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 16: *Correspondent Relationships*, which deals with business relationships between firms.
- Sector 17: *Syndicated lending*, which primarily deals with the syndication of loans and trading on the secondary market.
- Sector 19: *Name Passing Brokers,* which is directed at those firms who deal with wholesale market brokers in the inter-professional markets.
- Sector 20: *Brokerage Services to 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.

A. 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); and
- Structured products (e.g. equity linked notes).

18.2 This guidance provides general guidance on assessing risks in wholesale markets, due diligence and monitoring. It then provides additional guidance on each of the product types referred to above. Reference should be made to both the general and the relevant product-specific guidance in this section, as well as to the general guidance in Part I.

18.3 Traded products confer ‘rights’ or ‘obligations’; either between an investor and the issuer, or between parties engaged in the trading of the instruments. Traded products 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").

18.4 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.

Role of the parties

18.5 The following are persons typically involved in wholesale market activities:

- **Instructing Counterparty:** The customer on whose behalf the transaction or trade is being conducted**;**
- **Agent:** An agent in the context of the wholesale markets is an entity which provides related financial services for or on behalf of a customer;
- **Executing Broker:** An executing broker is the broker or dealer that finalises and processes an order to transact/trade on behalf of a customer;
- **Clearing Broker:** A clearing broker settles transactions/trades on behalf of the customer and as such will handle the movement of funds or assets for the customer in settlement of respective transactions and liabilities;
- **Central Counterparty (CCP):** A CCP is an organisation that exists to help facilitate trading activities on certain markets by providing efficiency and stability as a financial intermediary to a transaction/trade;
- **Custodian:** A custodian is a financial institution that holds a customer’s securities for safekeeping and protection; and
- **Investment Manager or Adviser:** Funds are managed by an investment manager, which is a separate legal entity from the fund, and which is given authority to act as agent and manage the funds and investments held by the fund vehicle. It is often the investment manager that will make investment decisions and place transactions with a firm as agent of the fund. The investment manager may delegate certain activities to a separate Investment Adviser.

Exchange-traded products

18.6 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 or as agent for the firms’ underlying customers.

18.7 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. Similar relationships may be recognised on other exchanges and different terminology used to denote these relationships.

18.8 Most exchanges have a 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

18.9 OTC products are bilateral agreements between two parties (or may be multilateral agreements, 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).

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

18.10 Traded products are usually traded on regulated markets or other trading venues (e.g. an MTF or OTF[1]), or between regulated parties, or with regulated parties involved acting as agent or principal.

18.11 However, the characteristics of traded products, which facilitate the rapid and sometimes opaque transfer of ownership, and the ability to change the nature of an asset and market mechanisms that potentially complicate the audit trail, together with a diverse international customer base, present specific money laundering risks that need to be addressed and managed appropriately. *[Note: the "National risk assessment of money laundering and terrorist financing (as periodically updated)" has been taken into account when updating this chapter and this guidance is considered to accord with the provisions of that document.]*

18.12 Given wholesale markets' global flows of funds, speed of transactions and potential ease of converting holdings to cash, they are capable of being used for money laundering, but it is important to recognise that these markets may be abused by criminals at different stages of the money laundering process and that the risks of money laundering in the wholesale markets may vary, depending upon the products and services a firm offers to a customer. It is important for a firm to understand at which stage(s) risks may arise (and this may vary from firm to firm):

