An Effective AML Risk Management Framework for Private Funds in Mainland China

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Executive Summary

In China, the private funds industry is a growing market. As of November 2018, there are 24,418 private funds companies registered with the Asset Management Association of China (AMAC), and the managing asset scale has reached 790 billion RMB\(^1\).

With this growth, more institutions are becoming involved in the private funds industry. In recent years, many foreign asset management companies have entered the market of private funds in China. In the face of complicated regulations and different norms among foreign asset management systems, understanding the relevant laws and regulations of China's private funds, and the requirements of anti-money laundering supervision, can assist foreign asset management companies in carrying out more practical anti-money laundering procedures to fit the requirements of China’s domestic market.

This paper will introduce the regulations of private funds in China, the requirements of regulations for qualified investors, and the diversity products of private funds. The second section introduces the latest anti-money laundering norms in China. Private fund companies are not financial institutions, but they have financial supervision. In the application of anti-money laundering laws and regulations, there are no laws and regulations specifically designed for the private sector, and this also increases the risk of private funds companies failing to follow anti-money laundering norms.

The main topic of this paper is how to establish an effective anti-money laundering risk management system for private funds companies. We discuss how to use investigative techniques to identify suspicious transaction patterns in the anti-money laundering investigation procedures of customers and products. We also discuss how building cooperation with intermediaries, and setting information sharing and notification models, can make anti-money laundering investigation procedures more complete.

The top-to-bottom approach that companies use to manage the risks of anti-money laundering determines the effectiveness of implementation. We discuss how to set up corresponding investigation units and an anti-money laundering management center in private funds companies as the companies’ ultimate defense.

\(^1\) Source: Private Fund Manager Registration and Private Fund Products Filing Monthly Report (No. 11, 2018)
Section I: Introduction of Private Funds in China

1. Regulatory

Private funds (privately-raised investment funds) are the investment funds established by raising capital from investors in a non-public manner, and within the territory of the People's Republic of China (“China”).

In China, business activities relating to private funds are supervised by the China Securities Regulatory Commission (CSRC) and the Asset Management Association of China (AMAC). AMAC is a self-regulated association responsible for issuing self-disciplinary rules, conducting self-disciplinary management of private fund businesses, and providing industry development.

CSRC and AMAC issued several regulations to set basic guidance of private funds activity, including: “Interim Measures for the Supervision and Administration of Privately-Raised Investment Funds”; “Measures of the Administration of Fund Raising Practices of Private Investment Funds”; “Guidelines of the Qualified Investor for Raising Fund Institutions.” All indicate that the institutions shall engage qualified investors for selling private funds.

2. Qualified Investors

(1) Definition

There are two types of qualified investors: qualified investors and those that deem as qualified investors. A qualified investor shall refer to an entity or individual that has the appropriate capability of risk identification and risk tolerance, that invests at least RMB 1 million in a single private fund, and that meets the standard issued by CSRC. Those that deem as qualified investors are regulated by the CSRC, and include, but are not limited to: social security funds, pension funds, charitable funds, investment schemes registered in AMAC, and the employees of the fundraising institution.

(2) Limited Number of Qualified Investors

A signal private funds shall not exceed 200 qualified investors. Managers of private funds and institutions selling private funds shall verify the investment to review whether the ultimate investor is a qualified investor or not, and calculate a consolidated number of investors. The verification does not apply to social security funds, pension funds, charitable funds, investment schemes registered in AMAC, and other investors prescribed by the CSRC.

(3) Risk Identification and Risk Tolerance

A qualified investor shall have an acceptable capability of risk identification and risk tolerance. Based on “Measures for the Suitability Management of Securities and Futures
Investors," effective on July 1st, 2017 investors shall be divided into professional investors and ordinary investors. The regulations give ordinary investors special protection, such as information notification, risk disclosure, and a client suitability matching process.

Professional investors refers to investors satisfying any of the following conditions:

A. financial institutions;
B. wealth management;
C. social security funds, pension funds, charitable funds, and other social public welfare funds;
D. qualified foreign institutional investors (QFII) and RMB-qualified foreign institutional investors (RQFII);
E. legal entity satisfies the conditions issued by CSRS;
F. natural person satisfies the conditions issued by CSRS.

