Jersey Financial Services Commission

TRUST COMPANY BUSINESS

ON-SITE EXAMINATION PROGRAMME 2010
SUMMARY FINDINGS

DOCUMENT OVERVIEW

1 Introduction

1.1 During 2010 the Jersey Financial Services Commission (the "**Commission**") continued its programme of on-site examinations as part of its supervision of trust company businesses.

1.2 The purpose of an on-site examination is to assess a business in terms of its performance against the legislative and regulatory framework, i.e. Laws, Orders and Codes of Practice. The objective in publishing summary findings from a programme of on-site examinations is to provide industry with an overview from the Commission's perspective and to share some examples of good working practices.

2 Scope

2.1 The Commission undertook a range of on-site examinations during 2010 using discovery, focused and themed techniques to review a broad spectrum of businesses. The principal theme during 2010 was anti-money laundering/countering the financing of terrorism (**"AML"**).

2.2 During 2010, the Commission also commenced a programme for examining those individuals holding only a "Class G" registration, which permits them to act as a director or alternate director of a company. Three such individuals were examined during 2010 and all of the remainder will be examined during 2011. Feedback from this programme will be shared during 2012.

2.3 The AML examinations took a narrow, but in depth view of a business's compliance with Section 2 of the Handbook for the Prevention and Detection of Money Laundering and the Financing of Terrorism (the **"Handbook"**), which covers the corporate governance aspects of AML. One of the principal areas of focus was the review of the content and effectiveness of the business risk assessment and formal written strategy to counter money laundering and the financing of terrorism.

2.4 Irrespective of the type of examination or theme being applied, it is standard practice for the Commission to review the "conduct of business". This is the term used for evaluating the manner in which a trust company provides services to its customers. Examination is achieved by way of reviewing a selection of customer files and records. This provides the Commission with a valuable insight into the standards of administration within the business and enables the Commission to compare this with the business's documented policies and procedures.

3 Process

3.1 Businesses were selected on the basis of their risk rating and their past examination history. Each business selected for an examination was asked to complete a tailored self-assessment questionnaire and provide relevant information, such as extracts of their procedures manual. Responses were analysed to identify any areas of potential concern and help define the agenda for the examination.

3.2 Once on-site, Commission officers considered the adequacy of the relevant policies and procedures, assessing the effectiveness of their implementation through conduct of business reviews. Discussions were held with management and staff involved in operational and compliance matters.

4 Overview

4.1 A total of 39 on-site examinations were conducted during 2010, compared with 56 in 2009. The reduction in examination numbers for 2010 was primarily due to the allocation of resources to carefully scrutinise some serious issues that were identified with a small number of businesses during 2010.

4.2 The breakdown by type of examination was as follows:

AML and Conduct of Business	21	
Conduct of Business	2	
Class G sector[1]	3	
Class O sector[2]	2	
Managed Trust Companies	1	
Private Trust Companies	1	
Total themed examinations		30
Discovery examinations[3]		8
Focused examinations[4]		1
Total examinations		**39**

4.3 The action taken by the Commission as a result of the on-site examination programme was dependent on the materiality of the findings and is summarised below:

Action	**2010 Number**	**2010 Percentage**	**2009 Percentage**
Enforcement action taken (for example directions issued or co-signatories appointed).	4	10%	7%
Heightened supervision during the period of remediation, including follow up examinations and regular meetings with management.	6	15%	5%
Formal monitoring of implementation of corrective action plan, via Post Examination Monitoring Schedule.	13	33%	43%
No formal monitoring.	16	42%	45%
Total	**39**	**100%**	**100%**

1 Refers to individuals holding only a "Class G" registration which permits them to act as a director or alternate director of a company.
2 Refers to businesses holding only a "Class O" registration whereby they offer a limited service solely to local businesses.
3 Examination type whereby the Commission seeks to understand in more detail certain aspects of a business.
4 The most wide ranging examination type.

