18: Wholesale markets

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.

This sectoral guidance considers specific issues over and above the more general guidance set out in Part 1, Chapters 4, 5, and 7, which firms operating in the wholesale markets may want to take into account when considering applying a risk-based approach. Firms may also find the guidance for the following sectors useful:

- Sector 8: *Non-life providers of investment fund products*, which deals with exchange-traded products where the firm acts as agent for private customers, (e.g. where a fund provider that is not an exchange member buys securities for its private customers).
- Sector 9: *Discretionary and advisory investment management*, which covers how investment managers may interact with wholesale markets.
- Sector 10: *Execution-only stockbrokers*, which will be more relevant for firms dealing in wholesale market products as agent or principal for retail customers.
- Sector 14: *Corporate finance*, which deals with the issuance of traded products or instruments, which are traded in a 'secondary' wholesale market, allowing investors in the primary market to realise their investment.
- Sector 19: *Name Passing Brokers,* which is directed at those firms who deal with wholesale market brokers in the inter-professional markets.
- Sector 20: *Servicing higher risk funds*, which is intended for firms who are involved in multipartite relationships in respect of, and/or provide services, including the execution and clearing of transaction in wholesale market products to, unregulated funds.

Overview of the sector

18.1 The wholesale markets comprise exchanges and dealing arrangements that facilitate the trading (buying and selling) of wholesale investment products, and hedging instruments ("traded products"), including, but not limited to:

- Securities: equities, fixed income, warrants and investment funds (Exchange Traded Funds – ETFs);
- Money market instruments: FX, interest rate products, term deposits;
- Financial derivatives: options, futures, swaps and warrants;
- Commodities: physical commodities and commodity derivatives, including exotic derivatives (e.g., weather derivatives);
- Structured products (e.g., equity linked notes); and
- Syndicated loans traded on the secondary market

18.2 Traded products confer 'rights' or 'obligations'; either between an investor and the issuer, or between parties engaged in the trading of the instruments. Traded product instruments can be bought, sold, borrowed or lent; as such, they facilitate the transfer of property or assets and usually represent an intrinsic value, which may be attractive to money launderers. Traded products can be bought or sold either on an exchange ("exchange traded products"), or between parties 'over-the-counter' (OTC).

18.3 Some traded products or instruments, such as equities, are issued in a 'primary' market, and are traded in a 'secondary' market, allowing investors in the primary market to realise their

investment. Other traded products are created to enable investors to manage assets and liabilities, exchange risks and exposure to particular assets, commodities or securities.

Exchange-traded products

18.4 Exchange-traded products are financial products that are traded on exchanges, which have standardised terms (e.g. amounts, delivery dates and terms) and settlement procedures and transparent pricing. Firms may deal in exchange-traded products as principal or as agent for their customers. In the financial and commodity derivatives markets, firms will typically deal as principal, and on certain exchanges (e.g. Euronext.LIFFE, ICE Futures, LME) must do so when dealing as a clearing member in relation to their customers' transactions. In the securities markets, firms can deal as either principal (for their own account) or as agent for the firms' underlying customers.

18.5 The London Stock Exchange recognises different types of relationships between a settlement agent and its customers, which it denotes as Model A and Model B (see paragraphs 18.72ff). Similar relationships may be recognised on other exchanges and different terminology used to denote these relationships.

18.6 Most exchanges have a central counterparty (CCP) which stands between the exchange members that are buying and selling a product (becoming the buyer to the seller and the seller to the buyer). Where an exchange or trading platform does not have a CCP, the members contract with each other.

OTC products

18.7 OTC products are bilateral agreements between two parties, or multilateral, depending on the settlement process, that are not traded or executed on an exchange. The terms of the agreement are tailored to meet the needs of the parties, i.e., there are not necessarily standardised terms, contract sizes or delivery dates. Where firms deal OTC, they usually deal as principal. Some OTC dealing is facilitated by brokers and while settlement is normally effected directly between the parties, it is becoming increasingly common for exchanges and clearers to provide clearing facilities i.e., the trades are executed as OTC but are then given up for clearing by a CCP.

What are the money laundering risks in the wholesale markets sector?

18.8 Traded products are usually traded on regulated markets, or between regulated parties, or with regulated parties involved acting as agent or principal.

18.9 However: the characteristics of products, which facilitate the rapid and sometimes opaque transfer of ownership; the ability to change the nature of an asset and market mechanisms that potentially extend the audit trail; together with, a diverse international customer base, have specific money laundering risks that need to be addressed and managed appropriately.

18.10 One of the most significant risks associated with the wholesale markets and traded products, is where a transaction involves payment in cash and/or third party payments.