The Private Fund Manager (PFM) and the institution selling private funds shall consider the source of income, financial status, debit, knowledge and experience of investment, risk preference, and credit ability to identify risk tolerance of ordinary investors. Based on the risk identification, the manager and the institution could classify ordinary investors and review the classification regularly. Ordinary investors could be classified into five classes, from C1 to C5. C1 refers to investors with zero risk tolerance, or that cannot bear any investment lost; C5 investors have the highest risk tolerance and are able to subscribe the highest risk product provided by the PFM.

(4) Periodical Review
The classification of ordinary investors shall be reviewed every six months. If any material changes for the investor, including shareholder structure, regulatory penalty of the company or its senior manager, financial status and/or other major changes, then the ordinary investor shall inform the PFM in time to review the suitability of classification.

3. Product of Private Funds
(1) Private Fund Types
According to the guidance issued by the AMAC, the PFM can raise private funds using the following types:

A. Private Securities Investment Fund
B. Venture Capital Fund
C. Private Equity Fund
D. Private Multi-Asset Allocation Fund
E. Other types of Private Funds
All of the above private fund types can be formed as “fund of fund” (FoF). The investment target could be equity, equity fund, bank deposit, standard bond, bond fund, stock pledge repurchase, bank wealth management product with target return rate, trust plan, future, future right and other derivative commodities, real estate, purchase the stocks of those re-build up companies, infrastructure construction, works of art, wine, and other properties.

(2) Product Risk Classification
The PFM and institution selling private funds shall classify the risk of private funds from R1 to R5 based on the following the conditions:
   A. product structure;
   B. historical volatility of performance and net worth;
   C. liquidity of investment subject;
   D. investment derivative commodity strategy; or
   E. valuation policy.

R5 shall be the highest risk product. This type of product generally has a complex investment structure, high historical volatility, bad liquidity, and unclear valuation. R5 products may only sell to ordinary investors classified as C5 and to professional investors. Ordinary investors classified as C4 can subscript product from R1 to R4; C3 can subscript product from R1 to R3; C2 can subscript product with R1 and R2; and C1 can only subscript product of R1.

Professional investors can subscript the product from R1 to R5. There is no mandatory requirement to classify the risk tolerance of professional investors; it is subject to the discretionary of the PFM.

4. Potential AML Risk
Under regulations, the PFM may only engage with qualified investors, and a single product shall not exceed 200 investors. Those investors are identified as high net worth clients, and the subscription threshold is RMB 1 million. Private funds could be designed diversity, and invest into not only the second market but also real estate, art work, wine and other properties goods. Private funds could be an investment scheme for high net worth clients to allocate and manage their assets with limited supervision. Until now, PFM was not deemed as a financial institution, which means that Anti-Money Laundering (AML) regulations did not directly apply to PFM, and most PFMs lacked human resources to conduct KYC and AML investigations. The next section introduces the most updated AML regulations in China.
Section II: Anti-Money Laundering Laws and Regulations in China

A. Know Your Client
   There were series of anti-money laundering regulations issued from 2016 to 2017. Those new regulations applied to financial institutions, Internet financial service providers and payment tools, certain businesses involved with currency exchange, accounting firms, and corporate agencies.

(1) Anti-money Laundering Obligation of PFM
   According to “Measures of the Administration of Fund Raising Practices of Private Investment Funds,” the raising private fund institutions shall fulfill AML obligations. However, there is no clear definition of AML obligation of the PFM in AML regulations. Most PFM follow the regulations regarding public funds, or refer to the practice of other financial institutions.

(2) Client Due Diligence (CDD)
   For fulfillment of client suitability and risk classification requirements, AMAC issued templates of nature persons, legal entities, and investment schemes for collecting basic information. In general, that information shall contain:
   A. the name, contact information, and address with identification;
   B. source of funds and financial status with relevant documents to prove it;
   C. investment knowledge and experience;
   D. risk preference;
   E. credit record; and
   F. ultimate beneficial owner.

   Client shall claim that all information is accurate, effective, and complete. PFM need to verify the client’s valid identity certificate or other identity certification documents, register the client's basic information, and retain a copy of the valid identity certificate or other identity certification documents prior to client onboarding.

(3) Enhanced Client Due Diligence (EDD)
   Each legal entity and investment scheme shall identify a natural person as ultimate beneficial owner in accordance with those new regulations. Ultimate beneficial owner could be This person has real control of the company, senior management of the company, and the investment manager of the funds raised. This person can be identified as the “controller” within the legal structure or contract.

