Anti-Money Laundering and Countering the Financing of Terrorism

SECTOR RISK ASSESSMENT

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New Zealand

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March 2011

ISBN 978-0-478-36519-1 (print)
ISBN 978-0-478-36520-7 (online)

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Part 1: Executive summary

1. This section provides a brief outline of the sector risk assessment (SRA) and a summary of the risk ratings for the sub-sectors.

The scope of the SRA

2. This sector risk assessment (SRA) is a preliminary assessment by the AML/CFT supervisors to assess the risks of money laundering across the sector they will supervise. The Securities Commission will supervise issuers of securities, trustee corporations, futures dealers, collective investment schemes, share brokers and financial advisers for the purposes of the Anti-Money Laundering and Countering the Financing of Terrorism Act 2009 (the Act). Other AML/CFT supervisors (the Department of Internal Affairs and the Reserve Bank) have published similar risk assessments for the sectors they supervise.

3. This SRA will assist the AML/CFT supervisors in understanding the risks of money laundering in the sector. It will also benefit reporting entities as it will assist them to prepare for undertaking risk assessments in their business. Reporting entities are required by the Act to undertake a risk assessment prior to establishing an AML/CFT programme. This document provides guidance to reporting entities on areas which may be of higher risk in their business.

Limitations

4. The assessments of each industry or sub-sector undertaken in this document are based on structural risk factors. For consistency when comparing sub-sectors we have not taken into account the adequacy or effectiveness of any controls at this stage as the supervisory arrangements provided for in the Act are yet to take effect.

5. There is limited information available on money laundering or terrorist financing risks in New Zealand. A national risk assessment undertaken by the New Zealand Police Financial Intelligence Unit (FIU) has only recently been published. This SRA draws significantly on risk assessments, guidance and reports from other jurisdictions and international organisations such as the Financial Action Taskforce.

Overview of current findings

6. The following assessments are a result of considering the internationally recognised structural risk factors of money laundering in the sub-sectors below. Those structural risk indicators include size and scale of the sector,

cash intensity of business, amount of international business, customer base and the existence of potential money laundering activities.

7. The risk assessment model rates structural indicators as high, medium or low based on available data. Indicators of higher risk are cash intensive products and services along with certain types of customers.

8. The ratings in this SRA do not take into account risk mitigants that are in place in individual entities or across the sub-sectors. Only a relatively narrow set of AML/CFT requirements is currently in force across the sector. For most reporting entities the AML/CFT supervisors cannot test the effectiveness of existing controls. AML/CFT supervisors' powers are limited until the Act comes into force, probably in early 2013. For this reason controls have been noted where they exist, but not included in the risk rating process, in order to present consistent ratings that can be compared across sectors.

9. There is little information or evidence to support a rating on terrorist financing in New Zealand at present.

Sub-sector type	**Structural risk assessment of ML risk**
Issuers of securities	Low
Trustee companies	Medium / High
Futures dealers	Medium / High
Collective investment schemes	Medium / High
Brokers	Medium
Financial advisers	Medium / High

Part 2: Introduction

The Anti-Money Laundering and Countering Financing of Terrorism Act 2009

10. The Anti-Money Laundering and Countering the Financing of Terrorism Act 2009 (the Act) was passed in October 2009. The purposes of the Act are:

    - To detect and deter money laundering and the financing of terrorism (ML/TF); and

    - To maintain and enhance New Zealand's international reputation by adopting, where appropriate in the New Zealand context, recommendations issued by the Financial Action Task Force (FATF); and

    - To contribute to public confidence in the financial system.

11. Under Section 131 of the Act, one of the functions of each AML/CFT (anti-money laundering and countering the financing of terrorism) supervisor is to assess the level of risk of ML/TF across all of the reporting entities that it supervises. This has been undertaken in the form of the Sector Risk Assessment (SRA). Three SRAs have been produced – one for each of the three AML/CFT supervisors' sectors (see 'AML/CFT supervisors' below).

Purpose of the SRA

12. This SRA is the first assessment undertaken by the AML/CFT supervisor of the money laundering risks in the sector.

13. The SRA is intended to:

    - Assist the supervisors in their understanding of particular ML/TF risks within their designated sector; and

    - Provide guidance to reporting entities on the specific risks relevant to their sector or sub-sector; and

    - Contribute to the New Zealand Police FIU assessment of ML/TF risks in New Zealand.

AML/CFT Supervisors

14. The relevant supervisors for the types of reporting entities are detailed in Section 130 of the Act. That section allows for AML/CFT supervisors to agree on the appropriate supervisor for a reporting entity where the products or services offered by that reporting entity may be covered by more than one

AML/CFT supervisor. There is also provision for supervision of a group of reporting entities as a Designated Business Group (DBG) by one or more than one AML/CFT supervisor.

15. A reporting entity can only have one supervisor. The National AML/CFT co-ordination committee can appoint an AML/CFT supervisor for a reporting entity in the absence of any agreement by the supervisors. The Act designates three AML/CFT supervisors and gives them and the FIU powers to carry out their AML/CFT functions.

16. The Reserve Bank is the relevant AML/CFT supervisor for:

- Registered banks
- Non-bank deposit takers (NBDTs)
- Life insurers.

17. The Securities Commission is the AML/CFT supervisor for:

- Issuers of securities
- Trustee companies
- Futures dealers
- Collective investment schemes
- Brokers
- Financial advisers.

18. The Department of Internal Affairs (the Department) is the AML/CFT supervisor for all reporting entities not covered by the Reserve Bank and Securities Commission. At present this includes:

- Casinos
- Money service businesses (including currency exchange and money remittance/transfer)
- Payroll remittance
- Lending and other services (including non-bank non deposit taking lenders, debt collection and factoring)
- Financial leasing
- Cash transporters
- Safe deposit/cash storage
- Issuing and managing means of payment (including non-bank credit card and stored value card providers).

Structure

19. There are 4 parts to this document.

20. **Part 1: Executive Summary** – provides a brief outline of the risk ratings for the sub-sectors.

21. **Part 2: Introduction** - introduces the relevant legislation and gives an overview of the risk assessment process~~,~~ the methodology used in the assessment of the ML/TF risks in the sector and limitations with the current SRA.

22. **Part 3: Sector summary -** provides a summary of each sub-sector and the key risk areas.

23. **Part 4: Sector risks** – addresses each sub-sector in depth by highlighting the factors considered in the risk assessment of each sub-sector. In turn this is arranged into different sections:

    - Overview - this provides some general comments on the sub-sector as a whole.

    - Structural risks - drawing on international guidance, this section considers the areas of risk that relate to the nature and scale of the sub-sector and its operations.

    - Specific risks – again drawing on international guidance, this section details the major areas of risk of ML/TF in a sub-sector relevant to the business activities undertaken by reporting entities in that sub-sector.

Other ML/TF assessments

Mutual evaluation report of New Zealand

24. The FATF and the Asia-Pacific Group on Money Laundering (APG) completed a Mutual Evaluation Report on New Zealand in October 2009 which described some deficiencies with AML/CFT requirements in New Zealand at that time. These included gaps in law and regulation, limited Customer Due Diligence (CDD), insufficient beneficial ownership information availability and vulnerabilities in the New Zealand companies registration process.

25. The Act, along with Regulations and Codes of Practice yet to be introduced, aim to address vulnerabilities identified by the FATF.

The risk-based regime – three levels of risk assessment

26. The regime introduced under the AML/CFT Act enables AML/CFT activities to be based on risk. The purpose of this is to minimise compliance costs and ensure that resources are targeted towards high-risk, high-priority areas. The Act provides for risk assessment at three levels:

National Risk Assessment

27. The FIU has undertaken a National Risk Assessment (NRA) pursuant to section 142(k) of the Act. The NRA's primary audience is relevant

government agencies including the AML/CFT supervisors. It gives an overview of AML/CFT issues affecting New Zealand from a law enforcement perspective. Information from government organisations, both domestic and international, contributed to this assessment. Further information will be available from the AML/CFT supervisors and reporting entities for future national risk assessments.

28. The NRA acknowledges the information gaps in the data available to assess ML/TF. The FIU intends to develop and maintain valid and reliable indicators of ML/TF and publish Quarterly Typology Reports. The reports, along with other available intelligence, will inform the AML/CFT supervisors and sectors of trends. Future SRAs will benefit from this information.

