

29 January 2010

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Dear Ms Atkins

Treatment of Custodians under the AML/CTF Legislation

We refer to your letter dated 20 May 2009, responding to the submissions made by IFSA and ACSA on 15 September 2008. We have now had an opportunity to consider AUSTRAC's response and to consult with the members of the relevant IFSA and ACSA working groups.

In this letter, the *Anti-Money Laundering and Counter-Terrorism Financing Act 2006* (Cth) is referred to as the **AML/CTF Act** and the *Anti-Money Laundering and Counter-Terrorism Financing Rules 2007 (No 1)* are referred to as the **AML/CTF Rules** or **Rules**.

1. Acknowledgement – Full name of trust

IFSA and ACSA thank AUSTRAC for its acknowledgement of the problem faced by custodians and their nominees when they are requested by other reporting entities, particularly providers of designated services under Item 35 (Issuing a security), to provide the 'full name of the trust'.

AUSTRAC has invited IFSA and ACSA to submit possible amendments to paragraphs 4.4.3(1) and 4.4.5(1) to include the possibility of some other descriptor of "the trust". IFSA and ACSA submit that a simple acknowledgement in the Rules would suffice that the name of a trust does not need to be provided when the person to whom the designated service is provided is carrying on a business of providing a "custodial or depository service" within the meaning of sub-section 766E(1) of the *Corporations Act 2001* (Cth), and is either:

- the holder of an Australian financial services licence that covers the provision of custodial or depository services; or
- exempt from the requirement to hold an Australian financial services licence for the provision of a custodial or depository service.

2. Continuing AML concerns

IFSA and ACSA continue to be concerned about the treatment of custodians under the AML/CTF regime established by the AML/CTF Act and the Rules with regard to their role as registered holders of assets and securities on behalf of underlying holders.

In essence, there are two primary concerns which have not been addressed by AUSTRAC's response and that IFSA and ACSA submit ought to be addressed to allow for the practical identification and verification of custodians as recipients of designated services under the AML/CTF Act:

- **Verification from trust deed** – The Rules require verification of a trust from a 'trust deed': there is no 'trust deed' in the usual sense used for the engagement of a custodian or its nominee in a professional custody environment.
- **Beneficiary verification** – The Rules require a reporting entity to collect, at a minimum, KYC information which, relevantly, includes the full name of each beneficiary of "the trust". Where a reporting entity seeks KYC information from a custodian or its nominee, because the custodian itself generally provides designated services under Item 46 of Table 1 in Section 6 of the AML/CTF Act and is a reporting entity regulated under the AML/CTF Act, the custodian is subject to an obligation to undertake KYC on its customers (and thus the beneficiaries) in accordance with the requirements of the AML/CTF Act. To have the reporting entity require the same KYC information from the custodian duplicates the KYC exercise undertaken on the beneficiary and is therefore unnecessary to meet the objectives of the AML/CTF Act.

3. Summary of recommendations

IFSA and ACSA therefore submit that AUSTRAC should amend the Rules to exclude a reporting entity from the obligation to:

- (a) collect the full name of the trust;
- (b) verify the full name of the trust from a trust deed, certified copy or certified extract of the trust deed, reliable and independent documents relating to the trust or reliable and independent electronic data; and
- (c) collect either the full name of each beneficiary in respect of the trust or, if the terms of the trust identify the beneficiaries by reference to membership of a class – details of the class,

in the following circumstances:

- (d) the person to whom the designated service is provided is carrying on a business of providing a "custodial or depository service" within the meaning of sub-section 766E(1) of the Corporations Act, and is either:
 - (i) the holder of an Australian financial services licence that covers the provision of custodial or depository services; or
 - (ii) exempt from the requirement to hold an Australian financial services licence for the provision of a custodial or depository service; and
- (e) such person certifies to the reporting entity that the relevant custodian provides designated services under Item 46 of Table 1 in Section 6 of the AML/CTF Act, is a reporting entity regulated under that Act and is subject to an obligation to carry out applicable customer identification procedures in accordance with the requirements of that Act.

