AML, CTF & Sanctions Guidance Part II

Subject: Corporate Finance

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Preface

This part of the AML, CFT & Sanctions Guidance comprises Corporate Finance specific additional guidance focused on ML/TF risks and complements the general Guidance in Part I. Specific sanctions risks related to Corporate Finance are not (yet) addressed in this part of the guidance and will be further developed. Please refer to Part I chapter 4 for the general section on Sanctions.

This part is incomplete on its own and must be read in conjunction with the main guidance set out in Part I of this AML, CFT & Sanctions Guidance. Please refer to the Preface of Part I for the applicable regulatory framework and the purpose and the scope of the Guidance.

8. Corporate Finance

Introduction

General overview of the sector

8.1 Corporate finance activities are associated with transactions in which capital is raised in order to create, develop, grow or acquire businesses:

- The issue of securities. These activities might be conducted with an issuer in respect to itself, or with a holder or owner of securities. Examples include: arranging an initial public offering (IPO), a sale of new shares, or a rights issue for a company, as well as making arrangements with owners of securities concerning the repurchase, exchange or redemption of those securities;
- The financing, structuring and management of a body corporate, partnership or other organisation. Examples include: advice about the restructuring of a business and its management, and advising on, or facilitating, financing operations including securitisations;
- Changes in the ownership of a business. Examples include: advising on mergers and acquisitions; takeovers, or working with a company to find a strategic investor;
- Business carried on by a bank for its own account where that business arises in the course of activities covered in the points above, including cases where the bank itself becomes a strategic investor in an enterprise.

Money laundering risk in corporate finance

8.2 As with any financial service activity, corporate finance business can be used to launder money. The money laundering activity through corporate finance will not usually involve the placement stage of money laundering, as the transaction will involve funds or assets already within the financial system. However, corporate finance could be involved in the layering or integration stages of money laundering. It could also involve the concealment, use and possession of criminal property and arrangements to do so, or terrorist funding.

8.3 The money laundering risks associated with corporate finance relate to the transfer of assets between parties, in exchange for cash or other assets. The assets can take the form of securities or other corporate instruments.

8.4 The challenge is to spot the money laundering behind the corporate finance transaction. Customer risk relates primarily to parties involved in corporate finance transaction including but not limited to PEPs (politically exposed persons). And secondly to the risk of violating International provisions, such as sanctions (i.e. circumvention, corruption, criminal activities or tax evasion).

Assessment of risk elements in this sector

8.5 In order to combat financial crime, including money laundering and terrorist financing, it is important to obtain on a risk-based approach background knowledge about all the participants in a corporate finance transaction, and not just those who are customers.

8.6 In its assessment of the financial crime risk of a particular corporate finance transaction, a bank should use - where possible and appropriate - the information it has obtained as a result of the due diligence it normally undertakes in any corporate finance transaction. This may include, but not be limited to, firms assessing the probity of directors, shareholders, and any others with significant involvement in the customer’s business and the corporate finance transaction.

8.7 The money laundering risks associated with corporate finance activity can be mitigated if a bank understands or obtains assurances from appropriate third parties and/or the customer as to the source and nature of the funds or assets involved in the transaction. Banks should consider, on a risk-based approach, the need to corroborate this information.

8.8 In addition, a bank should assess on a risk-based approach whether the financial performance of an enterprise is in line with the nature and scale of its business, and whether the corporate finance services it seeks appear legitimate in the context of those activities. The outcome of this assessment should be consistent with the purpose and intended nature of the customer relationship.

8.9 Identification of business activity and industry type may include the identification of the turnover for past years, jurisdictions to and from which the money will flow, countries of the customer's main suppliers, main clients, main investments and list of countries where the customer generates majority of their income, and establishment of purpose and intended nature of the relationship should include but is not limited to rationale why the customer wishes to enter into the customer relationship with a bank, role of the enterprise in the respective customer group, nature of the activities of the enterprise, and product(s) / service(s) sought by the enterprise and explanation on their purpose.

Who is the customer for CDD purposes?

Issuer of securities

8.10 Where a bank is facilitating the issue or offer of securities by an entity, that entity is the bank's customer.

8.11 In circumstances where vehicles are created for the purpose of issuing securities to investors e.g. Special Purpose Vehicles / Special Purpose Acquisition Company's (SPV, SPAC, respectively), the issuing SPV/SPAC will be considered the customer of the bank. These issuing SPVs or SPACs are often set up as "orphan" structures, typically owned by other entities which can either be discretionary in nature (e.g. Trusts) or not (e.g. TCSP). In such situations, the economic beneficiary (i.e. the issuer) may not have an obvious equitable interest in the SPV/SPAC. In which case additional information regarding the entity that has provided assets to the SPV and insight into how participation/investment into the SPV is structured is advised to understand the legitimate business purpose.

