



Jersey Financial Services Commission

TRUST COMPANY BUSINESS

ON-SITE EXAMINATION PROGRAMME 2011 SUMMARY FINDINGS

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1 Introduction

- 1.1 During 2011, the Jersey Financial Services Commission (the “**Commission**”) continued its programme of on-site examinations (“**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 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 examinations during 2011 using discovery, focused and themed techniques, to review a broad spectrum of businesses. The principal themes during 2011 were anti-money laundering/countering the financing of terrorism (“**AML**”) and assessing the adequacy of remediation identified as necessary during a previous on-site examination (“**remediation**”). Additionally, a new theme was introduced and applied to a number of businesses, to assess the adequacy of their own internal ‘Self-Test’ environment.
- 2.2 Since the issuance of the On-Site Examination 2010 Summary findings Report (the “**2010 Feedback Report**”) in March 2011, the Commission reassessed the basis upon which it would examine individuals holding only a “Class G” registration. A Self-Assessment Questionnaire (“**SAQ**”) was issued to all Class G holders (with the exception of the three who were examined in 2010) and, following receipt of responses, four individuals were examined during 2011. The responses from the SAQ and examination findings have resulted in the Commission deciding to focus on desk-based only supervision of Class G holders for 2012, with no formal examinations planned.
- 2.3 For 2011, the AML examinations undertook a broader review of businesses’ compliance with the Handbook for the Prevention and Detection of Money Laundering and the Financing of Terrorism for Financial Services Business regulated under the Regulatory Laws (the “**AML/CFT Handbook**”).
- 2.4 Irrespective of the type of examination or theme being applied, it is standard practice for the Commission to include a review of a trust company’s “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 As in previous years, businesses were selected primarily on the basis of their risk rating and their past examination history. Each business selected for an examination was asked to complete a tailored SAQ and provide relevant information, such as extracts of their procedures manual and appropriate registers. 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 47 examinations were conducted during 2011, compared with 39 in 2010. Whilst the Commission aims to conduct approximately 50 Trust Company Business examinations each year, prioritised according to the degree of risk and regulatory history of businesses, this number is invariably influenced by the level of resource required to heighten supervise any businesses that require significant remediation. Accordingly the number of examinations conducted will usually fluctuate year on year. The breakdown by type of examination was as follows:

AML and Conduct of Business	9
Corporate Governance / Compliance Monitoring	5
Class G sector ¹	4
Remediation Follow up	8
Self Test	3
Total Themed Examinations	29
Discovery Examinations ²	14
Focused Examinations ³	<u>4</u>
Total Examinations	<u>47</u>

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 Examination type whereby the Commission seeks to understand in more detail certain aspects of a business.

³ The most wide ranging and comprehensive examination type.

4.2 The action taken by the Commission as a result of the examination programme was dependent on the materiality of the findings and is summarised in the table below:

Action	2011 Number	2011 Percentage	2010 Percentage
Enforcement action taken (for example directions issued or co-signatories appointed).	6	13%	10%
Heightened supervision during the period of remediation, including follow up examinations and regular meetings with management.	4	8%	15%
Formal monitoring of implementation of corrective action plan, via Post Examination Monitoring Schedule.	24	51%	33%
No formal monitoring.	13	28%	42%
Total	47	100%	100%

4.3 It is now almost four years since the Director General issued a Dear CEO letter entitled “Common regulatory shortfalls and completion of the transitional TCB phase” in June 2008. This letter noted the end to the transitional phase, detailed certain common areas of regulatory shortfall and explained the Commission’s future approach. It is useful therefore to examine the trends in regulatory action since that time.

4.4 In 2008, enforcement action was taken in respect of only one business following an examination. This number increased to four in each of 2009 and 2010 with a further increase to six in 2011. Whilst, on the face of it, this represents a disappointing trend, it is also a reflection of the Commission’s reduced level of tolerance in the event that businesses are found to be materially non-compliant in key areas.

4.5 It is pleasing to note the percentage of businesses requiring either heightened supervision or enforcement action has fallen from 25% to 21% in the last year. It should also be noted that the percentage changes in formal monitoring and no formal monitoring (33% to 51% and 42% to 28% respectively) can be explained, to a degree, by the Trust Company Business Division’s approach that any findings identified as a result of an examination will now, ordinarily, result in a report being issued, with any required remediation being subject to formal monitoring.

4.6 That said, 28% of businesses examined were operating to the required regulatory standards and almost 80% did not require any heightened supervision or enforcement action.

