AML Solutions Group

Discontinuing Your Business Relationship with AML Deficient Investors

Executive summary

One of the most challenging issues raised in the Central Bank of Ireland's report on AML Compliance[1] in the Funds Sector relates to the discontinuance of business relationships with AML deficient investors. Specifically the Central Bank cited it had identified a lack of procedures and controls for ceasing the provision of services to, or discontinuing business relationships with, investors who have failed to provide the required or updated Customer Due Diligence ("CDD") documentation or information requested by funds.

This article sets out what the legislative requirements are, how we believe the Central Bank interprets those requirements and current market practice. It offers fund boards some practical options to comply with the Central Bank's expectations. We believe that most funds can adopt a pragmatic policy that should minimize the need to cease business relationships due to AML deficiencies. However we also expect that there will be some funds, mainly with retail investors, which may encounter some practical issues in resolving investor AML deficiencies and in then ceasing business relationships with those investors.

We believe the key message for boards is to avoid the creation of a large number of AML deficient investors in the first place. Where for whatever reason this does occur the board should partner with the transfer agent and distributors to develop a sound remediation programme. If, after the completion of that programme, there are still AML deficient investors in a fund then there will be a number of options to be explored and professional advice should be sought and if necessary discussed with the Central Bank.

The requirements from the Criminal Justice Act 2010, as amended by the Criminal Justice Act 2013 ("the Act")

Section 33 (1)(a) of the Act requires the completion of Customer Due Diligence ("CDD") procedures prior to establishing a business relationship. A business relationship is defined as "a business, professional or commercial relationship between the person and the customer that the person expects to be ongoing".

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[1] Report on Anti-Money Laundering/Countering the Financing of Terrorism and Financial Sanctions Compliance in the Irish Funds Sector, Central Bank of Ireland, November 2015

Section 33 (5) of the Act however permits a person to conduct CDD during the establishment of a business relationship with an investor if the Designated Person has reasonable grounds to believe that:

- verifying the identity of the investor prior to the establishment of the relationship would interrupt the normal conduct of business; and
- there is no real risk of money laundering or terrorist financing occurring provided that verification is completed as soon as practicable after the initial contact.

Section 33(8) of the Act states that in relation to a customer who fails to provide the designated person with CDD documents or information then the designated person:
(*a*) shall not provide the service or carry out the transaction sought by that customer for so long as the failure remains unrectified, and
(*b*) shall discontinue the business relationship (if any) with the customer.

In summary the Act allows a fund in certain circumstances to undertake investor CDD after the investor has made an investment in the fund. However in those circumstances the fund should seek to obtain the CDD information as soon as practicable and if the investor does not supply the information it should ultimately discontinue its business relationship with the investor.

The Central Bank's likely interpretation

While we cannot speak on behalf of the Central Bank, we have made the following observations based on information published by the Central Bank and our industry discussions.

What does a fund need to do to discontinue its business relationship with an investor?

In its November 2015 report the Central Bank indicated it had found that some funds have mistakenly assumed that blocking additional subscriptions to the investor's account effectively discontinues the business relationship and meets the requirements of Section 33(8)(b) of the Act. So the answer to how to discontinue a business relationship lies elsewhere. We believe the answer depends on the information available to the fund, its contractual relationship with the investor set out in the scheme documentation and whether or not there is any suspicion of money laundering.

In some cases it may be possible to redeem the units and send the proceeds back to the investor. In other cases it may be appropriate to redeem the units but to hold the cash proceeds in an escrow account. Of course in the case of any suspicious investors, no return of redemption proceeds should occur without obtaining permission from the Garda to do so. In practice these decisions should be made on a case by case basis rather than adopting a blanket one size fits all approach. What is clear from the Central Bank's published views is that simply blocking the investor's account in itself is not sufficient.

What steps should a fund take before discontinuing its business relationship due to AML deficiencies?

That is ultimately a matter for the board to determine. However the Central Bank has indicated in its November 2015 report that it would expect that the Fund makes reasonable efforts to remedy the deficiency and that the investor is warned of the consequences of non-compliance. Investors should be treated fairly and the steps to be taken should be consistent with the Fund's contractual obligations to the investor.

After what timeframe should the relationship be discontinued?

Again that is a matter for the board to determine. However we would expect that most AML deficiencies should be able to be resolved within six months from the date of subscription to the fund. It should be exceptional for a fund to have AML deficient investors older than that.

Could returning an investor's subscription be deemed to be aiding money laundering?

