CONSULTATION PAPER NO. 89

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PROPOSED CHANGES TO THE DFSA'S ANTI-MONEY LAUNDERING AND ANCILLARY SERVICE PROVIDER REGIMES (SECOND CONSULTATION)

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Why are we issuing this paper?

1. In response to comments received in relation to the proposed changes to the DFSA's anti-money laundering and ancillary service provider regimes (Consultation Paper No.86), the DFSA has conducted a further review of the architecture of the proposed AML Module in an effort to make it more intuitive and has also addressed some policy points which arose following consultation.

2. The DFSA would like to take this opportunity to thank all those who provided comments.

Who should read this paper?

3. The proposals in this paper would be of interest to:

   (a) Authorised Persons;

   (b) Ancillary Service Providers;

   (c) Registered Auditors; and

   (d) any of the following persons not falling into (a) to (c) above who carry on business in the DIFC:

      (i) real estate developers or agencies which carry out transactions with a customer which concern the buying or selling of real property;

      (ii) dealers in precious metals or precious stones;

      (iii) dealers in high-value goods;

      (iv) law firms, notary firms, or other independent legal businesses;

      (v) accounting, audit or insolvency firms;

      (vi) company service providers; and

      (vii) Single Family Offices.

How is this paper structured?

4. In this paper, we set out:

   (a) the background to the proposals and overview (paragraphs 8 – 15); and

(b) the key proposed changes to the new AML module made since the DFSA consultation in October 2012 (paragraphs 16 – 33).

How to provide comments?

5. All comments should be in writing and sent to the address or email specified below. If sending your comments by email, please use the Consultation Paper number in the subject line. You may, if relevant, identify the organisation you represent in providing your comments. The DFSA reserves the right to publish, including on its website, any comments you provide, unless you expressly request otherwise at the time of making comments.

Comments to be addressed or emailed to:

Consultation Paper No. 89
Policy and Legal Services
DFSA
PO Box 75850
Dubai, UAE

Email: consultation@dfsa.ae

Tel: +971(0)4 3621500

What happens next?

6. The deadline for providing comments on the proposals is **15 May 2013**. Once we receive your comments, we shall consider if any further refinements are required to these proposals. We may then proceed to recommend the proposed changes to the Regulatory Law 2004 to the President for enactment by the Ruler. If the proposed changes to the Regulatory Law 2004 are enacted, we shall then proceed to enact the relevant changes to the DFSA's Rulebook. You should not act on these proposals until the relevant changes to the Regulatory Law 2004 and DFSA Rulebook are made. We shall issue a notice on our website telling you when this happens.

Terminology in this paper

7. In this paper, defined terms are identified throughout by the capitalisation of the initial letter of a word or of each word in a phrase and are defined in the Glossary module (GLO) or in the proposed amendments. Unless the context otherwise requires, where capitalisation of the initial letter is not used, the expression has its natural meaning.

Background

8. In October 2012 the DFSA published Consultation Paper 86 ("CP86"), which set out proposals to create a new, consolidated AML module with general application to all persons who are subject to the DIFC's AML regime.

9. The key driver for this proposed change was to bring the AML regime into line with the revised Financial Action Task Force (FATF) 40 recommendations on combating money laundering and terrorist financing.

10. CP86 also set out our proposals to consolidate all the AML provisions in the DFSA's Rulebook into one single module and bring Ancillary Service Providers ("ASP") into the Designated Non-Financial Businesses and Professions ("DNFBP") regime and, consequently, repeal the ASP regime, with existing ASPs being re-classified as DNFBPs.

11. CP86 closed on 16 December 2012 and the DFSA received responses from 22 consultees. The responses were generally positive about the DFSA's proposals and, in particular, many commented that the increased emphasis on using the risk-based approach ("RBA") was a positive step. The topics covered by the responses varied greatly and it is notable that many were, in essence, requests for clarification on a particular aspect of the proposed AML Rules or policy. Some of the comments were about the actual drafting.

12. A number of themes arose from the responses which the DFSA felt it should address. These themes included the following broad topics: the scope of application of the module; the application of the RBA; our proposed treatment of beneficial owners; what customer types may be treated as automatically low risk, high-risk factors; and reliance on third parties.

13. The responses also led the DFSA to reconsider the broader architecture of the module because it became clear, from some of the comments received, that the structure of the module may have led to some confusion as to how the various chapters operated and interacted.

14. The DFSA has, therefore, amended the architecture of the module in an effort to make it more intuitive and to improve the "flow". At the same time, the DFSA has attempted, where possible, to simplify some of the language whilst maintaining legal certainty. The DFSA has also made amendments to the Guidance notes and the definitions section.