- 4.7 The levels of remediation required of those businesses subject to formal monitoring varied considerably, from relatively minor changes being required, to those requiring more substantial changes and improvements to be made. It is anticipated that going forward this category will continue to be the most populous, with businesses continuing to implement the Commission's recommendations for improvements within a framework of formal monitoring.

5 Findings Arising From Examinations

- 5.1 The observations detailed below have been drawn from findings across all types of examinations conducted in 2011.

Corporate Governance

- 5.2 It is considered that all the findings resulting from an examination can, ultimately, be attributed to whether the board fulfils its responsibilities in an effective manner. Findings relating to poor corporate governance were identified in five of the six examinations which resulted in enforcement action being taken, indicating that shortcomings in this area can result in serious consequences including business failure. Best practice was in evidence where it was demonstrated that all board members were fully aware of their duties and obligations and ensured that they were provided with sufficient information in order for them to properly discharge their duties. Directors should be fully aware of the collective responsibility of the board as a whole as well as their individual duties and responsibilities.

Effective Documentation of Control of Business

- 5.3 The Codes of Practice for Trust Company Business (the "TCB Codes") require businesses to operate an effective corporate governance system. Businesses would ordinarily be able to demonstrate compliance with this requirement by providing documentary evidence to support the framework within which they manage and control their business.
- 5.4 The most common finding when reviewing the records of the boards of businesses concerned the lack of documentation relating to the thought process and deliberations of the board when reaching decisions.

Terms of Reference for Committees

- 5.5 Most businesses utilise committees in managing their affairs. Commission findings in this area included a lack of formal approval by the board with regard to the formation of a committee, lack of or inadequate terms of reference, no reporting back to the board or inadequate consideration by the board of the activities of the committee.

Conflicts of Interest

- 5.6 A Dear CEO Letter entitled "Conflicts of Interest" issued on 22 October 2010 made a specific request for businesses to undertake a review of their internal controls in respect of conflicts of interest. The Commission therefore expected businesses to have undertaken such reviews when examinations took place in 2011.

- 5.7 A range of findings arose in respect of conflicts of interest. These varied from relatively minor findings relating to the requirement to update policies and procedures through to more fundamental failures. For example, businesses failing to recognise and record the conflicts of interest arising where shareholders and board members of businesses were co-investing with, lending to and borrowing from both customers directly and customer entities for which they were responsible.
- 5.8 Other findings included:
- 5.8.1 ineffective performance of board members undertaking multiple roles such as Compliance Officer (“CO”), Money Laundering Reporting Officer (“MLRO”) and Money Laundering Compliance Officer (“MLCO”) as well as undertaking a client facing role;
 - 5.8.2 a transaction where a director was involved in the decision-making where he was to directly benefit from the outcome of the decision; and
 - 5.8.3 a business had not considered or recorded instances where services were being provided to customer entities that were owned by shareholders of the business itself.
- 5.9 These findings demonstrate there is some way to go for certain businesses in identifying, properly considering, evaluating and mitigating the risks inherent with conflicts of interest as they arise. However, it should again be said that the most egregious examples noted above were isolated incidents and best practice was evidenced with clear disclosure being documented where appropriate.

Anti-Money Laundering

Customer Due Diligence (“CDD”) deficiencies

- 5.10 Deficiencies in the area relating to CDD represented the most common findings with respect to the 2011 examination programme. Findings included:
- 5.10.1 a lack of certification of CDD information or other additional checks where businesses were relying on such information to satisfy non face-to-face identification and verification;
 - 5.10.2 CDD documentation not being appropriately certified (e.g. customers self-certifying documentation);
 - 5.10.3 illegible address verification and unrecognizable photographic identification; and
 - 5.10.4 a lack of understanding of the nature and level of CDD records required in respect of higher risk customers.

- 5.11 Another common area of findings related to businesses not obtaining enhanced CDD when required or not documenting the additional measures undertaken to fully address this segment of business. Businesses will note that section 3.4 of the AML/CFT Handbook relating to enhanced CDD is not prescriptive as to how to address this matter, but does offer an overview and guidance to assist in this respect.
- 5.12 A further common theme to emerge was the lack of appreciation of the requirements when using group introduction certificates. In these circumstances, the Commission found examples where no assessment of risk had been undertaken, nor had there been any testing to determine whether the group company held the required CDD and could provide copies upon request.
- 5.13 Disappointingly, the certificate itself in some instances had failed to contain relevant CDD information, such as an individual's date of birth. When considering whether to use or to continue to use group introduction certificates to satisfy CDD requirements, businesses should consider the provisions contained in section 4.10 of the AML/CFT Handbook.