4. Background

What is a custodian?

As you are aware, a custodian is a financial institution responsible for safeguarding a financial asset. The role of a custodian may include:

- holding in safekeeping assets such as equities and interests in managed investment schemes;

- on instruction arranging settlement of any purchases and sales of such assets;
- collecting information on and income from such assets;
- providing information to their clients on the underlying companies in which investments are held and their meetings;
- processing cash transactions; and
- providing regular reporting on all their activities to their clients.

How is 'custodial or depository service' defined in the AML/CTF Act?

Section 5 of the AML/CTF Act provides that **providing a custodial or depository service** includes engaging in conduct that, under subsection 766E(1) of the Corporations Act, constitutes providing a custodial or depository service within the meaning of Chapter 7 of that Act, but does not include:

- (a) conduct covered by subsection 766E(3) of that Act; or
- (b) conduct specified in the AML/CTF Rules.

Sub-section 766E(1) of the Corporations Act provides, inter alia, that a 'custodial or depository service' is one under which a person holds a financial product, or a beneficial interest in a financial product, on trust for or on behalf of another person, under an arrangement with that person or with another person.

Conduct covered by sub-section 766E(3) of the Corporations Act includes:

- (a) the operation of a clearing and settlement facility;
- (b) the operation of a registered scheme or holding the assets of a registered scheme;
- (c) the operation of a superannuation fund, approved deposit fund or pooled superannuation trust;
- (d) the operation of a statutory fund of a life insurance company;
- (e) the operation of an FHSA trust by an FHSA provider;
- (f) the provision of services to a related body corporate; and
- (g) a range of other services prescribed by the regulations.

Custodian as trustee?

While a custodian is generally considered to hold assets as a trustee, it is considered to act as a bare trustee only, in that a custodian will only act on the proper instructions of the custodian's client. The terms on which the custodian will act (and hence the manner in which proper instructions may be provided by the client and accepted by the custodian) are established under a custody agreement between it and the client. The terms of these agreements are commercially sensitive as between custodians, as they contain sensitive pricing information, information about the quality and nature of the services which may be provided and other important terms, such as indemnity and liability provisions. These are not standard documents.

Reason for appointing a custodian

There are a variety of commercial and regulatory reasons why an investing institution will choose to hold investments through a custodian. One reason is to maintain efficiency in

the performance of investment activities such as attending to the safe custody of securities purchased, monitoring and reporting on assets held, collection of relevant income, attending to corporate actions, monitoring specific investment guidelines and reporting details of all transactions to the investing institution and/or fund manager as required.

Another reason is that the investing institution may be required to appoint a third party custodian to hold scheme or trust assets under applicable legislation. For example, the *Superannuation Industry (Supervision) Act 1993 (Cth)* requires a trustee of a regulated superannuation entity to appoint a custodian, and a responsible entity of a registered managed investment scheme may also be required by ASIC to appoint a third party custodian to hold scheme assets where it does not have sufficient net tangible assets or meet certain operational requirements.

Role of nominee company

Many ACSA members use a nominee company to act as a bare trustee for the custodian and hold investments on behalf of the custodian, which in turn is custodian for its client. These nominee companies are typically special purpose subsidiaries of custodians, and hold no assets other than the assets of the custodian's clients. Custodians often have regulatory requirements to keep assets of clients separate to their own assets, and the use of nominee companies enables a custodian to evidence meeting these requirements. These nominee companies may not hold an Australian financial services licence, as many of them will have the benefit of an exemption from the requirement to hold an Australian financial services licence under paragraph 7.6.01(1)(k) of the *Corporations Regulations* or will be exempt under paragraph 911A(2)(b) of the *Corporations Act* because they are acting as an authorised representative of the licensed custodian.

