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Legal Update

UK Financial Conduct Authority issues report following thematic review of money laundering risks in the capital markets

On 10 June 2019, the Financial Conduct Authority ("**FCA**") published a report (the "**Report**") following its Thematic Review of the money laundering risks in the capital markets[1]. The review involved 19 participants covering different segments of the market. Although the review was broad in terms of the participants, which included investment banks, custodian banks, inter-dealer brokers, and clearing houses, it did not include assessment of the participants' systems and controls. This alert highlights some of the key findings from the Report, and seeks to extrapolate points of practical guidance that may arise out of it.

Key findings

1. The Report recognises that the capital markets are generally **less attractive for money launderers** than traditional (i.e. deposit-taking, payment-processing) banking services. This is due to greater barriers to entry, levels of scrutiny, and complexity of product. However, the Report finds that there could be greater awareness amongst participants of the nature of money laundering risks within capital markets and the typologies of such schemes. The Report includes an Annex of a number of relevant typologies that will assist market participants in better understanding some of those risks.
2. Fundamentally, effective **KYC and CDD** are at the heart of managing money laundering and other financial crime risks arising out of capital markets (or any banking) activities. To be able to identify *suspicious* transactions or activity, a holistic view of the financial crime risks posed by a customer and its business is required, given that the ultimate driver of the risk is the customer rather than the product or delivery channel.
3. There is some **confusion in the market regarding the obligation to file Suspicious Activity Reports (SARs)** to the National Crime Agency, particularly where a Suspicious Transaction and Order Report ("**STOR**") has already been submitted to the FCA in respect of the same transaction for suspected market abuse (such as insider dealing or market manipulation). This is consistent with the UK Law Commission report on the SARs regime[2], which finds that there does not seem to be a consistent approach to the filing of SARs, and a lack of guidance on, and understanding of, the circumstances in which a SAR needs to be filed. The Report clarifies that SARs and STORs should be considered separately, and the obligation to file a SAR arises as soon as one knows or suspects that a person is engaged in

1 https://www.fca.org.uk/publication/thematic-reviews/tr19-004.pdf

2 https://www.lawcom.gov.uk/project/anti-money-laundering/

money laundering or dealing in criminal property. Filing a STOR is merely a civil requirement and therefore does not discharge a firm from its legal obligation to file a SAR. If a transaction is reviewed but the decision is taken not to file a SAR, the rationale for reaching that conclusion should be documented.

4. Further, a relatively **small proportion of SARs** filed relate to capital markets transactions. The Report attributes this to:

   (a) the erroneous belief that the suspicious activity was market abuse and therefore reporting was limited to a STOR;

   (b) insufficient knowledge of the transaction or capability to detect suspicious factors. In this regard, it is noted that there are relatively few case studies and typologies on which to draw;

   (c) the belief that the money laundering would have occurred elsewhere in the transaction chain and therefore that submission of a separate / further SAR was unnecessary.

5. The nature of transactions and activities in the secondary markets means that in many cases **no one firm will have a holistic view** over the entire transaction and the risks arising out of it. There is similarly a lack of visibility of the customer's customer or the ultimate beneficial owner of the asset being traded, because there is no obligation to know the customer's customer. This renders good KYC even more important. The Report finds that some participants "*perceive that others in the transaction chain, such as the exchange or the custodian bank, were more responsible than them for preventing money laundering*".

6. This **apparent complacency** is mirrored in the Report's observation that the business, as the "first line of defence", should generally take a greater degree of ownership and responsibility for managing the financial crime risks arising out of capital markets transactions. Given the complexity of the transactions, often involving multiple jurisdictions and parties, it is the front office whose awareness and knowledge of customers, products, and markets are key in identifying suspicions, as they also have the clearest line of sight into each transaction. The Report finds that the participants' front line staff often view AML and other compliance issues as purely a second line concern, and that their sense of responsibility for these matters was insufficient. In other words, a stronger culture of compliance needs to be embedded.

7. **Information sharing** within the market and between participants could be improved and would enhance the detection and prevention of money laundering. The Report indicates that the FCA "*continue to encourage the industry to work together to share information where possible*". This may, however, be challenging where confidentiality and data protection concerns are prevalent.

8. The review included participants' use of **transaction monitoring systems**. The Report finds that transaction monitoring systems for capital markets focus mainly on market abuse rather than money laundering. Again, awareness of money laundering risks and their parallels with market abuse risk was found to be scant amongst participants. The FCA observed a "*growing synergy*" between AML transaction monitoring systems and trade surveillance functions, and "*anticipate[s] this more coordinated approach will continue*", alongside developments in AI tools which will enhance automated monitoring. The Report encourages the use of a combination of automated and manual transaction monitoring systems, and found the firms who used both were better equipped to identify suspicious activity than those using automated systems only. The Report also observes that not all automated systems may be appropriately calibrated in accordance with each participant's customer base, transactional activity, and financial crime risk profile.

Practical points

What practical guidance and lessons can be derived from the Report?

- Assumption and allocation of responsibility: firms, and in particular the front line, should take greater responsibility for the money laundering risks arising out of capital markets transactions. This could include:
  - » focused training on capital markets-specific typologies and risks (ideally face-to-face);
  - » formal allocation of responsibility and ownership of risk to the front-line, for example by enhancements to applicable policies and procedures, and introduction of customer or transaction related attestations from relationship managers and the front-line;
  - » a review of the basis on which front line staff are remunerated.

  These improvements should lead to a greater number (and higher quality) of SARs filed in relation to capital markets transactions for money laundering suspicions. The Report's explanation of 7 different types of money laundering typologies in the capital markets should provide a useful starting point. The recommendations in the Law Commission's report regarding reform of the SARs regime should also assist.
- KYC is critical: The Report serves to reinforce the importance of a robust and effective customer risk assessment and KYC process in understanding customers' businesses and transactions, and to detect suspicious behaviour.
- Manual transaction monitoring systems complement the automated: effective transaction monitoring involves use of both manual and automated systems. Automated systems need to be appropriately tuned so as to be suitable for the specific needs and activities of each firm in order to be effective.
- To share is to care: greater consideration should be given to how information and intelligence might be shared between participants regarding suspicious market activity. This will, of course, be subject to management of other risks (for example, legal risks relating to customer confidentiality).

If you have any questions about the issues raised in this legal update, please get in touch with your usual Mayer Brown contact or:

Sam Eastwood

Partner, London
E: seastwood@mayerbrown.com
T: +44 20 3130 3087

Chris Chapman

Partner, London
E: cchapman@mayerbrown.com
T: +44 20 3130 3344

Stephen Moi

Senior Associate, London
E: smoi@mayerbrown.com
T: +44 20 3130 3730

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- *preparation or review of financial crime related training programmes and materials*
- *responding to specific inquiries regarding typologies that may indicate money laundering or related financial crime risk*
- *enhancement or review of internal policies and procedures relating to the management of financial crime risk*
- *advising on regulatory and law enforcement reviews of all aspects of compliance programmes, including reviews of various transaction monitoring, screening, and payment alert systems*
- *analysing applicable data privacy laws across various jurisdictions for regulatory or law enforcement requests and investigations, intra-group information sharing, and other financial crime risk management purposes.*

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