

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 act without the customer's authority on a deal-by-deal basis - 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 handle incoming or outgoing funds, or it may be done entirely by the customer's custodian.
- 9.6 In either case, the typical firm deals with low volumes of high value customers, for which there must 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 Firms should maintain ongoing contact 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 regulated custodian, with money paid to or from the customer through their bank or building society account. Investment management itself is not a mechanism for the movement of assets from one person to another, although in-specie transfers to another regulated investment manager may occur. Some third party payments may be made subject to a firm's risk-based approach.
- 9.9 The risk of money laundering within the investment management sector, in the context of the

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"typical" circumstances described above, would be low. Clearly, however, and dependent upon a firm's risk-based approach, the risk will increase when dealing with certain types of customers, such as:

- offshore trusts/companies,
- higher-risk PEPs, and
- customers from high-risk countries.

Note: Firms that provide investment management alongside banking facilities and other complex services should refer to Sector 5: *Wealth Management*.

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Risk Based Approach

9.10 As outlined in Part I Chapter 4, all firms must develop a risk-based approach to mitigating the risk of their products and services being used for the purposes of money laundering or terrorist financing. Firms start from the premise that most customers are not money launderers or terrorist financiers. However, firms should have systems in place to identify and highlight those customers who, on criteria established by the firm, may indicate that they present a higher risk.

9.11 Firms should assess the risk of the products they provide, the services they offer and the relationships that they have with their customers. Where a low degree of risk is determined then Simplified Due Diligence (SDD) may be applied. Where a high risk is identified then Enhanced Due Diligence (EDD) measures must be applied; in other circumstances, standard Customer Due Diligence (CDD) will apply.

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Product/Service Characteristics

Risk Factor	Inherent Risk	Industry Standard	Risk Mitigation	Residual Risk
Changes to strategy or agreements.	Medium	Generally, any changes to discretionary or advisory investment management will be fully discussed between the firm and the client	Amendments to agreements are approved by those persons authorized to give authority.	Low
Third party payers/subscribers which could disguise the source or destination of laundered funds.	Medium	¶As a rule, third-party payments are only accepted in limited specific scenarios (determined by firms in line with their risk appetite) or where made to/from another regulated entity.	Monitoring¶ seeks to identify exceptions which will be reviewed and, where necessary, CDD will be performed on the third party.	Low

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Client Characteristics

Risk Factor	Inherent risk	Industry Standard	Risk Mitigation	Residual Risk
Complex corporate ownership structures, which can make it easier to conceal underlying beneficiaries	High	Clients are largely the subject of some form of regulation or are occupational pension funds and large charities. <u>Understand the ownership and control structure of companies, trusts etc., in line with Regulation. EDD undertaken for high-risk relationships.</u>	CDD / EDD is performed on the client and any beneficial owners, where required.	Low
Customers represented by a third party	Medium	These tend to be regulated custodians or administrators.	Evidence of official appointment obtained	Low

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Involvement of an individual in a prominent public position (PEP/RCA)	High	Regulations require EDD for PEP/RCA relationships.	Regular screening of public source information (e.g. World- check, Dow Jones). Enhanced CDD performed	High
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Transactions

Risk Factor	Inherent Risk	Industry Standard	Risk Mitigation	Residual Risk
Transaction activity is high in value	Medium	This is generally the norm with discretionary and advisory investment management. This can differ depending on the client profile.	Transaction inflows and outflows will be discussed with and notified to the appointed client manager in advance. In most cases, all money and other assets within the portfolio are held under the control of a regulated custodian, with money paid to or from the customer through their bank or building society account.	Low
Transaction activity is high in volume	Medium	This can differ depending on the client profile.	Monitoring seeks to identify any unusual trading patterns.	Low

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Delivery Channels

Risk Factor	Inherent Risk	Industry Standard	Risk Mitigation	Residual Risk
Ability to transact face-to-face	Low	Clients will have an appointed client manager.	Contact between the client manager and the client will usually be on a regular basis.	Low

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Geography

Much of the risk assessment mentioned above will be dependent upon the jurisdiction in which the client is domiciled. Firms will take note of their own internal country risk assessment which will be driven by assessments and information provided by government, regulators and other relevant authorities. Where the risk dictates, increased measures will be taken to mitigate the ML/TF risk.

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Defining the customer for AML purposes

- 9.12 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.
- 9.13 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 customer will be the other regulated firm, in which case the firm should determine the need to consider any underlying beneficial ownership or control on a risk based approach.

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Customer due diligence

Identity verification measures

- 9.14 As noted above, investment management, in itself as a service, would generally be considered as low risk, although certain investment types (e.g. real estate, infrastructure, corporate debt etc.) may represent a higher risk. In the absence of any features regarding the customer or service provided that are considered to increase the risk, standard identity verification measures, as set out in Part I, paragraphs 5.3.69 to 5.3.293, may be applied. Where the relationship is intermediated through a regulated adviser (e.g. financial adviser or

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consulting actuary), confirmation of the customer's identity by the regulated intermediary, similar to that provided at Part I, paragraphs 5.6.4 - 5.6.23 and Annex 5- I, may take place.