8.12 In transactions where assets are consolidated into or contributed to SPVs (e.g. certain notes or obligations), the bank should consider the source of funds of these assets and the identity of those entities/individuals providing the assets for the SPV. Where the bank is unable to identify the source of this 3rd party, money laundering risk arises, for example inadequate identification of a potential sanctioned party.

Purchaser of securities

8.13 Purchasers of securities must be considered as customers for CDD purposes when:

- A direct relationship already exists between the bank and the purchaser;
- A direct pitch by the bank to a potential purchaser will create a customer relationship for the bank;
- Purchasers of securities may be deemed to be customers of the bank delivering the securities in settlement.

Owners of securities

8.14 Where a bank advises the owners of securities, in respect of the repurchase, exchange or redemption by an issuer of those securities, the owners will be customers of the bank for CDD purposes.

Financing, structuring and management of a body corporate, partnership or other organisation

8.15 The entity with which a bank is doing investment business, whether by way of advice provided to the entity, or through engaging in transactions on its behalf, will be a customer of the bank for CDD purposes.

8.16 The activity undertaken by a bank may entail the bank dealing in some way with other entities/parties on behalf of the customer entity, for example, through the sale of part of its customer's business to another entity or party. In these circumstances, the other entity or party whom the bank deals with on behalf of the customer will not also become the bank's customer as a result of the bank's contact with them during the sale. (For Securitisations transactions see paragraph 13.1)

Changes in the ownership of a business

8.17 The entity with which a bank is mandated to undertake investment business, whether by way of advice or through engaging in transactions, will be the customer of the bank for CDD purposes.

8.18 Other entities or parties affected by changes in ownership, for example a takeover or merger target, will not become the bank's customers, unless a bank provides advice or other investment business services to that entity or party. Similarly, an approach by a bank to a potential investor on behalf of a customer does not require the bank to treat the potential investor as its customer for CDD purposes, unless the bank provides advice or other investment business services to that investor.

Business carried on by a bank for its own account

8.19 Where a bank makes a principal investment in an entity, that entity will not be a customer of the bank. A principal investment in this context means an investment utilising the bank's capital and one that would not involve the bank entering into a customer relationship within the meaning of the Wwft. If, as well as making a principal investment in an entity, a bank enters into a customer relationship with that entity, for example, by providing investment services or financing to the entity, the bank must treat the entity as a customer. When a bank has determined that the investment is not subject to the requirements of the Wwft, it may nevertheless wish to consider, in a risk-based approach whether there are any money laundering implications in the investment it is making and may decide to apply appropriate due diligence measures.

8.20 A bank should establish at the outset whether it has a customer relationship with another regulated firm and, if so the identity of that firm has to be verified (see Part I).

Customer due diligence

8.21 Corporate finance activity may be undertaken with a wide range of customers, but is predominantly carried on with listed and unlisted companies or their owners. The guidance contained in Part I, Chapter 2 indicates the customer due diligence procedures that should be followed in these cases. However, the following is intended to amplify aspects of the Part I, Chapter 2 procedures, with particular reference to the business practices and money laundering risks inherent in a corporate finance relationship.

8.22 In addition to the standard due diligence requirements laid out in Part I, it is important to check the history of the customer and to carry out reputational checks about its business and representatives and shareholders before customer acceptance.

Timing

8.23 In corporate finance transactions, when a mandate or an engagement letter is signed is generally considered the point at which the bank enters into a binding relationship with the customer. Note, it is common for a bank to begin discussions with a customer before a mandate or engagement letter has been signed, and a bank may put in place indemnity or conditional commitment arrangements prior to agreeing any express mandate or engagement Such arrangements may not constitute a binding customer relationship, as they are often designed to afford legal protections to the parties early on in a discussion and before the bank and its prospective customer(s) agree to a binding customer relationship.

8.24 A bank should determine when it is appropriate to undertake customer due diligence on a prospective customer and where applicable any UBOs. In all cases, however, the bank must ensure that it has completed appropriate customer due diligence before a binding customer relationship has been established.

8.25 Where, having completed customer due diligence, a mandate or engagement letter is not entered into until sometime after the commencement of the relationship, a bank is not required to obtain another form of evidence confirming the customer's agreement to the relationship with the bank prior to the signing of the mandate, provided it is satisfied that those individuals with whom it is dealing have authority to represent the customer.

SPVs / SPAs Companies

8.26 Where SPV (Special Purpose Vehicle) / SPA (Special Purpose Adquisition) represents a legal entity or a group of entities that is created specifically for a particular transaction, the identity, ownership structure and the purpose of the vehicle have to be established. Such vehicle is created by an originator or sponsoring bank to fulfil a temporary objective or a particular transaction in the interest of the sponsoring bank. The originator/collateral manager and purpose of the SPV can be identified via the prospectus or other transaction documents.

8.27 Depending on the purpose of the SPV, the originator can set up an SPV within its own ownership and control structure or as an 'off-balance sheet vehicle' (orphan company).

