

MODULE 4

Summary of the vulnerability of the securities sector conducted during the national risk assessment

Members of the working group:

- (Financial Supervision Authority, head of the working group)
- (Financial Intelligence Unit)
- (Ministry of Finance)
- (Financial Supervision Authority)
- (Estonian Banking Association)

Introduction

The new recommendations of the Financial Action Task Force (FATF) (recommendation 1), which entered into force in February 2012, require countries to systematically conduct national risk assessments of money laundering and terrorist financing, and unlike in the past, official risk assessment documents are no longer sufficient. It is therefore necessary to use a methodological approach and extend the limits of risk assessment beyond the institutional view, by preparing the national risk assessment (hereinafter *NRA* or *national risk assessment*).

In order to prepare the NRA, the Government Committee for the Prevention of Money Laundering and Terrorist Financing decided at the meeting on 17 October 2012 to establish a separate working group (hereinafter *risk assessment working group*). The work of the risk assessment working group is led by the Ministry of Finance and its members are: representatives of the Ministry of Justice, Ministry of the Interior, Ministry of Foreign Affairs, Ministry of Finance, Tax and Customs Board, Internal Security Service, Police and Border Guard Board, Financial Intelligence Unit and Financial Supervision Authority.

The aim of the module and brief description of its structure

When assessing the vulnerability of the securities sector, general assessment on the sector's vulnerability was first given according to the World Bank module. Under the influence of the entire sector, the applicable regulations, data availability and other factors that form the basis for compliance with the requirements arising from the Money Laundering and Terrorist Financing Prevention Act (hereinafter *RahaPTS*) and other international standards, including FATF

recommendations, were assessed. The second part assessed the vulnerability of products and services offered in a specific sector. The assessment has taken into account the data and circumstances of 2010 - 2012. Thereby group 4 has not taken into account the guidance materials, the results of the Moneyval IV evaluation report and other relevant changes that have entered into force after 2012 and which by their nature may affect the conclusions.

Assessment

1. Overall assessment of the vulnerability of the sector

As part of the overall assessments of the sector's vulnerability, the members of the working group 4 assessed that the securities sector is well covered by anti-money laundering and anti-terrorist financing regulations. At the same time it was found that it is always possible to make the regulation even better or more precise, which is why the regulations were assessed as high (0.95). With regard to financial supervision, it was found that it is well organized in the securities sector in Estonia, including the right of the Financial Supervision Authority to issue instructions on money laundering, issue precepts, prosecute misdemeanours and revoke activity licenses. At the same time it was found that supervision could be further improved by involving more people. Due to the above, the quality and integrity of supervision was assessed as high (0.85).

Group 4 found that the securities sector was under pressure to comply with money laundering requirements beyond the regulatory and supervisory framework, leading to a medium/high pressure rating (0.75). At the same time the management company as the obliged entity and the management board of investment firm is generally committed to the corporate governance practices of the company, and there is also a corresponding compliance function and audit. In view of the above, the commitment of corporate governance was rated high (0.85).

Group 4 found that a suitable customer or transaction identification structure in accordance with the European Union legislation and international standards has been established in Estonia, which is why it was rated high (0.95). The same rating was given to the system in place to verify the data provided or collected from independent sources. The identification of beneficial owners was rated as medium/high (0.75), as obliged entities are able to fully identify the beneficial owners, and in particular those who otherwise control the management of the legal entity.

Data retention, transaction monitoring and screening, identification of politically exposed persons and identification of the subject of an international sanction and compliance with the notification obligation were rated as high (0.80). This rating is not maximum, as it is possible to raise the awareness of obliged entities in case of suspicion of money laundering and terrorist financing and, consequently, to increase the number and quality of notifications submitted to the Financial Intelligence Unit. The rating was also affected by the fact that the supervisory procedures revealed

that investment firms and management companies did not comply with the internal rules on data retention.

Staff training was rated as medium (0.50). This assessment was made due to the fact that, although there is a corresponding regulation that refers to the mandatory nature of training, there are not enough statistics on the quality of the training that has not been conducted by the Financial Supervision Authority or Financial Intelligence Unit. At the same time, the existence of compliance checks and the fulfilment of the respective obligations were assessed as high (0.85).

Group 4 also found that the national penal policy in relation to the prevention of money laundering and terrorist financing is disproportionate to the crime committed. At the same time there are adequate measures to prosecute individuals. Therefore, the penalties were rated as medium (0.50). The market participants were aware of the measures taken to prosecute and were also aware that the breaches of money laundering requirements would lead to penalties. At the same time it was found that on the basis of conviction statistics it cannot be stated with certainty that all money laundering offences can be punished, which is why the punishment of money laundering offences was assessed as medium/high (0.70). Although RahaPTS and other legislation do not provide for a specific obligation to establish internal procedures to ensure that the employees do not cooperate with criminals, on the other hand the employee is obliged to be loyal to the employer, employees are constantly monitored and remuneration principles are in place, therefore the integrity of the employees was rated as high (0.85).