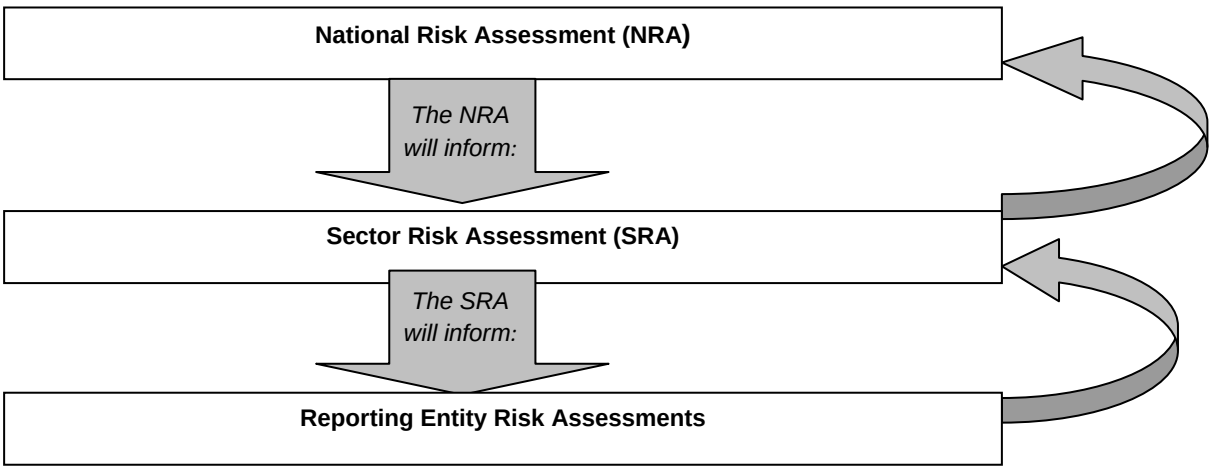
Sector Risk Assessment

29. Sector AML/CFT supervisors have each produced a risk assessment for their own sector. Future SRAs will draw on a variety of sources, including risk assessments carried out by the FIU and reporting entities. Ongoing SRA work will be conducted by the AML/CFT supervisors in order to fully understand the ML/FT risks within their sectors and to inform reporting entities on risk indicators, trends and emerging issues. SRAs may be revised regularly or on an ad-hoc basis, depending on the rate of change in ML/TF risk affecting a sector.

Reporting Entity Risk Assessments

30. Section 58 of the Act requires all reporting entities to undertake an assessment of the risk of ML/FT in their business. The risk assessment must consider the nature, size and complexity of its business, products and services including delivery methods, its customers and any countries it has dealings with as a part of its business. One of the factors that reporting entities must have regard to in developing their risk assessments is guidance material on risk assessment produced by an AML/CFT Supervisor or the Commissioner of Police. This SRA forms part of the guidance material issued by an AML/CFT supervisor. AML/CFT supervisors are preparing further guidance on the process of carrying out a reporting entity risk assessment.

31. 31.The diagram illustrates the inter-relationship of the risk assessment process:



Information sources

32. The SRA has drawn together information from a number of sources. Currently there is little comprehensive or precise data available to fully assess the ML/TF risks across all products, services or areas in each sector. As a result, the SRAs drew heavily on overseas based experience and findings from similar jurisdictions with AML/CFT requirements, such as the Australian Transaction Reports and Analysis Centre (AUSTRAC). This is combined with observations from multi-national organisations that New Zealand is a member of including the FATF and APG, as well as the Wolfsberg Group, Interpol, and the International Monetary Fund where applicable.

33. This information is supplemented by local information, particularly data received from entities that responded to various surveys and/or interviews by AML/CFT supervisors. Consideration has been given to other data sources available to the AML/CFT supervisors including summary Suspicious Transaction Report (STR) data and information provided by the FIU, as well as industry expertise, knowledge and experience from internal and external resources relevant to the sector.

34. The variable quality of risk data across the whole sector reflects the current variation of AML/CFT obligations and level of AML/CFT supervision. In early 2010, in an effort to improve the quality of such data, the Securities Commission, assisted by Research New Zealand, surveyed known reporting entities on their AML/CFT preparedness (the questionnaire). The questionnaire asked them about particular AML/CFT risk indicia including customer types, non-face-to-face products and services, cash receipts and payments, their business's geographical reach, their AML/CFT awareness and their assessment of where AML/CFT risks lay.

35. 800 questionnaires were sent out. Table 1 shows the responses from each sub-sector.

Sub-sector	Total number of identified reporting entities	Number of respondents	Response rate
Financial Advisers	5000[1]	107	2%
NZX Sharebrokers	18[2]	14	73%
Non-NZX Sharebrokers	300	29	10%
Trustee Corporations	6	3	50%
Collective Investment Schemes	40	5	12%
Futures and Options	5	5	100%
Issuers of Securities	Please see paragraphs 241-247 for a detailed explanation.		

Methodology

36. The AML/CFT supervisors have drawn upon international guidance to prepare the SRAs. This assessment follows an international model for AML/CFT risk assessments developed by the World Bank and the APG.

37. The model assesses a series of factors to indicate the nature and scale of possible ML/TF in New Zealand. These include:

- Size of the sub-sector or industry, including value of transactions;
- Turnover volume;
- High cash intensive products and services;
- Frequency of international transactions;
- Higher risk customer types; and
- Indicators of potential ML activities – including the number of STRs currently recorded from each sub-sector under the Financial Transaction Reporting Act 1996 requirements, any prosecutions or convictions that indicate ML.

38. Each risk indicator is assessed as LOW, MEDIUM or HIGH based on current information and understanding of the ML/TF risk in the sector.

39. Following the assessment of the structural risks, the assessment model then considers a basic overview of any high level AML/CFT regulatory

[1] Estimated number because FAs at the time of writing this assessment were not registered.

[2] This figure includes both trading (9) and advising (9) NZX Brokers.

requirements and the current supervision environment. Potential high level considerations include:

- AML/CFT Regulations/Guidelines/enforcement mechanisms;
- AML/CFT on-site inspections and off-site monitoring;
- Resources committed to AML/CFT supervisory authorities;
- Market entry/control (including fit and proper requirements); and
- Monitoring of transactions and adequacy of STR reporting.

40. Because the Act is not fully in force, the policies, procedures and controls that may manage or mitigate the risks in the sectors' reporting entities have not been assessed. Because we are not considering the effectiveness of reporting entities' controls in the risk rating process, we have made no judgements whether the risks in the sector are adequately managed or mitigated. Individual entities may have systems and controls in their business that adequately address some or all of the risks discussed in the risk assessment. This SRA assesses the risk across the sector and not at the individual reporting entity level. Entities that have already developed expertise and knowledge in ML/TF will find that knowledge beneficial when interpreting the ML/TF risks to their business.

41. Specific areas of risk within the sector are also identified and assessed in the SRA. Products and services offered by businesses in a sector that are susceptible to ML/TF are evaluated as well as determining whether any delivery channels or customer types were likely to be more at risk of money laundering. This SRA does not necessarily identify or comment on all financial activities undertaken by entities within the sector.

42. Given the limitations of available information and the early stage of the implementation of the AML/CFT requirements of the Act, it is likely that this first SRA will differ in scope from subsequent assessments. It is intended that this assessment will be the foundation of more detailed and informative assessments in years to come. The AML/CFT supervisors anticipate that SRAs will be revised as further information and data becomes available from reporting entities, the FIU and overseas.

43. It is anticipated that reporting entities may determine how ML/TF risks will be assessed in their business using a different approach to the SRA methodology.

Limitations

44. This SRA has been produced prior to full implementation of the Act with limitations on the risk assessment process. The following limitations to the SRA process were identified:

- information on money laundering in New Zealand is limited, with some reliance on international typologies and guidance to identify risks;

- reporting entities have various degrees of understanding of AML/CFT legislation, procedures or the ML/TF risks in their business, therefore the perception of risks may not be fully developed in some responses to surveys;
- insufficient availability of detailed data and information to inform some risk areas;
- variable quality of data across some of the sectors with more qualitative sources used;
- the limited scope of current legislative requirements;
- STR data reporting currently only allows for quantitative analysis;
- the Securities Commission's lack of a complete database on all reporting entities under its supervision; future assessments will benefit from law requiring all Financial Service Providers and Financial Advisers to be registered; and
- very low STR submission by reporting entities, which leave gaps in some assessment areas.

45. The majority of these limitations will be addressed by development of the AML/CFT regime and more engagement with reporting entities. The SRA will evolve as the quality of information improves. AML/CFT supervisors expect that when the statutory obligations come into force and reporting entities are supervised for compliance with these obligations, more and better information on the AML/CFT risks facing the sectors will emerge. Future risk assessments should contain a better balance of quantitative and qualitative information.

Money laundering and Terrorist Financing

46. This assessment focuses on the risk of money laundering in the sector as there is limited information on terrorist financing in New Zealand for the AML/CFT supervisors to comment on.

47. Money laundering is concerned with concealing the origins of funds or assets. Funds are generated through illegal operations, such as drug manufacture and supply, and launderers attempt to hide its origin through a number of often complex transactions. There are generally 3 stages to money laundering:
    - Placement –involving the introduction of illicit funds into the financial system
    - Layering - the numerous transactions designed to confuse any tracing of funds to its original source
    - Integration – legitimising the funds through ordinary financial activity

48. With money laundering, the criminal activity has already taken place. With terrorist financing, the focus is on preventing the criminal activity from occurring. The characteristics of terrorist financing can make it difficult to identify. These include the low value of transactions and that funding can come from legitimate as well as illicit sources. Where illicit funds are being used, the methods employed to monitor money laundering may also be applicable for terrorist financing as the movement of those funds often relies on similar methods to money laundering.

49. There have been no convictions for terrorist related offences in New Zealand since the introduction of the Terrorism Suppression Act in 2002. The FIU and the 2009 Mutual Evaluation Report indicate that there is little evidence to suggest terrorist financing is occurring in New Zealand and consider the risk of terrorist financing to be low. The FIU is better placed to provide information on terrorist financing indicators and activities at present.

Other Relevant Legislation

Financial Transactions Reporting Act 1996 (FTRA)

50. The FTRA contains the AML/CFT requirements that will be in place for financial institutions and casinos until the Act fully commences. The FTRA currently applies to most entities that are the subject of this risk assessment.

