AML, CTF & Sanctions Guidance Part II

Subject: Wholesale Markets

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Preface

This part of the AML, CFT & Sanctions Guidance comprises Wholesale Markets specific additional guidance focused on ML/TF risks and complements the general Guidance in Part I. Specific sanctions risks related to Wholesale Markets 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.

12. Wholesale Markets

Overview of the sector

12.1 Wholesale banking refers to banking services between merchant banks and other financial institutions. This type of banking deals with professional customers, such as large corporations and other banks.

12.2 Wholesale banking services include currency conversion, working capital financing, large trade transactions, and other types of specialized services for generally high net worth corporate entities. 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).

12.3 This section 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.

12.4 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").

12.5 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 assets, commodities or securities.

Exchange-traded products

12.6 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. Banks may deal in exchange-traded products as principals or as agents for their customers. In the financial and commodity derivatives markets, banks will typically deal as principals, 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, banks can deal as either principals or as agents for the banks’ underlying customers.

12.7 Most exchanges have a Central Counterparty (CCP) that stands between the exchange members that are buying and selling a product (becoming the buyer to the seller and the seller to the buyer). When an exchange or trading platform does not have a CCP, the members contract with each other.

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 that 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 the bank as agent of the fund. The investment manager may delegate certain activities to a separate Investment Adviser.

OTC products

12.8 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. they are not necessarily standardised terms, contract sizes or delivery dates. Where banks deal OTC, they usually deal as principals. Some OTC dealing is facilitated by brokers and, while settlement is normally affected directly between the parties, it is becoming increasingly common for exchanges and clearers to provide clearing facilities (i.e. the trades are executed as OTC but are then given up for clearing by a CCP).

What are the money laundering and terrorist financing risks in Wholesale?

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

12.10 In the Wholesale Markets most participants have no knowledge of their customer's customer or, for example, the UBO of the asset being traded. In the Wwft there is no obligation to know your customer's customer. This means it is important that each financial institution in the chain is correctly fulfilling its obligations in relation to CDD for its own customer. While this is not unique to this sector, it is particularly important here, as trading chains

often have multiple layers, involve complex products with many players and are often cross-border.

12.11 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.

12.12 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 on the products and services a bank offers to a customer. It is important for a bank to understand at which stage(s) risks may arise (and this may vary from bank to bank):

- Placement: It is unlikely that cash or bearer instruments could be placed into the wholesale financial markets, as the primary acceptance of such assets is not a service offered by banks carrying out business in the NL within this sector.
- Layering: The wholesale financial markets grant the means to execute and clear a chain of transactions that 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. The bank should be aware of common methods that are highly suggestive of financial crime such as ‘mirror trading’, ‘wash trading’ or ‘offsetting transactions’. A bank 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 bank may then facilitate the further integration of these funds through the purchase or transfer of other existing assets. While these activities are generally legal and legitimate, banks 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.

- 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 bank whose customer is the end party (and which would therefore have carried out 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 bank that has conducted CDD on that party as its customer.

12.13 Banks 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. Banks should consider whether third party payments are possible and whether the ability to make such payments presents additional money laundering risks and should into account the product specific guidance in this section where relevant.

12.14 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 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 banks will need to consider the approach they will adopt in relation to any such requests in respect of customers dealing OTC. Trades that

are executed as OTC but are then centrally cleared may have a different risk profile to trades that are executed and settled OTC. Hence, when dealing in the OTC markets banks will need to take a more considered risk-based approach and undertake more detailed risk-based assessment.

Risk assessment

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

12.16 When implementing a risk-based approach, producing or reviewing risk assessments, or assessing the risk profile of a prospective customer, there are several areas that banks may want to consider in addition to the more general matters set out in Part I.

- 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;
    - 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
    - Trusts and partnerships.

- A customer’s nature, status, and the degree of independent regulation to which it is subject may affect the bank’s assessment of risk for the customer or for the bank's business.

- 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 to reach informed decisions on the risk profile the customer presents.

- The way that a bank addresses the jurisdictional risk posed by a customer will depend on several 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.

- Banks should ensure that any factors mitigating 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.

- Banks 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 banks may need to consider, such as corruption risk, see paragraph 12.19.