18.11 Given the global flows of funds in the wholesale financial markets, it is important to recognise that although customers may remit funds from credit institutions, a firm could still be used to launder money. Traded products might, for example, be used as a means of changing assets rapidly into different form, possibly using multiple brokers to disguise total wealth and ultimate origin of the funds or assets, or as savings and investment vehicles for money launderers and other criminals.

18.12 Firms dealing in traded products in the wholesale markets do not generally accept cash deposits or provide personal accounts that facilitate money transmission and/or third party funding that is not related to specific underlying investment transactions. In the money markets, however, customers may request payments to third parties (e.g., FX payments to suppliers) and the associated AML risks need to be considered by the firm (see paragraph 18.16ff). There may also be third party funding of the transactions in the commodities markets. Also, where a bank is lending funds to a customer to purchase a physical commodity and the customer hedges the risks associated with the transaction in the derivatives market through a broker, the bank may guarantee the payment of margin to that broker; this results in a flow of money between the broker and bank on the customer's behalf. However, both the party making the payment on behalf of the customer, and the party receiving the funds, will be regulated financial institutions.

18.13 The extent to which certain products are subject to margin or option premium payment arrangements will affect the level of risk. The nature and form of any margin will need to be taken into account by the firm, through their risk-based approach, when identifying the customer and determining appropriate payment procedures.

18.14 OTC and exchange-based trading can also present very different money laundering risk profiles. Exchanges that are regulated in equivalent jurisdictions, are transparent and have a central counterparty to clear trades, can largely be seen as carrying a lower generic money laundering risk. OTC business may, generally, be less well regulated and it is not possible to make the same generalisations concerning the money laundering risk as with exchange-traded products. For example, trades that are executed as OTC but then are centrally cleared, have a different risk profile to trades that are executed and settled OTC. Hence, when dealing in the OTC markets firms will need to take a more considered risk-based approach and undertake more detailed risk-based assessment.

18.15 For example, exchanges often impose specific requirements on position transfers, which have the effect of reducing the level of money laundering risk. These procedures will not apply in the OTC markets, where firms will need to consider the approach they would adopt in relation to any such requests in respect of customers dealing OTC.

How to assess the elements of risk in the wholesale markets sector

Generic risk elements

18.16 The main factors to consider when assessing the risk when undertaking business in the wholesale markets are: the nature of the customer (including their source of funds), the market participants, the products involved; and, whether the products are exchange traded or OTC.

18.17 When implementing a risk-based approach, and producing or reviewing risk assessments or the risk profile of a prospective customer, there are a number of areas which firms might want to take into account in addition to the more general matters set out in Part I, Chapters 4 and 5. The wholesale markets are populated by customers with a wide range of different business interests.

- The types of participants present might typically include, but not be limited to:

    - Sovereign governments;
    - Local authorities (municipal bodies);

- Regulated financial firms (e.g.,. banks, brokers, investment managers and funds);
- Unregulated financial entities (e.g., off-shore funds);
- Corporations (e.g.,. listed companies, private companies);
- Trust and partnerships.

➢ A customer's nature, status, and the degree of independent oversight it is subject to, will affect the firm's assessment of risk for a particular customer or the firm's business as a whole.

➢ The instruments traded in the wholesale markets can allow for long-term investment, speculative trading, hedging and physical delivery of certain financial instruments and commodities. Understanding the role of a prospective customer in the market, and his reasons for trading, will help inform decisions on the risk profile they present.

➢ The way that a firm addresses the jurisdictional risk posed by a customer will depend on many factors. The jurisdictional risk may, however, be mitigated by the rationale for the customer being located or operating in a particular jurisdiction. Customers located in potentially higher-risk jurisdictions may have legitimate commercial interests, which can mitigate the perceived risk. For example, an oil producer in a higher-risk territory may seek to use derivative instruments to hedge price risks and this does not necessarily present a high money laundering risk. For discussion of other factors firms may need to take into account, such as corruption risk, see paragraph 18.20.

➢ Firms should ensure that any factors mitigating the jurisdictional or other risks of a customer are adequately documented and periodically reviewed in the light of international findings or developments.

18.18 When dealing on an exchange or trading platform, a firm needs to identify its counterparty and any associated risks:

➢ Where there is a CCP, a firm must assess the risks associated with the exchange e.g., what value can be placed on the exchange's admission procedure, does the exchange carry out due diligence on potential members, are private individuals members?

➢ If there is no CCP, a firm will need to perform due diligence on the party with whom they deal - even if their name is not known until after the trade - before the trade is settled.

➢ As a result of trading on an exchange or trading platform, a firm may execute a trade with a member who does not have an account with the firm. A firm should consider obtaining, from the exchange or trading platform, a list of members and either identify and verify them upfront (to avoid possible delays in settlement) or on case by case basis. In some cases platforms operators provide credit management functionality which has the effect of restricting execution of trades to certain counterparties only.

