EBF_33677
17 August 2018

EBF Provisional Comments on the FATF Public Consultation on the Draft Risk Based Approach Guidance for the Securities Sector

The European Banking Federation (EBF), which is the voice of European banks, welcomes the opportunity to provide comments on the FATF Public Consultation on the Draft Risk Based Approach Guidance for the Securities Sector.

In the securities sector, the characteristics of services and the related risks/ risk mitigations vary significantly depending on:

- **The type of service/service provider;**
- **The type of security;**
- **The type of customer/relationship.**

In order to define workable AML standards, the Guidance should take into consideration distinct categories of **services/service providers**. For example, part II of the UK Joint Money Laundering Steering Group (JMLSG) Guidance adequately draws a distinction between wealth management, private equity and execution-only stock brokers.

One potential solution would be for the Guidance to be repurposed to focus solely on the retail sector, because considerable redrafting is required for it to adequately incorporate wholesale securities without resulting in unintended consequences. However, if the Guidance intends to cover both sectors, we would recommend the following definitions:

- "**Retail investor**" is a person who invests in his capacity as a retail client. That is, a client who is neither a professional client nor an eligible counterparty.

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- “**Professional clients**” and “**eligible counterparties**” are institutional clients and individuals who invest by way of business.

The scope of the Guidance remains flawed by not separating retail and wholesale activities. The conflation of retail/ wholesale is reflected in the current drafting as “cash”, as a means of integration, is irrelevant to the wholesale market. By failing to separate wholesale and retail activities, the Guidance is misleading with regards its assessment of the risks of the former (e.g. inherent risks refer to “physical cash”, “account”, “transaction”, “penny/ microcap stocks” and “bank-like products”). The current approach also results in confusion with regard to intermediaries (which are not defined within the context of wholesale banking), channels, and transaction monitoring. Meaningful monitoring of wholesale should not, given the limited visibility of the customer’s overall activity and given that the securities provider deals with the trade and not the settlement, simply mirror the electronic solutions implemented by retail banks.

The Guidance is an opportunity to set out the inherent risks and controls in wholesale banking, as they differ from retail banking. The former is generally a mature, principle-to-principle market with known, regulated participants and is therefore distinctly different from retail securities (i.e. processing of an instruction at the request of an underlying customer, where factors such as cash layering come into play). Risks covered in the Guidance, such as cold calling/unfamiliar participants apply (e.g. layering rather than placement).

The term “securities” in paragraph 10 of the Guidance is broadly defined and seems to be aligned with the MiFID II definition of financial instruments. The Guidance should distinguish between the different **types of securities**, and reflect the difference between investment securities (such as cash equities, e.g. stocks and bonds) and hedging securities (such as swaps and FX contracts). Indeed, a swap or FX contract is almost always used to hedge a risk related to another financial product such as a loan. The risk that this kind of products is used for money laundering is smaller than with investment securities. Without such a distinction, the AML standards proposed in the Guidance may not work in practice for certain types of securities. This is the case of the PRiiPs Regulation (Packaged Retail and Insurance-based Investment Products) that is not only applicable to investment products (right scoping), but also to hedging products (wrong scoping). This has led to rules with unwanted consequences in case of hedging situations.

Section 1.4.2. should mention that a key risk in capital market transactions is the number of participants involved with no overall participant having complete oversight; this role should vest with the regulator(s). So, for example, although 1.4.2. is correct regarding the high liquidity of some securities products, the point about encashment only applies upon exit from the product and not to the other participants.

More detail and explanation of risks and controls is required in the Chapter “Securities Providers”. The following examples illustrate this idea:

- In the section related to Funds, it would be better to explain in more detail the different risks per type of fund and also to always identify the investor as the party that should generally be subject to due diligence.

- The description of brokers as securities providers requires more details. There is no reference to introducing brokers, who also play a role in the market and may be

considered as intermediaries. Additional distinctions in relation to the role of "executing brokers" and "clearing brokers" may be necessary, as well as distinguishing the different risks that different types of brokers may identify and the controls that they may implement depending on the activity of each broker and the actual parties they are dealing with. For example, a clearing broker will not be able to spot attempts to manipulate or deceive the market through trading practices as an execution broker could. An execution broker, on the other hand, will not be able to implement controls towards other brokers as a clearing broker could.

- It is also necessary to clearly distinguish among the different types of intermediaries. The level of due diligence varies depending on whether they are introducers or intermediaries with executing powers on behalf of the customer. There is indeed an attempt to do so in Section 7.1.5. with particular considerations to intermediaries, but it is confusing, as there is no connection or interrelation with Section 1.4.4. Moreover, there is no cross-reference with the Reliance on Intermediaries Section 7.1.8.

In many situations the service provider does not have a **client relationship** (customer account or other permanent/temporary relationship) or he does not have any information about the end clients/customers (no names or other identifiable information, but only one amount of securities for a group of clients from another financial institution). In fact, the securities service provider only plays a small part in the total process of securities dealing. The draft FATF Guidance only partly takes this into account. In particular, the requirements under paragraphs 86 and 87 for a service provider to obtain policies and procedures from counterparties will not work in practice, nor will they help mitigate AML risks. The same applies for paragraphs 90, 100 – 102. These paragraphs in the Draft RBA are problematic in the absence of clear clarification of what an intermediary is in this regard; a KYC-utility or an actor in the securities service value chain. If it is the latter, then it blatantly contradicts paragraphs 86, 87, 95-98. This still needs further clarification.

