

## 8: Non-life providers of investment fund products

*Note: This sectoral guidance is incomplete on its own. It must be read in conjunction with the main guidance set out in Part I of the Guidance.*

### Overview of the sector

8.1 The guidance contained within this section is directed at firms offering the following types of investment vehicle:

- (a) *Retail investment funds* - authorised unit trusts and open-ended investment companies (oeics).
- (b) *Other investment fund-based products/services* - which may comprise one, or a combination of, regular savings schemes (including those relating to investment trusts), regular withdrawal schemes, ISAs, personal pension schemes and fund supermarkets.

Typical investors using retail funds and associated products/services vary depending upon the product, but include private individuals, regulated firms investing as principal (eg. life companies); other regulated firms (including nominee company subsidiaries) acting on behalf of underlying customers, other corporates, personal and corporate pension schemes, charities and other trusts.

- (c) *Institutional funds* - authorised and unauthorised collective investment schemes and unitised life assurance funds that are dedicated to investment by institutional investors.

Investment in such funds is often restricted to UK investors who are exempt from taxation on capital gains - principally HMRC approved pension schemes and charities.

- 8.2 For most firms, investors will be mainly, but not exclusively, UK resident.
- 8.3 This section does not aim to provide guidance to life assurance companies, other than for the purposes of providing institutional funds as described in paragraph 8.1(c). Nor does it cover the issue or trading of shares in closed-ended investment vehicles (eg. investment trusts). Guidance on other life assurance products can be found in sector 7: *Life assurance and life-related pensions and investment products*. The issue and trading of shares in investment trusts etc. fall within the scope of sector 14: *Corporate finance* and sector 10: *Execution-only stockbroking*, respectively.
- 8.4 Guidance for those involved in managing private equity funds is contained within sector 13: *Private equity*.

***What are the money laundering risks relating to investment fund products?***

Retail funds and products/services

- 8.5 The vast majority of investment fund business is conducted on a non-face-to-face basis (post, telephone, internet) and investors generally have easy access to the funds involved. At face value, therefore, investment fund products may appear attractive for money launderers who may wish to hide behind false or stolen identities and move their funds quickly. In addition, some firms accept payment by debit card, which exposes them to the risk of card fraud.
- 8.6 However, there are also factors that limit the attractiveness of these products for any money laundering process, which therefore mitigate the risks suggested above and elsewhere in this section. In particular, in order to mitigate the money laundering risk, firms invariably take steps to identify any third party subscribers or payees, and some firms refuse to accept or make third party payments. Furthermore, most retail investors use these products for medium and long-term savings, which makes short-term investment or high turnover unusual and often relatively straightforward to monitor.
- 8.7 The typical retail investor might place anything up to £50,000 in investment funds. Larger investments are not uncommon, however, especially for firms whose target market is higher net worth individuals.
- 8.8 Investors are rarely asked to provide additional customer information about the purpose of the relationship, which will be self-evident, or their background. However, their behaviour is better measured against that of other investors than against uncorroborated customer data, which any criminal could provide in support of their expected activity.
- 8.9 Holdings of investment fund units may be transferred freely between different parties. Such transfers will be recorded by the registrar of the fund (usually the product provider or a third party administrator acting on their behalf) who should have a mechanism in place to alert them to unusual transfer activity (see paragraph 8.40).
- 8.10 On balance, therefore, investment funds and products that involve the restrictions referred to in paragraph 8.6 may generally be considered to be low risk in terms of their use for money laundering purposes. Notwithstanding this, the firm's risk-based approach will need to take account of the additional risk that would be associated with higher value (for example, the source of funds should not be used as evidence of identity for transactions of more than £50,000 - see paragraph 8.19(ii)). In any event, if the features of a product or service provide additional flexibility (for example, where some or all of the restrictions referred to in paragraph 8.6 are not applied), the firm should consider the potential increase in the money laundering risk given all the relevant factors and, where appropriate, take additional steps to mitigate that risk (for example, by undertaking further identity verification measures and/or obtaining additional customer information). Firms should also consider whether or not the nature of their distribution channels and the geographic location of their customers might suggest that their products are more likely to be used for the purposes of money laundering.
- 8.11 It is accepted that those who are able to provide convincing evidence of identity and behave in the same way as other investors will be very difficult to detect, in the absence of any other information to cause the firm to have doubts about the customer. Nevertheless, whilst investment fund products may generally be unattractive vehicles for the money laundering process, firms must be alert to the fact that career criminals will

almost certainly invest in their sector using the proceeds of crime, and should consider any unusual activity in that light.