How are securities held?

Securities held by custodians and their nominees are typically registered or held in what are known as 'omnibus accounts'. An 'omnibus account' is a single account in which the assets of a number of clients may be pooled. For example, securities may be held in a single CHESS account, with a single holder identification number (HIN).

Securities held in an omnibus account are fungible. The client's interest in a number of securities is recorded in the books of the custodian. The client is entitled to recover equivalent securities to those which may have been acquired originally on the client's instructions; in other words, to an identical number of the same securities. The client is not entitled to an identifiable, individually numbered security.

Accordingly, when a custodian or nominee applies for a security, it may be acting for a number of different underlying clients, from each of whom a proper instruction to acquire the relevant securities has been received. The custodian or nominee will hold the new securities in a pool for the benefit of the clients who have an interest in the relevant securities held in the omnibus account.

Reporting entities and clients of reporting entities

Custodian as a reporting entity

Typically under the AML/CTF Act, if the custodian is an Australian entity or conducts business from a permanent establishment in Australia, the custodian will itself be a reporting entity under the AML/CTF regime, at least in respect of certain of its clients, where the services that the custodian provides fall within the definition of 'custodial or depository service' under Item 46 of Table 1 in Section 6 of the AML/CTF Act.

Who are ACSA members' custodian clients?

The clients of ACSA members generally comprise:

- Responsible entities of registered managed investment schemes;
- Trustees of wholesale (unregistered) managed investment schemes;
- Operators of investor-directed portfolio services;
- Trustees of regulated superannuation entities; and
- Authorised life and general insurance companies.

Many of these entities will themselves be providers of 'designated services' and so will themselves also be 'reporting entities' under the AML/CTF Act. Accordingly, as reporting entities subject to the AML/CTF Act, these 'custodian client' entities will in turn undertake customer identification and verification of the identity of their own clients (investors).

Custodian as recipient of designated services

In the course of providing custodial services to its clients, the custodian or its nominee will apply for, and be issued with, securities which the nominee and custodian will hold for the benefit of the underlying custody client. The provider of that service will generally be a 'reporting entity' in respect of the provision of that service, under Item 35.

5. Treatment of custodians as trustees

As noted above, the relationship between the custodian and its client is generally considered to amount to a bare trust under which the custodian holds the assets or securities on behalf of their client. However, for reasons which are outlined in further detail below, the custodial relationship differs from a traditional trust relationship.

As you are aware, a custodian is not identified as a separate type of customer in Part 4 of the AML/CTF Rules. As such, an application of the Rules as they are currently drafted may result in the anomaly of requiring reporting entities to identify custodians on the basis that the custodian is a trustee.

The Rules currently provide that "[i]n so far as a reporting entity has any customer who acts in the capacity of a trustee of a trust", the reporting entity must (Rule 4.4):

- Verify certain information about the trust including "the full name of the trust from a trust deed, certified copy or certified extract of the trust deed, reliable and independent documents relating to the trust or reliable and independent electronic data."¹

¹ The AML/CTF Rules establish a simplified verification procedure, in rule 4.4.8, with respect to a trust that is:

- a managed investment scheme registered by ASIC; or
- a managed investment scheme not registered by ASIC but which only has wholesale clients and does not make small scale offerings to which section 1012E of the Corporations Act applies; or
- registered and subject to regulatory oversight of a Commonwealth statutory regulator in relation to its activities as a trust; or
- a government superannuation fund established by legislation.

This simplified verification procedure for trustees is not applicable in the case of a custodian because a custodial service is not a managed investment scheme and is not registered with a statutory authority, as required by rule 4.4.8.