51. The purpose of the FTRA is to facilitate the prevention, detection, and investigation of money laundering in New Zealand. This is assisted by requiring financial institutions to meet certain obligations in relation to financial transactions. This includes the verification of identity, STRs and record keeping.

The Financial Service Providers (Registration and Dispute Resolution) Act 2008

52. The objectives of the Financial Service Providers (Registration and Dispute Resolution) Act 2008 (FSPA) are to identify financial service providers, to allow for more effective monitoring and evaluation of financial service providers, to assist supervision of reporting entities with AML/CFT obligations and to improve consumer redress in the financial sector.

53. Financial service providers (other than financial advisers) were required to be registered by December 2010. Financial advisers must be registered by March 2011.

Part 3 Summary by Sub-sector

Sub-sector Risk Table

Sub-sector	Overall Risk Rating
Sharebrokers	Medium
Financial Advisers	Medium High
Trustee Corporations	Medium High
Collective Investment Schemes	Medium High
Futures and Options Dealers	Medium High
Issuers of Securities	Low

Table 2 shows the overall risk for each sub-sector as determined by the methodology used.

Sharebrokers

Overall Risk Rating: **Medium**

54. This sub-sector is made up of New Zealand Exchange Limited (NZX) participants and sharebrokers licensed under the Sharebrokers Act 1908. NZX Participant Rules (NZX Rules) contain some AML obligations and there is some regulatory scrutiny of their compliance.

55. The industry generally does not accept cash from customers for the sale and purchase of securities listed on the NZX. Sharebrokers that do not accept cash are much less likely to be used by money launderers to place funds into the financial system. Sharebrokers are typically used to layer funds by moving funds between various sharebroking accounts.

56. With approximately 589,000 trades to the value of $24 billion in the last financial year, the NZX is a small exchange compared to other world markets. Nevertheless, these are considerable amounts in terms of AML/CFT.

57. While many NZX participants' international customers are based in Australia, significant numbers reside in the USA, UK, Brunei, China and Singapore. By far the majority of customers of non-NZX sharebrokers are New Zealand-based. New Zealanders traveling or working abroad account for some international transactions.

58. The NRA lists only five STRs from this sub-sector in the last six years. One relates to the purchase of shares using proceeds from cannabis sales. We do not know if five STRs are a true reflection of sub-sector ML activity. Our research leads us to expect more STRs based purely on suspicion. Any increase in STR submissions will be a direct effect of greater sub-sector ML awareness.

Financial Advisers

Overall Risk Rating: **Medium High**

59. The main risks for sharebrokers are related to cash management accounts, third-party payments/receipts and an over-reliance on CDD undertaken by a third party, such as a bank or wealth manager.

60. No financial adviser register or record existed before 1 December 2010, which means a good deal of uncertainty over sub-sector participant numbers and activities. There are an estimated 5000 financial advisers. The FSPA and the Financial Advisers Act 2008 (FAA) will eventually provide much more certainty on this issue. By 1 July 2011, all will be registered and authorised.

61. Financial advisers offer a wide range of products, and range from the part-time and unqualified to the highly experienced and qualified who work for medium and large companies.

62. Most financial advisers do not hold customer funds. This considerably reduces the AML/CFT risk. Financial advisers still play an important role in AML/CFT, however: they are the contact point between investment product providers and customers. They have knowledge of, and opportunity to question, a customer, when product providers, who typically have limited or no customer contact, do not.

63. A financial adviser could be involved in all three stages of money-laundering. This is a low risk for those not accepting cash deposits; risks that should be considered are fund layering and integration.

64. With an estimated 5000 advisors undertaking approximately 20 million transactions annually, $20 to $30 billion a year could be passing through the securities sector. This estimation is based on questionnaire responses; more accurate annual report data will be available for future assessments.

65. Financial advisers have international customers. These tend to be based in Australia, having originated in New Zealand. Many financial advisers discourage contact with customers without a New Zealand bank account.

66. AML/CFT awareness among financial advisers is generally low. They have been working to the FTRA standard, which only required financial advisers to submit STRs if they handled cash. This may explain why only one STR had been submitted in the last three years.

67. Financial advisers will have to consider two main risks: failure to conduct robust and thorough CDD appropriate to the level of risk a customer presents; and, reliance on third- party CDD and identity verification.

Trustee Corporations

68. Overall Risk Rating: **Medium High**

69. Six trustee corporations have approximately $80 billion under supervision. They offer a wide range of products and services, including legal, financial, investment, trusts, home loans, wealth management, conveyance, estate administration and estate protection. Their customers include individuals (settlors and beneficiaries), corporate entities, trusts, issuers and other investment vehicles.

70. Some aspects of this business, such as conveyance and estate administration, are low risk. Others, such as trusts, are in some circumstances high risk. Trusts pose a risk because of the anonymity of settlors and beneficiaries, who can hide behind nominees and companies.

71. This sub-sector would be used predominantly for layering and integrating funds. Some trustee corporations accept cash, so there is potential for placing funds into the financial system through these organisations.

72. Trustee corporations have international customers, mainly from UK, USA, India and Europe. Little reliable information exists on whether such customers are higher risk.

73. The sub-sector is aware of AML/CFT, and respondents have various controls for detecting and then escalating suspicious transactions to senior management. It has submitted five STRs in the last three years.

74. Trustee corporations will have to consider two main risks: the anonymity of trust beneficial owners, such as an individual settling funds into a trust or a company or gatekeeper that is settling the funds into the trust; and, undue reliance on CDD presented by another.

Collective Investment Schemes

Overall Risk Rating: **Medium High**

75. There are approximately 65 collective investment scheme (CIS) managers, and the industry administers an estimated $63 billion or more managed funds. The Securities Commission does not regulate all CIS managers. It is not unusual for investment departments of banks and large insurance companies to undertake CIS management.

76. As part of the money-laundering process, CISs would be used for layering funds.

77. Products in this sub-sector are not cash intensive. Payments are mainly direct transfers between customer and CIS manager accounts, and cheques.

There appeared to be an acceptance that CDD is completed to the required standard if a customer holds a bank account.

78. International transactions do occur but they are infrequent and low value. Such customers are predominantly from Australia, UK and USA.

79. The main legislation affecting a CIS is the FTRA. It requires entities to submit a STR, but there is no record of the sub-sector originating one in the last three years.

80. This may be due to a lack of AML/CFT sub-sector training.

81. All respondents regarded this as a low-risk sub-sector. The main risks for a CIS are gifting units, and reliance on CDD completed by third parties. A more detailed explanation on gifting units can be found in paragraph 208.

Futures and Options Dealers

Overall Risk Rating: **Medium High**

82. NZX has authorised five futures and options firms and five introducing brokers. The NZX is the frontline regulator of futures dealers who operate under the NZX Futures and Options Rules.

83. As the statutory regulator of futures dealers, the Securities Commission also authorises individual dealers. It has authorised 11 retail futures dealers and 28 wholesale dealers via individual notices.

84. In addition, 22 named people are authorised to deal in “electricity price futures contracts”. Many are electricity generators or retailers, though a few provide consulting services to entities with large energy needs.

85. This sub-sector has retail and wholesale dealers. Retail dealers can be NZX participants or not. Most trade in over-the-counter or off-exchange products.

86. The wholesale dealers are mainly fund managers with access to funds from unrelated investors investing in various collective schemes. Wholesale dealers that are not fund managers tend to be hedging investments for multi-million dollar corporation customers.

87. This sub-sector sees many cash movements, allowing both placement and integration.

88. As mentioned, the industry is cash intensive. Its retail side accepts large amounts of cash from customers, and also makes cash payments to customers.

89. International transactions are common, with US and HK dollar, Euro, Chinese yuan, Japanese yen and sterling the most common currencies.

90. Although respondents indicated having submitted STRs, NRA statistics show this sub-sector has not submitted one in the last five years. Some of the respondents did not have a procedure for managing STRs.

91. All dealers responded to the questionnaire, establishing there was reasonable sub-sector awareness of AML/CFT.

92. The main risk in this sub-sector is its large cash flow and international transfers from banks/customers based in higher risk jurisdictions.

Issuers of securities

Overall Risk Rating: **Low**

93. Responses to questionnaires sent to listed issuers that are not in the financial business of issuing securities showed that these occasional issuers pose limited ML risks. For instance other than retail sales, financial products or services were not offered by the respondents.

94. The Commission will be issuing guidance on its approach to entities that in the ordinary course of their business participate in securities issues and provide financial services related to those issues. This sub-sector is considered low risk due to the absence of factors that have been identified in international studies as risk factors.

Part 4: Sector risks

Sharebrokers

Overall Risk Rating – **Medium**

Overview

95. This sub-sector comprises NZX market participants and sharebrokers licensed under the Sharebrokers Act 1908. An NZX market participant is a business accredited by New Zealand's only registered exchange, the New Zealand Exchange (NZX), to participate in, and trade listed securities on, the markets NZX provides. NZX participant types include NZX trading and advising firms and NZX advising firms. An NZX trading and advising firm is one of three types that can trade in any NZX markets and also advise customers. An NZX advising firm cannot trade but can advise customers about securities listed in any NZX market. There are 19 NZX trading and advising firms, and NZX advising firms (known collectively as NZX participants).