4.4 It is noteworthy that the percentage of businesses subject to heightened supervision shows a significant increase from 5% in 2009 to 15% in 2010 and there was also an increase, albeit smaller, in the percentage of cases subject to enforcement action. The reason for this is that a number of entities selected for examination in 2010 were the subject of a previous examination resulting in substantial remediation work. In some cases, the Commission was disappointed with the lack of progress made with remediation and it was necessary for more serious measures to be taken.

4.5 As the Commission's enforcement capability continues to be developed, there is a trend to the increased use of intelligence in the planning of on-site examinations. In line with its risk based approach, the Commission has focused on the higher risk sector of the industry for more frequent examinations and this methodology has been borne out by serious issues continuing to be found, with the consequent impact on the Commission's resources.

4.6 However, 42% of businesses were operating to the required regulatory standards and, whilst there were levels of remediation required, the systems and controls environment, compliance function and corporate governance was such that the businesses have been permitted to implement the Commission's recommendations for further enhancement without formal monitoring.

5 Findings arising from on-site examinations

5.1 The observations detailed below have been drawn from findings across all types of on-site examinations conducted in 2010.

Anti-Money Laundering Findings

Business Risk Assessment and Strategy

5.2 The requirement to prepare a business risk assessment and strategy was introduced in the Handbook in February 2008. The Commission's expectation was that all businesses examined during 2010 would have completed the preparation and approval of an appropriate document to demonstrate compliance with this requirement. Whilst it was encouraging to find that all of the businesses examined had indeed prepared a risk assessment, the Commission was disappointed to note that, in 5 cases, no strategy had been prepared. In 2 cases the business risk assessment and strategy had not been approved by the Board.

5.3 The Commission found the business risk assessment to be inadequate in 22 of the businesses examined. The most common finding was the failure by businesses to consider and identify the specific risks applicable to their own business, rather than the generic risks applicable to the trust company business sector. In the absence of a detailed specific risk assessment, it is difficult to produce a meaningful strategy which is of use to the business. As stated in previous examination feedback reports, the strategy should be based upon the risk assessment, and there should be a clear connection between the risk assessment, strategy and policies and procedures. Specific guidance in this respect is set out in Section 2.3.1 of the Handbook. This is a repeat finding from both the 2009 and 2008 examination feedback reports.

5.4 There was little evidence that businesses were revisiting the risk assessment on a regular basis. Whilst the Handbook does not require an annual review of the risk assessment for all businesses, the Commission would expect boards to be aware of changes taking place within their operations and customer bases and revisit the risk assessment accordingly. In particular, the acquisition of another trust company or book of business will trigger a requirement for a revised risk assessment.

5.5 The Commission encountered one situation where a trust business, which was also acting as the manager of a managed trust company, had prepared a combined risk assessment and strategy for the two separate businesses. As a managed trust company is a registered person in its own right, the Commission would expect a separate business risk assessment and strategy to be prepared for each business as each business faces separate and distinct risks.

5.6 In 3 cases, the business was not able to demonstrate that the risk assessment had had the benefit of the involvement of all Board members in determining the risks posed. In one case, the risk assessment was prepared for the business by a third party and it was not clear as to whether the document had been approved by the Board.

Business Acceptance Procedures

5.7 The requirement to maintain policies for the application of customer due diligence ("**CDD**") procedures that are appropriate, having regard to the degree of risk of money laundering and the financing of terrorism, is set out in Article 11(1) of the Money Laundering (Jersey) Order 2008 (the **"MLO"**).

5.8 The Commission found some excellent examples of good practice where businesses were using a comprehensive initial risk review process, which tied back to the business risk assessment and strategy, before progressing the acceptance of the customer relationship. In some instances involving the take on of potentially higher risk relationships, it was pleasing to see that businesses are prepared to invest substantial amounts of resource into verifying the CDD information, including the use of independent experts where appropriate. It was also encouraging to find businesses refusing to take on new business which did not meet the standards imposed by their own policies and procedures.

5.9 However, in 26% of the entities examined deficiencies in business acceptance procedures were found. In many cases, there was a failure to update policies, procedures and processes to take full account of the changes flowing from the introduction of the revised AML regime introduced in February 2008.