#### Institutional funds

- 8.12 Many institutional funds are open only to tax-exempt investors, such as pension schemes and charities.
- 8.13 As with retail funds, investors are rarely asked to provide additional customer information. However, in many cases the investment will be made on behalf of a client by the firm itself, another group company or another regulated firm, who will have obtained such information in the context of their role as an investment manager.
- 8.14 Overall, many institutional funds may be considered to be of lower risk than their retail counterparts, albeit by virtue of the restricted types of investor, rather than the product features. The risk will increase, however, in the case of "non-exempt" funds or share classes, which may admit other types of UK and non-UK institutional investor that are not subject to HMRC approval for tax exemption purposes.

#### ***Who is the customer for AML purposes?***

- 8.15 The Money Laundering Regulations 2007 introduce a much wider definition of "business relationship", which now includes any business, professional or commercial relationship between the firm and its customer, which is expected to have an element of duration. Essentially, this definition would apply to any open-ended product relationship (e.g., managing an ISA), irrespective of whether it was for the purposes of lump sum or regular investment. Furthermore, a fund manager's obligation to redeem units at the request of the holder at some future time provides the relationship and element of duration necessary for the definition to apply in the case of any registered holder of units, however their holding was acquired.
- 8.16 The handling of third party payments is an important feature of the typical risk profile of the fund management sector. Where the firm accepts payment from a third party at any point, that party should also be regarded as a customer and verified as such.
- Exceptionally, where a donor to a charity makes an investment on behalf of a customer that is a charity, the firm does not need to verify the identity of the donor unless it has classified the charity as a higher risk customer or it has some reason to be suspicious about the payment concerned.
- 8.17 Should a firm wish to meet a request by the investor to pay redemption proceeds to a third party, that party should likewise be regarded as a customer (on whose behalf the registered investor may have been acting), and their identity should be verified before any funds are remitted.
- 8.18 Firms are not required to assume that payment from an unidentified source (e.g., by wire transfer from a UK bank or building society cheque that does not identify the account from which it is made) is being made by a third party unless they are aware of some fact that suggests that this is, or may be, the case.