- Placement: It is unlikely that physical currency or bearer instruments could be placed into the wholesale financial markets, as the primary acceptance of such assets is not a service offered by firms carrying out business in the UK within this sector. However, market abuse is a key predicate offence within capital markets; the settlement of such trades would represent placement activity.
- Layering: The wholesale financial markets grant the means to execute and clear a chain of transactions which may be complex, involving a multitude of financial instruments and/or financial institutions. This environment may potentially be abused by a criminal to layer funds and/or asset ownership with an aim of obfuscating the illicit origin of such funds/assets. Methods such as 'mirror trading', 'wash trading' or 'offsetting transactions' have been identified by the FCA as having been utilised in a manner highly suggestive of financial crime[2]. A firm should also consider whether it facilitates the electronic transfer of funds into the wholesale market sector from an outside source, particularly from a third party or jurisdiction considered to present a higher risk for money laundering.
- Integration: Some financial instruments transacted on the wholesale markets can be rapidly liquidated to cash or reinvested into other holdings. A firm may then facilitate the further integration of these funds through the purchase or transfer of other existing assets. Whilst these activities are generally legal and legitimate, firms should consider the associated and varied money laundering risks when a customer instructs the transfer of value (by payment or change of asset ownership) to an overseas jurisdiction, particularly where a third party is involved.

---

[1] Multilateral trading facilities and organised trading facilities | FCA

[2] https://www.fca.org.uk/publication/final-notices/deutsche-bank-2017.pdf

- Post-integration (use of criminal proceeds): It can be very difficult to identify proceeds of crime once they have been integrated and mixed with legitimate funds in wholesale market products. Once proceeds of crime have been integrated in this way, it is likely that only the firm whose customer is the end party (and which would therefore have carried out customer due diligence ("CDD") on that party) would be in a position to potentially identify such proceeds, by identifying any irregularity/inconsistency between the value of the transaction and its customer's source of wealth or funds (although such inconsistencies may, even then, be difficult to identify). Where the end party already has significant legitimate wealth, the use by that party of the proceeds of crime for investment purposes (rather than further layering of funds) will, again, be difficult to identify, even by the firm which has conducted CDD on that party as its customer.

18.13 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. Third party payments may, however, be used in relation to particular products, such as FX and/or commodities. Firms should consider whether third party payments are possible and whether the ability to make such payments presents additional money laundering risks, and should have regard to the product-specific guidance in this chapter where relevant.

18.14 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 its risk-based approach, when identifying the customer and determining appropriate payment procedures.

18.15 OTC and exchange-based trading can also present very different money laundering risk profiles. Exchanges that are regulated in assessed lower risk jurisdictions, are transparent and have a CCP to clear trades, can ordinarily be seen as carrying a lower generic money laundering risk. OTC business will, generally, be less transparent, and it is not possible to make the same generalisations concerning the money laundering risk as with exchange-traded products. 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. Trades that are executed as OTC but then are centrally cleared may 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.

18.16 Firms should also consider the FCA's Thematic Reviews on the money-laundering risks and vulnerabilities in the capital markets.

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

18.17 The main factors to consider when assessing the risk when undertaking business in the wholesale markets are: the nature of the customer; the market participants; the products involved; and whether the products are exchange traded or OTC.

18.18 When implementing a risk-based approach, producing or reviewing risk assessments, or assessing the risk profile of a prospective customer, there are a number of areas which firms may 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 are not 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); or
  - Trust and partnerships.

- ➢ A customer's nature, status, and the degree of independent oversight to which it is subject may affect the firm's assessment of risk for the particular customer or for 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 the customer's reasons for trading, will help inform decisions on the risk profile the customer presents.
- ➢ The way that a firm addresses the jurisdictional risk posed by a customer will depend on a number of factors. Jurisdictional risk should be considered but may, in relevant cases, 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, and presence in a higher risk jurisdiction does not necessarily render a customer high risk for AML/CTF purposes. 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.
- ➢ 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, and due diligence gathered as part of ongoing monitoring.
- ➢ Firms should take a holistic view of the risk associated with a given situation and note that the presence of isolated risk factors does not necessarily move a relationship into a higher or lower risk category.
- ➢ For discussion of other risk areas firms may need to take into account, such as corruption risk, see paragraph 18.21.

