

9: Discretionary and advisory investment management

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

- 9.1 *Investment management* includes both discretionary and advisory management of segregated portfolios of assets (securities, derivatives, cash, property etc.) for the firm's customers. Where investment management is provided as part of a broader "wealth management" service, readers should refer instead to sector 5: *Wealth Management*.
- 9.2 Discretionary managers are given powers to decide upon stock selection and to undertake transactions within the portfolio as necessary, according to an investment mandate agreed between the firm and the customer.
- 9.3 Advisory relationships differ, in that, having determined the appropriate stock selection, the manager has no power to deal without the customer's authority - in some cases the customer will execute their own transactions in light of the manager's advice. This should not be confused with "financial advice", which involves advising customers on their investment needs (typically for long-term savings and pension provision) and selecting the appropriate products. Financial advice is dealt with in sector 6: *Financial advisers*.
- 9.4 The activities referred to above may be carried out for private or institutional investors. Note that guidance on the operation of investment funds, including those that are solely for institutional investors, is given in sector 8: *Non-life providers of investment fund products*.

What are the money laundering risks relating to investment management?

- 9.5 In terms of money laundering risk, there is little difference between discretionary and advisory investment management. In both cases, the firm may itself physically handle incoming or outgoing funds, or it may be done entirely by the client's custodian.
- 9.6 In either case, the typical firm deals with low volumes of high value customers, for which there is likely to be a take-on process that involves a level of understanding of the customer's circumstances, needs and priorities and anticipated inflows and outflows of funds, in order to determine suitable investment parameters.
- 9.7 There is likely to be ongoing contact, often face-to-face, with the customer in order to review market developments and performance, and review the customer's circumstances, etc. Unexpected inflows/outflows of funds are not common occurrences - ad hoc requirements and movements are usually the subject of discussion between the firm and the customer.
- 9.8 In most cases, all money and other assets within the portfolio are held under the control of a UK-regulated custodian, with money paid to or from the customer through their UK bank or building society account. Investment management is not a mechanism for the movement of assets from one person to another, although some third party payments may be made (eg. in the case of private customers, for the payment of school fees).

- 9.9 The risk of money laundering to the investment management sector, in the context of the "typical" circumstances described above, would be low. Clearly, however, the risk will increase when dealing with certain types of customer, such as offshore trusts/companies, PEPs and customers from higher risk non-FATF jurisdictions, and may also be affected by other service features that a firm offers to its customers. Note: Firms that provide investment management alongside banking facilities and other complex services should refer to Sector 5: *Wealth Management*.

Who is the customer for AML purposes?

- 9.10 The typical investors to whom investment managers provide services are high net worth individuals, trusts, companies, government bodies and other investing institutions such as pension schemes, charities and open/closed-ended pooled investment vehicles. In such cases, the firm's customer will be the individual or entity concerned. The firm must also consider whether there are any beneficial owners or controllers.
- 9.11 Firms may also be contracted to provide investment management services to other appropriately regulated UK and overseas firms in respect of their own investments (e.g., life companies) or assets they are managing for others - in either instance the investment manager's client will be the other regulated firm, in which case there will be no requirement to consider any underlying beneficial ownership or control.

Customer due diligence

Verification of identity

- 9.12 As noted above, investment management in itself as a service would be considered as low risk. Therefore, in the absence of any features regarding the customer or service provided that are adjudged to increase that risk, standard identity verification measures, as set out in Part I, paragraphs 5.3.68 to 5.3.278, may be applied. Where the relationship is intermediated through a regulated adviser (e.g., financial adviser or consulting actuary), confirmation of the customer's identity by the regulated intermediary, similar to that provided at Part I, Annex 5-II, may take place.

Private individuals

- 9.13 The standard verification requirements for private individuals would be adequate to establish their identity, as described in Part I, paragraphs 5.3.68 – 5.3.114. The source of funds may also be used as evidence of identity (see Part I, paragraphs 5.3.92 – 5.3.96), subject to the restrictions that apply generally to its use. However, the firm must also adopt enhanced measures, as necessary, in respect of higher-risk categories of customer (e.g., PEPs) and jurisdiction.

Customers other than private individuals

- 9.14 When dealing with other types of customer, firms would normally be able to rely on the standard verification measures, including simplified due diligence for qualifying customers, as described in Part I, paragraphs 5.3.115 – 5.3.278.
- 9.15 For overseas pension schemes and charities, additional verification steps may be required, depending upon the risk associated with the type of customer and their location (e.g., in a higher risk jurisdiction).

- 9.16 For most charities, the firm will be able to regard those that may benefit from the charity as a class of beneficiary. As such, they do not need to be identified and verified individually. The members of occupational pensions schemes that do not qualify for simplified due diligence may be treated similarly.
- 9.17 In instances where the identities of beneficial owners or controllers must be verified individually, this may be done in accordance with Part I, paragraphs 5.3.8 - 5.3.13. 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 itself (see Part I, paragraphs 5.3.11 and 5.3.12).