96. In addition to NZX participants, approximately 500 individuals are also licensed under the Sharebrokers Act 1908 (licensed sharebrokers). Some licensed sharebrokers work for NZX participants. We do not know the exact number of licensed sharebrokers because a consolidated sharebroker register is not required to be kept under the Sharebrokers Act. A more comprehensive and accurate database of brokers will be available after 1 July 2011. From that date the Sharebrokers Act will be repealed and only members of a registered exchange (i.e. NZX participants) can use the term sharebroker in any advertising or promotional material. Many of the licensed sharebrokers will be financial advisers of brokers under the FAA and they will also have to be authorised by 1 July 2011. In addition, as of December 2010, individuals and entities that offer broking services or trade in transferable securities on behalf of another were required to register as a financial service provider under the FSPA.

97. Our research shows that licensed sharebrokers hold sharebroking licences for a variety of reasons. As mentioned earlier many fall into the category of financial advisers, and sharebroking is one aspect of their business. Quite often, sharebroking is a low turn-over facility offered to existing customers. In all cases, Non-NZX sharebrokers have to trade through an NZX participant for NZX listed securities. Also, although they are not regulated by the NZX, all are indirectly subject to the standards demanded by NZX rules via their contractual agreements with the NZX participant.

98. Two pieces of legislation will replace the Sharebrokers Act in 2011:

- The FSPA will require a provider of financial services to register and set up a dispute resolution scheme. Under the Act, buying and selling securities is a financial service; therefore a company currently buying or selling securities is required to register. All companies had to be

registered by 1 December 2010. Financial advisers must be registered by 31 March 2011

- The FAA requires financial advisers to be authorised by the Securities Commission by 1 July 2011. This includes those selling category 1 products, which include shares and futures contracts. The Act also requires sharebrokers to be registered.

99. These two Acts will ensure that people buying and selling securities on behalf of others are subject to regulation and supervision. Eventually, all brokers will be on a central register that will provide more comprehensive and accurate data for future sub-sector assessments.

100. Ten NZX participants responded to the questionnaire. They offer a range of services, including investment advising and securities trading services to investors, securities issuance and underwriting to issuers.

101. Seventeen other sharebrokers responded to the questionnaire. Their services are limited to superannuation schemes, unit trusts, sharebroking, company refinance and financial advice.

- The overall risk of NZX participant sharebrokers is **medium**.

- The overall risk of licensed sharebrokers is also **medium**.

Structural Risks

Sub-sector size in terms of cash flow and transaction volumes

102. In the last financial year, approximately 589,000 trades to the value of $24 billion were transacted on NZX markets. Compared to world markets, NZX is a small exchange. The $24 billion figure refers only to brokers registered with the NZX. A significant amount of business is transacted by licensed brokers that are not part of the NZX. However, because they have to trade through an NZX participant, most transactions are accounted for in the above figures.

Proportion of high cash-intensive products and services

103. Sharebrokers offer a wide range of products, but respondents indicated that none accept cash. A cash transaction may be considered in exceptional circumstances but a higher degree of CDD would be expected.

104. Some NZX participants offer customers cash management accounts (CMAs). This type of deposit account is maintained at a bank but often offers more favourable interest rates than a bank deposit account. A CMA benefits customer and broker because of easy access to funds for the purchase and sale of securities. Although cash is not used, the funds have a degree of liquidity and can be moved in and out of the account fairly easily. Respondents indicated that CMAs were one of their riskier products.

105. Licensed sharebrokers indicated that it was rare for them to handle customer funds, and that they do not accept cash from customers.

Proportion of international transactions

106. NZX participants have a large proportion of customers based outside New Zealand, predominantly in Australia, but with links to other jurisdictions, such as the USA, UK, Brunei, China and Singapore.

107. Licensed sharebrokers are community-based with long-standing customers. International customers are normally New Zealanders living abroad who continue to trade in New Zealand.

Proportion of customers who pose a higher risk

108. There is little reliable information about the proportion of high-risk customers (such as politically exposed persons (PEPs), non-resident and private banking customers, trusts, bearer shareholders etc). However, our research suggests that sharebrokers have non-New Zealand resident customers, who are considered higher risk. Australian and foreign trusts, Australian and foreign corporations are also identified customers.

Indicators of potential ML/TF activities

109. There have been few identified cases of sharebrokers being used by money launderers or terrorist financiers in New Zealand. This sub-sector has submitted few STRs. The NRA reports one incident in which proceeds from the sale of cannabis were used to buy shares. We are also aware that the Police Asset Recovery Unit has cited investments generally as an area of concern.

Control Measures

AML/CFT regulations/guidelines/enforcement mechanisms in place

110. NZX participants are subject to NZX rules. These were updated in 2007 and contain AML/CFT obligations as well as FTRA requirements. NZX participants are, for instance, required to consider factors such as past and present business activities, and the source and nature of funds, when assessing a customer's potential ML risk. They must also have in place controls and procedures to mitigate the risk of introducing laundered funds. NZX participants are required to ensure employees are trained to recognise suspected ML activity and report them to the compliance manager or designated AML reporting officer. Although NZX requirements are not as strict as the Act's, there is a high level of industry awareness and preparedness. We anticipate NZX participants finding transition to the Act less difficult than other sector participants.

111. The NZX rules have had a considerable positive impact on the sub-sector. However, some areas still need improvement: for instance, reliance on third parties for CDD and certification of copy documents.

112. Licensed sharebrokers that are not employed by NZX participants are indirectly subject to the standards expected by the NZX rules through contractual agreements with the NZX participant for trades through NZX.

AML/CFT on-site inspections and off-site monitoring – supervisory compliance ratings

113. NZX is the sub-sector's frontline regulator, and periodically makes site visits. The NZX can also apply sanctions to a NZX firm if necessary. This level of regulatory oversight in the securities sector is currently unique to NZX participants. In addition, the Commission conducts annual oversight reviews of NZX to assess whether NZX is operating its markets in accordance with its rules.

114. Although there is a higher level of regulatory scrutiny of this sub-sector relative to the other sub-sectors under the Commission's supervision, the efficacy of the AML/CFT controls in NZX participants cannot be assessed in the absence of full supervision by the Commission in its capacity as the relevant AML/CFT supervisor under the Act. In the future when the Act takes effect we will be able to conduct on-site inspections. This may affect the risk rating of the sub-sector.

Resources committed to AML/CFT by supervisory authorities (budget and number of staff)

115. The Act establishes AML/CFT supervisors. However, supervisors will not begin to significantly impact the sub-sector until reporting entities' obligations come into effect when the Act is fully in force.

Market entry/control (including fit and proper)

116. Sharebroking firms are required to meet certain standards in order to be registered as NZX participants. Under the FSPA, from 1 December 2010 anyone offering a financial service, including dealing in securities, will have to be registered.

Monitoring transactions and adequacy of STR reporting

117. All respondents have procedures or policies for detecting unusual customer activity (such as a complex, unusually large transaction or an unusual pattern of transactions with no apparent economic or lawful purpose).

118. All respondents also confirm that they have procedures or policies on responding to and managing such unusual or suspicious activity (such as escalation to senior management for appropriate follow-up).

Suspicious Transaction Reporting

119. Only five STRs were submitted in the last three years. To our knowledge, these were all submitted by NZX participants.

Industry Risks

120. Respondents' listings of the five highest-risk products are:

- securities trading
- cash management acounts
- FOREX (cash or deliverable)
- derivatives
- payment services and distribution of primary securities issues.

121. There is a close correlation between these and the products respondents consider their top five earners.

122. There is a risk of reporting entities focusing on layering and integration, and missing the predicate offences unique to the securities sector. Insider dealing, for instance, can generate proceeds of crime from apparently legitimate securities transactions. Feeding these proceeds into the financial system could be considered placement.

123. CMAs pose a risk if reporting entities do not have adequate monitoring systems in place. These would need to detect a significant increase or change in activity, frequent or substantial wire transfers that are out of the ordinary, and any activity inappropriate to the nature of the business.

124. Where a firm's product range allows a customer to make third-party deposits or payments (through linked banking services, for example) there is a higher risk.

125. The APG Yearly Typologies Report 2010 identified the following risks relevant to New Zealand sharebrokers:

- **Entities involved in securities products –** broker-dealers display over-reliance on CDD conducted by other financial institutions (in particular, banks, investment advisers and wealth managers).
- **Customers and account types –** trusts, nominees and omnibus accounts present particular vulnerabilities. It may be difficult to obtain beneficial ownership information, especially when business is conducted in such a way that information has not been collected for many years.
- **Determination of value –** lack of price transparency is evident in some transactions (such as, off-market transactions).
- **Rogue employees** – employees who help customers in AML/CFT make a financial institution seriously vulnerable.

- **Predicate offences linked to securities transactions** – noted as a particular issue in case studies provided by the APG.
- **Case study** (Canada, page 8) – use of front companies, professionals to facilitate introduction of proceeds, margin-trading accounts and money orders.

Financial Advisers

Overall Risk Rating – **Medium High**

How the Act defines a financial adviser

126. The Financial Advisers Act 2008 (FAA) states that a financial adviser is a person who provides a financial advice service.

127. The FSPA requires all financial advisers to be registered. Under the FAA, financial advisers who provide personalised advice on category 1 products (which relate mostly to securities) will have to be authorised as well as registered (except under certain circumstances relating to Qualifying Financial Entities). They will be known as Authorised Financial Advisers (AFAs). Registering and authorising financial advisers will give a clearer picture of the sub-sector's size and make up.