   EDD shall take into account that if the client and ultimate beneficial owner are foreign PEPs, then the client is a match on the Sanction Lists issued by the Chinese Government.
and United Nations, and the client comes from a high-risk country/area issued by FATF, APG, and EAG. Most of the local PFMs don’t have enough resources to conduct PEPs and sanction screening, given the difficulty to acquire the list. Domestic data providers have to have a comprehensive database, and external data providers, such as Dow Jones, FACTIVA, and World-Check are too expensive for local PFMs. On the other hand, there is no mandatory requirement to conduct EDD on domestic PEPs; it became a leakage of the AML process.

B. Entrust the Third Party to Fulfill AML Obligations
A third party can be entrusted to perform the client’s identification check. Nevertheless, if a PFM entrusts the third party to ascertain the client’s identity, then the PFM shall bear the liability for failing client due diligence. PFMs may obtain client information provided by the third party and the originals, copies, or photocopies of the valid identity certificate or identity certification documentation from the third party when necessary.

C. Suspicious Transactions
In the client onboarding process and ongoing monitoring, PFMs shall identify the following activities as suspicious transactions:
(1) The client refuses to provide valid identity certificate or other identity certification.
(2) The client refuses to update its basic information without a justified cause.
(3) The authenticity, validity, and completeness of the previously obtained information about the client’s identity are questioned after adopting necessary measures.
(4) The client activities meet the transaction monitoring standards established by the financial institution. Transaction monitoring standards shall cover, among others, the circumstances where the identity and behavior of a client, the sources of funds for a transaction, and the transaction amount, frequency, flow, and nature, etc. are abnormal.
(5) The real-time monitoring of terrorist organizations and terrorists match.

D. Report
Financial institutions are required to file suspicious transaction reports to the China Anti-Money Laundering Monitoring and Analysis Center and local branches of the People's Bank of China. Given that PFMs are not financial institutions, and there is no clear guidance to follow, most PFMs do not know how to file the suspicious transaction report.

E. AML Risk Framework
The People’s Bank of China Anti-Money Laundering Bureau issued “Guidelines on Risk Management of Money Laundering and Terrorist Financing in Incorporated Financial Institution (Trial)” on October 10, 2018. It will go into effect on Jan 1, 2019. Under these new
guidelines, financial institutions shall be required to have an effective AML risk framework in place to mitigate AML risk.

In light of the increasing demands of management of anti-money laundering on financial institutions, it has become important to establish a set of anti-money laundering risk management systems for the PFM themselves, even though private funds institutions are still not deemed financial institutions.
AN EFFECTIVE AML RISK MANAGEMENT FRAMEWORK

Section III: Proposal of AML Risk Framework of PFM

1. Risk-based Approach

Risk can represent opportunity. Private funds have a flexible investment scope and gather money from high net worth clients. Flexible investment strategies, and a huge amount of money, give PFMs the opportunities to create value for high net worth clients, but also higher AML risk, given that PFMs could possibly be used as tools to help specific clients manage and relocate money. With the increasing demand for AML, PFMs must strive to build up an effective AML risk framework to manage risk.

In October, 2019, FATF published guidance for a risk-based approach (RBA) for the securities sector. In the guidance, investment funds including “undertakings for collective investment (UCIs) and pooled investment vehicles are undertakings established as limited companies, limited partnerships or by contract that generally pool money from a number of third party investors and invest it in assets such as securities.” Under this definition, private funds shall be catalogued as investment funds and apply for guidance.

According to the guidance, investment funds shall establish risk frameworks to allocate and manage risk, identify Money Laundering/Terrorist Financing (ML/TF) risk, and mitigate ML/TF risk. The common risk criteria include geographic risk, client risk, product risk, and intermediary risk.

Due to the limited sales methods of private funds in China, private funds can only be sold by PFMs, or by securities companies and third-party sales institutions registered with CSRC, and all must follow the same regulations to conduct client suitability analysis. In addition, securities companies also have to comply with anti-money laundering regulations and internal control requirements. PFMs need to conduct due diligence when establishing cooperation with securities companies and specify the requirements of anti-money laundering in the agreements. Therefore, there is a clear control mechanism for the risk of money laundering in intermediary services. For these reasons, this section will discuss country or geographic risk, client risk, and product risk; intermediary risk will focus on cooperation and communication between PFMs and third-party sales institutions.

