

2nd THEMATIC REVIEW (2021)

ON FIs licensed for activity of Custodian of Securities

To assess their compliance with FATF requirements under
Recommendation 17

Concerning reliance on third parties

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1. INTRODUCTION:

The 2nd thematic review for the year 2021 was performed on the licensed companies for securities custody activity. There are currently five such companies, all of them are either banks or local branches of foreign banks. All five companies hold their banking activity license from the Central Bank of UAE.

2. ACTIVITY OF CUSTODY OF SECURITIES:

The nature of activity of a custodian of securities requires them to act as a safeguarding intermediary in the transaction cycle for a securities market transaction. The securities market custodian receives information of a trade done by a client on the securities exchange from the client and is required to ensure that the trade is properly settled in accordance with the instructions of the client. The custodian receives the securities from the market and pays the purchase price in case the client has done a purchase transaction and delivers securities and receives cash on behalf of the client if he has done a sale transaction. Therefore, the custodians are required to hold securities as well as cash on behalf of their clients and that is why all custody service license holders are banking companies.

The nature of the custodian activity, with most clients which use the custodian's services being institutions and many of them based offshore, the custodians are likely to use the services provided by third parties, specifically for the purposes of performing due diligence, initial and ongoing. In view of this, we considered to assess the risk of using third parties for these companies in this thematic review.

3. FATF's RECOMMENDATION REGARDING ENGAGING THIRD PARTIES

Recommendation 17 (R17) of FATF's recommendations for AML/CFT talks about the compliance required when FIs engage third parties for providing services or performing part of their compliance functions. The R17 outlines requirements when supervised financial institutions engage third parties for performing some of their key responsibilities. **Recommendation 17 states**

Countries may permit financial institutions to rely on third parties to perform elements (a)-(c) of the CDD measures set out in Recommendation 10 or to introduce business, provided that the criteria set out below are met. Where such reliance is permitted, the ultimate responsibility for CDD measures remains with the financial institution relying on the third party. The criteria that should be met are as follows:

(a) A financial institution relying upon a third party should immediately obtain the necessary information concerning elements (a)-(c) of the CDD measures set out in Recommendation 10.

(b) Financial institutions should take adequate steps to satisfy themselves that copies of identification data and other relevant documentation relating to the CDD requirements will be made available from the third party upon request without delay.

(c) The financial institution should satisfy itself that the third party is regulated, supervised or monitored for, and has measures in place for compliance with, CDD and record-keeping requirements in line with Recommendations 10 and 11.

(d) When determining in which countries the third party that meets the conditions can be based, countries should have regard to information available on the level of country risk.

When a financial institution relies on a third party that is part of the same financial group, and (i) that group applies CDD and record-keeping requirements, in line with Recommendations 10, 11 and 12, and programmes against money laundering and terrorist financing, in accordance with Recommendation 18; and (ii) where the effective implementation of those CDD and record-keeping requirements and AML/CFT programmes is supervised at a group level by a competent authority, then relevant competent authorities may consider that the financial institution applies measures under (b) and (c) above through its group programme, and may decide that (d) is not a necessary precondition to reliance when higher country risk is adequately mitigated by the group AML/CFT policies.

4. METHODOLOGY:

A questionnaire was designed to assess the degree of compliance of the custodian companies with the requirements of FATF Recommendation 17. The questionnaire had 21 questions. The questionnaire begins by asking the respondents to state whether they are engaging any third parties for conducting CDD and if so, what are the elements of CDD which are delegated to the third parties and whether such third parties are located in the UAE or abroad and how is their regulatory status confirmed.

Further, the questionnaire has questions about the oversight over the engaged third party, whether the third party is in-house or external, how the relationship is governed, reviewed, method of communication and periodicity of communicating, assessing the risks arising out of the relationship, etc.

The questionnaire was delivered as an excel sheet and the respondents were asked to provide Y/N answers, provide explanation of their answers and attach snapshots of their policies and procedures wherever required.

5. FINDINGS:

1. All five companies responded to the questionnaire on time. The response rate was 100%.
2. Four out of five companies responded that they engaged services of third parties in their process of carrying out due diligence on their clients. One company stated that it did not engage any third parties in its CDD process.
3. Two companies were engaging the third parties which were part of the same financial group. Two companies were engaging external third parties. However, all the third parties which were engaged were either regulated entities on their own or they were part of a larger entity which was regulated. Two of the engaged third parties were listed entities, one in the UAE and another in a foreign jurisdiction.
4. The requirement of confirming that the third party was regulated for its business activity, as recommended by FATF methodology, was complied with by all the companies engaging third parties since two of them were listed entities and the remaining two were part of a group which is a regulated entity and therefore, their role while acting as a third party for the SCA licensed custodian entity was subject to regulatory supervision and oversight.
5. All the companies had formalized and contractual arrangements documented in the form of a contract or a service level agreement (SLA) laying out the scope of work to be done by the third party, whether the third parties were independent companies or they were part of the same group as the SCA licensed entity.
6. The reasons provided by the respondents for engaging outsourcing companies were the following:
 - 40% respondents stated that they engaged the third party for cost efficiency

- 20% mentioned that they intended to utilize the specialized skills of the outsourced company to augment their own CDD procedures.
 - 20% respondents stated technological advantage with the outsourced company
 - 20% respondents mentioned that they intended to have globally consistent CDD processes and hence relied upon the outsourced company with specialization in those processes and for the purpose of implementing it across the group globally.
7. While all companies engaging third parties stated that they had defined procedures for selecting the third party, one company stated that they perform due diligence checks on the outsourced company by using world check apart from having a third party assessment procedure and criteria.
 8. The engagement procedures were generally approved at senior levels, in one case by the Audit Committee, another case by the Head of Risk and in 2 cases by the Heads of Procurement.
 9. The common services which were outsourced by the custodian companies were processes related to CDD.
 10. One company was also engaging the outsourced entity for EDD and sanctions screening.
 11. One company was engaging for a check on the CDD procedures as a gap analysis while one company was using it only for the purpose of verification of national IDs.