18.19 When dealing on an exchange or trading platform, a firm needs to identify its counterparty (section D below describes who should be subject to CDD) and consider any associated risks:

I. Where there is a CCP, a firm must assess the risks associated with the exchange. For example, what value can be placed on the exchange's admission procedure, does the exchange carry out due diligence on potential members, can private individuals be members? Based on this assessment a firm may gain assurance over the exchanges' policies, systems and controls, or otherwise.

II. If there is no CCP, a firm will need to perform due diligence on the party with whom it deals - even if their name is not known until after the trade - before the trade is settled, which may present operational challenges due to T+2/T+1. 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. Where there is no CCP, 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 a case by-case basis. In some cases, platform operators provide credit management functionality which has the effect of restricting execution of trades to certain counterparties only.

18.20 Product risk should also be considered. Transactions which give rise to cash movements (such as those 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 a particular product is part of a wider business relationship and is compatible with other activity between the firm and the customer, the risk may be reduced.

18.21 While assessing ML/TF risks, firms will also wish to assess other factors such as reputational risk, sanctions risks and bribery and corruption risks. For example:

- New customers and payments on behalf of clients to third parties will typically need to be screened for sanctions purposes, and new additions to sanctions lists checked against existing clients, in line with the firm's approach to sanctions compliance.
- Firms should assess whether they have a due diligence requirement 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.

D. Customer due diligence, including simplified and enhanced due diligence

Who is the customer?

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

18.23 Where the firm's customer qualifies for simplified due diligence (see Part I, section 5.4), or is otherwise assessed as posing a lower risk, a lesser extent of CDD may be appropriate (as described by Chapter 5).

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

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

ii. As discussed in paragraph 18.19(I) 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 identify 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, including consideration of regulatory equivalence. 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.

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

iv. Where a firm executes a trade OTC with a customer, which is then centrally cleared, and settled by the CCP, the firm has visibility of the customer and may need to verify the identity of the customer with whom they contract. By contrast, the CCP would not be a customer of the firm, and as such the firm would not be required to conduct due diligence on the CCP from an AML/CTF perspective. In certain situations, the firm may open customer accounts at the request of a CCP, in which case due diligence obligations would arise. However, this would only occur in a default management scenario, and such arrangements would be documented in a separate customer agreement with the CCP.

v. Where a firm is acting as agent for another party, the party for whom the firm is acting will be the firm's customer.

18.25 Where the firm is transacting with a counterparty trading as agent for its own underlying customers, the counterparty will be the customer of the firm. Where the firm is performing services on behalf of an investment manager, the investment manager is the firm's customer. An investment manager may itself be acting on behalf of an underlying entity, such as a fund

(or other legal entity), to whom it may provide advisory or discretionary investment management services. Whether CDD is performed on the underlying entity will depend on the firm's business relationship with both entities and the nature and status of the investment manager. As stated in Part I, Chapter 5, paragraph 5.6.38, where a firm takes instruction from an underlying entity, or where the firm acts on the underlying entity's behalf (e.g., the firm is contracting with and holding assets for safekeeping on behalf of the fund as a custodian), the firm then has an obligation to carry out CDD measures in respect of that entity. This is irrespective of the form of that underlying legal entity, which may be a fund, individual or corporate entity.

18.26 Accordingly, when determining whether CDD should be performed on the underlying entity, firms may wish to undertake a risk assessment that includes consideration of whether:

(i) the investment manager or the underlying entity is the instructing party (e.g. does the investment adviser/manager have discretionary trading authority and full control to instruct transactions on behalf of the underlying entity);

(ii) the investment manager (or delegated Investment Adviser/Fund Administrator where present) is incorporated in a jurisdiction assessed, by the firm, as lower risk;

(iii) the investment manager (or delegated Investment Adviser/Fund Administrator where present) is subject to and supervised for compliance with satisfactory anti-money laundering requirements, for example because it is subject to national legislation implementing the EU Fourth Money Laundering Directive; and/or

(iv) the product or service is assessed, by the firm, as lower risk (see 18.20 above).