2. Client Risk

(1) Information Gathering

Before client onboarding, PFMs shall collect basic information about their clients. For natural persons, this includes name, gender, nation, occupation, address, contact number,

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and ID (type, number, and expiration date). For entities or products, this includes the name of the company/product, business address, institution number, product number, tax number, business license, product registered certification, legal representative, authorized person, and ultimate beneficial owner.

The original documents and licenses are required when the salesperson and/or client relationship manager examines their authenticity. In practice, the original identity documents of the legal representative, the authorized person of the company, and the original business registration documents of the company are not easy to obtain. Therefore, most companies will provide photocopies and stamp the company seal to prove the validity of the documents.

Obtaining basic information and relevant certification documents is the first step to knowing your clients and conducting a client suitability analysis. Next, PFMs need to know more about the clients, and the accuracy of the information they provide, in order to analyze ML/TF risk.

(2) Investigation
To verify the accuracy of the information provided by clients, PFMs can refer to the official information from authorities or the third-party companies that specialize in providing corporate information. The following is an introduction to common query methods and available information in China.

A. National Database
- National Enterprise Credit Information Publicity System
  This website is a very useful tool that includes business license information, shareholder information, main personnel information, any material changes information, mortgage information, shareholder pledge information, and intellectual property pledge information. In addition, the company's annual financial report could be obtained on the website, subject to the companies. If the company has been listed in the list of abnormal operations or serious breaches of trust, this will also be disclosed.

- National Enterprise Bankruptcy Information Disclosure Platform
  If the enterprise has entered bankruptcy proceedings or is in the stage of corporate restructuring, the website can be used to better understand the situation. Creditors can also use the announcement information on the website

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to understand their rights. PFPs can use the information on this website to understand the financial status of the entity clients.

- **China Executive Information Open Network**
  Natural persons can use this website to understand their personal credit statuses. By using their names and ID card numbers, they can determine whether their credit statuses are enforced by the court. In order to protect personal information, the ID number advertised on the webpage has four hidden digits. Through the case content, we can know more clearly whether it is the same person or not. This website is run by the Supreme People's Court of The People's Republic of China.

- **Credit China**
  For natural persons, this website provides the most updated list of the Public List of Joint Punishment for Breach of Credit. For enterprises, the List of Key Joint Punishment Notices Concerning Large Amounts of Credit Breaking Enterprises will give us more detail about enterprises involved in major cases of tax evasion involving more than 30 million tax revenues, and enterprises involved in major tax violation cases related to falsely issuing VAT invoices.

### B. Reliable Service Provider

There are many private institutions specializing in providing enterprise information in China. In addition to official information acquired from authorities, those third parties provide the service to analyze the relationship among shareholders and quickly know the relationship structure of the query object. They have also launched apps for mobile phones, enabling users access anytime, anywhere.

There are three well-known service providers:

- **TianYanCha**: [https://www.tianyancha.com/](https://www.tianyancha.com/)
- **Qixin**: [https://www.qixin.com/](https://www.qixin.com/)
- **Qichacha**: [https://www.qichacha.com/](https://www.qichacha.com/)

### C. Negative News

In China, personal criminal records can only be accessed by the Ministry of Public Security of the People's Republic of China. As a result, the only relevant information that can be queried for financial suspects or other negative news is

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6 Credit China: [https://www.creditchina.gov.cn/home/index.html](https://www.creditchina.gov.cn/home/index.html)
through the Internet. Searching for negative news can help us understand whether clients are involved in criminal acts, scandals, bribery, tax evasion, or other major incidents. That information could be used as further analysis of client risk.

(3) Enhanced Due Diligence

A. Ultimate Beneficial Owner (UBO)

Through checking the national database and data service provider, PFM"s may identify the major shareholders of a company and can also determine the actual controller from the shareholder structure. For investment products as client, the investment manager could be deemed a UBO; after the fund is launched, investors holding more than 25% shares will be recognized as UBO. Some information can be acquired from the fund contract, but it is impossible to verify the correctness of that data from a third party. PFMs can only rely on the initiative of clients. In particular, products that can invest in private funds are usually private, and relevant information cannot be obtained publicly.

By signing an agreement with the client, the motivation of clients to provide correct and updated information on their own initiative may be increased. For example, one could add a declaration field to the client"s base Information form or add the client"s obligation to actively inform PFMs with fund contracts. The information provided by clients must be verified by third parties, such as client lists, which can determine the major shareholders and can be provided by a custodian to increase availability.

