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your reference

your message of

city_date
Frankfurt/Main, 17.08.2018

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

Dear Sir or Madam,

the Bundesverband der Wertpapierfirmen e.V. (bwf) is a trade association representing securities trading firms and brokerage houses at the exchanges and other securities markets throughout Germany. In this capacity the bwf expressly welcomes the opportunity to provide comments on the FATF draft risk-based approach guidance for the securities sector.

We fully support the FATF's objective to provide guidance for financial institutions active in the securities sector and supervisors alike to identify and efficiently address vulnerabilities of the sector to money laundering and terrorist financing in a risk based and proportionate way. We therefore would like to thank everyone who contributed to the presented draft. However, while we remain fully supportive for the intention behind the RBA as such, we also think that the overall concept as well as some of the suggested detailed provisions should be given some additional consideration.

1. General concept of sector-specific risk based approaches

The proposed FATF RBA guidance for the securities sector represents a further part in a publication series, complementing the existing sector specific guidelines, e.g. the FATF RBA 2009 guidance for the life insurance sector (currently revised and also consultated) or the 2014 guidance for the banking sector.

There is a wide agreement that ML/TF vulnerabilities in different parts of the economy might show different patterns and characteristics and therefore practical AML/CTF efforts need to take into account the particularities of the specific sector in question. However, when comparing the different sector specific FATF

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RBA guidance, it becomes obvious that many core elements of the risk based approach developed by FATF e.g.

– the risk sensitive resource allocation,

– the initial/ongoing CDD approach,

– the need to implement appropriate risk mitigation strategies,

– senior management involvement and responsibilities,

– staff qualification and training,

– the importance of adequate internal controls or

– the importance of leadership and compliance culture

are rather universal in nature and therefore apply across sectors. Accordingly, it is not surprising that the 2014 FATF RBA guidance for the banking sector obviously was used as a blueprint for the presented draft for the securities sector. In fact, wide text passages were taken over almost 1:1 and only the terms “banks” and “securities providers” were exchanged.

Sometimes paragraphs were rearranged, amended or moved across the text - not always in a comprehensible, non-contradictive way. E.g. the description of the detailed procedure for CDD, which was copied from paragraph 61 of the FATF RBA for the banking sector, now appears twice, once in paragraph 80 and only slight modified in paragraph 90, leading to unnecessary redundancies.

A more formal aspect we recognized is the change of the structural sequence of the text compared to the guidance for the insurance and banking sector which put the guidance for supervisors first before requirements for the sector specific institutions are specified. While this has no effects on the content of the guidance as such, it certainly does not facilitate comparability of the different documents.

Furthermore, the presented draft for the securities sector extends certain provision adopted from the banking sector guidance by additional rules, which might or might not be specifically designed for the securities sector. E.g. given the level of interaction and interconnectedness of today’s securities markets, reliance on intermediaries (point 7.1.7.) is certainly an important characteristic which should be addressed in the course of AML/CFT efforts in the securities sector. However, even though it might be a “typical” issue to be dealt with, intermediation is by no means exclusive to the securities sector but occurs (in various forms) in banking and within the insurance sector as well.

The same holds true for outsourcing which we agree should be taken into account when comprehensive and effective AML/CFT policies are discussed. However, once again, outsourcing per se and here outsourcing of certain AML/CFT functionalities, e.g. transaction monitoring, is nothing specific to the securities sector.

In other words, the outsourcing of the securities transactions monitoring, raises basically the same questions in terms of responsibilities and reliance on third parties as e.g. the outsourcing of the monitoring of payment streams for banks.

We are therefore concerned that the observable practice of adopting a basic concept from one sector and extending it by additional provisions which – at a closer look – are not truly sector specific, might lead to different levels of prescriptive detail for different sectors, resulting de facto in unintended different levels of regulation and an uneven administrative burden for various sectors.

One could argue that the existing FATF sectoral RBAs could and should be adjusted accordingly (actually the currently consulted revised RBA for the life insurance sector also recognizes the relevance of outsourcing and intermediation for the insurance sector). However, we think that it would be a more efficient and consistent way forward to reconsider whether sector specific RBAs really are the best regulatory approach. As shown above the core elements of the RBA as developed by FATF seem to be rather universal than sector specific, at least as different sectors of the financial services industry are concerned. We therefore suggest that FATF should consider to harmonize the basic RBA for all financial institutions in order to insure regulatory consistency and to provide for a "level playing field" with respect to the applicable provisions (even though the RBA is formally non-binding) in the field of AML/CFT for financial institutions.