More specifically, Rule 4.4 requires that a reporting entity:

- Adopt appropriate risk-based systems and controls in order to be reasonably satisfied that the trust exists and the "name of each trustee and beneficiary, or a description of each class of beneficiary, of the trust has been provided" (rule 4.4.2);
- Collect and verify certain information about the trustee (rules 4.4.3 and 4.4.5); and
- Collect certain information about the underlying trust, including the trust name, the type of trust and the full names of the beneficiaries of the trust (rules 4.4.3 and 4.4.9).

Practicalities of identifying custodian as a trustee

The Rules set out a number of permissible methods of verification of information about a trust. Rule 4.4.15 outlines that verification should be based on a trust deed; a certified copy or certified extract of a trust deed; reliable and independent documents relating to the trust; reliable and independent electronic data; or a combination of these.

A custody arrangement is generally not established or evidenced by a trust deed. In most instances, the bare trust constituted by the provision of custodial services will be established and evidenced by a custody agreement between the underlying client and the custodian. The custody agreement is a commercially sensitive contract containing detailed pricing, service provisions and other terms which would not typically be in a trust deed.

It could be argued that the custody agreement should be regarded as the 'trust deed' for KYC verification purposes, and certainly, security issuers with whom custodians have been directed by their clients to deal have been demanding a copy of the relevant custody agreement on the basis that they are required to do so under the AML/CTF Act. However, those issuers are often the clients of other custodians in the market or even related bodies corporate of competitor custodians. The release of a custody agreement to those issuers would therefore potentially have a significant impact on the business of the custodian from whom it is requested, given the commercially sensitive nature of custody agreements. In any event, if the custody agreement is being requested as a means of verifying the name of the trust, then it should not be required because, as has been acknowledged by AUSTRAC, these relationships have no name.

Submission on trust deed issue

IFSA and ACSA submit that a reporting entity should not be required to verify the full name of the trust from a trust deed, certified copy or certified extract of the trust deed, reliable and independent documents relating to the trust or reliable and independent electronic data, when the person to whom the designated service is provided (namely the custodian or nominee) is a person who provides a designated service by carrying on a business of providing a "custodial or depository service" within the meaning of sub-section 766E(1) of the Corporations Act, and is either:

- the holder of an Australian financial services licence that covers the provision of custodial or depository services; or
- exempt from the requirement to hold an Australian financial services licence for the provision of a custodial or depository service.

6. Identification and verification of identity for custody clients

By virtue of its provision of designated services under Item 46 of Table 1 in Section 6, a custodian is subject to the 'Part B' customer identification regime contained in the AML/CTF Act and Rules. As you are aware, these Part B requirements set out requirements for the collection and verification of minimum KYC information.

Most custodians routinely undertake KYC of their own clients before providing a custodial service, even when the service is not strictly a 'custodial or depository service' within the meaning of the AML/CTF Act, but do not repeat that KYC each time an underlying security is acquired on the client's behalf.

IFSA and ACSA submit that custodians would be prepared to certify that the custodian provides designated services under Item 46 of Table 1 in Section 6 of the AML/CTF Act, is a reporting entity regulated under that Act and is subject to an obligation to carry out applicable customer identification procedures in accordance with the requirements of that Act.

Duplication

In practice, a custodial service operates as one aspect of a multi-layered financial relationship. In the case that a nominee is a registered holder of investments, the following contractual relationships and AML/CTF regime KYC obligations are typical:

- Initially, an investor or underlying holder, invests into an entity operated by the client of the custodian, for example, by a responsible entity of a managed investment scheme. The client of the custodian is generally a reporting entity under Item 35 of Table 1, section 6, and as such, the client is required to do KYC on each investor in the scheme.
- The custodian is appointed by its client under a custody agreement to act as custodian for the assets of the client or scheme. The custodian is typically providing a designated service under Item 46 (custodial or depository services) and as such undertakes KYC on each of its clients (in the above example, the responsible entity of the managed investment scheme and on the scheme as a trust), before providing a designated service. Even in instances where the custodian is not strictly obliged to undertake KYC, a custodian will nonetheless typically undertake KYC.
- A nominee operates on behalf of the custodian as the registered holder of the investments, generally holding them in omnibus accounts. The nominee is typically exempt from the Australian financial services licensing requirements under regulation 7.6.01(l)(k) or paragraph 911A(2)(b) of the Corporations Act. The nominee is the registered holder of the investments with a product issuer.
- The product issuer is required by Item 35 to undertake KYC on each of its investors and so will seek to undertake KYC on the nominee company. As the nominee company is a bare trustee for the custodian, this KYC exercise should simply occur once and show that the nominee holds as nominee for the custodian.