Business Risk Assessment ("BRA") and Strategy

- 5.14 As has been noted in the previous three feedback reports, the requirement to prepare a BRA and strategy was introduced by the AML/CFT Handbook in February 2008. Whilst it is disappointing that the lack of compliance with this requirement has remained a common finding, the nature of the issues arising, generally, are of a lesser degree of importance in terms of risk, than those identified in previous years.
- 5.15 A number of managed trust company businesses were identified as incorrectly relying on the BRA and strategy of their manager. This represents a repeat finding from the 2010 Feedback Report. The AML/CFT Handbook requires each separate business to conduct and document a BRA and strategy as each faces distinct risks and it should be understood that a managed trust company is a registered person in its own right.
- 5.16 A number of businesses had BRAs and strategies in place but had not given adequate consideration to any changes which may be required following the occurrence of trigger events. Examples of circumstances where the Commission would expect a revised consideration of a business's BRA and strategy include: a change of status from/to a managed trust company; organisational restructuring; or indeed a change in business emphasis.
- 5.17 The most common finding relating to the BRA was again 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 BRA, it is difficult to produce a meaningful strategy which is of use to the business.
- 5.18 As stated in previous examination feedback reports, the strategy should be based upon the BRA and there should be a clear connection between the BRA, strategy and a business's related policies and procedures. Specific guidance in this respect is set out in section 2.3.1 of the AML/CFT Handbook.

- 5.19 Examination findings suggest some businesses were not revisiting their BRA on a regular basis. Whilst the Handbook does not prescribe an annual review of the BRA, the Commission would expect boards to be aware that changes taking place within the business should trigger a review of the BRA and strategy.
- 5.20 In particular, the acquisition of another trust company or book of business should trigger a requirement for a revised BRA. It should be noted however, that overall, the findings are considered to represent a positive move by businesses in the area of BRA and strategy compared to previous years. It is hoped this will be continued in 2012.

Suspicious Activity Reporting

- 5.21 Following on from 2010, the Commission was encouraged by the relatively small number of findings in this area. Issues that were identified related to a lack of formal acknowledgement of internal suspicious activity reports (“SARs”) by the MLRO to staff and a lack of detail in documenting the consideration and decision reached by the MLRO with regard to the potential external reporting of the SAR.
- 5.22 As noted in the 2010 Feedback Report, weaknesses in documenting the evaluation of internal SARs by the MLRO may result in an inability to provide employees with the evidence they would need in order to be able to rely on the statutory defence available in Articles 32(5) and 33(8) of the Proceeds of Crime (Jersey) Law 1999.

Risk Assessments

Business Acceptance Procedures

- 5.23 Again, the Commission found some good examples of best practice being instigated where businesses were carrying out a detailed acceptance process which included full consideration of the risks to the business in establishing a customer relationship.
- 5.24 There were many occasions where businesses had undertaken enhanced CDD measures, including verifying the CDD information obtained and using third party expert research and reporting. In the main, the policies and procedures in place required limited amendment with the main finding attributed to businesses that had not followed their own procedures and/or clearly documented where they believed a temporary or permanent exception was appropriate.
- 5.25 Some of the more common findings occurred where businesses were approving new customer entities and commencing activity prior to obtaining appropriate CDD or undertaking enhanced CDD for higher risk customers.
- 5.26 The Commission identified repeat findings where some businesses had not completed and signed off client acceptance forms until some months after the business relationship was established. This included examples where businesses had undertaken transactions for customers without adequate CDD being held, thus breaching anti-money laundering legislation.

Rationale

- 5.27 The lack of a documented rationale for new and existing customer entities was another common finding of the 2011 examination programme. Whilst businesses demonstrated a good understanding of the activity of their customer entities, examinations identified that some businesses could not adequately demonstrate that they have an understanding of why the entity had been established.

Customer Background (including high profile customers and politically exposed persons (“PEPs”))

- 5.28 Effective consideration and documentation of a customer’s background should be a pre-requisite of any business acceptance procedure and should also be considered on an on-going basis. Whilst it is acknowledged that consideration of whether an individual is high profile can be somewhat subjective, the Commission would expect businesses to have formed an opinion of the criteria that they consider results in high profile status, ensure that those criteria are considered and that such consideration is clearly documented.
- 5.29 With regard to PEPs, the Commission would again expect businesses to be able to demonstrate how they have evaluated whether an individual is a PEP and to document such evaluation/consideration.
- 5.30 Issues identified during examinations included:
- 5.30.1 a lack of consideration as to whether a foreign Supreme Court Judge should be considered a PEP;
 - 5.30.2 no consideration of the high profile status of an ex-international sportsman with on-going media exposure; and
 - 5.30.3 no review of the source of wealth of the widow of a foreign ambassador.