This is, very obviously, not a criticism of the working group which was assigned to draw up this guidance but rather an encouragement to apply certain aspects of the proposed rules in a harmonized (but of course proportionate way) to all financial institutions, in order to foster a comprehensive and effective, general RBA and avoiding any undue additional administrative burden for the securities sector alone.

Such a harmonized RBA for the financial industry could then either be amended by several chapters/annexes which explore truly sector/business specific vulnerabilities, suspicious activities indicators and AML/CFT typologies. Another option would be to deal with everything which is really sector specific in an accompanying/amending document. However, our preference here would be a "single rulebook".

While we are aware well that it will be rather unlikely that our proposal for a harmonized basis RBA will be implemented any time soon, since the timely finalization of the sector specific RBA for securities markets might be a priority, we would nevertheless like to urge FATF for the reasons presented above to give serious consideration to a more harmonized cross sector RBA in the medium term.

2. The 2009 FATF report on money laundering and terrorist financing in the securities sector

As mentioned before, we think that the presented draft provides valuable subsequent extensions of a general RBA for financial institutions with large parts of the text being rather generic than securities sector specific in a narrow sense (except of in particular Annex B which list "suspicious activity indicators in relation to securities"). Therefore, it is not surprising that FATF suggests that the FATF draft RBA guidance for the securities sector "should be read in conjunction with the 2009 report on money laundering and terrorist financing ("ML/TF") in the securities sector, which outlines vulnerabilities in the sector."

However, one must note that the 2009 report, while still containing valuable information, in some respect might be dated when taking into account the rapide technical and structural changes to the securities markets during the last years as a result of technological developments and regulatory change resulting from the financial crisis and other factors. Therefore, we had hoped that the RBA would be based on an updated analysis of sector vulnerabilities, combined with practical guidance on how to address these vulnerabilities, ideally within a single document.

2.1 Predicated offences

As mentioned above, the 2009 report still offers valuable general orientation for the identification of certain ML/TF-risks within the securities sector. One of these still relevant aspects is the sector specific connection between ML and typical predicated offences, namely insider trading, market manipulation and securities fraud. In this context a very practical problem arises from the fact that in many jurisdictions AML/TCF and the predicated offences named above are governed by different legal frameworks, which might result in legal uncertainty and unnecessary and costly duplication of efforts, e.g. in terms of communication channels or even redundant double reporting. While the draft guidance to some extent recognizes such inefficiencies (cf. in paragraphs 16. and 121.), unfortunately no policy recommendations are given to supervisors for a better integration of AML/CTF policies with the market abuse regime.

Another issue which we think would be worthwhile to be addressed is the question how data generated for different purposes could be collected and analyzed more efficiently. Unlike in the payment environment, in many jurisdictions each security transaction must be reported timely to supervisors for the purpose of insider trading and market manipulation detection. Here some policy recommendations how to better integrate existing data-sets more efficiently into AML/CTF work-streams would be desirable, even more since this could avoid some costly duplication of efforts on different levels for the industry and supervisors alike.

2.2 Account keeping as a risk indicator

Unlike banks, which regularly run and consquently have access to customer accounts in form of deposits or other monies as well as of customer securities accounts, only a fraction of non-bank financial institutions are administering customer accounts. Therefore, it is all the more important to point out that from the comprehensive selection of case studies presented in the 2009 report, it becomes apparent that it is often e prerequisite for a business relationship to be misused for ML purposes, that a financial institution not only provides securities services but also runs cash and securities accounts for its customer (which then can be used to channel illegal proceeds other assets into the sector and to withdraw funds once they have been "washed"). Accordingly, we think that whether a securities provider keeps accounts for his customers or not should be an important factor in the risk assessment process which should be explicitly mentioned in the FATF RBA for the securities sector.