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Private individuals

9.15 The identification and verification requirements for private individuals would be adequate to establish their identity, as described in Part I, paragraphs 5.3.69 - 5.3.125. However, the firm must also adopt enhanced measures, as necessary, in respect of higher-risk categories of customer (e.g. PEPs) and those based in high risk third countries.

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Customers other than private individuals

9.16 When dealing with other types of customers, firms would normally be able to rely on the identification and verification measures, including simplified due diligence for qualifying customers, as described in Part I, paragraphs 5.3.126 - 5.3.293.

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9.17 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).

9.18 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 may be treated similarly, as described in Part I, paragraph 5.3.236.

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9.19 In the case of beneficial owners or controllers, unless the relationship is higher risk (by virtue of the products/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 5.3.8 to 5.3.16).

Mandates relating to third party investment vehicles

9.20 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 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 follow a risk-based approach and take action to ensure that it is satisfied, on an ongoing basis, with the quality of checks that are carried out by whomever controls entry to the vehicle's register of holders, and that the information that will be available to the firm if required, is of the required standard. Otherwise the firm will need to undertake its own risk-based customer due diligence, as necessary.

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9.21 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.

9.22 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 (e.g. personal investment vehicles or family office arrangements), verification of their identities as beneficial owners/controllers

should be undertaken in accordance with the guidance given in Part I, paragraphs 5.3.8 - 5.3.16.

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9.23 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

9.24 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, that third party should also be regarded as if it was a customer (on whose behalf the registered investor may have been acting), and their identity should be verified on a risk-based approach before any payments are made/accepted. The reasons behind the payment/transfer and the capacity of the third party will also need to be understood. Whether this is the responsibility of the firm itself, or a separate custodian, will depend 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.

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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.

9.25 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.

9.26 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.

9.27 The firm may perform the custody function in-house, in which case it must take appropriate steps to verify the identity of any third parties that may be involved.

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9.28 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

9.29 Firms must verify a customer's identity as soon as practicable after first contact with the customer. While most institutional customers will be identified before funding their account, they are not prevented from entering into the relationship if not. 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 a reasonable time it 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 5.2.7 - 5.2.8).

9.30 If, however, after such reasonable time, and where 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, if the firm is suspicious, it must request a DAML (consent) from the NCA (see Part I paragraph 6.45-6.59).

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9.31 From the point at which the firm ceases proactive pursuit of evidence of identity (either without suspicions or by requesting a DAML (consent) from the NCA to terminate), it must block / restrict an investment, and:

(a) it must not accept further investments from the customer until they provide the evidence of identity required by the firm;

(b) unless waiting for consent, it must permit the investor to withdraw their investment upon production of the evidence of identity required by the firm;

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(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.

9.32 From the point at which a firm submits a SAR, until it receives such DAML (consent in either explicit form or following expiry of the relevant 7-day period), it must:

- adhere to bullet points (a)-(d) above; and
- desist from continuing to apply CDD measures in relation to that customer.

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

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Additional customer information

9.34 The client take-on process for investment management customers usually involves gaining an understanding of the customer, including their source of wealth and income, in line with a firm's risk-based approach, and their needs, and establishing at the outset the likely inflows and outflows of funds that are likely. Changes in this area and updates to customer information should be sought periodically or upon identified triggers from the customer or their adviser.

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9.35 The customer information, obtained for the purposes of agreeing the firm's mandate and the ongoing management of the customer'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

9.36 Customer activity relates only to receipts of new money or monetary withdrawals, and does 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 pension benefits). The firm should establish the rationale behind any unexpected ad hoc

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payments made or requested by the customer. In doing so, firms will rely upon the alertness and experience of its staff to spot unusual activity.

9.37 Firms may also consider the implementation of basic exception reporting to identify unusual activity in line with its risk-based approach.

9.38 As per paragraph 9.11 above, examples of other monitoring that firms may choose to undertake in line with its risk-based approach, includes monitoring for:

- Third party payments, and
- Account level transaction activity that is high in volume.

Non-liquid transactions

9.39 Some portfolios will include direct holdings in real assets¹. Unlike securities, the counterparties involved in the purchase and sale of direct holdings may not be other regulated financial institutions. Those purchases and sales will often involve special purpose vehicles, and in some cases will be owned via trusts and a wide variety of structures in a wide variety of jurisdictions which by their nature may increase the risk of coming into contact with the proceeds of crime.

Some portfolios will make direct investments in construction and development projects. The nature of these projects, and especially the risks of fraud, bribery and corruption and tax evasion may also increase the likelihood of coming into contact with the proceeds of crime.

9.40 The counterparty(s) 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(s) itself. Nevertheless, and as part of their risk-based approach, the investment firm may take account of the risk profile of the transaction and of the counterparty(s) involved. This may include ascertaining the counterparty's legal form (taking into account the jurisdiction in which the counterparty(s) is based and whether or not it is a regulated financial institution within another equivalently regulated jurisdiction, checking for adverse information, PEPs and sanctions-related screening.

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¹Note: Real assets is an investment asset class that covers investments in physical assets such as real estate, energy, and infrastructure.