15. Given that the DFSA has made significant changes to the module architecture, a mark-up of the changes has not been provided with this consultation paper, as this would be of limited value given the type and scope of changes made. However, the DFSA has summarised the key changes below. The amended module can be found at Appendix 1.

Key post-consultation changes

Chapter 1 – application of the module

16. In chapter 1, the application section at 1.1 has been expanded to include reference to a Relevant Person's senior management. Also the key Rule on responsibility for compliance with the module has been moved to this chapter and inserted as section 1.2. The application table has been inserted as section 1.3 and has been simplified to make it more readable.

Chapters 2 & 3 – overview and definitions

17. A new overview section has been added as chapter 2, which summarises the module chapter by chapter. In chapter 3, all the key definitions, some of which were previously embedded within the Rules or in discrete sections, have been placed into the glossary table and the guidance to this section has been cut back and simplified. Readers should note that, as before, some of the defined terms in the module are capitalised and some are not. Where a capitalised term is used this is usually because the same (or similar) term exists in GLO. Defined terms in lower case are either AML-specific terms such as "source of funds" or have been left in lower case to improve the readability of the module. As with the PIB module, the DFSA has, in the AML module, placed all defined terms in GLO for AML in chapter 3.

18. The proposed definition of a "beneficial owner" has been amended to limit its scope by carving out small ownership interests which pose no or negligible risk of money laundering. The previous version of the definition, which essentially followed FATF, was considered to be too broad, potentially catching small shareholders and so being fairly onerous for Relevant Persons to comply with. The proposed amendment provides some scope for Relevant Persons to make a judgement as to which ownership interests (and transactions) may be carved out based on an objective risk assessment. We have also added additional Guidance on the meaning of beneficial owner to chapter 7. Other jurisdictions use a fixed percentage threshold and some simply leave flexibility in interpretation. This is an area of FATF that creates some difficulty and the percentage approach has faced much criticism, because it allows criminals to game the system by keeping their stake below the relevant thresholds. The DFSA approach is a flexible one which essentially builds into the definition some scope for relaxation in relation to small ownership interests, provided that the Relevant Person has objectively assessed the customer and its beneficial ownership in light of the money laundering risks and found on reasonable grounds that there are no, or negligible, AML risks.

19. The definition of a "customer" has also been modified to make it broader and to make it clear that a "Client" of an Authorised Firm will always be a customer of the firm. The definition also clarifies that a firm commitment to enter into a transaction may create a customer relationship. This is important in the lending sector where a firm commitment may not take place until various conditions precedent have been met by the borrower. The Guidance in chapter 6 makes it clear that counterparties to a trade on a Regulated Exchange are not "customers" for the purpose of the AML Rules. However, such persons may be a customer of the relevant Authorised Market Institution.

20. The list of automatically low risk customers, previously contained in a Rule, is now set out as a definition, namely, "Prescribed Low Risk Customers" ("PLRC"), which has been added to the glossary table. The list of PLRCs has also been expanded to include customers receiving certain legal services and some overseas persons. A new definition of senior management, for the purposes of AML, has been added to the glossary.

21. Where a Relevant Person is assessing regulatory equivalence for the purposes of deciding whether a customer meets the definition of a PLRC, it should apply reasonable judgement and, to assist it, use relevant available resources. The proposed web-based guidance that will accompany the AML

module will reference resources such as Transparency International, the International Monetary Fund Financial Sector Assessment Programs and the FATF Mutual Evaluation Reports of rated countries, which are useful tools to assist a firm in assessing regulatory equivalence. This type of equivalence test will be familiar to many Relevant Persons because it already exists in other jurisdictions such as the EU.

22. Former chapter 3 (responsibility for compliance with AML) has been deleted with the key Rule moved to chapter 1, as mentioned above. The associated systems and controls Rules have been incorporated into chapter 5 which now deals with the business risk assessment.

Chapter 4 – the risk based approach

23. Chapter 4 (applying a risk-based approach) now sets out the key policy and Rules for Relevant Persons regarding the RBA and its application to the requirements in the module. This was previously embedded in the chapters dealing with assessing the business and customer risks. The new chapter 4 should provide the requisite prominence for the RBA in the module.

24. Chapter 4 contains two key rules. The first deals with a requirement for Relevant Persons to adopt the RBA and the second sets out the required standard for assessing AML risks in the module. A key change to the previous iteration of the module is that the latter Rule requires a Relevant Person, when undertaking any risk based assessment, to ensure that their assessment is objective and proportionate to the risks; based on reasonable grounds; properly documented and reviewed; and updated at appropriate intervals.

Chapter 5 – business risk assessment

25. Chapter 5 now contains the business risk assessment. It is largely unchanged from the previous draft except that the systems and controls provisions from chapter 3 have now been inserted and the requirement to re-assess AML risks has been moved to chapter 4.