In addition to the process identified above, because the AML/CTF Rules require reporting entities to identify each of the beneficiaries of a trust, the practice of product issuers currently is to require custodians to identify each of the beneficiaries of custody arrangements.

Submission

IFSA and ACSA submit that the current AML/CTF regime requirement that the reporting entity obtain details about each underlying trust for which the custodian applies for investments is unnecessary given the fact that the custodian is itself required as a reporting entity to identify its clients and thus the requirement that a reporting entity identify beneficiaries of custody arrangements duplicates this requirement.

IFSA and ACSA therefore submit that it should be sufficient that the product issuing entity only be required to verify the identity of the custodian or its nominee, given

the custodian's own KYC checks in relation to its own clients. We note that this is consistent with the approach taken in various foreign jurisdictions, including the UK, Luxembourg, Hong Kong and Singapore.

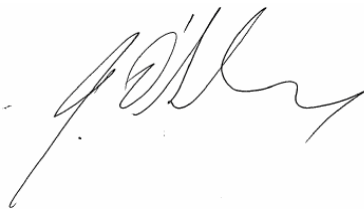
We attach as an annexure to this letter a brief summary of the approach taken in various foreign jurisdictions when the issuing entity is dealing with a custodian. Please note that information about these particular jurisdictions has been provided because they are jurisdictions in which custodians who are member entities have associated entities.

Recommendation

AUSTRAC should amend the Rules to exclude a reporting entity from the obligation to collect either the full name of each beneficiary in respect of the trust or, if the terms of the trust identify the beneficiaries by reference to membership of a class – details of the class, provided that the custodian (or nominee) certifies that the relevant custodian provides designated services under Item 46 of Table 1 in Section 6 of the AML/CTF Act, is a reporting entity regulated under that Act and is subject to an obligation to carry out applicable customer identification procedures in accordance with the requirements of that Act.

Please contact Lisa Simmons on **(02) 9258 6595** if you require further information, or wish to discuss any aspect of this submission.