12.17 When dealing on an exchange or trading platform, a bank needs to identify its counterparty (paragraph 12.20-12.41 below describes who should be subject to CDD) and consider any associated risks:

- Where there is a CCP, a bank must assess the risks associated with the exchange.

- If there is no CCP, a bank 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.

- While trading on an exchange or trading platform, a bank may execute a trade with a member who does not have an account with the bank. A bank 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.

12.18 Product risk should also be taken into consideration. Transactions that 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 bank. For example, if the use of a product (or service) is part of a wider business relationship and is compatible with other activity between the bank and the customer, the risk may be reduced.

12.19 While assessing ML/TF risks, banks 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 customers to third parties will typically need to be screened for sanctions purposes, and new additions to sanctions lists checked against existing customers, in line with the bank's approach to sanctions compliance.

- Banks should assess whether they have a due diligence requirement with respect to any introducing brokers who introduce new customers or other intermediaries and consider whether there are any red flags in relation to corruption risks.

Customer due diligence

About the customer

12.20 The bank should ensure that it fully understands the customer's legal form, structure and ownership, and must obtain sufficient additional information on the nature of its business, and the reasons for seeking the product or service from the bank.

12.21 It is important to know and understand any associations the customer may have with other jurisdictions (headquarters, operating facilities, branches, subsidiaries etc.) and the individuals who may influence its operations (political connections etc.).

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

12.23 Where the bank's customer qualifies for simplified due diligence see Part I, Chapter 2. Therefore, from an AML/CTF perspective, as a rule of thumb please refer to Part I, Chapter 2

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

- As discussed in paragraph 12.17 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 bank cannot know and therefore does not need to identify the other exchange member. Banks should, however, include the money laundering risk involved in the participation in any exchange or centralised clearing, as part of their overall risk-based approach. Participation in any exchange or centralised clearing system does not remove the need to adequately verify its own customer if the bank is dealing as agent for a customer.

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

- Where a bank executes a trade OTC with a customer, which is then centrally cleared, and settled by the CCP, the bank 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 bank, and as such the bank would not be required to conduct due diligence on the CCP from an AML/CTF perspective. In certain situations, the bank 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.

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

- Where the bank is transacting with a counterparty trading as agent for underlying entities, the counterparty will be the customer of the bank.

- Where the bank is performing services on behalf of an investment manager, the investment manager is the bank's customer. An investment manager may itself be acting on behalf of an underlying entity, such as a fund, to whom it may provide advisory or discretionary investment management services. Whether CDD is performed on the underlying entity will depend on the bank's customer relationship with both entities and the nature and status of the investment manager. Where a bank takes instruction from an underlying entity, or where the bank acts on the underlying entity's behalf (e.g. as a custodian), the bank then has an obligation to carry out CDD measures in respect of that underlying entity.

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

- 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);

- The investment manager is incorporated in a jurisdiction assessed by the bank as lower risk;

- The investment manager is subject to and supervised for compliance with equivalent AML/CTF system to the EU (please refer to the list of recognised regulators in Annex II in Part I); and/or

- The product or service is assessed, by the bank, as lower risk.

12.25 In circumstances where the bank determines that CDD should be performed on the underlying entity, the bank may consider

reliance with regards to CDD on the underlying entity.

12.26 Where a bank is receiving services from a counter-party broker, the bank 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).

12.27 An introducing broker may “introduce”, or a Receiver and Transmitter of orders may pass orders from, his customers to a bank to execute trades. This introducing broker may possibly perform related requirements in connection with the customers’ trades and bookkeeping and record keeping functions. The bank pays a fee to the introducing broker, usually based on the transactions undertaken. A customer often has no say in which bank the introducing broker selects to execute a trade. As such, the customer being introduced is a customer of both the introducing broker and the bank.

12.28 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.

12.29 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. This arrangement may commonly take the form of a tri-party agreement between the customer, the executing broker and the clearing broker. However, give-up

arrangements can extend to cover several different types of relationships.

12.30 Where a bank acts as executing broker, the party placing the order is the customer for AML/CTF purposes.

12.31 Where a bank 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.

12.32 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.

12.33 In some cases, other parties, who are not customers, may be linked to a transaction. A bank may, however, still wish to assess them as part of its own 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 in paragraph 12.27).