Geographic Risk

- 5.31 Businesses are exposed to geographic risk across a wide spectrum of areas. For example, those relating to the customer (e.g. residence, activities, source of wealth etc.) as well as those relating to the entity being established for the customer (proposed activities/assets and their location, source of funds etc.).
- 5.32 A number of risk scoring systems did not consider many of the above examples in calculating a customer’s risk rating.
- 5.33 The Commission continued to find a number of issues relating to geographic risk which are repeat findings from the 2010 examination programme.

- 5.34 In the 2010 Feedback Report, the Commission noted that businesses had the ability to consider information held by organisations such as the Financial Action Task Force, MONEYVAL and Transparency International when assessing geographical risk. The Commission observed that the majority of businesses examined in 2011 considered information held by one or more of such organisations when assessing geographic risk however, some businesses still do not use any independent data source.
- 5.35 Consideration of sanctions has become more important in recent years with reputational risk for both the business and the Island being of particular concern. This is an area where the Commission has seen considerable improvement with many businesses demonstrating appropriate consideration of Jersey Sanctions Orders. It should be noted the Commission's website provides businesses with guidance in relation to international sanctions which can be found at:
http://www.jerseyfsc.org/the_commission/sanctions/index.asp

Tax Planning Structures

- 5.36 The Commission has again noted the failure of some businesses to obtain copies of the relevant tax advice in respect of customer structures established primarily for the purpose of efficient tax structuring. In all but the most simple of cases, the Commission considers it would be difficult for businesses to demonstrate an adequate knowledge and understanding of the rationale for a tax driven structure, without sight of the tax advice supporting it.
- 5.37 It is appreciated that some customer entities form part of sophisticated and complex international tax planning structuring. In these circumstances the Commission would expect businesses to at least understand where their customer entity sits in the structure and the function it performs in the overall planning.
- 5.38 Given the constant changes in tax legislation it is also important that the relevance of the tax advice held for a customer entity is considered as part of a business's periodic review process.

Risk Scoring Systems

- 5.39 An effective risk scoring system is a vital tool for a business to properly consider and assess the various risks posed by a customer in order that they may build appropriate systems and controls to mitigate those risks or indeed to decline or exit a customer entity.
- 5.40 The Commission identified many businesses that operated effective risk scoring systems that made reference to the business's own risk profile as well as considering geographic risk, activity risk, customer risk and reputational risk. The best of these combined an objective consideration of a number of risk areas with a subjective review, usually carried out by a member of the board together with compliance, to ensure the risk rating resulting from the objective scoring is reasonable.
- 5.41 Examination findings that were identified in this area related to shortcomings in most of the areas noted above namely: rationale; customer risk; and geographic risk.

5.42 Notwithstanding the findings noted in relation to risk matters generally, the Commission considers that overall improvements have been made by businesses as a whole, with further upgrading of risk management systems being evidenced.

Compliance Monitoring

Compliance Monitoring Programme

5.43 A number of businesses demonstrated compliance with sections 3.5.3.1 and 3.5.3.2 of the TCB Codes by implementing a Compliance Monitoring Programme. The 2010 Feedback Report noted that the Commission intended to undertake some specific 'self-test' examinations which included specific reference to businesses' compliance monitoring programmes.

5.44 With regards to those businesses subject to the specific self-test themed examination, the overall results were encouraging. Those examined tended to be medium or large businesses with considerable compliance and risk management resources who were used to operating in such an environment

5.45 Certain other 2011 examinations identified a number of businesses that had failed to either carry out an effective compliance monitoring programme or to ensure the board were properly informed of the testing undertaken and its results.

5.46 Some businesses believed their periodic review process constituted compliance monitoring, which was of some concern.

5.47 A repeat finding from the 2010 examination programme was the failure to prepare adequate customer profiles at the outset of the relationship. Again, in some instances, no customer profiles had been prepared or were inadequate for the purposes of a business being able to perform effective transaction monitoring.

6 Conclusion

6.1 By their very nature, examination reports are designed to note findings where businesses have failed to comply, either in part or in full, with the TCB Codes and statutory legislation applicable to Trust Company Businesses. Whilst this report is therefore a summary of such findings, the Commission has sought to provide some comment, guidance and examples of good working practice which is evident in the majority of trust company businesses.

6.2 Comments on the content of this paper are welcomed and should be addressed to:

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