5.10 Specifically, some of the most common findings were the failure to include in the procedures:

5.10.1 the requirement for appropriate CDD and information to be obtained, prior to the approval and take on of a new client, as set out in Article 13 of the MLO and Section 3.3 of the Handbook;

5.10.2 the provision for politically exposed persons ("**PEPs**") to be subject to enhanced CDD as required by Article 15 of the MLO; and

5.10.3 the provision to evidence the information and supporting documentation tabled at the time the business was formally accepted, in order to demonstrate full compliance with Articles 11 and 13 of the MLO and Section 3 of the Handbook.

5.11 In other cases, the procedures appeared to be adequate but file testing revealed that the business was not following their procedures, thereby failing to fulfil their AML responsibilities. An example would be the failure to perform enhanced diligence checks on higher risk relationships, such as PEPs. Section 3.4 of the Handbook sets out some useful guidance as to the type of measures which may be implemented by trust company businesses to demonstrate that it has applied enhanced due diligence to higher risk customers.

5.12 The Commission was also concerned to find some instances where client acceptance forms were not completed and signed until many months after the business relationship was established.

5.13 The Commission continues to find isolated examples where business is approved, and on occasions transactions are processed, without adequate CDD, thereby placing the business at risk of breaching the anti-money laundering regime.

Customer Profiling and Transaction Monitoring

5.14 Article 13 of the MLO sets out the requirements for the monitoring of transactions. Section 5 of the Handbook provides further detail regarding the requirement to monitor activity and transactions, and provides some useful guidance regarding appropriate monitoring systems.

5.15 One of the most common findings from the 2010 examination programme was the failure to prepare adequate customer profiles at the outset of the relationship. The purpose of customer profiles is to enable a business to define a pattern of expected business activity in order to identify unusual or higher risk activity and transactions that may indicate money laundering or the financing of terrorism activity.

5.16 In some instances, the Commission was concerned to find that no customer profiles had been prepared at all. In the absence of adequate customer profiles, it is difficult for a business to demonstrate that it is able to perform effective transaction monitoring as required by the MLO.

5.17 Trust company businesses are expected to comply with the requirement to maintain specific customer monitoring and profiling procedures. The Commission's expectation is that the customer profile is a dynamic document and should be updated as key aspects of the relationship change over the course of time. Therefore, procedures demonstrating best practice would provide guidance on the trigger events that would cause a customer profile to be updated. Examples of trigger events may include:

5.17.1 change of beneficial owner;

5.17.2 change of country of residence of beneficial owner;

5.17.3 change in a customer's activity, source of wealth or occupation;

5.17.4 unexplained change in an entity's activity or unusual transactions; and

5.17.5 change of purpose of a structure under administration.

Introducers and Intermediaries

5.18 The number of findings in this area was relatively few in terms of the percentage of firms examined, principally because most businesses do not seek to rely on the concessions afforded by Articles 16 and 17 of the MLO. However, in respect of the small number of businesses who have attempted to take advantage of such concessions, the Commission found that there was a lack of understanding regarding the conditions that must be satisfied.

5.19 It is worth drawing attention to the provisions in Article 16(1)(b) of the MLO that each business remains responsible for any failure by an introducer or intermediary to apply identification measures.

5.20 The most common findings were:

5.20.1 the failure to appreciate the requirement to undertake a full risk assessment on the introducer or intermediary as set out in Article 16(4) of the MLO;

5.20.2 the failure to understand that the introducer or intermediary must either be a person regulated by the Commission or carrying on an equivalent business (as defined in Article 5 of the MLO); and

5.20.3 the failure to obtain sufficient information to produce a customer profile containing necessary customer due diligence information as required by Section 4.10.3 of the Handbook. It should be noted that this is a requirement even where a business is able to place reliance on an introducer or intermediary to obtain evidence of identity.

5.21 Where reliance is placed on a group introduction certificate, there was a failure to demonstrate that the business had satisfied itself that the group intermediary or introducer would provide the evidence on request and without delay, as required by Section 4.10.4 of the Handbook.