18.27 If a firm is specifically providing brokerage services to funds, Part II, Sector 20.22- 20.29 should be referred to in order to determine whether a correspondent securities relationship exists, and the level of risk-based due diligence to apply.

18.28 In other circumstances where the firm determines that CDD should be performed on the underlying entity, the firm may consider reliance subject to provisions of Regulation 39 of the ML Regulations (see Part I, Chapter 5, section 5.6.4 – 5.6.23), with regards to CDD on the underlying entity.

18.29 Where a firm is receiving services from a counter-party broker, the firm is the customer of the counter-party broker and it is not required to conduct CDD on that broker (although it may decide, on a risk-based approach, that some form of due diligence is appropriate).

Authorised Personnel acting on behalf of the Customer

18.30 Regulated financial institutions employ a multitude of internal personnel who are authorised to sign contractual documents (e.g. ISDAs) or place trading orders to execute transactions (as principal or agent) within domestic and international wholesale markets. These are internal employees and act on the financial institution's behalf as part of their day-to-day professional activities. Within the UK and other regulated financial centres, such individuals are generally subject to additional regulatory obligations concerning market conduct, fitness and propriety, for example, the FCA implements a formal Certification Regime[3] alongside a Conduct Rules Regime[4].

18.31 On this basis, when undertaking CDD on regulated financial institutions within the wholesale markets, the identities of internal personnel who are authorised to sign contractual documents may be collected by a firm for AML/CTF purposes on a risk-based approach. Any further verification measures for those individuals should be undertaken based on an assessment of the risks posed by the correspondent financial institution, contextualised by the nature of the relationship. There is generally no requirement to identify and verify internally authorised

[3] https://www.fca.org.uk/firms/senior-managers-certification-regime
[4] https://www.fca.org.usk/firms/senior-managers-and-certification-regime/conduct-rules

market-facing traders or day-to-day operations staff of regulated financial institutions from an AML/CTF perspective.

Other multi-partite relationships

18.32 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. Although an introducing broker may not be considered the firm's customer, a firm may wish to consider whether it should carry out due diligence, in particular in light of the "corporate offences" contained in the Bribery Act 2010[5] and/or the Criminal Finances Act 2017[6], as the introducing broker may be considered an "associated person".

18.33 A non-clearing member of an exchange 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.

- 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.
- 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.

18.34 Customers wishing to execute and clear transactions on regulated markets may do so using separate executing and clearing brokers. To complete such a trade, the executing broker will execute the order and then ‘give-up’ that transaction to the clearing broker for it to be cleared through the relevant exchange or clearing house.

18.35 This arrangement may commonly take the form of a tri-partite agreement between the customer, the executing broker and the clearing broker. However, give-up arrangements can extend to cover a number of different types of relationships.

18.36 As set out in paragraph 18.64 of this chapter, where a firm acts as executing broker, the party placing the order is the customer for AML/CTF purposes.

18.37 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 they may also act as custodian.

18.38 Where an executing broker and a clearing broker are involved in a ‘give up’ arrangement, the executing broker may, as part of its risk-based assessment, consider it appropriate to place reliance on the clearing broker (subject to the guidance and requirements within Part I, Chapter 5, paragraphs 5.6.4ff).

18.39 In some cases, other parties, who are not customers under the ML 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, sanctions and bribery and corruption risks (e.g. introducing brokers, particularly in higher risk jurisdictions, for the reasons described above).

---

[5] http://www.legislation.gov.uk/ukpga/2010/23/contents
[6] http://www.legislation.gov.uk/ukpga/2017/22/contents

Distributors

18.40 Firms who use third party distributors to distribute, sell and/or market particular products will generally have a customer relationship with the distributor, rather than the underlying entity (who is the customer of the distributor).