Specific risk elements

18.19 Paragraphs 18.31ff below discuss specific risks associated with particular sub-sectors within the wholesale markets.

Other risk factors to consider

18.20 While assessing AML risks, firms will also wish to assess other factors such as reputational risk, bribery and corruption risks. New customers and payments on behalf of clients to third parties also need to be screened for sanctions purposes and newly sanctioned entities run against existing clients.

18.21 Firms may also wish to carry out due diligence in respect of any introducing brokers who introduce new customers or other intermediaries and consider whether there are any red flags in relation to corruption risks.

Who is the customer for AML purposes?

18.22 It is very important to distinguish the relationship that exists between the various parties associated with a transaction. In particular, the firm should be clear whether it is acting as agent or principal on behalf of the customer and whether the firm has a responsibility to verify the identity of any underlying customers involved in transactions.

18.23 Where the firm's customer qualifies for the treatment of simplified due diligence (see Part I, section 5.4), no customer due diligence is required. This would be true even where the firm is aware that its customer is acting on behalf of an underlying customer who would not itself qualify for simplified due diligence; no question of reliance under Regulation 17 will arise.

18.24 Therefore, from an AML/CTF perspective, as a rule of thumb (although see Part I, Chapter 5, section 5.3.4):

- If the firm is acting as principal with another exchange member, the exchange member is the firm's customer.

- As discussed in paragraph 18.18 above, where an exchange-based trade is randomly and automatically matched with an equal and opposite exchange-based trade, it is recognised that, due to market mechanisms, the name of the other exchange member(s) may not be known. In these situations, where all the parties are members of the exchange and there is a CCP to match and settle the trades, the firm cannot know and therefore does not need to verify the identity of the other exchange member. Firms should, however, include the money laundering risk involved in the participation in any exchange or centralised clearing, as part of their overall risk-based approach. Participation in any exchange or centralised clearing system does not remove the need to adequately verify its own customer if the firm is dealing as agent for a customer.

- Where a firm is acting as principal with a non-exchange member, the non-exchange member is the firm's customer.

- Where a firm is acting as agent for another party, the party for whom the firm is acting will be the firm's customer (but see Part I, Chapter 5, section 5.3.4).

- Where the firm is acting for another party who is an intermediary for underlying third parties, the intermediary will be the customer of the firm provided simplified due diligence can be applied. See Part I, Chapter 5, section 5.6.37 ff, which considers whether/when underlying third parties will also be customers of the firm.

18.25 An introducing broker may "introduce", or a Receiver and Transmitter of orders may pass orders from, his customers to a firm to execute trades and, possibly, to perform related requirements in connection with the customers' trades and bookkeeping and record keeping functions. A fee is paid by the firm to the introducing broker, usually based on the transactions undertaken. A customer often has no say in which firm the introducing broker

selects to execute a particular trade. As such, the customer being introduced is a customer of both the introducing broker and the firm.

General clearing and non-clearing members of exchanges

18.26 A non-clearing member may maintain one or several accounts with a clearing member. Where a non-clearing member deals as agent for a customer, this may be through an omnibus account with the clearing member on behalf of all the non-clearing member's underlying customers who often have no say in the non-clearing member's selection of a clearing member.

18.27 Where a non-clearing member deals on a proprietary basis as principal, it will generally operate a separate account for such business. In that case the non-clearing member will be the customer of the clearing member.

18.28 The clearing member may, based upon his risk-based approach and/or the status of the non-clearing member, consider that the non-clearing member's underlying customer or customers are also his customers. For further guidance refer to Part I, sections 5.3 and 5.4.

Other considerations

18.29 In certain markets there are other types of relationship associated with a transaction that are not covered under an agent or principal relationship, and these should be subject to other considerations by a firm when considering what is appropriate customer due diligence.

18.30 In some cases, other parties, who are not customers under the AML Regulations, may be linked to a transaction. A firm may, however, still wish to assess them as part of its own commercial due diligence and to guard against reputation and bribery and corruption risks (e.g., introducing brokers in higher risk jurisdictions).

Wholesale market sector specific risks and issues

18.31 The following sections look at particular risks and issues associated with other sub-sectors within the wholesale markets.

A. Foreign exchange

18.32 To the extent that firms dealing in foreign exchange (FX) in the wholesale market tend to be regulated financial institutions and large corporates, the money laundering risk may be viewed as generally lower. However, this risk may be increased by the nature of the customer, or where, for example

- high risk clients (including PEPs) undertake speculative trading; and/or
- requests are made for payments to be made to third parties: for example, customers, particularly corporates, that need to make FX payments to suppliers and overseas affiliates.

18.33 When assessing the money laundering risk in such circumstances, a firm may want to take into account the nature of the customer's business and the frequency and type of third party payments that are likely to result from such business.