Tax Planning Structures

5.22 When undertaking file reviews, the Commission noted the failure of some businesses to obtain tax advice in respect of customer structures, even where the documented rationale indicated that tax planning was the primary reason for establishing the structure. The Commission would urge businesses to carefully consider this issue to avoid falling foul of the AML regime, potentially with serious consequences.

5.23 In some cases, the tax advice was obtained and placed on the file but was not fully understood or did not fully cover the circumstances. It is acknowledged that it may not always be necessary to obtain specific tax advice for every client structure. However, the Commission would expect to see tax advice in situations which involve complex or bespoke tax planning. Such advice should be in writing, prepared by an appropriately qualified tax advisor and cover all of the relevant circumstances. It is also important to ensure that such advice is updated regularly as circumstances change and as laws and regulations change.

5.24 Where examples of best practice were observed, businesses had fully considered the desirability of obtaining and updating relevant tax advice and it formed an integral part of key risk management processes, such as business acceptance, risk review and the periodic review.

Suspicious Activity Reporting

5.25 The Commission was encouraged to find that the vast majority of businesses take their reporting obligations very seriously. However, in 13% of businesses examined, the Commission had concerns regarding the adequacy of the suspicious activity reporting ("**SAR**") process. The most common finding was that the internal procedures were not adequate to demonstrate compliance with the requirement in Section 6.3.2 of the Handbook that the Money Laundering Reporting Officer ("**MLRO**") should document the evaluation process followed when considering internal SARs received and the reasons for the decision to report or not to report to the Joint Financial Crimes Unit ("**JFCU**").

5.26 Not only does the absence of adequate procedures pose a risk to the trust company business itself, but it also fails to ensure that employees are provided with the evidence they would need in order to be able to rely on the statutory defence available in Article 32(5) of the Proceeds of Crime (Jersey) Law 1999.

5.27 In some cases, the Commission also had concerns regarding the quality of the information submitted to the JFCU.

Risk Findings

Risk Procedures

5.28 This is an area where the Commission has found that great strides have been made by the vast majority of businesses in upgrading their risk management systems in recent years. It is apparent that there has been a significant investment in both technological and human resources resulting in some highly sophisticated and effective systems. The Commission encountered instances where considerable time had been expended by the business in tailoring an off the shelf system to their own requirements, including the adaptation of each bank of questions to address the specific risks inherent in each product offering. The result was an excellent bespoke system which enabled the business to demonstrate that its systems and controls were fully compliant with the requirements of the Handbook.

5.29 Some businesses have chosen to actively involve compliance staff in the process of updating the assessment of higher risk customer relationships in order to provide additional scrutiny to this important risk area.

5.30 The Commission does, however, continue to find examples where further work is required to enhance risk systems in order that they are fully effective to identify the risks associated with each customer entity.

5.31 One of the common failings in this regard is the failure of the procedures to include details of key factors which would influence the risk rating of a customer relationship. Guidance as to the factors to consider is set out in Section 3.3.4.1 of the Handbook.

5.32 The Commission also encountered situations where the risk scoring system did not always produce a logical result. For example, a PEP customer or a customer with links to a higher risk jurisdiction (such as a country where international sanctions are applicable) would not automatically default to higher risk as a starting position. In some instances this conflicted with the business risk assessment, which stated that this type of business would always be rated as higher risk.

5.33 The Commission also noted that some risk systems failed to take account of the additional areas for consideration contained within guidance in the Sector Specific Section of the Handbook which was issued in December 2009, such as the provision of registered office only services.

Geographic Risk

5.34 The Commission continued to find a number of issues relating to geographic risk from the 2010 examination programme. This is important as Jersey is vulnerable to reputational risk arising from the provision of services to customers connected to higher risk jurisdictions.

5.35 The main findings are set out below:

5.35.1 The lack of consideration of geographic risk during the compilation of the business risk assessment and strategy. This is particularly pertinent for businesses where higher risk customers comprise a significant percentage of the customer base. A failure to adequately consider these risks is unlikely to result in policies and procedures which properly mitigate the risks inherent in the business.