Yours sincerely,



John O'Shaughnessy
Deputy Chief Executive Officer
IFSA



Bryan Gray
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ANNEXURE

APPROACH TO CUSTOMER IDENTIFICATION AND VERIFICATION OF CUSTODIANS TAKEN IN VARIOUS FOREIGN JURISDICTIONS

<i>Jurisdiction</i>	<i>Summary of approach to custodians</i>
<i>Singapore</i>	<p>A person who manages collective investment schemes is required to hold a Capital Markets Services (CMS) licence and a person who markets collective investment schemes is required to hold a Financial Adviser (FA) licence. Both CMS and FA licensees are subject to MAS' Notice on Prevention of Money Laundering and Countering the Financing of Terrorism (AML Notice).</p> <p>In Singapore, the provision of custodial services for securities is a regulated activity under the Securities Futures Act which requires a CMS licence. In the case of Trustees, they are required to hold a licence under the Trust Companies Act. Both licensees under the SFA and Trust Companies Act are required to comply with MAS' AML Notice.</p> <p>Where the client (in this case custodian and trustee) is a financial institution supervised by MAS, the fund manager is allowed to perform simplified Customer Due Diligence measures and is not required to inquire whether there exists any beneficial owner.</p>
<i>Canada</i>	<p>The requirement in Canada is to document each client account in accordance with the <i>Proceeds of Crime (Money Laundering) and Terrorist Financing Act</i> (Canada). Both the Canadian AML regulatory body (FINTRAC) and the Canadian financial entities regulator (The Office of the Superintendent of Financial Institutions Canada (OSFI)) issued Guidelines mandate specific requirements for ascertaining the existence of legal entities and verifying the identity of persons with authority over an account.</p> <p>Canadian regulatory requirements differ based on the type of service provider and the client type. For example, requirements pertaining to the type of information to be obtained from a client vary depending on the type of service provider such as a financial entity, securities dealer, casino, insurance company etc.</p> <p>Common client identification verification requirements apply to all client types. However, some additional requirements apply to certain specific client types or transaction types as outlined in FINTRAC Guideline 6G. These requirements are specific to personal or institutional trusts ie not custodians.</p> <p>Regulations and Guidelines also provide exemptions for various Canadian regulated entities which eliminate the need to perform some of the KYC due diligence if such an entity is involved in the client relationship.</p> <p>Rules are based on the service provider type and client type. If the client was a trust company providing trustee and custody services, it is treated as a financial entity for KYC purposes. As a financial entity it would need to look at the requirements per client and refer to varying requirements based on whether they are a custodian or trustee.</p> <p>If the client is a trustee, KYC on trust related accounts includes a copy of the trust deed, a record of the settlor's name, address, principal business or occupation, and if the settler is an individual, their date of birth.</p> <p>If the client is a custodian rather than a trust company, then the standard KYC requirements for a company apply, rather than those applicable to a trustee.</p>

<i>Jurisdiction</i>	<i>Summary of approach to custodians</i>
	<p>Institutional custodians in Canada comprise a limited number of Canadian trust companies, governed by the Trust and Loan Companies Act and regulated by OSFI. Canadian AML Guidelines provide a general exception to record keeping requirements to any entity to which one or more proscribed conditions apply. If any one of these conditions are met by the custodian, it is exempt from the requirement to provide certain standard KYC information.</p>
<i>United Kingdom</i>	<p>The ML Regulations apply to:</p> <ul style="list-style-type: none"> • banks, building societies and other credit institutions; • individuals and firms engaged in regulated activities under FSMA; • insurance companies undertaking long-term life business, including the life business of Lloyd's of London; • issuers of electronic money; • money service businesses (bureaux de change, cheque encashment centres and money transmission services); • trust or company service providers, <p>and each of these must, in the course of carrying on business, undertake KYC checks on their clients with whom they have formed a 'business relationship'.</p> <p>Where the client is either a trustee or custodian who is regulated, a simplified due diligence (ie. ensure they are regulated and subject to equivalent laws and regulations) applies.</p>
<i>Hong Kong</i>	<p>In Hong Kong, the Securities and Futures Commission (SFC) has issued the Prevention of Money Laundering and Terrorist Financing Guidance Note, which provides that where an account established in the name of a financial or professional intermediary is an omnibus account in order for that financial or professional intermediary to engage in securities, futures or leveraged foreign exchange transactions on behalf of its customers, a licensed corporation or an associated entity should conduct identification and verification of the omnibus account holder (ie. the financial or professional intermediary) and is not required to 'drill down' through the financial or professional intermediary to identify and verify the underlying customers.</p> <p>Enhanced customer due diligence procedures should be performed, except where (inter alia) the omnibus account is established by a professional intermediary which is subject to a regulatory and supervisory regime that ensures the necessary anti-money laundering and terrorist financing measures have been effectively implemented and monitored in accordance with FATF standards, as the risk of money laundering and terrorist financing activity is considered lower and the application of simplified identification and verification procedures in relation to such accounts is considered appropriate. For this category of entity, it is generally sufficient to verify that the financial or professional intermediary or parent banking institution (in the case of a trust company) is on the list of authorised and supervised institutions in the jurisdiction concerned.</p>