18.34 FX (as well as many other traded products) is commonly traded on electronic trading systems. Such systems may be set up by brokers or independent providers. When a firm executes a

transaction on these systems the counterparty's identity is not usually known until the transaction is executed. The counterparty could be any one of the members who have signed up to the system. Firms should examine the admission policy of the platform before signing up to the system, to ensure that the platform only admits regulated financial institutions as members, or that the rules of the electronic trading system mean that all members are subject to satisfactory AML checks and identify its counterparty and any associated risks (see paragraph 18.18).

B. Exchange traded derivatives

(a) Financial derivatives

18.35 Financial products are utilised for a wide range of reasons, and market participants can be located anywhere within the world; firms will need to consider these issues when developing an appropriate risk-based approach. The nature, volume and frequency of trading, and whether these make sense in the context of the customer's and firm's corporate and financial status, will be key relevant factors that a firm will need to consider when developing an appropriate risk-based approach.

18.36 The risks between exchange-traded derivatives and OTC derivative products in the financial derivative markets are the same as those set out in paragraphs 18.8 – 18.15.

(b) Commodities

18.37 Where a customer deals purely in physical commodities for commercial purposes, the activity is not captured by the ML Regulations (although the sanctions regime still applies to such business). Regulated firms that, in addition to physical commodity activity, undertake any business with a customer which amounts to a regulated activity, including business associated with physical commodities will, however, be subject to the ML Regulations, including due diligence requirements with regard to that customer.

18.38 Where business does not fall within the scope of the AML Regulations, e.g., shipping and chartering, it is entirely a matter for firms to decide what commercial due diligence they perform on their counterparties. Firms are reminded, however, that sanctions regimes will apply to such business.

18.39 When implementing a risk-based approach and producing or reviewing risk assessments or the risk profile of a prospective customer, there are a number of areas which commodity market firms might want to take into account in addition to the more general matters set out in Part I, Chapters 4 and 5. These will include, but not be limited to:

- ➢ The wide range of different business interests which populate the commodity markets. The types of participants may typically include:
    - Producers (e.g., oil producers and mining firms);
    - Users (e.g., refiners and smelters);
    - Wholesalers (e.g., utility firms);
    - Commercial merchants, traders and agents;
    - Financial firms (e.g., banks and funds).
- ➢ These types of firm are illustrative and widely drawn and firms can be present in more than one category (for example, a refiner will be both a user of crude oil and a producer of oil products).

- The instruments traded in the wholesale commodity markets can allow for the speculative trading, hedging and physical delivery of commodities.

18.40 The risks should be taken in the round, with one risk possibly mitigating another. The global nature of the commodity markets means that firms from potentially higher risk jurisdictions with a perceived higher money laundering risk are likely to have legitimate commercial interests. Understanding the role of a prospective customer in the market, and their reasons for trading, will help inform decisions on the risk profile they present.

(c) 'Give-up business'

18.41 Customers wishing to execute transactions on certain regulated markets may do so through a "give-up agreement" whereby the customer elects to execute transactions through one or more executing brokers and to clear the transaction through a separate clearing broker. Once the transaction is executed, the executing broker will then "give-up" that transaction to the clearing broker for it to be cleared through the relevant exchange or clearing house.

18.42 Both the executing broker and the clearing broker have a relationship with the customer (e.g. both may be agents), for whom they perform separate functions.

18.43 It is usually (but not always) the customer that elects to execute transactions through one or more brokers and to clear such transactions through another broker and, to that end, selects both the clearing broker and executing broker(s).

18.44 Where a firm acts as executing broker, the party placing the order is the customer for AML/CTF purposes. Where the party placing the order is acting as agent for underlying customers, they, too, may be customers for AML/CTF purposes (see paragraphs 18.32 – 18.34). It is important to note that when acting as an executing broker, a firm executes customer orders only and does not receive or hold their funds. Transactions are settled by the customers' clearing broker, who also pays brokerage commission to the executing broker.

18.45 Where a firm acts as clearing broker, the customer on whose behalf the transaction is cleared is the customer for AML/CTF purposes. A clearing broker typically has a more extensive relationship with the customer as a result of holding their funds.

18.46 A customer may choose to use one or more executing brokers because:

- the customer may prefer, for reasons of functionality or cost, the executing broker's front-end electronic order routing;
- certain brokers develop a reputation for being able to execute transactions very efficiently in certain contracts, while the clearing broker provides superior post-trade clearing and settlement services;
- the customer may feel more comfortable with the credit risk of the clearing broker;
- the executing broker may provide access to certain value-added services linked to the execution of the customer's transactions; or
- the customer does not wish to disclose its trading strategy to other market participants; or for other reasons relevant to the customer's business.