5.35.2 In some cases, the risk rating system did not include consideration of geographic risk in relation to such factors as:

- the residence of the beneficial owners;
- the location of the activity of the customer entity, including underlying companies; and
- the location of the assets held within the customer entity.

5.36 In order to assist businesses with the task of assessing geographic risk, there are various useful data sources, which include:

- Financial Action Task Force ("**FATF**") blacklists;
- countries subject to a statement from MONEYVAL; and
- Transparency International Index which considers countries at high risk of corruption, drug trafficking or terrorist financing.

5.37 Some businesses were unable to demonstrate that they had identified that certain countries with which their customer relationships are connected, are subject to a Jersey Sanctions Order and, having done so, taken appropriate measures which would include seeking and obtaining enhanced CDD information. The Commission's expectation is that trust company businesses pay due consideration to the implications of international sanctions. Clearly, this is an area with a high potential for adverse impact on Jersey's vulnerability to reputational risk.

5.38 The Commission's website provides guidance in relation to international sanctions (http://www.jerseyfsc.org/the_commission/sanctions/index.asp)

The Provision of Limited Services (including Registered Office only)

5.39 The nature of these services is such that a business is unlikely to have any involvement in the activities of such companies, in the way that it would if it provided full administration services. This increases the risk that the business may not be aware if the customer entity is being used for money laundering or financing terrorism.

5.40 Detailed guidance as to how a business can demonstrate that it has properly assessed the product risk and collected relevant information is set out in guidance in Section 2.1 of the Sector Specific Section of the Handbook. It should be noted that the guidance recommends that such information is corroborated by reference to copies of minutes of directors' and members' meetings which, in the case of a Jersey company, must be kept under Part 15 of the Companies (Jersey) Law 1991 (the "**Companies Law**") and copies of accounts which, in the case of a Jersey company, must be prepared by the directors under Part 16 of the Companies Law.

5.41 Best practice in respect of the handling of such business is that:

5.41.1 the guidance set out in the Handbook is incorporated into the policies and procedures;

5.41.2 risk scoring systems will automatically rate such services as "higher risk" unless significant mitigating factors are evident; and

5.41.3 open source information is regularly monitored.

5.42 Given that such services are likely to be higher risk, enhanced CDD measures should also be performed in accordance with Article 15 of the MLO.

5.43 In one case, the trust business regarded an intermediary as their customer in respect of the provision of registered office only services and was therefore unable to demonstrate that they had assessed the risks posed by these customer entities, as required by Article 3(5) of the MLO and Section 3.3 of the Handbook.

Higher Risk Customers

5.44 The file testing performed in the 2010 examination programme revealed significant deficiencies in the quality of the CDD held in respect of customer entities. In over 50% of examinations, the Commission found that the CDD held was not sufficient to satisfy the requirements of the Handbook.

5.45 One of the most significant common issues was the failure to consider the requirements of Article 15 of the MLO regarding the application of enhanced CDD measures to higher risk customers. Such measures may include:

5.45.1 obtaining further CDD information from publicly available sources such as the internet;

5.45.2 taking additional steps to verify the CDD information obtained; and

5.45.3 commissioning due diligence reports from independent experts to confirm the veracity of CDD information held.

5.46 The Commission found some instances where a business was unable to obtain adequate CDD and considered that its obligations were fulfilled by the submission of a SAR, but then failed to also consider the provisions of Article 14 of the MLO which provides that a relationship must be terminated where CDD measures are not completed.

5.47 The Commission noted that in some cases there was no documented rationale in relation to entities established for higher risk customers. The Commission would expect businesses to document the rationale for all customer entities and for particular attention to be paid to the careful documentation of the rationale for higher risk customers, given the enhanced due diligence requirements.

5.48 In businesses where best practice was observed, there was considerable use of external data sources including independent experts to verify the veracity of the CDD information provided in respect of higher risk customers. A regular audit of PEP customers or higher risk customers was also used by some businesses to ensure that such relationships are kept under close scrutiny.