18.41 Firms should carry out CDD on the distributor in accordance with the provisions of Part I and will wish to consider seeking information and/or assurances about the distributor's own AML procedures (and the procedures the distributor has in place to mitigate other financial crime risks). The firm can also seek contractual protections in the distribution agreement.

Introducers of structured products contracting via custodians

18.42 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).

18.43 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.

18.44 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.

18.45 In each of the scenarios outlined above, the introducer should be subject to CDD. As part of that CDD, 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.

In addition, if the custodian bank cannot be subject to simplified due diligence or is not otherwise regarded as posing a lower risk, the firm will also have to look through to the custodian's underlying customers (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) and the Association for Financial Markets in Europe (AFME). 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 entities that are linked to an individual introducer, together with the particular type of products and tenor of the products that the underlying entities 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.

18.46 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.

18.47 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 introducer's clients use the same custodian bank.

Expected activity

18.48 A firm will, as part of CDD, assess, and where appropriate obtain information on, the purpose and intended nature of the business relationship and/or transaction. This information will assist firms when assessing whether the proposed relationship is in line with expectations and will support ongoing monitoring. The key consideration is being able to identify whether the client's activity (for example: transaction size and frequency) is in line with the firm's knowledge of the client. The firm will, in many cases, be able to infer the client's expected activity from the nature of the client itself (e.g. regulated financial institutions can generally be expected to trade products consistent with the typical operating model of such an institution).

18.49 Clients will typically have multiple brokers and deal in a multitude of products and asset classes and their strategy may be dependent on market conditions, which may influence changes in activity.

Source of wealth

18.50 A firm should, where appropriate, identify the source of wealth relevant to the business relationship and/or transaction. In the wholesale markets, the source of wealth for a counterparty may often be identifiable from the nature of the customer's business. Firms may wish to infer source of wealth where the relationship is deemed to be lower risk. However, where the relationship is with an entity which is indicative of personal wealth of an individual or a collective group of individuals (e.g. family offices), a firm may take additional steps to identify and verify, where appropriate, the client's source of wealth (see also Part II, Sector 5 on wealth management). Additionally, if settlement or collateral posting is received from a third party, firms should consider the rationale for this.

Source of funds

18.51 The source of funds may be identified and verified in certain situations to ensure the origin of the funds involved in the business relationship or occasional transaction is understood. Whether the identification and verification of a customer's source of funds is required will depend on the nature and status of the entity wishing to execute and clear wholesale markets transactions. If the entity is within points (i) and (ii) below (i.e. having an appropriately regulated and supervised status), or is otherwise determined to present a low ML/TF risk, the firm may, on a risk-based approach, conclude that it is not necessary to obtain specific evidence of the source of funds:

(i) subject to requirements in national legislation implementing the EU Fourth Money Laundering Directive (or equivalent) as an obliged entity (within the meaning of that Directive); and

(ii) supervised for compliance with those requirements in accordance with Chapter VI of the EU Fourth Money Laundering Directive (or equivalent).

18.52 In situations where the customer takes the form of a privately-controlled, unregulated entity (including, in particular a private investment company, SPV or family office) the risk is likely to be assessed as higher, and in cases which present a higher ML/TF risk, the source of funds for a business relationship or occasional transaction should be identified and, on a risk-based approach, verified by a firm in order for the firm to reasonably satisfy itself that the origin of the funds is legitimate.

Simplified due diligence

18.53 A firm may apply SDD measures in relation to a particular business relationship or transaction if it determines that, taking into account its risk assessment and the matters specified in Regulation 37 of the ML Regulations, the business relationship or transaction presents a lower degree of risk of ML/TF.

18.54 In the wholesale markets, a firm will often interact with other regulated firms, some of whom may be acting on behalf of underlying entities. In this context, firms should have regard to paragraphs 18.24 to 18.28 of this Chapter.

Enhanced due diligence (including Correspondent Relationships)

18.55 The ML Regulations prescribe that EDD measures are required to be carried out in respect of Correspondent Relationships with Respondents based in third country (ie. non-UK) jurisdictions (see Part II, Sector 16 for the definition of a "Correspondent Relationship").