18.47 In all give-up arrangements the customer, the executing broker, and the clearing broker are participants. Although this type of tri-partite arrangement is most common, give-up arrangements can extend to cover many types of relationships, and may extend through a number of parties with differing roles and responsibilities including advising, managing,

clearing or executing, for or on behalf of the underlying customer, before the trade reaches the ultimate clearing broker.

18.48 A common additional participant in a give-up arrangement is the customer's investment adviser or manager, who in the give-up agreement is usually referred to as a trader, to whom the customer has granted discretionary trading authority, including the authority to enter into give-up arrangements on the customer's behalf.

18.49 Typically, an adviser or manager acting for a client may only wish to disclosure a reference code, rather than their client's name, to the executing broker, particularly where the adviser or manager has multiple underlying accounts over which they exercise discretionary authority; hence, the clearing broker is likely to be the only party that knows the underlying customer's identity. Where a give-up agreement includes such an arrangement, firms should ensure that their risk-based approach addresses the risks posed, which may include the risk associated with the investment manager as appropriate, the type of fund and possibly the underlying investors. Hence, where a firm is acting as executing broker and there is an adviser or manager acting for an underlying customer, the customer due diligence performed, and whether there is an obligation to identify the underlying customer, will depend upon the regulatory status and location of the adviser or manager. For further guidance, see Part I, section 5.3.

18.50 Where simplified due diligence cannot be applied to the adviser or manager and there is an obligation to verify the identity of the adviser or manager and their underlying customers, the firm should take a risk-based approach (see Part I, Chapter 5, section 5.3), which may include consideration of whether it is appropriate, subject to satisfying the ML Regulations, to take into account any verification evidence obtained by, a clearing broker in the UK, EU or an equivalent jurisdiction or the involvement of the clearing broker in the transaction.

18.51 To avoid unnecessary duplication, where an executing broker and a clearing broker are undertaking elements of the same exchange transaction on behalf of the same customer (which is not itself a regulated firm from an equivalent jurisdiction), subject to a give-up arrangement, the executing broker may, where as part of its risk-based assessment it feels it is appropriate to do so:

- place reliance on the clearing broker, provided the clearing broker is regulated in the UK, another EU Member State or an equivalent jurisdiction and the requirements for third party reliance in the ML Regulations are satisfied. Guidance on reliance on third parties and on the factors to consider, as part of a firm's risk-based approach, when seeking to rely on another firm to apply the CDD measures (but not monitoring or sanction checking) is given in Part I, Chapter 5, paragraphs 5.6.4ff.; **or**

- take account of the fact, in its risk-based approach to customer identification and verification (see Part I, Chapter 5, paragraph 5.3.28), that there is another regulated firm from the UK/EU or an equivalent jurisdiction acting as the customer's clearing broker in respect of the transaction, which will handle all flows of funds. This may reduce the identity information or evidence requested from the client and what the firm verifies.

18.52 It is important to recognise that even if a clearing broker can, in principle, be relied upon under the ML Regulations, there are a number of exceptions that relate to the type of CDD carried out by the clearing broker in respect of the customer (see Part I, Chapter 5, paragraph 5.6.16ff). Firms also need to satisfy themselves (and evidence) that the clearing broker has given consent to be relied upon (see Part I, Chapter 5, paragraph 5.6.8ff).

18.53 In addition, as firms cannot delegate their responsibility to satisfy their legal obligations in respect of sanctions and the FSA's requirements to have in place effective systems and

controls to prevent the firm being used for financial crime, executing brokers wishing to place reliance should take steps to satisfy themselves re the clearing broker's procedures for screening clients against relevant sanctions lists.

18.54 Thus, firms considering placing reliance on clearing brokers to identify give-up customers should also ensure that they can satisfy other legal and regulatory requirements such as sanction list screening, which cannot be delegated. Whether a firm wishes to place reliance on the clearing broker will be part of its risk-based assessment but as firms cannot delegate their responsibilities for CDD, the assessment should include due diligence in respect of the clearing broker (Part I, Chapter 5, paragraph 5.6.13).

18.55 Given the risks and issues outlined above, most firms now take the relationship with the clearing broker into account in their own CDD on customers, rather than place reliance on the clearing broker.

18.56 Where an executing broker also provides other services to its 'give-up' customers, it should, check - where it has placed reliance on a clearing broker or has assessed a give-up relationship to be lower risk - that it can 'ring fence' the accounts of give-up customers (or has over controls in place), such that their relationships with the firm cannot be extended (e.g. dealing in different product types, receiving collateral) without triggering additional CDD requirements. Firms that are not able to ring-fence services provided to such customers should carry out CDD to the highest standard.

18.57 Finally, given the information asymmetries likely to exist between an executing broker and clearing broker, when a firm is acting as clearing broker, it would not be appropriate, from a risk-based perspective, to rely on an executing broker, even if this would be permitted under the ML Regulations. Clearing firms should undertake the CDD measures as set out in Part I, Chapter 5.