2.3 Scope of "financial institution" definition

In its conclusions, the 2009 report suggests in paragraph 204 that FATF should "keep the definition of "financial institution" under review, to ensure that all products and intermediaries are captured". In this context, we think it would be a rewarding exercise to include some general analysis on information flows and existing data-pools in the securities sector in the RBA. While the draft guidelines acknowledge the high level of interaction in the securities markets, unfortunately little analysis is given to the question where information relevant for AML/CFT can be most efficiently assessed.

In particular the so called "market infrastructure providers" (e.g. exchanges and other trading venues, central counterparties, trade depositories, clearing-houses and central securities depositories, etc.) – at least as long as they do not hold a banking license – to our understanding have not been in the direct focus of AML/CFT regulatory approaches in most jurisdictions so far. This is even more surprising since all these institutions today are huge "data-warehouses" where transaction related data is centrally stored and which might be used more intensively for AML/CTF purposes.

Regrettably, we could not find any such consideration within the draft guidance. Actually, only the term "clearing houses" appears once in the definition of "securities providers" in paragraph 17 but without further exploring their role or any additional reference in the rest of the text. Paragraph 27. provides some guidance to "clearing firms" which offer clearing services for individual securities (services) providers but these are to be discriminated from clearing houses of course.

3. Terminology

It is suggested in paragraph 17 to define for the purpose of the guidance "any natural or legal person who is, or who is required to be, licensed or registered by a competent authority to provide securities products or services as a business" as a "securities provider". Actually, we find this proposed wording somewhat confusing, even more since it is – as far as we are aware - not an established term within the securities sector. Even more, one could argue that semantically, provider/suppliers of securities in a material sense are the issuers of securities, even though they usually use a financial institution to place their securities in the market.

We therefore suggest to use the more common term "securities services provider" instead. Since the underwriting/placement of securities is also a securities service (aside from the other services named in paragraph 18), the meaning of term would be more comprehensive as well. If FATF should feel dissatisfied with the proposed change, we would alternatively suggest the – admittedly also rather "synthetic" but semantically clear – term "securities sector institution", analogous to "financial institution" as an established term in the field of AML/CTF. No matter which term FATF finally will choose, it should be clarified that it also encloses banks as far as the "provide securities products and services".

Equally important, we think that the interrelation of the terms "securities (services) provider" and "intermediaries" requires further clarification. In particular it should be noted that the intermediary can be and in fact very often is a "securities (services) provider" himself, providing securities services on behalf of another securities (services) provider within a chain of multi-step transaction/service provision.

4. Economic efficiency vs. AMT/CFT objectives

The FATF RBA draft guidance for the securities sector, correctly observes that securities markets are often characterized by complexity, internationality, a high level of interaction, high volumes, speed and anonymity. The reason why these particularities are not further evaluated might be that they have been self-evident for the members of the drafting group. However, we think it would be worthwhile to mention in the guidance that these attributes directly contribute to the core economic functions of securities markets with respect to efficient price-formation and capital allocation, which are paramount to economic growth, job creation and overall prosperity.

Therefore, a risk based AML/CFT approach also needs to recognize that to some extent an inextricable conflict of goals between demands for efficient markets which often result in speedy, high volume and anonymous transactions and AML/CFT objectives which ideally want economic interaction to be as transparent and traceable as possible, exists. This inherent valuation contradiction cannot be resolved by simply demanding securities (services) providers to undertake “all reasonable measures to identify and mitigate ML/TF risks” (paragraph 40).

As an example, a transaction in a centrally cleared security, where the central counterparty (CCP) – by novation – becomes the seller to every buyer and the buyer to every seller, efficiently mitigates counterparty credit risk and therefore contributes to more resilient securities markets. However, at the same time, centrally cleared securities reduce the transparency with respect to the identification of market participants with whom a transaction originally was concluded. Therefore the demand to take “all reasonable measures” in the AML/CTF context should be amended by an acknowledgement of what can be “realistically expected” by taking into account existing de facto constrains and impossibilities as well as possible conflicting objectives between AML/CFT endeavors and the most efficient functioning of securities markets which are essential for the functioning of our economies. We think that any risk based approach would be incomplete without at least mentioning this potential area of conflicting policy objectives.