Chapter 6 – customer risk assessment and PEPs

26. Chapter 6 now governs the customer risk assessment. This has been enhanced by including the requirement to identify the customer and any beneficial owner. The reason for inclusion of these requirements in this chapter is that, without undertaking the above identification, it is not really possible to do an effective risk assessment of the customer. Therefore, this simply reflects the reality that, in order to risk assess a customer, a Relevant Person must necessarily know who the customer is. There is invariably an overlap between the customer risk assessment and the conduct of customer due diligence ("CDD") and this overlap is now acknowledged explicitly in chapter 6.

27. Following feedback on CP86 the DFSA has reconsidered the proposed Rules on Politically Exposed Persons ("PEP"). The previous policy required all PEPs to be treated as high-risk unless the Relevant Person was providing the customer with a low-risk product or service. Under the new proposals the section on PEPs has been moved and split and the substantive provision (that requires a Relevant Person to have systems and controls to identify whether

a customer or beneficial owner is a PEP) has been subsumed into the general systems and controls requirements in chapter 5.

28. A new Rule 7.3.1(3) has been added to the section on CDD in chapter 7, which requires a Relevant Person to undertake two additional CDD measures on any customer who is a PEP (or where a beneficial owner is a PEP) unless the customer is a PLRC. The additional CDD measures are:

    (a) increasing the degree and nature of monitoring of the business relationship; and

    (b) obtaining the approval of senior management to commence a business relationship with the customer.

29. The outcome of this new approach is that, under chapter 6, a Relevant Person would simply risk assess and classify the customer in the usual manner. However, where there is a PEP customer or beneficial owner identified, it would need to undertake two additional CDD measures. It would not have to automatically classify every PEP as high-risk unless this was objectively justified by the customer risk assessment. The two additional CDD measures for PEPs would apply to all PEP customers (or where a beneficial owner is a PEP), whether classified as low, medium or high, unless the customer is a PLRC. For a high-risk PEP customer, a Relevant Person would still need to undertake Enhanced CDD measures, which includes the additional measures set out in paragraph 28 above.

30. The Guidance on higher risk customers (now in chapter 6) has been changed to remove the implication that a Relevant Person should automatically use a higher risk rating where a high-risk factor exists. A higher risk rating does not automatically result in such circumstances and it will be for the Relevant Person to assess the risk. We are also proposing to remove from the list of high-risk factors "non U.A.E. resident customers". The international nature of the DIFC means that this risk factor may not be so appropriate in the circumstances.

Chapter 7 – customer due diligence

31. The most important changes made to the AML module are in chapter 7, which now contains all the substantive CDD requirements, including Enhanced and Simplified CDD. The key changes to the CDD requirements are as follows:

    (a) Standard (as formally referred to, see paragraph (c) below), Enhanced and Simplified CDD have been merged into one chapter;

    (b) the definition of CDD has been greatly simplified and is now in four parts relating to: (i) verifying the identity of the customer and any beneficial owner, (ii) understanding the customer's source of funds, (iii) understanding the customer's source of wealth, and (iv) undertaking ongoing CDD;

    (c) the concept of "Standard" CDD has been dropped in favour of a single concept of CDD for all customers, with CDD being enhanced for high risk customers, and able to be simplified for low risk customers. This new approach more accurately reflects the fact that CDD is a single standard which should be adjusted according to the risks – it is not three distinct standards;

(d) the sections on timing of CDD and timing of verification have been merged;

(e) a new requirement has been added to Enhanced CDD which requires, where relevant, that any first payment by a customer in order to open an account with a Relevant Person must be carried out through a bank account in the customer's name with an Authorised Firm or Regulated Financial Institution. This is a FATF requirement contained in the interpretive notes to recommendation 10 (CDD) which was omitted from the first consultation draft. Its inclusion is in line with the overall DFSA policy of achieving FATF compliance;

(f) Simplified CDD has been converted from Guidance to Rules for legal certainty; and

(g) Specific CDD for insurance policies has been relocated to the main section on CDD.

Chapter 8 – reliance on third parties

32. Chapter 8, which sets out the requirements for reliance on a third party, has been revised to make it more intuitive. The previous draft was perceived to be legally correct but over-complex. It has been redrafted to focus the Rule on the Person who may be relied upon to do CDD on behalf of a Relevant Person.

Chapter 14 - money laundering reporting officer

33. Finally, chapter 14, which deals with the appointment of a Money Laundering Reporting Officer, has been moved to chapter 11 to improve the flow of the module.

34. The remainder of the AML module has been left largely untouched save for some minor drafting enhancements and amendments to enhance readability.

Issues for consideration

Do you have any general concerns or comments about the changes to the DFSA AML regime set out above and in the attached Rules in Appendix 1?