C. Structured products

18.58 Structured products are financial instruments specifically constructed to suit the needs of a particular customer or a group of customers. They are generally more complex than securities and are traded predominantly OTC, although some structured notes are also listed on exchanges (usually the Luxembourg or Irish Stock Exchanges).

18.59 There is a wide range of users of structured products. Typically they will include:

- Corporates,
- Private banks,
- Government agencies,
- Financial institutions

18.60 Transactions are normally undertaken on a principal basis between the provider (normally a financial institution) and the customer. Some structured products are also sold through banks and third party distributors (introducers). In the latter circumstances, it is important to clarify where the customer relationships and responsibilities lie (e.g. are the third parties introducing clients to the firm or distributing products on behalf the name of the firm) and to set out each party's responsibilities in relation to AML. Where a firm wishes to contract out its customer identification and verification obligation to a distributor, it should establish whose procedures are to be used (e.g., those of the firm's or the distributor), satisfy the reliance requirements and establish monitoring procedures.

18.61 Because of the sometimes complex nature of the products, they may generally be more difficult to value than cash securities. The lack of transparency may make it easier for money launderers, for example, to disguise the true value of their investments.

18.62 The complexity of the structure can also obscure the actual cash flows in the transaction, enabling customers to carry out circular transactions. Understanding the reason behind a customer's request for a particular product will help to determine the money laundering risk inherent in the structures.

18.63 The cash movements associated with structured products may present an increased money laundering risk, although this risk may be mitigated by the nature and status of the customer and the depth of the relationship the customer has with the firm. For example, if the use of structured products is part of a wider business relationship, and is compatible with other activity between the firm and the customer, the risk may be reduced.

18.64 In one scenario, an introducer (who may also be described as an "arranger" or "retrocession agent") may approach a firm to request, on behalf of an undisclosed client, a quote for a structured product with a particular set of features (e.g., reference assets/indices, capital guarantee, maximum upside, etc). If this quote is acceptable, the introducer will then recommend the structured product to his/her client. The introducer's client will typically contact their custodian bank to instruct the bank to purchase the structured product from the firm. The custodian bank will purchase, on an execution-only basis, the structured product as principal, settling directly with the firm. The firm then pays the introducer a fee, which is non-standardised and negotiated on a transaction by transaction basis. Alternatively, the firm may approach the introducer with a structured product that the introducer's clients may be interested in (although transaction flows remain the same as above).

18.65 In some cases, the introducer may act with a power of attorney from their client and thus have authority to purchase the structured product on behalf of the client. The firm should ascertain whether the introducer is acting under a power of attorney or not. Settlement of the transaction will be effected, by the firm, with the custodian bank of the undisclosed client, as outlined above.

18.66 Depending on local legislation, an introducer may or may not be required to be regulated in the country of his domicile or the countries of his/her main operation, which may be different. In Switzerland, for example, introducers who act exclusively in an advisory capacity do not need to be regulated but where the client gives an introducer power of attorney to transact on his behalf with the custodian bank, the introducer has to be regulated for AML purposes, but not conduct of business purposes, with one of the local Self Regulatory Organisations..

18.67 In each of the scenarios outlined in 18.64 and 18.65, the introducer should be subject to CDD; as part of which, a firm should check that the introducer satisfies the authorisation requirements (if any) of the introducer's country of domicile and main countries of operation. The firm should also consider obtaining details of the career in the financial services industry of each of the main employees or principals of the introducer.

18.68 In addition, if the custodian bank cannot be subject to simplified due diligence, the firm will also have to look through to the custodian's underlying clients (the beneficial owners). Firms may also wish to refer to the '*Retailed Structured Products: Principles for managing the provider-distributor relationship'* guidance, that was published in July 2007 by the European Securitisation Forum (ESF), International Capital Market Association (ICMA), International Swaps and Derivatives Association (ISDA), London Investment Banking Association (LIBA) and Securities Industry and Financial Markets Association (SIFMA). A copy of this guidance is available from the website of any of the above organisations. Firms may also wish to refer to this guidance to assist them in understanding the types of underlying clients that are linked

to an individual introducer, together with the particular type of products and tenor of the products that the underlying clients are interested in. Such information may assist firms to understand the expected type and level of business that an introducer may bring to a firm.

18.69 Firms should also be mindful of the issues in respect of payments to third parties raised by the FSA enforcement action, in January 2009, against Aon Limited. For example, the FSA expects that payments to third parties, such as introducers, should be subject to due diligence before they are made and payments and the relationship in general reviewed and monitored regularly. Factors firms should consider as part of their due diligence include whether the payments are reasonable for the benefit provided, whether the funds are being remitted, electronically, to a bank account in the introducer's name, in the country in which the introducer is domiciled/operates.