Relationship similar to Correspondent Banking Relationship in case of Intermediaries

All banking laws and Supervisory Authorities should coherently apply the definition of correspondent banking and other correspondent relationships. Unfortunately, that does not seem to be the case, since incoherence already at the level of the definition as to when any relationship between banks is a CBR cease has been observed. A common understanding and agreement of the bodies mentioned on one definition and its exact reiteration in European legislation e.g. the Anti-Money-Laundering Directive and national legislation would be recommended. That said, a Global Custodian Bank may have a 'correspondent banking' relationship with a bank or it may just have a 'custody' relationship. These roles are very different. As a Custodian, the sub-custodian performs the role of safekeeping securities and funds for the global custodian bank. Therefore, the sub-custodian is not performing the role of a correspondent bank here and hence this should not be construed as 'correspondent banking' relationship. It is clear that the terminology "Correspondent Banking Relationship" is somewhat at odds with the securities sector and the roles that are performed. That being said, paragraph 95 echoes the sentiment of paragraphs 86 and 87 namely; for a securities provider, providing services for its customer who in turn acts on behalf of their own customers, the CDD should be performed by the customer, i.e. the "intermediary"/"respondent" using the terms used in this draft RBA. The clarity and impact of paragraphs 94-98 would benefit from using

practical examples of relationships in the securities sector. It is important that this section adopts the approach taken by the JMLSG that not all correspondent banking relationships pose the same level of risk, and securities providers should therefore adjust the type and extent of EDD measures to account for the risk posed by the respondent.

- National legislators should always take into account possible impact for de-risking when passing legislation, in particular when regulating Anti-Money-Laundering (AML) / Combating the Financing of Terrorism (CFT). Banks should remain free to classify their correspondent relationships as low, regular or high-risk correspondents in accordance with their own risk assessment, and apply a risk-based approach to the degree of mandatory EDD required for non-EEA respondents. This proportionate approach is supported by FATF guidance, which focuses on a sub-set of higher risk correspondent relationships, for the provision of banking-related services by one bank to another, such as international funds transfers, trade finance arrangements and foreign exchange services ('correspondent banking relationships'), as opposed to less risky relationships such as peer-to-peer securities transactions ('correspondent trading relationships). Furthermore, the final decision of whether to retain or close a CBR is the correspondent's alone, which may be satisfied or dissatisfied with the respondent's respective customer acceptance policy. We welcome the call for international cooperation in paragraph 35. However, given the global connectivity of the financial system, we recommend that competent authorities within FATF members consider proactive cooperation, particularly with regards information sharing in relationship to capital markets and with regard to the sharing of ML/TF risks, as per paragraph 49.

- However, we then need standardized Request-For-Information (RFI) forms – for low, medium and high-risk correspondent banking relationships respectively - that unify the Know-Your-Customer (KYC) questions that have to be exchanged between correspondent banks. At present the RFI exchanged to fulfil the KYC due diligence between correspondent banks vary largely. The variation in these RFI make the handling of correspondent bank relationships difficult and expensive. These variations further lead to ever-longer individual RFI as Supervisory Authorities and auditors tend to add further request made in one RFI to be applied to the next RFI between different correspondent banks they scrutinize. The "race to the top" creating ever longer RFI ultimately tends to make at least some correspondent banking relationships onerous beyond profit and lead to "de-risking" i.e. the termination of these correspondent banking relationships.

- KYC requirements should be harmonised at global level, including a standard instrument for 'KYC self-certification', so as to avoid the issuance of individual KYC documents by banks and add efficiency to the KYC process. This should however not prevent banks from asking additional bilateral information in certain cases. In this context, we would like to refer to both the Wolfsberg Correspondent Banking Due Diligence Questionnaire, which aims to standardise the collection of information that correspondent banks ask from other banks when opening and maintaining these relationships, and the ISSA Due Diligence questionnaire (https://www.issanet.org/m/e/3/current-wgs/compliance-transparency-value-chain/123-compliance-transparency.html) which, asthe securities equivalent to Wolfsberg, targeted questions specific to the securities industry and the roles, services and account structures performed. The ISSA and Wolfsberg questionnaires combined

will therefore help with the desired harmonization in the context of the securities industry.

Some suspicious activity red flags are a repetition of general red flags that can probably be omitted in this specialised document (e.g. "transactions with no apparent economic rationale" or "transaction pattern indicating a value of transactions just beneath any applicable reporting threshold", "customer is reluctant to provide information in relation to its identity and/or transactions" or "payment to a third party to which the customer has no apparent connection"). Some other red flags may need additional detail. For example, "sudden spikes in transaction volumes deviating from previous transactional activity" (Annex B Section I.5. "Suspicious Activity Indicators in Relation to Securities") is not a red flag itself, if the transaction has an adequate explanation. The conflation of wholesale and retail flags in Appendix B risks misinterpretation, with the potential that regulators may expect securities providers to identify and investigate red flags that are not applicable to wholesale banking (e.g. A dormant account suddenly becomes active without a plausible explanation, large amounts are suddenly wired out etc.). We recommend that the red flags are split between retail and wholesale.

In Section 7.1.8. "**Outsourcing**", we should not assume that the company outsourcing the service has a full control to ensure that the third party is implementing the securities provider procedures. Language may need to be softened. We understand that the full responsibility lies with the securities provider and that the agreement should ensure conditions. It should be clear, however, that the securities provider will not be held liable.

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About the EBF

The European Banking Federation is the voice of the European banking sector, bringing together 32 national banking associations in Europe that together represent a significant majority of all banking assets in Europe, with 3,500 banks - large and small, wholesale and retail, local and international – while employing approximately two million people. EBF members represent banks that make available loans to the European economy in excess of €20 trillion and that reliably handle more than 400 million payment transactions per day. Launched in 1960, the EBF is committed to a single market for financial services in the European Union and to supporting policies that foster economic growth.

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