5. Customer due dilligance (CDD) and the identification of beneficial owners in the securities sector

There is a wide agreement that considerations on initial and ongoing CDD are key factors of any AML/CFT policy and therefore rightly play an important role in the FATF RBA draft guidance for the securities sector as well. However, it is fair and necessary to conclude that AML/CFT CDD procedures clearly were not developed from the perspective of the securities sector and therefore, depending on the circumstances, might not be fit for purpose or cannot be fulfilled 1:1 under all circumstances.

Here, we think that the draft guidance in its CDD considerations relies too strongly on general CDD requirements which do not appropriately take into account the particularities of the sector. Especially, the general CDD concept as described in paragraph 88 which assumes that CDD obligations are either triggered by the establishment of a business relationship or by occasional transactions above a certain threshold and which demand that securities (services) providers to refrain from carrying out a transaction or terminate an existing business relationship, simply ignores a number of important characteristics of securities markets. While “standard CDD” might be appropriate in some areas like the relationship between a retail-broker (which in some jurisdictions might be a universal banks in most cases) and its direct customers or in the field of individual portfolio/asset management, the 1:1 application of the CDD concept, depending on market structures, might be more difficult or even de facto impossible under some circumstances.

5.1 Securities services without dedicated “customers”

E.g. a market maker, who constantly holds himself out to the market by posting simultaneously two side quotes in a specific security does not provide a service to individual “customers” in the narrow sense but to the market as a whole by providing liquidity on a constant and predictable way. Consequently, if somebody "hits" his quote, he concludes a transaction with a "market counterpart" rather than with a "client". Furthermore, if he conducts his business "on exchange", based on a contract with the trading venue, he might typically – up to a certain trading volume – even be obliged to enter into a contract with every party admitted for trading on this venue. In other words, he has only a very limited degree of freedom while the CDD provisions assume that every securities (services) provider is free in his decision with whom he does business. Very obviously, here the original CDD concept does not "fit" without a reasonable modification which balances AML/CTF goals with securities markets objective structural constrains. – And market making is certainly not the only example where a 1:1 application of the "general" CDD concept is practically impossible.

While we do not advocate that market makers should be outside the scope of the AML/CFT regime, their obligations shall be in line with their factual span of control, which would suggest that their AML/CFT policies should focus on occasional transactions above a certain threshold or – regardless of transaction size – on observable, obviously suspicious transaction patterns.

Therefore, we would find it helpful and necessary that the FATF RBA for the securities sector at least in a general way points out that the CDD regime was originally designed without giving any attention to the securities sector which might lead to practical implementation problems.

5.2 Avoiding "gold plating" for the securities sector

In this context, the draft guidance suggests in paragraph 88 that securities (services) providers themselves designate monetary thresholds for occasional transactions which would trigger CDD obligations. We strictly object this approach which would be clearly "gold plating" and set the securities sector at a disadvantage with other financial institutions and other parts of the economy which also have to apply the AML/CTF regime. Instead, the thresholds for occasional transactions which trigger AML/CTF obligations should be continued to be set by law in a homogenous way for all obliged entities, regardless of the sector in which they are active. According to Article 11 of the 4. European AMLD, these thresholds are 15 thousand Euros for non-cash and 10 thousand Euros for cash transactions.

It must be further reminded that securities (services) providers are not only obliged to implement specific AML/CTF policies but efficient procedures for the detection of predicate offences like insider trading and market manipulation as well which already require a monitoring of all transactions regardless of size. Therefore, any additional specific AML/CTF provision appears unnecessary and inappropriate since the administrative burden for securities (services) providers is already significantly higher than in other sectors.

Furthermore, we have similar concerns regarding "gold plating" with respect to paragraph 92 which allegedly implies – without providing any contestable evidence – that the ML/TF risk exposure in the securities markets might be higher than in other parts of the economy.

5.3 CDD responsibilities in multi-step transactions and corresponding brokerage/banking relationships

Due to the high level of interaction and intermediation in the securities sector, the draft guidance correctly addresses the question of the assignment of CDD obligation and the possible reliance on intermediaries and third parties as an important key aspect in the design of a RBA for the securities sector. Furthermore, depending on circumstances and the perspective it might be even difficult to identify who is in a specific situation the intermediary to whom. Hence, we would find it extremely helpful, if the guidance could include more practical examples presented in a graphical form similar to the diagram presented in paragraph 20.