128. The activities of financial advisers are not necessarily caught by the Act. It is proposed that a regulation will include those persons required to be AFAs, and entities providing financial advice services in respect of category 1 products (including to wholesale clients) into the definition of reporting entity, in so far as they arrange for other reporting entities to provide financial services (those financial activities listed in the definition of financial institution) to a customer.

129. In future, therefore, the financial adviser sub-sector will consist of AFAs (along with financial advisers who offer wholesale client advice, and those caught by the Act because they accept customer funds for investment). In this assessment, *financial adviser* means those carrying out activities that make them reporting entities under the Act and its regulations.

Background

130. A broad group provides a wide range of financial advice. Most simply help customers with financial planning and recommend investment products. Only a few accept customer funds for investment.

131. Until very recently, provision of financial advice was unregulated in New Zealand. Financial advisers who accept customer funds and invest on behalf of customers are subject to the FTRA, as discussed below.

132. There is no register or record of financial advisers. Therefore there is great uncertainty about their numbers and activities.

133. Unless stated otherwise, information presented here is derived from conversations with financial advisers and members of industry groups, such as the Institute of Financial Advisers; the questionnaire (107 financial advisers responded); conversations with Securities Commission staff working with the FAA; and, information from research reports, such as the Mutual Evaluation Report 2009 produced by the APG.

Overview

134. Our research shows a diverse industry, ranging from part-time, unqualified advisers to highly experienced and qualified advisers working for multi-national banks. Financial advisers employed by banks and life insurers will not be supervised by the Securities Commission, therefore their activities are not included in this assessment.

135. Current data does not, however, allow us to separate out the activities of financial advisers included in this assessment who also offer products irrelevant to AML or CFT, such as KiwiSaver and non-life insurance. This artificially inflates securities-related product figures.

136. Since most financial advisers do not accept customer funds for investment or have customer trust accounts, a customer buying a product on a financial adviser's recommendation pays for it directly into the product provider's account, either electronically or by cheque. In most cases, therefore, a customer must deposit funds with another financial institution, such as a bank, before they can use a financial adviser. They then transfer the funds into another financial institution's account (that of the product provider, for example). Both financial institutions will have their own AML/CFT procedures or policies in place.

137. This makes most sub-sector activities inherently lower risk. The World Bank/APG template does not fully account for the nature of most financial advisers' business. It is weighted towards the few who have trust accounts and accept customer funds. This is why, although we assess the risk posed by financial advisers as medium/high, we believe it relates more to the advisers that accept customer funds.

138. Nevertheless, financial advisers still play an important role in AML/CFT. Even though most do not handle customer funds, they are the contact point between investment product providers and customers. Typically, firms themselves have limited or no direct contact with customers.

139. Financial advisers themselves are, therefore, best placed to undertake CDD and submit STRs. They have an all-round view of a customer's investment transaction behaviour that a product provider cannot have.

140. The overall risk posed by financial advisers is **medium high**.

Structural Risks

Size of the sub-sector

141. The estimate of 5000 financial advisers in this sub-sector will stand until more detailed data is available from the FSP register.

142. As AFAs do not have to be authorised until 1 July 2011, their precise numbers are unknown. The requirement, under the FSPA and the FAA, to register will enhance future assessments by giving a more accurate indication of the sub-sector's size.

- Most financial advisers do not have any related entities in their group. Our research indicates that:
- a quarter are sole-person operations: three-quarters have five or fewer employees; few have more than five;
- three-quarters turned over less than $500,000 in their most recent financial year;
- 80% have less than $100m in total assets/funds under management (excluding private wealth services)

Volume of money flowing through sub-sector

143. As much as $20-$30 billion may be flowing in, out and around the securities sector in conjunction with advice from 5000 financial advisers. This size of the sub-sector makes it high risk.

144. This dollar estimate may be much higher than the actual amount (taking into account, for example, KiwiSaver and non-life insurance products). Even if it is, we still consider the size of the sub-sector poses a high risk, due to the many financial advisers operating within it and the difficulty a supervisor would have monitoring so many participants.

Number of transactions

145. Our research suggests that on an average day, the average financial adviser might make 15 transactions. For the purposes of this assessment, we interpret "transaction" in a very broad sense, including, for example, passing cheques to product providers (and so, in a way, facilitating the transaction), payments to customers, receiving commissions and accepting fees.

146. This would mean there are perhaps 20 million transactions across the sub-sector each year. We consider this to be medium risk.

Proportion of high cash-intensive products and services

147. Our research suggests that most financial advisers (perhaps 85%) do not accept cash. Of those that do, we believe most accept less than $10,000 a month.

148. Although a money launderer could conceivably shop around until they found an adviser that accepted cash, our information suggests the adviser would still have some difficulty placing this money (for example, because it may raise suspicion with product providers or banks).

149. For this reason, we believe the proportion of cash-intensive products available is minimal, and the risk low.

Proportion of international transactions

150. Our research indicates that financial advisers make a large number of international transactions, primarily with Australia. We do not have reliable information as to the proportion of these, however.

Proportion of customer who pose a higher risk (such as PEPs, non-resident customers, private banking customers, trusts, bearer share holders etc)

151. We have no reliable information on the proportion of higher-risk customers. However, our research does suggest around half financial advisers have non-New Zealand resident customers, who are considered higher risk. Many also have New Zealand trusts, foreign trusts and private wealth customers. We do not have reliable information as to the proportion of these.

Indicators of potential ML/TF activities

152. There have been no known cases of financial advisers being used by money launderers or terrorist financiers in New Zealand. There are few, if any, relevant STRs or successful prosecutions in this sub-sector and little in the way of information available from international bodies such as FATF or the APG.

Control Measures

AML/CFT Regulations/Guidelines/Enforcement mechanisms in place

153. The FTRA is the primary AML/CFT control in New Zealand at the time of this assessment. As most financial advisers only give advice (as opposed to accepting customer funds and making transactions on customers' behalf) they are not caught by the FTRA and its AML provisions. The regulations/guidelines/enforcement mechanisms in place have therefore been rated as low.

AML/CFT on-site inspections and off-site monitoring – supervisory compliance ratings

154. Financial advisers are currently unregulated for AML/CFT purposes, and there are no inspections or other supervision.

Resources committed to AML/CFT by supervisory authorities (budget and number of staff)

155. The Act established supervisory authorities. They will not begin to significantly impact on the sub-sector until regulations come into effect.

Market entry/control (including fit and proper)

156. There are no market or entry controls for financial advisers (however, as stated above, this is changing).

Monitoring of transactions and adequacy of STR reporting

157. Because the provision of financial advice (as opposed to making transactions on behalf of customers) is not caught by the FTRA, most financial advisers are not required to submit STRs or monitor transactions.

158. Most financial advisers who responded to our survey indicated they have procedures or policies for detecting unusual customer activity. A similar proportion claimed they have procedures or policies for responding to and managing unusual or suspicious activity. However, of 81 respondents, only one had filed a STR in the last three years.

159. Based on our research as a whole, we believe that, while most financial advisers have some form of monitoring system, these are generally well below the standards FATF considers desirable.

Industry Risks

160. Risks in this sector are:

- failure to conduct robust and thorough CDD appropriate to the level of risk a customer presents;
- reliance on third-party CDD and identity verification;
- cash-based transactions;
- rogue employees' ability to manipulate systems in order to disguise ownership of funds and owner identity; this includes aiding and abetting the primary offence of tax evasion.

Trustee Corporations

Overall Risk Rating – **Medium High**

Overview

161. At present, six trustee corporations have their own individual Acts of Parliament, which allow them to act as trustee for debt issuers and as statutory supervisor for issuers of participatory securities without prior approval from the Securities Commission. This will change with the passing of the Securities Trustees and Statutory Supervisors Bill. The Bill applies to trustees (including trustee corporations) and statutory supervisors. It addresses weaknesses in the current regime as reported in the IMF's and World Bank's New Zealand assessment by the Financial Sector Assessment Programme (2004); the Ministry of Economic Development's Review of Financial Products and Providers (2006); and the Registrar of Companies' report to the Commerce Committee following the 2006-2008 finance company failures.

162. The 2010 Trustee Corporations Association of New Zealand review shows there is more than $165 billion under administration and supervision through 26,459 personal trusts and 1,310 corporate trust investments. Trustee corporations offer a wide range of products and services, including legal, financial, investment, trusts, home loans, wealth management, conveyance, estate administration and estate protection. Their customers include individuals (settlors and beneficiaries), corporate entities, trusts, issuers and other investment vehicles.

163. Five trustee corporations were either interviewed or responded to the questionnaire.

164. The overall risk of trustee corporations is **medium high**.

Structural Risks

Size of the sub-sector: volume of money flowing through sub-sector and number of transactions

165. There is no complete, public, readily available record of transactions undertaken by trustee corporations, so total transactions in this sub-sector are unknown. However, it is recorded that trustee corporations and statutory supervisors have approximately $165 billion under supervision. The type of business the sub-sector undertakes indicates a high number of transactions.

Proportion of high cash-intensive products and services

166. A wide range of products and services is offered to customers. Questionnaire respondents indicated that they accept cash in certain circumstances but do not pay cash to customers.

Proportion of international transactions

167. Respondents indicate that international transactions are undertaken. The foreign customer base is mainly in the UK, USA, India and Europe.