2. Assessment of the vulnerability of products and services offered in the sector

The assessment of the vulnerability of products and services offered in the sector is based on the information provided by investment firms on the basis of a special questionnaire. Although management companies also provide services in the sector, they have not been taken into account in this assessment, as no management company registered in Estonia accepts cash for payment for services/assets. Payments can only be made through a bank or by using notary's account. As a result, the risk of money laundering in the management company sector is minimal. Venture capital funds have also not been covered, insofar as the latter explained in their replies that they do not hold the client's assets.

The assessments are based on the fact that the investment firms had opened only accounts opened by natural persons and legal entities for their own account. There were no accounts opened by natural persons and legal entities for the account of a third party.

2.1. Account opened by natural persons in their own name

The volume of accounts opened by natural persons in their own name was assessed by the group as low (0.2) as to all years, based on the fact that although private sector assets make up a very

small part of the sector, it should be taken into account that there are large investment firms in Estonia, for whom private individuals are the main customers.

Compared to the legal entities, the average transaction volume in all investment firms is lower for natural persons and, as a result, the average transaction volume at the sector level is also lower for natural persons. At the same time, the statistics of one investment firm have a significant effect on the low average value. The average transaction volume fell to a very low level in 2011. Due to the above, the average transaction value rating for 2011 is low (0.20) and the rating for 2010 and 2012 is low/medium (0.30).

The rating given to the client profile is medium (0.60), which is based on the fact that the share of non-resident clients is high in larger and internationally operating investment firms. However, the proportion of customers who would belong to another risk group is not significant. It was also important in the assessment that all investment firms always monitor face-to-face identification when establishing a client relationship.

With regard to other factors affecting the service, it should be pointed out that it is not possible to pay for the service in cash, nor can customers make payments from accounts in cash. In practice, customers have not entered into transactions where they are asked to transfer the assets to a low-tax country and then the service is stopped. The receipts from customers also do not come from unequal third countries, and customers were not able to use the service anonymously. Due to these circumstances, the exposure of investment firms to money laundering and terrorist financing is low as to all years (0.20).

In order to mitigate the aforementioned vulnerability, inspections in investment firms are performed by the internal auditor and compliance audit, whereas the Financial Supervision Authority evaluates the organization and results of the work of the internal auditor and compliance audit. The compliance officers of the Financial Intelligence Unit have also been appointed, who are responsible for making relevant notifications to the Financial Intelligence Unit in case of suspicion of money laundering. However, based on the results of the on-the-spot inspections carried out by the supervisor, it should be considered that the performance of the control procedures provided for in the internal rules of procedure and law in day-to-day business is deficient and needs to be improved. Based on the above, group 4 rated the existence of the respective controls as medium/high as to all years (0.65).

2.2. Account opened by legal entities in their own name

The volume of accounts opened by legal entities in their own name was assessed by the group as medium (0.60) as to all years. This assessment was given, as at the end of 2012 the volume of assets of legal entities exceeded the total volume of investment firms' own assets more than 33 times.

The lion's share (98.9% as of 2012) of such clients' assets is the volume of clients' assets held and managed by one investment firm. Therefore, it cannot be said that the volume of assets of clients as legal entities would be extremely high in all investment firms operating in Estonia.

The volume of the transaction was rated medium (0.50) for 2012, low/medium (0.40) for 2011 and medium (0.60) for 2010 for the accounts opened by legal entities in their own name. This assessment was given, as the average volume of transactions is several times (3 times in 2012) higher than the average volume of transactions performed by private individuals. There is also one service provider for legal entities, whose average transaction volume is very small (193 euros in 2012). In case of other investment firms, the average transaction volume is higher (20,000 to 40,000 euros in 2012). At the same time, the average transaction volume of legal entities decreased in 2011, but in 2012 it has increased again.

With regard to client profiles, it was established that in 2012 the share of non-residents among clients as legal entities in the largest investment firms was 52.5% and 98.6%, respectively. Others have a lower share (0-50%). Unlike the clients as natural persons, the clients as legal entities also include the clients with interests in low-tax countries. Two investment firms have such clients and their shares are 11% and 23% of clients, respectively. There are no clients as politically exposed persons and the clients who have been criminally punished or avoid tax liability among the clients as legal entities. Due to the above, the rating was medium as to all years (0.60).

The conditions and practice for accounts opened in the name of legal persons are analogous to those opened in the name of natural persons. Therefore, the rating is the same, i.e. low (0.20) as to all years.

In order to mitigate the vulnerability mentioned in the previous clauses, accounts opened in the name of legal entities also have a similar practice as accounts opened in the name of natural persons. Therefore, the rating is the same, i.e. medium/high as to all years (0.65).

Summary

By summarizing the data and circumstances for 2010-2012, group 4 considered that in terms of overall vulnerability, more attention should be paid to employee training, as well as increasing the criminalization of money laundering offences. The accounts opened by legal entities in their own name had the highest risk in the comparison of products and services. In doing so, group 4 has not taken into account guidance material, the results of Moneyval's IV evaluation report and other relevant changes that have entered into force after 2012 and which, by their nature, may affect the conclusions reached.