- For respondents based in the UK, the firm's risk assessment will require EDD measures to be applied if the firm determines that the relationship presents a higher degree of ML/TF risk.
- In meeting the prescribed EDD measures for third country counterparties, a firm should consider the matters set out in the relevant sections of Sector 16 and should document its decision-making process.

18.56 Otherwise, product risk alone will not ordinarily 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.

E. Monitoring and surveillance

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

18.58 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 the entirety of a customer's trading activities. Extreme market conditions may also impact on a customer's trading strategy and the commercial rationale for a particular transaction will often be linked to market conditions. 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.

18.59 The nature and extent of any monitoring activity will therefore need to be determined by a firm based on an assessment of its 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; and/or
- payment processes (including payments to third parties, if permitted).

18.60 Firms should ensure that any relevant factors are taken into account in determining their monitoring activities, and that the programme is adequately documented and subject to periodic review on an ongoing basis. 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.

18.61 Firms relying on third parties under the ML Regulations to apply CDD measures **cannot** rely on the third party in respect of monitoring of transactions and the customer relationship.

18.62 Firms may wish to leverage existing surveillance frameworks established for the purposes of compliance with the Market Abuse Regulation (MAR)[7], to assist in monitoring certain wholesale markets activities for unusual transactions which may constitute financial crime. Where suspicious trading activity is identified and the firm considers it necessary to file a suspicious transaction & order report (STOR), the firm should consider whether the filing of a suspicious activity report (SAR) under the Proceeds of Crime Act (POCA) is also appropriate.

F. Guidance on specific products

Securities

Product specific risks

18.63 Securities are typically regarded as a lower risk asset class and are a typical product traded on the wholesale markets. Firms should, however, be alive to the risk of insider dealing and market abuse (and the subsequent laundering of the proceeds of such offences) in the context of securities trading. In addition, firms should adhere to relevant sanctions regimes to identify securities which may be subject to financial sanctions restrictions and identify if there is a need to report them to relevant UK authorities.

Who is and is not the customer?

18.64 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.

---

[7] https://www.fca.org.uk/markets/market-abuse

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

18.66 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.

18.67 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 entities, they, too, may be customers for AML/CTF purposes. In this context, firms should have regard to paragraphs 18.24 to 18.28 of this sectoral guidance.

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

18.69 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 investment adviser or manager acting for an underlying entity, the CDD performed, and whether there is an obligation to identify the underlying entity, will depend upon the regulatory status and location of the adviser or manager. When considering whether it is necessary to undertake CDD on the underlying entity, firms should have regard to paragraphs 18.25 and 18.27 of this sectoral guidance.

Customer due diligence

18.70 Where the underlying entity is to be considered to be subject to CDD by the executing broker, a risk-based approach to CDD can take into account the investment manager and/or the settlement agent/custodian's equivalent regulatory status, pursuant to Part I, paragraph 5.6.4. This may reduce the identity information or evidence requested and what the firm verifies. Firms should take the relationship with the Investment Manager and settlement agent/custodian into account in their own CDD on customers, rather than place full reliance on the settlement agent/custodian.

18.71 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.

18.72 Where transactions are settled on a free of payment basis, firms should ensure that they understand the commercial rationale for this arrangement.

Monitoring

18.73 See the general guidance on monitoring at section E above.

Money market instruments

Product specific risks

18.74 "Money Market Instruments" is the term used to collectively cover foreign exchange (FX), interest rate products and term deposits. These instruments will typically be traded in the wholesale market between regulated financial institutions and large corporates (listed and private) and the money laundering risk may therefore be viewed as generally lower. However, this risk may be increased by matters such as:

- the nature of the customer (e.g. the customer's business);
- the customer's regulatory status (e.g. a sophisticated private investor);
- the purpose of the trading (e.g. hedging may be regarded as lower risk than speculative transactions);

- requests for payments to be made to third parties: for example, customers, particularly corporates, that need to make FX payments to suppliers and overseas affiliates.