Proportion of customers who pose a higher risk (such as PEPs, non-resident customers, private banking customers, trusts, bearer share holders etc)

168. There is little reliable information on the proportion of higher-risk customers. However, our research indicates that customers include offshore trusts and corporations, structures that can obscure the true identity of operators. Such customers pose a risk if their beneficial owners are not adequately identified.

169. Respondents do not identify PEPs as customers. Given the potential for trust anonymity, this would represent a risk if trustee corporations have no procedures for identifying PEPs.

Indicators of potential ML/TF activities

170. We are not aware of any New Zealand cases of trustee corporations being used by criminal elements. Given, however, that trusts allow customer anonymity, a trust is a high-risk product.

Control Measures

AML/CFT Regulations/Guidelines/Enforcement mechanisms in place

171. At the time of this assessment the FTRA is the main AML legislative requirement. Trustee corporations have obligations under the FTRA because their business consists of acting as trustee in respect of others' funds, or administering or managing funds on behalf of others. A trustee corporation that is either a trustee or administration manager or an investment manager of a superannuation scheme, or a trustee or manager of a unit trust within the meaning of the Unit Trust Act 1960, also has obligations under the FTRA.

172. The Securities Commission is not responsible for monitoring trustee corporations' compliance with the FTRA. We understand that trustee corporations have policies and procedures in place for managing FTRA requirements. Some are also preparing for the AML/CFT Act by putting in place high- level policies. It is intended that the detail is added to these policies when the regulations are released.

173. For now we consider the regulations/guidelines/enforcement mechanisms in place to be below what is required by the AML/CFT Act and have rated this control as low.

174. When the Commission assumes responsibility for licensing securities, trustees and statutory supervisors, the Commission must assess the applicant's financial resources, governance structures and other areas in

relation to the applicant's business processes and experience before a licence is issued. Although there is no explicit requirement in the Securities Trustees and Statutory Supervisors Bill for the Commission to assess the applicant's AML/CFT controls, licensing this sub-sector will benefit AML/CFT supervision.

AML/CFT on-site inspections and off-site monitoring – supervisory compliance ratings

175. This sub-sector is not subject to regulatory visits to meet AML/CFT obligations.

Resources committed to AML/CFT by supervisory authorities (budget and number of staff)

176. The Act established AML/CFT supervisors. They will not significantly impact on the sub-sector until the Act is fully in force and its regulations in effect.

Market entry/control (including fit and proper)

177. According to their individual Acts of Parliament, six trustee corporations have an automatic right under the Securities Act 1978, the Unit Trusts Act 1960 and the Retirement Villages Act 2003 to act as trustees, statutory supervisors or unit trustees. Other entities have to be authorised by the Securities Commission to act as trustees for offers of debt securities and as statutory supervisors for participatory securities. Other than these six trustee corporations, only companies or banks approved by the Minister of Commerce can act as unit trustees or unit trusts, and only people approved by the Registrar of Retirement Villages may act as statutory supervisors of retirement villages.

178. When the Securities Trustees and Statutory Supervisors Bill becomes law, automatic statutory approval of these six trustee corporations will be removed and they will have to be licensed by the Securities Commission to act as securities trustees and statutory supervisors. The proposed licensing regime will include fit and proper requirements for the applicant's directors and senior management.

Monitoring of transactions and adequacy of STR reporting

179. Respondents indicated they have procedures or policies for detecting unusual customer activity (such as a complex, unusually large transaction or unusual pattern of transactions with no apparent economic or lawful purpose).

180. Respondents confirmed they have procedures or policies for responding to and managing such unusual or suspicious activity (such as escalation to senior management for appropriate follow-up action).

Suspicious Transaction Reporting

181. Respondents have submitted only five STRs in the last three years.

Industry Risks

182. Respondents listed the following five products as having the highest risk for money laundering and terrorist financing:

- foreign trusts
- foreign investment
- on-call accounts
- payments to foreign beneficiaries
- term deposits.

183. Our research suggests the following areas constitute sub-sector risks:

- anonymity of trust beneficial owners – an individual settling funds into a trust or hiding behind a company or gatekeeper that is settling the funds into the trust;
- existing trusts with anonymous settlers and beneficiaries;
- failure to identify people who control funds;
- over-reliance on a third-party provider;
- payment to third parties not associated with the trust or customer;
- New Zealand trusts that have internationally based trustees/directors.

Collective Investment Schemes

Overall Risk Rating – **Medium High**

Overview

184. A collective investment scheme (CIS) is a form of investing that allows investors to pool their funds to invest in assets. Typically, the investor does not have day-to-day control over investment decisions or the assets purchased with his or her funds. Instead, they enjoy the benefits of a diversified portfolio of investments under professional management and risk diversification. CIS include KiwiSaver schemes, superannuation schemes, unit trusts and participatory securities (such as bloodstock interests, property syndicates and forestry partnerships).

    Typically a CIS consists of:

- a manager who makes investment decisions;
- an administrator who manages trading, reconciliations, valuation and unit pricing;
- an investment vehicle that can take a number of legal forms: depending on whether the CIS is established as a corporate entity or trust, there will be a board of directors or trustees who safeguard the assets and ensure CIS operations comply with relevant laws and regulations.

185. The industry has more than 65 CIS managers. Of these, five responded to our questionnaire.

186. As mentioned in the sharebroker section, only NZX participants can trade listed securities on markets operated by the NZX. A CIS manager does not have to be an NZX participant to market a CIS. However, because of the close association between securities trading and CIS, some NZX participants are also CIS managers.

187. In the money laundering process a CIS would be used for layering funds.

188. The AML/CFT risks of CIS are **medium high**.

Structural Risks

Size of the sub-sector: volume of money flowing through sub-sector and number of transactions

189. The sub-sector's precise dollar value and number of transactions are unknown. There is an estimated $53 billion or more in managed funds. This figure is the total the industry administers, not the amount held solely by entities the Commission supervises.

190. We know that funds under management have increased $3.7 billion to $56.7 billion during 2010. We do not know how much of that increase is due to market fluctuation or deposits from investors. With more than $56 billion under management, it is fair to assume there are many transactions in this sub-sector.

Proportion of high cash-intensive products and services

191. The range offered customers does not include cash-intensive products. No respondents accepted or made payments in cash.

192. Cash is rarely used in CIS transactions. Accepted forms of payment are electronic transfer and cheque. Both give the CIS manager a degree of comfort in that the financial institution involved will have completed required CDD. However, this comfort is limited by knowing that the FTRA came into effect in 1996, and that before then, an account may have been opened anonymously or in a fictitious name.

Proportion of international transactions

193. International transactions occur but are infrequent and of low value. International customers are mostly located in UK, USA and Australia.

Proportion of customer who pose higher risk (such as PEPs, non-resident customers, private banking customers, trusts, bearer share holders etc)

194. There is little reliable information on the proportion of high-risk customers. However, our research does suggest that since the customer base includes offshore trusts, these could pose a higher risk of ML. PEPs are not identified. At least one respondent could check names through a commercial product to establish whether customer were PEPs. Other Reporting Entities spoken to did not check for PEPs.

Indicators of potential ML/TF activities

195. There have been no known cases of New Zealand CISs being used by criminal elements.

Control Measures

AML/CFT Regulations/Guidelines/Enforcement mechanisms in place

196. The FTRA is the main AML/CFT control at the time of this assessment. The regulations/guidelines/enforcement mechanisms in place are therefore rated as low.

197. A CIS has obligations under the FTRA if it is (i) a trustee or administration manager, or investment manager of a superannuation scheme; or (ii) a trustee or manager of a unit trust (collectively known as CIS managers.) These obligations include verifying the identity of all new investors and people conducting certain occasional transactions. New investors must produce a photocopy of at least one form of identification, although some managers require two forms, one to include a photograph of the investor. All that is required when gifting units (see explanation below) to another person is name, address and a personalised cheque. These obligations will change under the Act.

198. CIS managers that are also NZX participants must adhere to the NZX rules for CDD, in line with their brokerage and trading business. As discussed in the sharebroking section, NZX rules require a higher standard of customer identification.

AML/CFT on-site inspections and off-site monitoring – supervisory compliance ratings

199. This sub-sector is not yet subject to AML/CFT regulatory visits by the Securities Commission.

Resources committed to AML/CFT by supervisory authorities (budget and number of staff)

200. The Act establishes supervisory authorities. They will not significantly impact on the sub-sector until the Act comes fully into force and reporting entities' AML/CFT obligations take effect.

Market entry/control (including fit and proper)

201. There is little control in this area. Under the FSPA, a CIS manager will be deemed to be providing a financial service, which, at the least, will mean they are registered. This will help with future assessments by accurately representing sub-sector size.

Monitoring of transactions and adequacy of STR reporting

202. Respondents have procedures or policies for detecting unusual customer activity (such as a complex, unusually large transaction or unusual pattern of transactions with no apparent economic or lawful purpose).

203. Respondents confirmed they have procedures or policies for responding to and managing such unusual or suspicious activity (such as escalation to senior management for appropriate follow-up action).

Suspicious Transaction Reporting

204. The FTRA requires CIS managers to report suspicious transactions. No respondents have submitted an STR in the last three years.

205. Of the three who responded to this question, only one said staff had had AML/CFT training in the last three years. Lack of staff training could explain why few STRs have been submitted.