Each case must be viewed on its own merits. However returning subscription money to the account from which it originated does not in itself suggest a breach of AML/CTF requirements in the absence of any suspicion any more than blocking additional subscriptions (and returning the funds) does.

Does an investor's failure to provide AML/CTF documentation automatically mean the Fund MLRO should make a suspicious transaction report ("STR")?

This is a matter for the Fund MLRO to consider on a case by case basis. The reason, or the likely reason, for the failure to provide the information should be considered and if necessary a STR should be made. It is possible that there will be no suspicions to report.

Current Market Practice

Many funds permit investment to be made prior to completion of investor due diligence. Most funds are aware of the need to prevent any redemptions until the relevant information is received. Many funds then have time triggers to prompt further action. These can involve new attempts to contact the investor and obtain the information and the imposition of additional restrictions on the account such as prohibiting additional subscriptions. We are aware of relatively few funds which actively then seek to terminate their business relationship with investors by repaying subscription monies back to the investor. This mirrors the Central Bank's own recent findings.

Boards have cited various practical impediments to repaying subscription monies such as not having the original bank details on file to process a repayment or the investor's original bank account no longer being in operation. Other issues relate to a concern that they may be aiding money laundering by repaying subscriptions and the desire not to unnecessarily

penalize investors who may have complied with the requirements in place at the point of initial investment several years ago but who are no longer compliant with current AML/CTF standards.

We have also spoken to a number of MLROs, solicitors and industry representatives who have questioned how best to meet the Central Bank's expectations. We are aware that a number have raised questions similar to those reproduced above.

Options for Board Consideration

One simple solution that may work for certain funds is to prevent subscriptions until investor due diligence has been completed. There are several mainly institutional funds which do not deal on a daily basis which have adopted this approach. There may of course still be a need to refresh or obtain additional documentation after the initial investment due to trigger events such as the investor becoming a PEP.

We would recommend that all funds have a policy which defines how to deal with AML deficient investors. This should include the following details:

- time limits for follow up communication with the investor to obtain the information (many funds look to communicate at least three times over a 90-day period);
- time limits for raising individual investors to the board so consideration can be given to what steps to take. Many funds report all investors who have been deficient for more than 60 days. Steps should include using alternative means of contacting non-responsive investors such as email, telephone, personal knowledge of the investor, etc.;
- time limits for seeking to discontinue the business relationship (we would recommend 180 days to meet the Central Bank's expectations); and
- the possibility for allowing individual exceptions to these timeframes to be approved by the board.

We would recommend that boards ensure fund documentation details the circumstances and process that will apply to discontinuing the business relationship. How to actually discontinue the business relationship with an investor should be determined on a case by case basis.

We expect that most boards, if they work closely with the Administrator and promoter /distributor of the fund can avoid reaching the 180 day limit for cessation of the business relationship. Even where this occurs the board can, if it believes there is still the possibility of obtaining the documentation, make an exception and continue the business relationship.

Certain funds however may encounter the practical issues described above in discontinuing a business relationship. These need to be examined on a case by case basis. Various options can be considered including redeeming units and paying proceeds to an escrow accounts, cancelling units with proceeds

being retained by the fund or employing agents to trace the investor. In these cases specific advice should be sought and consideration should be given as to what the contractual arrangements allow.

We believe that the key aim of the Central Bank is to avoid the existence of large numbers of AML deficient investors where the only action being taken by the board is to block redemptions from the account. If boards can demonstrate they are applying an active remediation programme then that will go a long way to meeting the Central Bank's expectations. In the event that all efforts to remediate investors have been exhausted and there are practical difficulties in ceasing the business relationship we would recommend seeking expert assistance and in certain cases entering into dialogue with the Central Bank to agree a suitable way forward.

How AML Solutions can help

We are currently assisting boards to :

- develop suitable policies for AML deficient investors;
- remediate deficient AML investors; and
- oversee remediation being carried out by Administrators.

About AML Solutions

AML Solutions is one of the leading providers of AML services and MLRO individuals to investment funds in Ireland. We have developed our own unique, detailed methodologies to assist fund boards assess AML/CTF risk and to oversee relevant processes delegated to third parties. Should you require additional information or have any questions regarding this article or our services please contact us as follows:

Craig Josephson +353 83 100 3939
craig.josephson@amlsolutionsgroup.com

Sam Stewart +353 86 884 8599
sam.stewart@amlsolutionsgroup.com