18.75 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.

Who is and is not the customer?

18.76 See the general guidance in paragraphs 18.222 to 18.52.

Customer due diligence

18.77 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 anti-money laundering checks, and identify its counterparty and any associated risks (see paragraph 18.19).

Monitoring

18.78 See section E for general guidance on monitoring.

Financial derivatives

Product specific risks

18.79 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 and holistic 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. Firms should also consider whether the particular derivative to be traded is consistent with its understanding of the customer's expected activity.

18.80 Where firms are trading commodity futures, they should be mindful of the fact that physical delivery may be required.

18.81 The risks between exchange-traded derivatives and OTC derivative products in the financial derivative markets are the same as those set out in paragraphs 18.10 to 18.156.

18.82 Some derivative products may be complex in nature and linked to a chain of underlying assets. On this basis, where the firm is facilitating the trade of a derivative product, it is not expected to have sight of the specific asset underlying the derivative.

Who is and is not the customer?

18.83 See the general guidance in paragraphs 18.222 to 18.52.

Customer due diligence

18.84 See the general guidance in section D.

Monitoring

18.85 See the general guidance in section E.

18.86 When assessing alerts triggered by a firm's surveillance or other monitoring procedures, firms may wish to consider the nature of the client, and whether the observed activity is consistent with the firm's understanding of that client's expected activity (see also paragraphs 18.48 to 18.49 on expected activity more generally).

Commodities

Product specific risks

18.87 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 be subject to the ML Regulations, including being required to conduct CDD on the customer.

18.88 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 may 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; and
    - Financial firms (e.g. banks and funds).
- These types of entity are illustrative and widely drawn and entities 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.
- There may be third party funding of transactions in the commodities markets. Also, where a bank is sending 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 the 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.
- Firms should also consider whether it is necessary to assess the potential higher risk of corruption, money laundering, fraud or sanctions issues associated with extractive industries or governmental licences in higher risk jurisdictions through its CDD processes.

18.89 The risks and potential mitigating factors should be taken in the round. 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 (see paragraph 18.188).

18.90 When undertaking commodities business, firms should have particular regard to the sanctions guidance in Part III, to the guidance on financial sanctions produced by the Office of Financial Sanctions Implementation within HM Treasury[8], and to any relevant trade sanctions[9].

18.91 Based on the commodities being traded and jurisdictions involved, a firm may consider its obligations under its own policy statement pursuant to the Modern Slavery Act (2015)[10].

---

[8] Financial sanctions: guidance - GOV.UK (www.gov.uk)

[9] See https://www.gov.uk/government/organisations/export-control-organisation and https://www.gov.uk/guidance/current-arms-embargoes-and-other-restrictions

[10] http://www.legislation.gov.uk/ukpga/2015/30/contents/enacted

Who is and is not the customer?

18.92 See the general guidance at paragraphs 18.22 to 18.52.

18.93 Where business does not fall within the scope of the ML Regulations, e.g., shipping and chartering, it is entirely a matter for firms to decide what commercial due diligence they perform on their counterparties, and what due diligence they may wish to undertake to mitigate ML/TF and other financial crime risks (e.g. for the purposes of complying with applicable sanctions regimes).

Customer due diligence

18.94 See the general guidance at section D.

Monitoring

18.95 See the general guidance in section E. Firms should remain alert to the need to carry out sanctions screening (including screening the names of vessels etc.) as part of their ongoing monitoring in this area.

Structured products

Product specific risks

18.96 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).

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

- Corporates;
- Private banks;
- Government agencies; and
- Financial institutions.