#### ***Customer Due Diligence***

##### *Identity verification measures*

- 8.19 Standard verification procedures for the type of customer concerned, and any beneficial owner or controller, as described in Part I, Chapter 5, should be followed. Subject to the restrictions that apply generally to their use, various exemptions and concessions are available. Typically, these would include:
- (i) application of simplified due diligence in relation to qualifying customers or products as described in Part I, Chapter 5;
  - (ii) use of the source of funds as evidence of identity - see Part I, paragraphs 5.3.92 to 5.3.96 (firms should limit its use to lowest risk cases, and should not use it where the value exceeds £50,000).
  - (iii) application of the measures described in Part I, paragraphs 5.3.86 and 5.3.87 in relation to the administration of deceased investors and Court of Protection Orders.
- 8.20 In addition, the destination of funds at the time of redemption can be used as evidence of identity in cases where there has not previously been a requirement to verify, for example where the firm had been able to rely on an exemption. In these cases, depending on the firm's assessment of the risk presented by the situation, including the circumstances in which the customer acquired the investment, it may be possible to satisfy the standard identification requirement by means of a payment to an account with a UK or EU regulated credit institution in the sole or joint name of the customer.
- 8.21 Where the firm is required to verify the identity of a customer that is being introduced by an appropriately regulated intermediary (see Part I, paragraph 5.6.18), reliance may be placed on the intermediary, following the guidance in Part I, paragraphs 5.6.19ff.
- 8.22 In the case of beneficial owners or controllers, unless the circumstances of the relationship indicate that more stringent measures should be undertaken (by virtue of the services to be provided or the specific nature of the customer), the identity of beneficial owners and controllers may be confirmed by the customer themselves (see Part I, paragraphs 5.3.11 and 5.3.12).
- 8.23 Knowledge that the customer(s) is/are acting in a trustee capacity and identification of the beneficial owners does not mean that a firm has accepted or recorded notice of trust or otherwise make the firm a constructive trustee.
- 8.24 Various types of small occupational pension scheme may invest in retail funds - in cases where Simplified Due Diligence cannot be applied the verification procedures described in Part I, paragraphs 5.3.216 to 5.3.225 should be followed. Where the customer is a UK-based personal pension scheme (e.g., a SIPP), however, the firm should confirm that any third party trustee or administrator that may deal with the firm has been appointed by the regulated scheme operator. This will allow the firm to apply simplified due diligence to such customers.
- 8.25 As most business within this sector is conducted non-face-to-face, consideration needs to be given to the higher money laundering risk this may present compared with face-to-face business, and in particular whether or not the person with whom the firm is dealing may be impersonating someone else. Given the lower risk of this sector being used for money laundering purposes, the usual measure taken in this respect is to ensure that the confirmation of a transaction or acknowledgement letter is sent by post to the customer's known address and is not returned or queried by the occupant.

*Firms inevitably will have legacy customers whose identity has not been verified due to the circumstances under which they became investors, and the requirements and exemptions etc. that existed at that time. Firms are not expected to undertake specific exercises or projects to verify the identities of those customers retrospectively, but must do so upon future trigger events, as appropriate according to their risk-based approach.*

*Additional customer information*

- 8.26 Additional customer information over and above that confirming identity, which is appropriate in many sectors, either for business purposes or because of the greater money laundering risks that their products and services entail, is of less relevance to this sector. From an AML/CTF perspective, the principal objective in obtaining such information is to understand the motive for establishing the relationship and to permit assessment of any subsequent activity. The motive for investing in funds is usually self-evident.
- 8.27 Very high value transactions from individuals should, however, be treated with caution. High net worth individuals are more likely to use the services of an investment manager, who would need to obtain considerably more customer information in order to service their needs properly - direct investment by such individuals may be an indicator that they are seeking to avoid having to provide that additional information.
- 8.28 Furthermore, firms will need to take a risk-based approach in deciding whether or not to consider a customer's potential status as a politically exposed person (PEP). Firms are required to take risk-based steps to determining PEP status, where the money laundering risk is higher - depending, for example, on the value of the investment and/or the location of the customer.
- 8.29 The nature of retail investment products means that the reasons for using them are limited and investment will reasonably be accepted from virtually anyone wishing to do so. Furthermore, activity monitoring in this area can be equally, if not more, effective by comparing the behaviour of one customer with that of others (see paragraphs 8.38 – 8.41).
- 8.30 Care should also be exercised when dealing with those claiming the reduced verification measures applicable to certain types of special cases (e.g., asylum seekers, those on low incomes), whose first priority would not be expected to be investment of their limited resources for the future.

*Timing of verification*

- 8.31 In this sector, the obligation to verify a customer arises at the point when it is clear that they wish to enter into an arrangement with the firm, either to buy or sell units in a fund or to establish some form of investment scheme or account. In addition, given the revised definition of "business relationship" (see paragraph 8.15) the transfer of units from an existing holder to a third party will also give rise to an obligation to verify the identity of the transferee.
- 8.32 Firms must verify a customer's identity as soon as practicable after first contact with the customer, but are not prevented from entering into the relationship or commencing the initial transaction before the checks are completed. Firms should take all reasonable steps to verify the customer's identity within a reasonable time. Where the firm is unable to verify the identity of the investor within that time it will cease proactive pursuit of evidence of identity and must, at that point, consider if the circumstances give any grounds to suspect money laundering or terrorist financing and act accordingly (see Part I, paragraph 5.2.8).