We fully agree that the relationship between securities (services) providers and intermediaries with respect to the underlying customers should be treated similar (see paragraph 77, second bullet point) to the relationship between correspondent and respondent in correspondent banking relationships (here, we suggest to extend the term to "correspondent banking/brokerage relationships"). Accordingly, we kindly ask FATF to include a clarification in paragraph 87 that the securities (services) provider is not responsible to conduct its own CDD on the intermediary's underlying customers, analogue to the note given in paragraph 95 (cf. "FATF Recommendations do not require the correspondent securities providers to conduct CDD on the customers of their respondent institutions").

Even though, it is an immanent consequence of the lack of CDD obligations for the securities (services) provider in the circumstances described above that he cannot be hold responsible for the identification of potential beneficial owners behind the clients of his intermediary or respondent, we would deem it helpful, if this also could be clarified under points 7.1.3. ("The Securities Provider's Customers") and point 7.1.6. ("Relationships similar to Correspondent Banking Relationships in case of Intermediaries"). – Not to be mixed up with the prevailing obligation to identify a potential beneficial owner on whose behalf the respondent or the intermediary himself might be acting.

5.4 Identification of customers acting on his own or on behalf of its underlying clients

We agree in principle that for AML/CFT purposes it can be helpful and sometimes necessary for a securities (services) provider to know whether his customers act on their own behalf or on behalf of their own underlying customers. However, as long as there are no concrete suspicious activity indicators it is neither necessary nor practical for a securities (services) provider in the normal course of business to evaluate the initiator of each and every transaction, even more since the securities (services) provider – as emphasized by FATF – has no CDD obligation with respect to his clients underlying clients.

Sometimes the nature and origin of a transaction are obvious or easy to detect, e.g. a portfolio manager (on the basis of a power of attorney) places an order on behalf of one of his clients with a securities (services) provider who is running cash and securities accounts for the portfolio managers client. In other cases, e.g. where a securities (services) provider offers order routing functionalities or direct market access to clients which might have underlying clients themselves, it would be clearly disproportionate and sometimes technologically impossible to discriminate whether an order sent by an intermediary was initiated by himself or by one of his clients. In fact, an order might even be an aggregated "parent order" which contains "child orders" placed by different clients of the intermediary or sometimes might be even in part allocated to the intermediaries "nostro" and "vostro" accounts.

Therefore, once again one needs to strike a balance between sufficient information regarding an intermediary and its underlying client base and the avoidance of any undue administrative burden and possibly conflicting additional legal obligations (e.g. data protection issues) a securities (services) provider needs to comply with.

In paragraph 93, box 1, 3. Bullet point under the "enhanced due diligence" headline the guidance uses the term "Where appropriate, obtaining information about the intermediary's underlying customer base and its AML/CFT controls" which clearly indicates that any evaluation regarding the underlying customer base (and let alone information on individual customers) of a securities (services) provider's client (the intermediary) is only justified if the prior risk assessment implicates the appropriateness of enhanced CDD – with respect to the intermediary, not his underlying client base – measures to be applied.

In contrast, the wording of paragraph 86. and paragraph 90., first sub bullet point of bullet point three, seem to be less clear to us (despite the text also contains some verbal conditionality: "using a risk based approach" in paragraph 86. and "where appropriate" in paragraph 90). However, paragraph 86 also points out that it makes a significant difference whether the intermediary is regulated for AML/CFT or not. It therefore would be helpful and in our understanding completely in line with the regulatory intention behind the draft guidance, if it could be clarified in Paragraphs 86. and 90. that any attempt to obtain information about an intermediary's underlying client base is only justified in the presence of actual risk indicators calling for enhanced CDD measures with respect to the intermediary (the securities (services) provider's direct client).

In reverse, if this principle would not be observed,, we were seriously concerned that “second level CDD obligations” which – according to FATF standards – are not required in cross boarder correspondent banking relationships could be introduced even for non-cross-border business relationships with intermediaries “through the back door” as an alleged part of “first level” CDD for business relationships with intermediaries.