18.98 The money laundering risk associated with structured products is not generally considered to be high, because of the involvement of regulated parties and because trading in structured products is unlikely to be a particularly effective way to launder criminal proceeds. However, because of the sometimes complex nature of the products, they may generally be more difficult to value than cash securities. This complexity may make it easier for money launderers, for example, to disguise the true value of their investments. Firms should therefore remain mindful of their obligations when trading in structured products, and ensure that they carry out EDD where red flags are identified.

18.99 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 firms to assess the money laundering risk inherent in the structure.

18.100 Structuring bespoke cross-border transactions in a way which constitutes dividend arbitrage gives rise to tax evasion risks which firms should in turn consider as a higher risk for money laundering. The intention of dividend arbitrage is to place shares in alternative tax jurisdictions around dividend dates, with the aim of minimising withholding tax or generating withholding tax reclaims. This may involve several different trading activities including trading and lending securities and trading derivatives, including futures and total return swaps, designed to hedge movements in the price of the securities over the dividend dates. Firms should assess all types of bespoke cross-border structured transactions on a case-by-case basis, carrying out EDD (See

Part 1, 4.64) where appropriate.

Who is and is not the customer?

18.101 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 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. the firm's or the distributor's), satisfy the reliance requirements and establish monitoring procedures.

Customer due diligence

18.102 See general guidance on CDD in section D.

Monitoring

18.103 See general guidance on monitoring in section E.

Wholesale Subscription Finance in Private Capital Funds

Product specific risks

18.104 Subscription finance facilities are wholesale lines of credit issued to private funds primarily to manage liquidity and capital calls on the funds' investors (limited partners [LPs]). For example, instead of calling capital from LPs multiple times during a quarter, a fund may draw on its wholesale subscription facility from a firm when it makes investments, and then call capital from its LPs to pay down the facility. LP investors would typically include:

- Pension Funds
- Insurance Companies
- Private Equity Funds
- Sovereign Wealth Funds
- Endowment Funds
- Funds-of-Funds
- High Net Worth Individuals

Subscription facilities are typically set up as short-medium term revolving facilities provided by a firm.

18.105 Parties to the private fund are outlined within a Limited Partnership Agreement and Facility Agreement. These typically include:

- LPs which provide capital to the fund.
- A General Partner (GP) which manages the fund and its investments.
- An additional Investment Manager may be designated by the GP.

18.106 The ML/TF risk associated with providing wholesale subscription finance is not generally considered to be high, because of the involvement of regulated financial institutions and the institutional nature of their investors.

18.107 However, a theoretical inherent ML/TF risk could arise if the LPs were to pledge suspicious capital resulting in the subscription finance facility being repaid with suspected criminal proceeds, or, if the GP or Investment Manager invests lent funds into criminal, terrorist, or proliferation-centric assets. These scenarios however are unlikely where regulated financial

institutions are present. Risk-based CDD can mitigate inherent money laundering or terrorist financing risks.

Who is and is not the customer requiring Customer due Diligence?

18.108 Within this context, the private fund is the contractual borrower under the primary market non-traded credit facility, therefore is a customer for AML purposes requiring CDD.

18.109 Firms should consider performing risk-based due diligence:

- On the GP where the GP acts on behalf of the fund and gives instructions to the firm;
- On the investment manager where a separate investment manager is designated by the GP and gives instructions to the firm;
- On the sub-manager where a separate investment manager contractually delegates discretionary authority to act on behalf of a fund to a sub-manager.

18.110 The LPs are not customers of the firm for AML purposes, as they have no direct business relationship with the firm. Assurance letters provided by the GP may provide some comfort.

In the event the fund entity defaults, the LPs may be required to fulfil contractual commitments and directly provide capital/collateral to the firm. In these unique circumstances, the LP would become a customer for AML purposes, requiring CDD.

Customer due diligence

18.111 See general guidance on CDD in section D, and within Part 2, Sector 20.38 – 20.56 where relevant.

Monitoring

18.112 See general guidance on monitoring in section E.