Distributors

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

12.35 Banks must carry out CDD on the distributor in accordance with the provisions of Part I and should consider seeking information and/or assurances about the distributor's own AML/CTF procedures. The bank can also seek contractual protections in the distribution agreement.

Arranger of structured products contracting via custodians

12.36 In one scenario, an arranger (who may also be described as an "introducer" or "retrocession agent") may approach a bank to request, on behalf of an undisclosed customer, a quote for a structured product with a set of features (e.g. reference assets/indices, capital guarantee, maximum upside, etc.). If this quote is acceptable, the arranger will then recommend the

structured product to their customer. The arranger's customer will typically instruct their custodian bank to purchase the structured product from the bank. The custodian bank will purchase, on an execution-only basis, the structured product as principal, settling directly with the bank. The bank then pays the arranger a fee, which is non-standardised and negotiated on a transaction by transaction basis. Alternatively, the bank may approach the arranger with a structured product that the arranger's customers may be interested in (although transaction flows remain the same as above).

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

12.38 In NL, an arranger is required to be regulated and registered. However, depending on local legislation, an arranger may or may not be required to be regulated in their country of domicile or of main operation, which may be different.

12.39 In each of the scenarios outlined above, the arranger must be subject to CDD. The bank should check that the arranger satisfies the authorisation requirements (if any) of the arranger's country of domicile or of main operation. The bank should also consider obtaining details of the career in the financial services industry of each of the main employees or principals of the arranger.

12.40 In addition, if the custodian bank cannot be subject to simplified due diligence or is not otherwise regarded as posing a lower risk, the bank will also have to look through to the custodian's underlying customers (the UBOs).

12.41 Banks should consider, if an arranger 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 of main operation, whether such requests give rise to suspicions of bribery, corruption or tax evasion. Banks may wish to consider introducing a policy of paying fees only to a bank account in the

name of the arranger that is held at a bank in the country of the arranger's domicile or a country of main operation. Banks may also wish to confirm that there is full disclosure of any fees on relevant documentation for each transaction.

12.42 Banks should also be alert to the risk that an arranger who is an individual may be carrying on their own personal business while still employed by, and managing the affairs of customers of, another financial institution such as a bank, asset manager or wealth manager. The arranger may be acting in their own name or via a corporate entity that they control. If, because of its CDD, the bank has suspicions that an arranger may be currently employed by a financial institution, the bank 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 bank and their employee. Similar suspicions may also arise where all of an arranger's customers use the same custodian bank.

Expected activity

12.43 A bank will, as part of CDD, assess, and where appropriate obtain information on, the purpose and intended nature of the customer relationship and/or transaction. This information will assist banks 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 customer's activity (for example: transaction size and frequency) is in line with the bank's knowledge of the customer. The bank will, in many cases, be able to infer the customer's expected activity from the nature of the customer itself (e.g. regulated financial institutions can generally be expected to trade products consistent with the typical operating model of such an institution).

12.44 Customers 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 funds

12.45 A bank should, where appropriate, identify and verify the source of funds to understand the origin of the funds involved in the business relationship and/or occasional transaction. 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. The bank may decide, on a risk-based approach, to obtain specific evidence of the source of funds.

12.46 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 the bank in order to reasonably satisfy itself that the origin of the funds is legitimate.

Monitoring and surveillance

12.47 Guidance on general monitoring requirements is set out in Part I. Monitoring in wholesale markets will be affected by the fact that banks may only have access to part of the overall picture of their customer's trading activities. The fact that many customers spread their activities over several financial firms will mean that many banks will have a limited view of the entirety of a customer's trading activities. Extreme market conditions may also impact 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 that will impact a bank involved in the wholesale markets monitoring activity. These include:

- Scale of activity: 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 bank.
- Use of multiple brokers: Customers may choose to split execution and clearing services between different financial 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 specialism within one financial firm. This will restrict a bank'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: Increasingly, electronic order routing is used where customers access markets directly and there is little or no personal contact between the bank and the customer in the day-to-day execution of the customer's business. This means that the bank may not know the rationale for transactions.