Industry Risks

206. All respondents believe this to be a low-risk sub-sector. Only one responded to the question about the product carrying the highest risk.

207. Our research indicates the following industry risks:

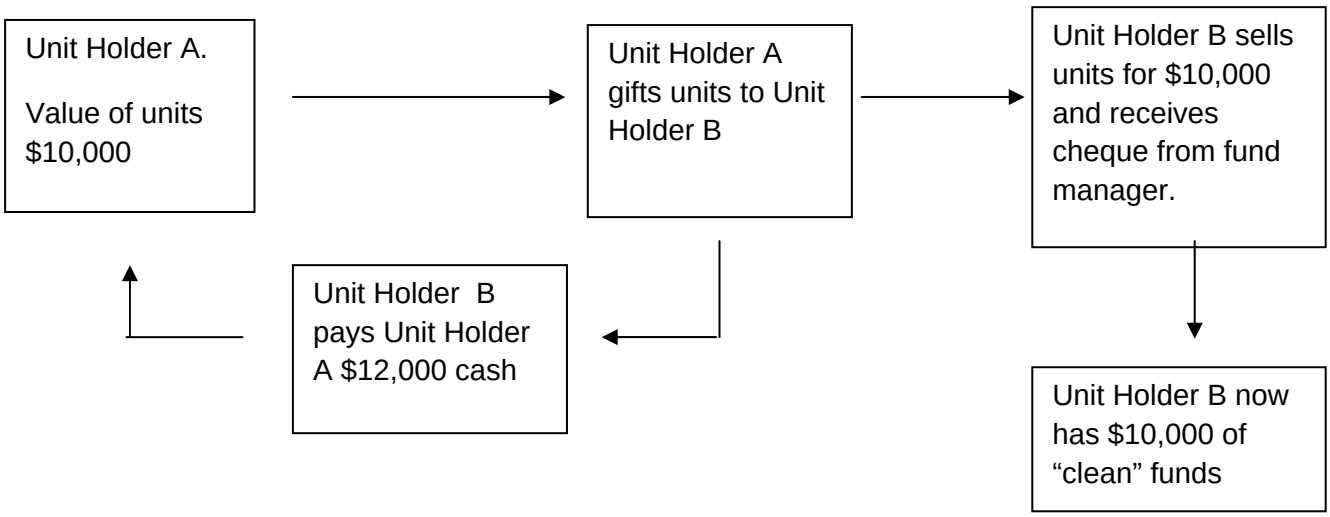
- current regulatory oversight and procedures not being robust enough to ensure legislation is being properly complied with. The most important factor is guaranteeing the authenticity of identity documents and their relation to the applicant. This risk applies to the entire application process and will change when the Act comes into force.

- gifting units without robust CDD on both parties making it possible for someone to gift units to a third party then receive an enhanced cash payment later. When the third party sells the units he/she will be in

possession of funds that, at face value, originated from a CIS manager as the result of selling fund units (see the scenario depicted below).

- relying on third parties to conduct CDD.

208. Scenario



Futures and Options Dealers

Overall Risk Rating – **Medium High**

Overview

209. Under the Securities Markets Act 1988 (SMA), no one may deal in futures contracts unless:

- they are authorised by the Securities Commission to do so, or belong to a class of people that are; or
- they have been approved by an authorised futures exchange under its rules to deal in futures contracts according to the exchange's rules.

210. "Futures contract" is broadly defined in New Zealand and covers derivative contracts that other jurisdictions may not be consider to be futures contracts. They include some financial instruments, such as contracts for difference, margin foreign exchange and other structured option products (depending on their terms). These instruments are not generally exchange-traded products and probably account for most of what is regulated in New Zealand as retail futures dealing. They are offered by most of the retail futures dealers the Securities Commission authorises and by most NZX dealers. New Zealand has no regime for regulating derivative contracts that are neither futures contracts nor securities. It is possible that this will change as

part of the Securities Act review but that will not take effect until sometime in 2012 at the earliest.

211. From 30 April 2004, all futures and options participants under the NZX Futures and Options (NZFOX) Rules have been authorised by the Securities Commission under the Authorised Futures Dealers Notice (No 3) 2004. The notice defines an NZX participant as a futures and options firm, a futures and options introducing broker and a futures and options advisor designated by NZX under the NZX Futures and Options Rules.

212. NZX has authorised five futures and options firms and five introducing brokers. The NZX is the frontline regulator of futures dealers operating under the NZX Futures and Options Rules. Most of them offer over-the-counter (OTC) contracts in the same way as directly authorised dealers.

213. As the statutory regulator of futures dealers, the Securities Commission also authorises individual dealers. It has authorised 11 retail futures dealers and 28 wholesale dealers through individual notices.

214. The retail futures dealers authorised by the Commission are not NZX participants. Most retail dealers trade OTC or off-exchange products.

215. Wholesale dealers that are not fund managers tend to be hedging investments or business risk for multi-million-dollar corporation customers. These dealers include a few who only advise customers and instruct executing brokers, but do not handle customer funds, plus a few also offering brokerage services and/or trading with customers as principal. Most firms in this last category are large, reputable, international financial services firms.

216. Twenty-two named people are authorised to deal in “electricity price futures contracts”. Many are electricity generators or retailers, though a few provide consulting services to entities with large energy needs. This authorisation restricts them to larger or more experienced customers (although the specific criteria differs from the standard “wholesale customer” in that it focuses on the customers being in the electricity industry or being a big electricity user). The authorisation covers OTC dealing or dealing on an authorised exchange, although we understand the market is shifting its focus to contracts traded on The Sydney Futures Exchange (now known as the ASX 24 market).

217. Further, there are class notices for ASX 24 participants and registered banks.

218. The ASX 24 is an Australian market operated by the ASX Group. This authorisation covers only dealing in products that are traded on the ASX 24 – it does not cover OTC dealing. We do not know exactly who is relying on this authorisation to trade for New Zealand customers. Most, if not all, dealers on this market will be subject to any AML requirements set by ASX, ASIC and AUSTRAC.

219. The registered banks authorisation and associated exemption clarified for these entities the wider issues to do with derivative products. Dealing will be the ordinary business of banks and so come under Reserve Bank supervision.

220. There are also authorisations and a power for NZX to approve dealers in connection with its new derivatives market. This is an authorised futures exchange. These authorisations for dealers only cover dealing on the NZX derivatives market – they do not cover OTC dealing. This market and the authorisations connected with it are separate from the NZFOX participants referred to in paragraphs 211 and 212 above.

221. The overall risk of the futures and options sub-sector is **medium high**.

Structural Risks

Size of the sub-sector: volume of money flowing through sub-sector and number of transactions.

222. The number of transactions flowing through this sub-sector is unknown; given an industry turnover of more than $50 million, we assume it's a considerable number, and one that will increase with development of a new derivatives market in NZX transactions.

223. The six respondents were all either NZX participants or authorised by the Securities Commission as retail futures dealers. Estimated annual turnover ranged between less than $500,000 and the $10 million-plus indicated by five respondents. If other dealers follow this pattern, the sub-sector turnover is significant.

Proportion of high cash-intensive products and services

224. Respondents indicated that large cash sums are received from customers and used to pay customers. It is likely that cash flow also involves other aspects of the respondents' business, such as FX. Movement of cash poses a higher risk of money-laundering and terrorist financing.

Proportion of international transactions

225. International transactions are common in this sub-sector, whose customer base is international. In New Zealand, the market is particularly favoured by Chinese and Hong Kong investors. Other than New Zealand dollars, the main currencies traded are the US dollar, Hong Kong dollar, Euro, Chinese yuan, Japanese yen and sterling.

Proportion of customer who pose higher risk (such as PEPs, non-resident customers, private banking customers, trusts, bearer share holders etc)

226. There is little reliable information on numbers of higher-risk customers. Our research shows that offshore trusts as well as high-risk industries, such as precious metal dealers, are customers. PEPs are not identified, but this could be because the Reporting Entities do not have procedures for identifying this category of customer.

Indicators of potential ML/TF activities

227. There are no known cases of futures and options dealers being used by criminal elements in New Zealand.

Control Measures

AML/CFT Regulations/Guidelines/Enforcement mechanisms in place

228. NZFOX participants are subject to the NZX Futures and Options Rules.

229. Where a futures dealer handles customer funds, the activity is regulated by the Futures Industry (Customer Funds) Regulations 1990. These give some comfort from an AML/CFT perspective because accounts should be monitored and records of payments kept. Third-party payments should be allowed only from known sources on the customer's written authorisation.

AML/CFT on-site inspections and off-site monitoring – supervisory compliance ratings

230. Apart from NZX participants, sub-sector individuals and companies are not subject to regulatory visits.

Resources committed to AML/CFT by supervisory authorities (budget and number of staff)

231. The Act established supervisory authorities. They will not impact significantly on the sub-sector until regulations come fully into effect.

Market entry/control (including fit and proper)

232. Dealers must be authorised to deal in futures contracts. In most cases, authorisation requires some assessment of suitability.

233. When considering individual authorisation applications, the Commission subjects dealers to an initial "fit and proper" assessment. Where individual authorisations have an expiry date (as all retail authorisations do), the "fit and proper" test is reconsidered as part of a renewal application. Other than this, there is no periodic assessment of suitability.