Mandates relating to third party investment vehicles

- 9.18 Some investment managers provide services to third party investment vehicles (e.g., hedge funds), which may be open or closed ended. Those firms must consider whether or not there is a need for them to look at the underlying investors in such vehicles. This will depend up on the status of the vehicle and how it is operated in terms of dealing in its units/shares:
- Where such dealings are handled by an appropriately regulated entity (e.g., fund manager or transfer agent) or are traded on a regulated market or exchange, the investment manager does not need to be concerned with the underlying investors.
 - If a vehicle operates under less stringent conditions than those described above, the firm may take a risk-based approach and ensure that it is satisfied, on an ongoing basis, with the checks that are carried out by whoever controls entry to the vehicle's register of holders, and the information that will be available to the firm if required. Otherwise the firm will need to undertake its own customer due diligence, as necessary.
- 9.19 In any event, the firm must carry out appropriate due diligence on third party investment vehicles to establish and verify their form, status, purpose, and the identity of any persons who are in positions of control.
- 9.20 In most cases, the investors in such funds would be regarded as a class of beneficiary and so would not need to be verified individually. However, where the vehicle is being operated for "private" use by a specific group of individuals, verification of their identities as beneficial owners/controllers should be undertaken in accordance with the guidance given in Part I, paragraphs 5.3.8 - 5.3.13.
- 9.21 Investment management firms which provide services to unregulated vehicles such as hedge funds will find it helpful also to refer to sector 20: *Brokerage services to funds*.

Custody and third party payments/transfers

- 9.22 Where, money or investments are to be received from or transferred to someone other than a person that has been verified as a customer or beneficial owner, the reasons behind the payment/transfer and the capacity of the third party will need to be understood, and consideration given to the extent to which their identity may need to be verified. Whether this is the responsibility of the firm itself or a separate custodian will depend up on how custody is provided and the firm's role with regard to the payment or transfer. The different likely scenarios are discussed in the following paragraphs.

Note that this issue concerns additions to and withdrawals from the customer's portfolio, as opposed to the settlement of transactions undertaken by the firm in the course of managing the portfolio.

- 9.23 Where the customer enters into an agreement directly with a custodian other than the firm, it is the custodian that should be concerned about third party payments and transfers. The firm should consider the issue itself, however, where it is involved in the transmission of funds or otherwise passes instructions to the custodian regarding a receipt or withdrawal of funds/investments.
- 9.24 The firm may provide custody notionally as part of its service to the customer, but outsource the safe-keeping function to a sub-custodian. In these circumstances, the firm will usually instruct the sub-custodian regarding receipts or withdrawals from the portfolio and should therefore take appropriate steps to verify the identity of any third party that may be involved. The firm should also ensure that the issue is addressed, either by itself or by the sub-custodian, where the customer is able to instruct the sub-custodian directly.
- 9.25 The firm may perform the custody function in-house, in which case it must take appropriate steps itself to verify the identity any third parties that may be involved.
- 9.26 In any event, where the firm is asked to receive, make or arrange payment to/from someone other than a person it has verified as a customer or beneficial owner, it should seek to understand the reasons behind the payment and the capacity of the third party and consider the extent to which the identity of that third party may need to be verified.

Timing

- 9.27 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. 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).
- 9.28 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 it may terminate the relationship and return any monies received to their source. Alternatively, the firm may freeze any funds or assets pending eventual verification (see Part I, paragraph 5.2.9).
- 9.29 From the point at which the firm concludes it should *freeze* an investment:
- (a) it must not accept further investments 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 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 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 and managing the customer's portfolio where this does 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.

9.30 Firms are recommended to include in their terms of business that they may return or freeze the customer's investments unless or until the necessary evidence of identity can be obtained.

Additional customer information

9.31 The client take-on process for investment management customers usually involves gaining an understanding of the customer and their needs, and establishing at the outset the likely inflows and outflows of funds are likely. Developments in this area and updates to customer information should be sought periodically from the customer or his adviser.

9.32 The customer information, obtained for the purposes of agreeing the firm's mandate and the ongoing management of the client's portfolio, will usually comprise the additional information necessary to understand the nature and purpose of the relationship in a money laundering context, against which the customer's future activity should be considered.

Monitoring

9.33 Customer activity relates only to inflows and outflows of money that do not relate to the firm's own dealings in the portfolio of investments. Most movements into or out of the portfolio will usually be expected (e.g., pension scheme contributions or funding of pensions benefits). The firm should establish the rationale behind any unexpected ad hoc payments made or requested by the customer.

Real estate transactions

9.34 Some portfolios (usually in relation to property fund vehicles or very large segregated mandates) include direct holdings in real estate. Unlike securities, the counterparties involved in the purchase and sale of direct holdings in real estate may not be other regulated financial institutions. However, such transactions are generally conducted through solicitors, and the counterparty's solicitor will be obliged to verify its client's identity.

9.35 Furthermore, the counterparty would not normally be regarded as a customer of the investment firm and consequently the firm would not be obliged to verify the identity of the counterparty itself. However, in order to mitigate any reputational risk, firms may wish to seek appropriate assurances from their own solicitors that the identity of the counterparty will have been verified.