12.48 The nature and extent of any monitoring activity will therefore need to be determined by a bank based on an assessment of its business profile. This will vary for each bank 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).

12.49 Banks should ensure that any relevant factors are considered in determining their monitoring activities, and that the programme is adequately documented and subject to periodic review on an ongoing basis.

12.50 Banks may wish to leverage existing surveillance frameworks established for the purposes of compliance with the Market Abuse Regulation (MAR), to assist in monitoring certain wholesale markets activities for unusual transactions that may constitute financial crime.

Guidance on specific products Securities

General guidance for Securities

Product specific risks

12.51 Securities are typically regarded as a lower risk asset class and are a typical product traded on the wholesale markets. Banks should, however, be aware of the risk of insider dealing and market abuse (and the subsequent laundering of the proceeds of such offences) in the context of securities trading.

Who is and is not the customer?

12.52 Customers wishing to transact securities on a Delivery vs. Payment (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.

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

12.54 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.

12.55 Where a bank 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, banks should have consider paragraphs 12.23 to 12.26.

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

12.57 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 bank is acting as executing broker and an investment adviser or manager is acting for an underlying entity, the type of/or level of CDD measures 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, banks should consider paragraphs 12.24 and 12.25.

Customer due diligence

12.58 Where the underlying entity is 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 supervised by a regulator from the EEA or countries having an equivalent AML/CTF system to the EU. This may reduce the identity information or evidence requested and what the bank verifies. Banks 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.

12.59 Given the information asymmetries likely to exist between an executing broker and settlement agent/custodian, when a bank is acting as settlement agent/custodian it would not be appropriate, from a risk-based perspective, to rely on an executing broker. Settlement agents/custodians should undertake the CDD measures as set out in Part I.

12.60 Where transactions are settled on a free of payment basis (e.g. non-DVP), banks should ensure that they understand the commercial rationale for this arrangement.

12.61 Where suspicion of market abuse behavior needs to be checked, it might well be the case that these transactions are not only manipulating the market but also used for ML reasons. Therefore banks should also ensure that measures are taken and transactions/ financial instruments are checked against potential ML related pourposes and in the event of findings the local conduct regulator (in NL AFM) is informed and a STOR (Suspicious Transaction Order Report) is duly filled out.

Money market instruments

Product specific risks

12.62 "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.

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

Customer due diligence

12.64 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 bank executes a transaction in 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. Banks 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 entail that all members are subject to satisfactory anti-money laundering checks, and identify its counterparty and any associated risks.

Financial derivatives

Product specific risks

12.65 Financial products are used for a wide range of reasons, and market participants can be located anywhere within the world; banks 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 bank's corporate and financial status, will be key relevant factors that a bank needs to consider when developing an appropriate risk-based approach. Banks should also consider whether the derivative to be traded is consistent with its understanding of the customer's expected

activity.

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

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

Commodities

Product specific risks

12.68 Banks 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 CDD on the customer.

12.69 When implementing a risk-based approach and performing a risk assessment on a (prospective) customer, there are several areas that commodity market banks may want to consider in addition to the more general matters set out in Part I. These will include, but are not be limited to:

- The wide range of different business interests that 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 institutions (e.g. banks and funds).

- The above-mentioned types of firms are illustrative and widely drawn and 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 transferring 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.

- Banks 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.

12.70 The risks and potentially mitigating factors should be considered. The global nature of the commodity markets means that customers 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 to reach informed decisions on the risk profile they present.

12.71 When undertaking commodities business, banks should take into account any relevant trade sanctions.

Who is and is not the customer?

12.72 Where business does not fall within the scope of the AML/CTF regulations, e.g. shipping and chartering, it is entirely a matter for the banks 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).

Structured products

Product specific risks

12.73 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.

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

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

12.75 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. Banks should therefore remain mindful of their obligations when trading in structured products and ensure that they carry out EDD where red flags are identified.

12.76 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 product will help banks to assess the money laundering risk inherent in the structure.

Who is and is not the customer?

12.77 Transactions are usually 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 (arrangers). In the latter circumstances, it is important to clarify where the customer relationships and responsibilities lie (e.g. are the third parties introducing the customer to the bank or distributing products on behalf of the bank) and to set out each party's responsibilities in relation to AML/CTF.