Other evidence for customer due diligence

8.28 Where there is less transparency over the ownership of the customer, for example, where ownership or control is vested in other entities such as trusts or special purpose vehicles (SPV's), or less of an industry profile or less independent means of verification of the customer, a bank should consider how this affects the ML/TF risk presented. It will, in certain circumstances, be appropriate to conduct additional due diligence, over and above the bank's standard evidence It should also know and understand any associations the customer may have with other jurisdictions. It may also consider whether it should verify the identity of the UBOs, in addition to the standard CDD measures described in Part I Chapter 2. A bank may, subject to application of its risk-based approach, use other forms of evidence to confirm these matters. Consideration should be given as to whether or not the lack of transparency appears to be for reasonable business purposes. Banks will need to assess overall risk in deciding whether the "alternative" evidence, which is not documentary evidence as specified in Part I Chapter 2, is sufficient to demonstrate ownership and the structure as represented by the customer.

Subsequent activity for a customer

8.29 Some corporate finance activity involves a single transaction rather than an ongoing relationship with the customer. Where the activity is limited to a particular transaction or activity, and the customer subsequently engages the bank for other activity, the bank should ensure that the information and customer due diligence it holds are up to date and accurate at the time the subsequent activity is undertaken.

8.30 During the lifetime of the transaction, the CDD has to be up to date. The periods of the time driven review has to be set up according to the risk classification of the customer and event triggers have to include all relevant situations which might change the customer profile.

Securitisation transactions

8.31 Securitisation is the process of creating new financial instruments by pooling and combining existing financial assets, which are then marketed to investors. A bank may be involved in these transactions in one of three main ways in the context of corporate finance business:

- As advisor and facilitator in relation to a customer securitising assets such as future receivables. The bank will be responsible for advising the customer about the transaction and for setting up the special purpose vehicle (SPV), which will issue the asset-backed instruments. The bank may also be a counterparty to the SPV in any transactions subsequently undertaken by the SPV;
- As the owner of assets which it wants to securitise;
- As counterparty to an SPV established by another bank for its own customer or for itself - that is, solely as a counterparty in a transaction originated by an unconnected party.

8.32 As a general rule, the bank should be more concerned with the identity of those who provide the assets for the SPV, as this is the key money laundering risk. Where an SPV does not have a customer relationship with the bank, and the bank demonstrates the link between the provider of the funds and the SPV, then said SPV is not subject to fulfilment of all CDD requirements.

8.33 Whether a purchaser of the instruments issued by the SPV will be treated as customers will depend upon the relationship the bank has with them. Purchasers of instruments issued by the SPV arranged by a bank will not be customers of the bank so long as their decision to purchase is based on offering documentation alone, or on advice they receive from another bank, who will have a customer relationship with them. However, as part of a bank's risk-based approach, and for reputational reasons, it may also feel it appropriate to undertake due diligence on those who are purchasers of the instruments issued by the SPV.

8.34 In addition to verifying the identity of the customer in line with normal practice for the type of customer concerned, the bank should satisfy itself that the securitisation has a legitimate economic purpose. Where existing internal documents cannot be used for this purpose, background information, obtainable in many cases from rating agencies and prospectus, be used to record the purpose of the transaction and to assess the money laundering risk.

8.35 The bank needs to follow standard identity procedures and all CDD requirements with regard to the other customers of the bank to which it sells the new instruments issued by the SPV it has established. If the bank is dealing with a regulated agent acting on behalf of the SPV, it may place reliance on the CDD performed by the agent as described in Part I, Chapter 2.6. If the bank is dealing with an unregulated agent of the SPV, the bank must follow all CDD requirements for both the agent and the SPV.

Monitoring

8.36 The money laundering risks for banks operating within the corporate finance sector can be mitigated by the implementation of appropriate, documented, monitoring procedures.

8.37 Monitoring of corporate finance activity will generally, due to the relationship-based, rather than transaction-based (in the wholesale markets sense), nature of corporate finance, be undertaken by the staff engaged in the activity, rather than through the use of electronic systems.

8.38 The essence of monitoring corporate finance activity involves understanding the rationale for the customer undertaking the transaction or activity, documenting the intended use of proceeds, so that the staff can make a professional judgment on whether the monitored transactions is logical and appropriate. The bank should also update this periodically, to ensure that the logical and appropriateness of the transactions can always be determined.

8.39 The bank will have ongoing relationships with many of its customers where it must ensure that the documents, data or information held are kept up to date. Where, as is likely in some cases with corporate finance activities, the customers may not have an ongoing relationship with the bank, it is important that the bank's procedures to deal with new business from these customers is clearly understood and practised by the relevant staff. It is a key element of any system that up to date customer information is available as it is on the basis of this information that the unusual is spotted, questions asked and judgements made about whether something is suspicious.