial institution opens a facility in the name of either the collective investment scheme, the trustee of that scheme or a nominee for that scheme or that trustee, it should not have to look beyond the trustee if the trustee:
    - is a person who is subject to the same or equivalent CDD obligations as the financial institution; or
    - relies on identification and verification carried out by a manager of the collective investment scheme in accordance with the same or equivalent CDD obligations.

Discretionary Trusts

It may not be possible for a financial institution to identify and/or verify all beneficiaries of a trust at the outset. For example, some beneficiaries might be unborn and/or a person's interest might be contingent on the exercise of discretion by the trustee or another person or on the occurrence of some other specified event.

The Rules must be workable and strike an appropriate balance between the objectives of the legislation and the costs and administrative implications imposed on the financial institution. Costs ultimately will be borne by customers.

ISI considers that an acceptable approach would be for the Rules to stipulate that a financial institution should take reasonable measures to identify and verify the identity of:

- the trustee (or in the case of a trustee that is a body corporate, the persons who exercise control over the trustee in accordance with the Rules relating to verification of bodies corporate);
- a settlor;
- a person who exercises control over the trust, for example by the power to remove and appoint trustees or direct distributions from the trust;
- a beneficiary but **not** including a discretionary or contingent beneficiary.

We also note that it will be important that a financial institution be able to rely on verification of identity by another financial institution, for example that the financial institution is taken to have made reasonable measures to verify the identity of a trustee where the financial institution makes payment. This is on the basis that:

- The new legislative model provides for risk based exemptions, including in relation to Recommendation 5; and
- There is a threshold for identification and verification of occasional customers under Recommendation 5 of USD/EUR 15,000

We support maintaining the exemption for those non-principal facility holders who do not have control of the facility or the ability to access funds.

Other Comments on CDD Proposals

The proposal to require CDD on "any existing customers' pre-FTRA anonymous or fictitiously named accounts for which CDD has not been undertaken satisfactorily"
This would be very difficult to implement in practice and would not be justified in the absence of any suspicious transactions. We note, however, that it is proposed to limit this requirement to accounts where there has been a material and inconsistent change in the way the account is operated.

We would support this proposal only in circumstances where there was sufficient indication of a suspicious transaction to justify investigation.

Obtaining information on the purpose and intended nature of the business relationship
We note the proposal to include this requirement in the new Act and query what 'business relationship' is being referred to here, and what information may be required to be collected and held as evidence. In the case of life insurance, for instance, we recommend that it should suffice to note that the purpose of the relationship is to provide life insurance cover.

Extending the CDD obligations to non-cash transactions
The over-riding consideration should be whether the non-cash transaction already provides sufficient information to identify the source of the transaction.

We do not accept the necessity to carry out full CDD for non-cash transactions above the prescribed amount, in the absence of reasons to suspect money laundering or terrorist financing. It would be contrary to the principle of proportionality to require CDD in circumstances where the nature of the transaction provides identification of the origin of the funds.

Express provision for use of electronic verification methods
We strongly support provision for electronic verification of identity as a means of achieving compliance with FATF recommendations without introducing expensive and cumbersome hurdles for establishing financial relationships.

Occasional and 'On behalf of' Transactions
We would not support the removal of the threshold for 'on behalf of' transactions. In the absence of any reason for suspicion, that would unnecessarily increase compliance costs.

FATF Recommendation 8

We generally agree with the proposals that institutions should develop policies and practices to mitigate their potential exposure to money-laundering. That is a primary reason for having sector-specific rules focusing on the areas of risk for each sector.

Our comments in support of an express provision for electronic verification of identity also apply here.

FATF Recommendation 9:

We agree with the proposal and, as noted above in our comments in respect of wrap platforms, beneficial owners and reliance on third parties, we recommend that it should be deemed reasonable for an issuer to rely on identification verification by another financial institution subject to the same legislative requirements or a registered financial intermediary (once the new registration regime commences).

List of ISI Members

ISI MEMBERS

American International Assurance
AMP Financial Services
Asteron Life Ltd
AXA New Zealand
BNZ Investments and Insurance
BT Funds Management Ltd
CIGNA Life Insurance NZ Ltd
Equitable Group
Fidelity Life Assurance Co Ltd
Gen Re LifeHealth
Hannover Life Re of Australasia Ltd
ING New Zealand Ltd
Medical Assurance Society NZ Ltd
Munich Reinsurance Co of Australasia Ltd
Public Trust
RGA Reinsurance Co. of Australia Ltd
Save and Invest Ltd
Sovereign Ltd
Swiss Re Life & Health Australia Ltd
TOWER New Zealand

Associate Members

Bell Gully Buddle Weir
Bravura Solutions
Buddle Findlay
Burrowes & Co
Chapman Tripp Sheffield Young
Davies Financial & Actuarial Ltd
Deloitte Touche Tohmatsu
Ernst & Young
InvestmentLink (New Zealand) Ltd
KPMG
Kensington Swan
Melville Jessup Weaver
Mercer Human Resource Consulting Ltd
Morningstar Research Ltd
Phillips Fox
PricewaterhouseCoopers
Russell Investment Management
Russell McVeagh
Simpson Grierson