B. PEPs and Sanction Lists

China has not legislated domestic political persons and its related persons as PEPs, and it"s not to conduct enhanced due diligence on domestic PEPs. For foreign PEPs and Sanction Lists, most local PFMs can get the updated list from the website run by The People"s Bank of China. Some data service providers can provide free data from their websites, but it is difficult to confirm the accuracy. The most popular service provider with charge is Hang Seng Bank, which is more credible and reliable.

For foreign PFMs, their parent companies provide more support on PEPs and Sanction List screening systems. Dow Jones, World-Check, and FACTIVA are all

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very commonly used. Selecting the right and sufficient range of data is the basis of effective PEPs and Sanction List screening.

(4) AML Report and Ongoing Monitoring

After conducting AML due diligence on a new client, an investigation report to senior management is required. The content of the investigation report is important; too much information may lead the manager nowhere, so it is best to focus on a few points:

a) what type of client is the entity;
b) where the money came from;
c) which product may be invested;
d) shareholder structure;
e) negative news;
f) who is the UBO;
g) any match in PEPs and Sanction List screening.

If the client refuses to provide any required documents or provides incorrect information, or any other unusual activities occur, all of that should be written in the AML report.

The AML report needs a conclusion of acceptance of this new client (or not). Sometimes it is not easy to make a decision, based on the company's scale. The AML report can be circulated to senior management or a committee to set the final decision. A suspicious transaction report submission to the proper authority is necessary when the new client review results involve criminal activities, matched PEPs, or a Sanction List.

Every six months after a client is onboarded, PFMs shall reexamine client suitability according to regulation. This is a good opportunity to conduct ongoing monitoring; any updated information could be reexamined, including basic information, UBO, negative news, and PEPs/Sanction Lists screening, and any transactions conducted in the past six months. Building up transaction models for each client could make it easier to monitor suspicious transactions. Otherwise, false alarms or suspicious transactions can’t be recognized.

3. Know Your Product

(1) Investment Target Due Diligence

As mentioned in Section I, private funds can be designed in very different ways. The private fund with the lowest risk is invested in a second market, such as listed companies, bonds, or public funds. Private Equity Funds (PE Funds) will be more fixed and targeted to real properties, such as real estate, basic infrastructure, wines, and art works. Given high diversity, low liquidation, and the difficulty to valuate PE Funds, PE Funds are usually
rated with higher risk to R5. Conducting effective due diligence on investment targets becomes top priority for PE Funds.

AMAC is planning to issue guidance on credit information reports for PE Funds to set a baseline for PE Funds. The baseline will require the ability to know the investment target, managing investment project, and legal withdraws from the project. Before AMAC issues the guidance, PE Funds may use some investigation skills to understand the investment target. For example: a national database can show basic information on the target company. If the investment target is a national investment project, such as local infrastructure, search the National Investment Project online examination and approval supervision platform⁸ to learn more details.

On-site investigations always reveal more than paper investigations. To know the target company, one should go to its operations site and read data in written form. Some companies even use satellites to monitor their investment targets and to understand the company’s ability to produce, manufacture, and possibly achieve a business plan.

(2) Investment/Product Committee
It is mandatory that PFMs have internal controls on investment processes and trading flows in place. Some PFMs have product or investment committees to gather opinions from sales, compliance, product, investment, and operations. This kind of committee, or similar function, can take different perspectives into account.

(3) Transparency
Sharing product information with clients not only gains the trust of the client, but also avoids misuse of funds. Compared to financial institutions, private funds have lower supervision from regulators. Providing monthly, quarterly, and annual reports to clients and AMAC may reduce the occurrence of some illegal person using PFMs as a tool to raise funds illegally. As self-disciplined authority, AMAC issued a series of instructions to restrain illegal fundraising in the past year. These instructions include: identify ultimate beneficiary owner of PFMs, set senior manager roles to be responsible for PFMs’ businesses, and rely on law firms’ legal opinions to control and manage PFMs’ industry. Any violation is published on AMAC’s website and includes a blacklist of senior managers and law firms.

Even some PFMs claim that their investment formulas are confidential business information. PFMs face higher regulatory standards, so providing timely and accurate

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investment reports is significant to them. PFs’ accounts are reviewed by custodians to ensure correctness, in case of any artificial adjustment on performance. Some clients even ask for more details of investment reports to avoid any misuse of funds, such as top 10 investment holdings, top 5 investment loss targets, and specific targets’ most recent financial statements.