18.70 Firms should consider, if an introducer requests that his fee be paid to a bank account held in the name of an apparently unrelated third party or to an account at a bank in a country with no obvious connection to his country of domicile or his countries of main operation, whether such requests give rise to suspicions of bribery, corruption or tax evasion. Firms may wish to consider introducing a policy of paying fees only to a bank account in the name of the introducer that is held at a bank in the country of the introducer's domicile or a country of main operation. Firms may also wish to confirm that there is full disclosure of any fees on relevant documentation for each transaction.

18.71 Firms should also be alert to the risk that an introducer who is an individual may be carrying on their own personal business whilst still employed by, and managing the affairs of clients of, another firm such as a bank, asset manager or wealth manager. The introducer may be acting in his/her own name or via a corporate which he/she controls. If, as a result of its CDD, a firm has suspicions that an introducer may be currently employed by a financial institution, the firm should contact the financial institution concerned to ascertain whether the individual is employed by them and, if so, that they are content with the proposed relationship between the firm and their employee. Similar suspicions may also arise where all of an introducers clients use the same custodian bank.

D. Securities

18.72 There are fundamentally two types of arrangements that can exist in relation to the outsourcing of clearing and settlement processes in the securities markets. These are generally known as "Model A" and "Model B" clearing relationships. The specific characteristics of these relationships are outlined below.

"Model A" Clearing

18.73 Model A clearing usually involves the outsourcing of the settlement processing of transactions executed by a firm to a service provider. All transactions are executed and settled in the name of the executing firm, who retains full responsibility, including financial liability, for the transaction in relation to both the underlying customer and the market counterparty. The underlying customer remains solely a customer of the executing firm, which retains AML/CTF responsibility, and does not enter into a relationship with the settlement services provider.

18.74 The settlement services provider maintains a relationship solely with the executing firm, and acts as an agent on behalf of the executing firm. As such, the settlement services provider has no obligation to undertake the identification and verification requirements set out in Part I, Chapter 5, other than in relation to its customer, the firm.

“Model B” Clearing

18.75 In the securities markets, the executing broker/clearing firm arrangements are commonly referred to as “Model B” clearing arrangements.

18.76 The executing broker will usually open an account (or sub-accounts) with the clearing firm, in the name of his underlying customer, and will fulfil all verification and due diligence requirements on the underlying customer. A tri-partite relationship between the underlying customer, the executing broker and the clearing firm (the ‘tripartite relationship’) is created, by virtue of the fact that the executing broker has entered into a Model B clearing relationship with the clearing firm on his own behalf, and, acting as the agent of the customer.

18.77 Usually, the customer does not establish a relationship direct with the clearing firm, but rather will enter into the tri-partite relationship via the executing broker, which has a Model B clearing relationship with the clearing firm. There is little or no contact between the underlying customer and the clearing firm. The customer is generally unable to terminate his relationship with the executing broker whilst retaining a relationship with the clearing firm in isolation.

18.78 Should the executing broker terminate its relationship with the clearing firm, the underlying customer will move with the executing broker. If the clearing firm has provided custody services as part of the services being supplied to the executing broker, consent to transfer the assets is required, with any residual transfer of assets for non-responding customers usually being subject to a rule waiver from the FSA upon fulfilment of certain conditions.

18.79 Whilst, under a Model B relationship, the transaction is 'given up' to the clearing firm for settlement with the market, if the underlying customer fails to deliver funds or assets to fulfil settlement, the clearing broker may look to the executing broker to offset any outstanding liabilities through a secondary deposit or other funds held by the clearing firm on behalf of the executing broker. In turn, the executing broker would have to pursue the underlying customer for fulfilment of settlement/debt recovery.

18.80 Because the relationship with the underlying customer is always focused through the executing broker, the executing broker remains an integral part of the relationship and transaction process at all times. This is by virtue of the tri-partite relationship, rather than separate relationships between the executing broker and the underlying customer, and the underlying customer and the clearing firm. Therefore, the CDD measures set out in Part I, Chapter 5, are generally undertaken by the executing broker while the clearing firm may, if it considers it appropriate to do so under its risk-based approach, rely upon the executing broker provide that broker is a ‘third party’ as defined in the ML Regulations (see Part I, Chapter 5, paragraph 5.6.4ff).

E. Delivery versus payment (DVP)

18.81 Customers wishing to transact Securities on a DVP basis may do so through an executing broker that will generally settle with the customer’s settlement agent/custodian. Under this arrangement, the customer elects to execute transactions through an executing broker and to clear the transaction through a separate settlement agent/custodian. The orders can either be placed directly by the customer or by an agent on behalf of the customer. Once the transaction is executed, the executing broker will settle with the settlement agent/custodian simultaneously once payment is received.