<u>Other Findings</u>

Compliance Monitoring

5.49 The Commission's expectation is that all businesses will have implemented a robust and effective compliance monitoring programme in order to demonstrate compliance with Section 3.5.3 of the Codes of Practice for Trust Company Business (the "**Codes**"), which requires the Compliance Officer to ensure appropriate monitoring of operational performance.

5.50 The Commission would also expect the results of the compliance monitoring programme to be reported to the Board on a regular basis. Not only does this demonstrate compliance with the Codes but it also evidences sound corporate governance.

5.51 Examples where businesses were able to demonstrate a very comprehensive compliance monitoring function included the active and ongoing monitoring of various risk processes, a regular audit of all PEP business, a regular review of all powers of attorney and a regular audit of a sample of payments made from customer structures.

5.52 Whilst compliance monitoring was not specifically tested during each examination conducted during 2010, the Commission noted 5 businesses where there was no compliance monitoring programme in place. In a further 5 cases, the compliance monitoring programme was either inadequate or the results were not being reported to the Board.

5.53 As a result of these findings, the Commission intends to examine the self-test environment, including the business's compliance monitoring programme, as a theme for 2011.

Conflicts of Interest

5.54 Section 2.4 of the Codes sets out the requirement for the maintenance of robust procedures for identifying and managing conflicts of interest. Whilst the examination programme for 2010 did not specifically focus on this topic, file reviews revealed deficiencies in 13% of the businesses examined. In some instances, these represented very significant failings with potentially serious consequences.

5.55 The Commission issued a Dear CEO Letter on 22 October 2010 requesting that all trust company businesses undertake a review of their internal controls in respect of conflicts. Examples of the types of conflicts which should be captured are also explained.

Integration of Acquired Books of Business

5.56 The Commission has noted a continuing trend of merger and acquisitions activity. Where regulatory approval is given to such a proposal, it is common practice for the Commission to test the adequacy of the integration of such acquisitions, once the integration is complete.

5.57 Specifically, the Commission will expect to see a clear strategic plan at board level to direct, control and resource the acquisition so as to ensure that the customer base is fully integrated within the systems and controls of the acquirer within an agreed timescale. In some cases, businesses have failed to appreciate the level of resources required to risk review and undertake any necessary remediation and the impact that this work may have on the pre-existing business.

5.58 The Commission has been disappointed with the results of the examination of this area, although in percentage terms this affects a very small proportion of businesses examined. Where the Commission is not satisfied with the progress made in respect of business integration, it will be unlikely to provide regulatory approval to further acquisitions, until remediation is fully completed.

6 Conclusion

6.1 The foregoing is not intended as formal regulatory guidance, nor should it be taken to cover all aspects of the matters discussed.

6.2 Whilst this paper has highlighted various weaknesses found during the examination programme, it should be noted that some businesses have demonstrated excellent working practices, and the Commission recognises the efforts of the majority of trust company businesses to improve and enhance their systems and controls on a continuing basis, which can be particularly challenging in the current economic climate.

6.3 It is also encouraging to highlight the very positive attitude demonstrated by the vast majority of businesses, who are working closely with the Commission in respect of their remediation plans. In some cases, the speed with which the business grasped the seriousness of the findings in conjunction with a very robust approach to addressing the issues as a matter of priority, prevented more severe enforcement action.

6.4 The main theme for 2010 was AML. This theme will continue to feature in the overall programme for 2011. Additional themes for 2011 will be:

6.4.1 testing the implementation of a formal corrective action plan;

6.4.2 examining the efficacy of a firm's own self test environment, including the compliance monitoring programme; and

6.4.3 reviewing corporate governance and compliance monitoring through a combination of a self assessment questionnaire followed by formal meetings with the Board, the Compliance Officer, the MLRO and the Money Laundering Compliance Officer.

6.5 The Commission had only very minor observations in relation to the small number of individuals operating with a Class G registration who were examined in 2010. It is the intention to complete the examination of this entire sector during 2011 and any findings will be included in the 2011 examination feedback report.

6.6 Any comments on the content of this paper would be welcomed. The Commission would also be happy to address any concerns or questions that the reader may have on matters raised herein. Any such communications should be addressed to:

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