Ongoing risk monitoring on each PF is a way to mitigate investment risk and improve investment reporting. Investment or product committees can still play an important role to manage product risk. Regularly reviewing existing product performance and investment targets can help an investment manager adjust investment strategy and avoid any active breach of investment restriction.

4. Suspicious Transaction
(1) Establish Standard
Most PFs set a lock-off period in the fund contract to avoid frequent trades. Monthly, quarterly, and even semi-annually, it is common for PFs to open for investor subscription and redemption. According to regulation, the investment redemption can only be transferred to the designated account of the client that was used for subscription. These features make the continuous monitoring of suspicious transactions of PFMs different from that of the banking and securities industry.

Therefore, it is the basis for PFMs to consistently monitor suspicious transactional behavior by reviewing the client’s suitability every six months and reexamining the basic information, assets, financial status, and transaction behavior of clients. Monthly PEPs and Sanction Lists screening of existing clients are also essential.

Some cases can be used as indicators of suspicious transactions. If the client does not care about the investment performance and applies for the subscription on each open day, and the amount accumulates considerably, but the financial situation shows no increase or even decrease for the client, then the legitimacy of the client’s source of funds should be reviewed. If the client refuses to provide the updated basic information or claims that there is no update when regularly reviewing, or the information provided is inconsistent with the national database, then PFMs should further understand the real status of the client. This would be a red flag.

It is very important to design monitoring indicators for suspicious transactions according to the types of products. When investing in a private fund, if the client interferes too much with the investment target, or the client himself has a correlation with the investment
target, then PFMs should pay more attention; it could be some illegal deal between the client and the investment target.

(2) Corporation With Intermediary
China Anti-Money Laundering Monitoring and Analysis System is an official portal for online submissions of suspicious transactions. There are two types of reporting: one is for financial institutions such as securities, insurance, and trust, etc., and the other for non-financial institutions running payment businesses. PFMs are neither financial institutions nor running payment businesses. Under the current criteria, it will be difficult to report suspicious transactions via this portal.

There are two main ways to raise private funds. One is raised by PFMs themselves, and the other one is engaged by a placement agent, such as securities companies. Given that securities companies have many high net worth clients and business units, PFMs are willing to build long-term business relationships with securities companies. Under this model, although PFMs have the ultimate anti-money laundering responsibility, securities companies must also carry out anti-money laundering obligations, as well. Securities companies have an advantage in carrying out anti-money laundering obligations: they can file suspicious transaction reports via the portal. In this case, how to cooperate with securities companies to carry out anti-money laundering obligations is vital to PFMs.

Before establishing a relationship with a securities company, PFMs shall conduct due diligence on the anti-money laundering capability of the securities companies. Due diligence shall include an anti-money laundering framework, a responsible person and level, internal control policies and procedures, monitoring the frequency and standards of suspicious transactions, document preservation, and others. Upon completion of the due diligence, when establishing business relations, the requirements of the due diligence shall be implemented in the contract to constrain both sides.

It is also important to regularly review the anti-money laundering capabilities of cooperative securities companies. If a cooperative securities company is fined for its lack of anti-money laundering capabilities, then it should consider whether to continue its cooperative relationship.

Setting a communications counterpart for AML investigation and reporting should be established between securities companies and PFMs. By sharing information and exchanging information in time, PFMs or securities companies can submit suspicious transactions in a timely manner. Given that clients come from securities companies, securities companies have an obligation to collect a client’s information and provide it to
PFMs. As the ultimate responsible party for AML obligations, PFM has the right to obtain information from securities companies to judge whether clients are suspected of money laundering. As a placement agent, securities companies should cooperate with PFMs to submit suspicious reports and copy PFM for follow-up tracking.

(3) Report
In addition to the online portal, it is possible to submit a suspicious transaction report to the Anti-Money Laundering Monitoring and Analysis Center by mail. According to statistics, only 1,638 suspicious transaction reports were submitted by the Securities and Futures fund industry in 2015, accounting for 0.3% of the whole year's national suspicious transaction reports. The following problems exist in suspicious transaction reports: small number of reports, low value without manual analysis, incomplete reporting elements, mismatches between descriptions and features of suspicious transactions, misreporting, and false reports.