18.81 Both the executing broker and the settlement agent/custodian will have a relationship with the customer.

18.82 It is usually (but not always) the customer that elects to execute transactions through one or more brokers and to clear such transactions through a settlement agent/custodian and, to that end, selects both parties.

18.83 Where a firm acts as executing broker, the party placing the order is the customer for AML/CTF purposes. Where the party placing the order is acting as agent for underlying customers, they, too, may be customers for AML/CTF purposes (see paragraphs 18.32 – 18.34).

18.84 Where a firm acts as settlement agent/custodian, the customer on whose behalf the transaction is executed is the customer for AML/CTF purposes.

18.85 A common additional participant in a DVP arrangement is the customer's investment adviser or manager, to whom the customer has granted discretionary trading authority. Where a firm is acting as executing broker and there is an adviser or manager acting for an underlying customer, the customer due diligence performed, and whether there is an obligation to identify the underlying customer, will depend upon the regulatory status and location of the adviser or manager. For further guidance, see Part I, section 5.3.

18.8 Where the underlying customer is to be considered the client by the executing broker, a risk based approach to CDD can be taken into account on the basis of the Investment Manager and/or the Settlement Agent's equivalent regulatory status, pursuant with Part I, paragraph 5.6.4.This may reduce the identity information or evidence requested from the client and what the firm verifies. Firms should take the relationship with the IM and settlement agent/custodian into account in their own CDD on customers, rather than place full reliance on the settlement agent/custodian.

18.87 Where simplified due diligence cannot be applied to the adviser or manager there is an obligation to verify the identity of the adviser or manager and their underlying customers, the firm should undertake CDD on both parties (Part I, paragraph 5.3.1).

18.88 Finally, given the information asymmetries likely to exist between an executing broker and settlement agent/Custodian, when a firm is acting as settlement agent/Custodian, it would not be appropriate, from a risk-based perspective, to rely on an executing broker, even if this would be permitted under the ML Regulations. Settlement agents/custodians should undertake the CDD measures as set out in Part I, Chapter 5.

F. Syndicated loans

18.89 Guidance on syndicated loans is set out in Part II, sector 17: *Syndicated lending*.

Customer due diligence

18.90 Product risk alone should not be the determining factor in a firm assessing whether an enhanced level of due diligence is appropriate, therefore there are no enhanced due diligence requirements specific to the wholesale markets sector, over and above those set out in Part I, section 5.5, which take into account other risk factors such as client type and jurisdictional risk.

Monitoring

18.91 Guidance on general monitoring requirements is set out in Part I, section 5.7.

18.92 Monitoring in wholesale firms will be affected by the fact that firms may only have access to a part of the overall picture of their customer's trading activities. The fact that many customers spread their activities over a number of financial firms will mean that many firms will have a limited view of a customer's trading activities and it may be difficult to assess the commercial rationale of certain transactions. Extreme market conditions may also impact on a customer's trading strategy. There are, however, specific characteristics of the wholesale market sector which will impact a firm involved in the wholesale markets monitoring activity. These include:

- *Scale of activity*

  The wholesale markets involve very high volumes of transactions being executed by large numbers of customers. The monitoring activity undertaken should therefore be adequate to handle the volumes undertaken by the firm.

- *Use of multiple brokers*

  Customers may choose to split execution and clearing services between different firms and many customers may use more than one execution broker on the same market. The customer's reasons for this include ensuring that they obtain best execution, competitive rates, or to gain access to a particular specialism within one firm. This will restrict a firm's ability to monitor a customer, as they may not be aware of all activity or even contingent activity associated with the transactions they are undertaking.

- *Electronic execution*

  There is an increasing use of electronic order routing where customers access markets directly and there is little or no personal contact between the firm and the customer in the day to day execution of the customer's business. This means that the rationale for particular transactions may not be known by the firm.

18.93 The nature and extent of any monitoring activity will therefore need to be determined by a firm based on an assessment of their particular business profile. This will be different for each firm and may include an assessment of the following matters:

- extent of execution vs clearing business undertaken;
- nature of customer base (geographic location, regulated or unregulated);
- number of customers and volume of transactions;
- types of products traded and complexity of those products;
- payment processes (including payments to third parties, if permitted).

18.94 Firms should ensure that any relevant factors taken into account in determining their monitoring activities, that the programme is adequately documented and subject to periodic review. Given the bespoke nature of some wholesale market products and the difficulties in developing meaningful rules for electronic monitoring (e.g., a lack of typologies for the sector), it may well be appropriate for a firm to monitor manually. Firms should, however, be able to demonstrate the rationale for their monitoring strategy.

18.95 Firms relying on third parties under the ML Regulations to apply CDD measures **cannot** rely on the third party in respect of monitoring.