Furthermore, in the exceptional cases where it is justified and appropriate to require a securities (services) provider to obtain information for AML/CTF purposes about the client base of one of his own clients, he will not only be limited by the national legal framework, in particular with respect to data-protection laws, but also directly dependent on the cooperation of his client. Therefore, the guidance should also clarify that any such information gathering on somebody else’s clients is limited by the boundaries set by the general legal framework of the securities (services) providers and his clients jurisdiction(s) (which might significantly restrict the practical scope of application in some jurisdictions) and – in reverse – to the extend which is legally possible, require the intermediary in question to provide the information requested by the (securities) services provider..

6. Feedback by supervisors

One of the most challenging practical problems in the technical implementation of an efficient, risk based AML/CTF environment lies in the calibration of parameters within transaction monitoring systems (no matter whether they are automated or operated on a semi-automated or manual basis). Here the questions to be answered in particular are, which indicators are relevant for the identification of potentially suspicious transactions and which are the right “trigger levels” which would capture as many potentially suspicious transactions as possible, while efficiently avoiding any “false-positive” results to the highest extent possible?

Against this background, we think that one of the most important aspects in the design of an efficient RBA or AML/CTF regime – which up to know seems to be missing in all FATF RBA sectoral guidance – should be the establishment of a well-defined, institutionalized and technically sophisticated and timely feedback mechanism from the supervisor to whom a AML/CTF regulated entity (in this case a securities (services) provider) reports back to this reporting entity. It is easy to understand that such feedback is essential for the (re)calibration and “learning” of any dynamic surveillance system. In other words, a securities (services) provider will never know how risk sensitive his AML/CTF setup and controls really are, as long as he has no idea whether he “caught the right fish” with his monitoring/reporting-system.

However, we are well aware that such feedback might raise a number of additional legal questions in terms of general data-protection issues, confidentiality within the public administration and in the course of public prosecutor's investigation proceedings. Nevertheless, we think it is important that this issue is addressed and given the attention it deserves within the FATF framework. Therefore, the FATF RBA guidance should at least raise awareness and give some general policy recommendation on this important issue.

7. A final word on proportionality

Any risk based approach, which assumes that resource should be allocated in a way which best serves the regulatory objectives to be achieved, inherently acknowledges, that even in the field of regulations economic constrains for regulated entities which have to shoulder compliance costs apply and therefore any inefficiencies should be avoided to the highest extend possible. In other words, in a hypothetical world with unlimited resources, there would simply be no need for a risk based approach, because any regulatory policy objective could be achieved without paying any attention to associated costs.

Against this background, we expressly welcome that the draft guidance explicitly mentions and recognizes that proportionality considerations play a significant role in judging the appropriateness of AML/CTF policies (see paragraphs 157. And 158.) and therefore, “no one-size-fits-all AML/CFT approach should be applied”.

In this context, it is worthwhile mentioning that unlike in the banking sector, AML/CTF regulated entities in the securities sector in some jurisdictions (including Germany) are often SME companies. While SME companies play a recognizable role in some parts of the insurance sector as well, the number and frequency of transactions for them regularly is significant lower.

Due to the nature of the securities business with a high number of transactions, the establishment of transaction monitoring systems play an important role in AML/CTF setups for securities (services) providers. Here the economic challenge lies in the fact, that the higher the degree of principally desirable automation of transaction monitoring arrangements, the higher the fix-cost burden which needs to be refinanced by allocation of compliance costs to a given production function.

While the number of transactions (at least in the trading environment) handled by SME securities (services) providers are significantly higher than for firms of comparable size e.g. in the insurance business, it also must be recognized that gross margins in the insurance sector usually lie in the range of several percentage-points, while they are measured in basis-points (one basis-point equals a percentage of a percentage or 0,0001 in decimal fraction) within the securities sector.

Therefore the fix-cost-digression problem in the context of AML/CTF regulation poses a specific challenge for SME securities (services) providers. Since readers from outside the securities sector might not be aware of this specific scalability problem, we would consider it very helpful if the economic rationale behind the "no one-size-fits-all AML/CFT approach" could be briefly further exemplified.

In closing, we would like to reiterate our thanks to FATF for the opportunity to comment on the draft RBA guidance for the securities sector. Please do not hesitate to contact us for further discussion of the issues contained in this comment-letter.

Yours sincerely,

Michael H. Sterzenbach
Secretary General