234. Where dealers rely on a class authorisation, another entity may assess whether the dealer meets its criteria. For example, NZFOX dealers are assessed by NZX for suitability under the NZX Futures and Options Rules, but are not assessed by the Commission.

Monitoring of transactions and adequacy of STR reporting

235. Respondents monitor transactions daily, although what form this takes is unknown.

236. Only one respondent lacked a policy or procedure for detecting unusual customer activity (such as a complex, unusually large transaction or unusual pattern of transactions with no apparent economic or lawful purpose).

237. Half the respondents lacked a procedure or policy for responding to and managing such unusual or suspicious activity (such as escalation to senior management for appropriate follow-up action).

Suspicious Transaction Reporting

238. Reporting of suspicious transactions during the last three years varied between “0” and “many”. All respondents have a dedicated AML/Compliance officer, and most offer their staff AML training.

Industry Risks

239. Respondents nominated several products they considered high risk. The consensus was that cash/FX, and futures and options posed the greatest risk.

240. We consider the sector’s high cash flow poses a significant risk. Other risks are:

- international transfers from banks/customers based in higher-risk jurisdictions, that is, jurisdictions with weaker AML/CFT legislation;
- reliance on off-shore third parties to complete customer due diligence;
- use of cash-management accounts, which are controlled by the customer and allow deposits and withdrawals; these accounts may be mismanaged and used by third parties;
- access to the market by unauthorised dealers.

Issuers of Securities

Overall Risk Rating – **Low**

Overview and industry risk

241. All listed issuers and other entities issuing under the Securities Act 1978 and the Securities Markets Act 1988 were sent questionnaires. The six respondents are all listed issuers (on either an Australian or New Zealand exchange) and represent diverse businesses in retail and commerce sectors:

242. Although each respondent had issued securities, the essential nature of their business is not participating in securities issues for purposes of the Act. The questionnaire responses clearly indicated that it would not be feasible for an occasional issuer to be caught by the Act. For instance other than retail sales there were no financial products or services offered by the respondents. Not surprisingly answers to the specific AML/CFT questions showed no awareness of AML/CFT.

    The Commission will be issuing guidelines to clarify when an entity is captured by the Act when it participates in a securities issue. Briefly, the entity has to meet all three requirements:

    - issuing securities must be an ongoing part of the actual operations of the entity,
    - it must take part in the issue of securities,
    - it must provide or offer to provide any service or product of a financial nature in connection with securities issues.

    For a more detailed explanation of an issuer of securities please refer to the guidelines on “Issuers of Securities” that will be issued.

243. Underwriters, trustees, managers, statutory supervisors and custodians would generally be considered to be in the business of providing financial services in securities issues. The nature of the New Zealand financial markets is that reporting entities tend to offer several products or services. It will not be unusual for an issuer of securities to be regulated by a supervisor other than the Securities Commission.

244. An element of AML/CFT risk is associated with issuing securities, notably, private issuers and penny stocks.

245. A private issue poses the risk of anonymity and manipulation of the shareholding prior to the offer. This may occur when a criminal element uses the private company as a front for mingling the proceeds of crime with legitimate commerce. A criminal element could also invest cash in exchange for a percentage share of the company. Following a successful launch, the criminal can sell his/her shares in the company through the stock exchange and receive laundered funds.

246. Here, the risk stems from failure to undertake adequate CDD on the purchasers of a company's controlling stake before securities are publicly offered. Risks do not lie with subscribers, and are, arguably, better managed by adequate CDD on the part of the investment bankers and brokers of the issuer's controlling shareholders.

247. Another consideration is funding a company that operates across unregulated territories. Even though the parent is incorporated or registered in a well-regulated territory, the risk may be greater than if the business operated out of one well-regulated territory; appropriate levels of verification and CDD should be considered.

APPENDIX A: Assessment Methodology

Structural risks	Factors that increase the risk	Factors that reduce the risk
Size	Large assets held by entities in the industry High values of transactions	Fewer assets held by entities in the industry Low values of transactions
Volume	High volumes of transactions making it harder to check the legitimacy of each transaction	Low volumes of transactions making it easier to check each transaction
Products and services	High number of cash based products and services High percentage of products and services paid for with cash or able to be loaded with cash	Limited or no products and services that rely on cash for payment or as part of the product (loading)
International transactions	High level of transactions with overseas entities or to other countries Parties to the transaction based in higher risk jurisdictions Nested / payable through accounts available or operated through correspondent accounts NZ is neither the origin nor destination in the transaction	Domestic only transactions Transacts only with jurisdictions with known AML/CFT control requirements Transacts with entities regulated for AML/CFT requirements in those jurisdictions
Customers	Has customers that are: • Foreign PEPs • High net worth individuals • Trusts and charities • Overseas entities, especially those in off-shore secrecy havens	All or high number of domestic customers (NZ resident) Low value accounts and transactions Transactions consistent with profiles Transparent ownership structures Regulated entities for AML/CFT compliance
Indicators	High number of reporting Suspicious Transaction Reports (STRs) High number of those reports as quality reports showing tangible evidence of suspect behaviour or transactions Low level of reporting of STR where inconsistent with the level expected in line with crime rates or reporting in other industries	Low number of STR reports consistent with expectation and lowering crime rates in NZ

APPENDIX B: Acronyms

AFA	Authorised Financial Adviser
AML/CFT	anti-money laundering/countering the financing of terrorism
APG	Asia Pacific Group
ASIC	Australian Securities and Investments Commission
ASX	Australian Securities Exchange
AUSTRAC	Australian Transaction Reports and Analysis Centre
BNI	Bearer Negotiable Instrument
CDD	Customer Due Diligence
CIS	Collective Investment Scheme
CMA	Cash Management Account
EDD	Enhanced Due Diligence
FAA	Financial Advisors Act 2008
FATFA	Financial Action Task Force
FIU	Financial Intelligence Unit (New Zealand Police)
FOREX	Foreign Exchange Transactions
FTRA	Financial Transaction Reporting Act 1996
FX	Foreign Exchange
IMF	International Monetary Fund
KYC	Know Your Customer
ML/TF	Money laundering/Terrorist Financing
NASDAQ	National Association of Securities Dealers (American Stock Exchange)
NRA	National Risk Assessment
NZX	New Zealand Stock Exchange
OTC	Over the Counter
RE	Reporting Entity
SMA	Security Markets Act 1988
SRA	Sector Risk Assessment
STRs	Suspicious Transaction Reports

APPENDIX C: Definitions

AML/CFT Supervisors are defined by the FATF as *"the designated competent authorities responsible for ensuring compliance by financial institutions with requirements to combat money laundering and terrorist financing"*. It is proposed that New Zealand incorporates a multi-supervisor model to capitalise on existing regulators expertise and industry knowledge of each financial sector. Proposed supervisors are:

Securities Commission of New Zealand – supervisor for issuers of securities, trustee companies, futures dealers, funds managers, brokers and financial advisers.

Reserve Bank of New Zealand – supervisor for registered banks, non-bank deposit takers and life insurers.

Department of Internal Affairs – supervisor for money remitters, TCSPs, casinos, currency exchangers, NBNDTLs, financial leasing, safe deposit boxes, debt collection, payroll remittance, non-bank credit cards and entities not elsewhere supervised.

Bearer Negotiable Instruments include monetary instruments in bearer form such as: travellers cheques; negotiable instruments (including cheques, promissory notes and money orders) that are either in bearer form, endorsed without restriction, made out to a fictitious payee, or in such a form that title passes on delivery; incomplete instruments (including cheques, promissory notes and money orders) signed, but with the payee's name omitted.

IMF – an organisation of 187 countries working to foster global monetary cooperation, secure financial stability, facilitate international trade, promote high employment and sustainable economic growth, and reduce poverty around the world.

Financial Action Task Force – an intergovernmental body whose purpose is the development and promotion of national and international policies to combat money laundering and terrorist financing.

Financial Institutions – defined in Part 1, Section 3 of the FTRA96 to include these entities:

- accountants (within specified limits)
- building societies
- friendly societies or credit unions
- lawyers (within specified limits)
- licensed casinos
- life insurance companies
- New Zealand Racing Board
- real estate agents
- registered banks

- Reserve Bank of New Zealand
- sharebrokers
- trustees or managers of superannuation schemes
- trustees or managers of unit trusts
- anyone whose business, or a principal part of whose business, consists of any of the following:
    - borrowing or lending or investing money
    - administering or managing funds on behalf of others
    - acting as trustee in respect of another's funds
    - dealing in life insurance policies
    - providing financial services that involve transferring or exchanging funds, including (without limitation) payment services, foreign exchange services, or risk management services (such as provision of forward foreign exchange contracts); but not including provision of services consisting solely of financial advice, as per Part 1, Section 3(k) of the FTRA96.

Foreign Exchange Market – a worldwide decentralised over the counter financial market for trading currencies. The foreign exchange market determines the relative values of currencies.

Integration – the third stage of money laundering in which funds re-enter the legitimate economy

Layering – the second stage of money laundering where the launderer engages in a series of conversions or movements to distance funds from their source.

Over-the-counter – OTC or off-exchange trading is the direct trading of financial instruments such as stocks, bonds, commodities or derivatives between two parties. It contrasts with exchange trading which occurs via facilities constructed for that purpose, such as futures exchanges or stock exchanges.

Placement – the first stage of money laundering where the launderer introduces illegal profits into the financial system.