- 8.33 If, however, after such reasonable time the firm has no grounds to suspect and is satisfied that the risk of money laundering is minimal, subject to its terms of business or the status of a contract to purchase units in its funds directly, it may terminate the relationship and return any monies received to their source. Alternatively, and particularly in purchases of units where the contract has been completed, the firm should freeze any funds or assets pending eventual verification (see Part I, paragraph 5.2.9).
- 8.34 From the point at which the firm concludes it should *freeze* an investment:
- (a) it must not accept further investments (ad hoc or regular savings) from the customer until they provide the evidence of identity required by the firm;
  - (b) subject to (c) below, it must permit the investor to withdraw, redeem or transfer their investment upon production of the evidence of identity required by the firm;
  - (c) it must terminate the relationship and return any funds to the investor should they insist upon withdrawal or redemption while still refusing to produce evidence of identity, subject to considering whether or not it should make a report to SOCA and seek consent;
  - (d) it should otherwise continue to act in accordance with any relevant terms of business and regulatory obligations until such time as the relationship may be terminated (this would include issuing periodic statements, making normal dividend/interest payments and administering the customer's investments according to their instructions where these do not involve the investment or withdrawal of capital); and
  - (e) it must take steps to remind customers (individually or generically, as appropriate according to their risk-based approach) that evidence of identity may still be required, noting the consequences of failure to comply with the firm's request.
- 8.35 A customer may wish to redeem their investment or exercise a right to cancel a purchase transaction before the firm has been able to verify their identity. In such circumstances, the firm should consider whether or not the circumstances might suggest grounds for suspicion of money laundering or terrorist financing and a need to seek consent from SOCA, before returning any funds to the customer (see also paragraph 8.40 below).
- 8.36 Firms should also exercise caution in the event that a holder seeks to transfer units to someone else before the firm has been able to verify their identity. This will either be soon after the units were acquired and while the firm is still attempting to verify the transferor, or where the firm has frozen the investment having been unable to complete satisfactory customer due diligence. In either situation, the firm should consider whether the circumstances are suspicious, such that consent from SOCA should be sought before registering the transfer.
- 8.37 Firms are recommended to include in their terms of business, or otherwise advise the customer at the outset, that they may return or freeze the customer's investments unless or until the necessary evidence of identity can be obtained.

### ***Monitoring***

- 8.38 As mentioned in paragraph 8.29, one of the most effective ways of monitoring the activity of an investor is to compare it with that of the "typical investor". This may vary for different types of customer (e.g., private individual compared to a corporate investor)

and also for different types of fund (e.g., money market fund compared to an equity fund).

- 8.39 Other than in the case of regular savings/withdrawal schemes, the use of investment funds and products is by its nature ad hoc. Even with regular savings and withdrawal schemes, however, there is nothing unusual in ad hoc additional, or top-up, subscriptions. However, whilst there may be various legitimate reasons for redeeming an investment after a relatively short period of time, most retail investment is made for the medium to long-term.
- 8.40 As such, firms in this sector will place some reliance upon the alertness and experience of its staff to spot unusual activity. However, firms may also consider the implementation of basic exception reporting to identify, for example, short-term investment by individuals. Disposals so identified might be reviewed in the context of the original purchase (e.g., is it within the charge-back period for a subscription by debit card?) against market conditions, or in the light of any specific information the firm has about the investor. The exercise of cancellation rights is relatively rare and should be considered in a similar way.
- 8.41 Transfers involving either a regulated firm (or a nominee company subsidiary) or arising from the distribution of assets from a trust or the estate of a deceased, give less cause for concern over a subsequent transfer of the holding by the recipient. However, the purchase of units by one individual and transfer to another, and then to a third, and so on, is unusual and may indicate that money or other consideration is changing hands in the background with the aim of avoiding verification of the identity of those in the middle of the chain. Firms should be alert to such activity and take appropriate steps to investigate the nature and purpose of any unusual patterns that emerge.