Only by improving the reporting standard of suspicious transaction reports and improving the analytical ability of anti-money laundering staff on suspicious transactions can these reports effectively assist the investigation by the Anti-Money Laundering Monitoring and Analysis Center. The quality and quantity of suspicious transaction reports can be strengthened by finding experienced anti-money laundering experts to serve PFMs or training internal personnel with external experts. Most importantly, the top management of the company must understand the importance of anti-money laundering obligations to the company's business.

5. Corporate Governance
(1) First Line of Defense
Most PFMs have a limited number of employees. The newly established PFM usually has five employees based on the requirements of regulations. As with the growth of PFMs, the number of staff usually extends to 20-30 people, not usually exceeding 40. In this case, PFMs can establish AML investigation roles on the basis of segregation of duties according to the types of products and the professional competence of personnel.

According to the Three Lines of Defense theory, the first line of defense is operational management. The second line of defense is risk management and compliance functions, and the third line of defense is an internal audit function. Based on the scale of PFMs, there are two feasible schemes proposed as a first line of defense of AML risk management for PFMs:

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9 Source: AMAC training material.
A. Personnel of the Company Concurrently

As a contact window to establish business relationships with clients, the client relationship manager is not suitable to conduct AML investigations. For small-scale PFMs with insufficient manpower, anti-money laundering investigation may be carried out by operational personnel or personnel of the product department.

The disadvantage of this method is that investigators are usually not trained professionally, lack awareness of money laundering signs, and are less able to distinguish and detect suspicious transactions.

B. Set a Role for Anti-money Laundering Investigators

For PFMs that have reached a certain scale, it is quite effective to set up full-time roles to conduct anti-money laundering investigations. Professional investigators can analyze the information collected by client relationship managers and synthesize various investigative techniques to determine the correctness of the data and any suspicious activities that may arise. In addition, when making suspicious transaction reports, they can carry out manual analysis and correctly express the suspicious transaction pattern and content of the report, so as to improve the efficiency of the national investigation.

(2) Second Line of Defense

The compliance and risk officer is a necessary position for PFMs and should be registered as a senior management officer in the AMAC, as per regulatory requirement. As the second line of defense, the compliance and risk department shall establish an appropriate internal control system, training for staff, and identify risks and follow up the mitigation programs. For the results of anti-money laundering investigations, the investigators on the first line can report to compliance and risk officer, for further action.

However, at the company management level, whether to accept clients and whether to report a suspicious transaction is subject to the decision of the compliance and risk officer, and has a potential ethical risk. A risk management committee could be set up in PFMs, regardless of the scale. The members of the risk management committee could include: a general manager, a compliance and risk officer, a product or investment manager, and a client relationship manager. Any suspicious transaction could be reported to the committee in a timely manner, and the decision could be made by the committee. This may reduce subjective influence.

The Risk Management Committee can establish the corporate culture of anti-money laundering for the company. From top to bottom, facing up to the importance of anti-
money laundering and providing necessary support can make PFMs continuously improve the anti-money laundering and investigation processes, both in manpower and resources.

(3) Third Line of Defense

PFMs seldom have internal auditors. Some of them adopt external auditing, and some have no concept of auditing at all. Therefore, the compliance officer sometimes also plays an internal audit role in PFMs. However, considering the segregation of duties, engaging external auditors might be a better way to ensure the effectiveness of internal controls if PFMs don’t want to pay for, or cannot afford, an internal auditor.

Relying on legal opinions of external lawyers is one of the management methods to establish the effectiveness of an internal control system. Under the current regulations, external lawyers should be entrusted to give legal opinions on the internal control system for PFMs’ registration on AMAC. Unfortunately, anti-money laundering policy is not mandatory by AMAC to implement an internal control system of PFMs. It will be helpful if an incorporated anti-money laundering policy was inserted into a client suitability policy, as part of an internal control system. External lawyers can also examine the compliance of an anti-money laundering policy, which will help PFMs to establish an effective internal control system.
Section IV: Case Study

1. Background
Alice is a product specialist for a PFM company. The client relationship manager recently introduced a client and asked the product department to assist in designing a private fund to meet the client’s needs.

Alice did a background check on this client. It was found that the client had a criminal record for fraud. The company operated by the client mainly produced Chinese medicine cupping equipment. It claimed to sell through a multi-level pyramid selling mode, but it could not explain the main client and sources of funds. The client asked Alice to design a framework for setting up a limited company in the Cayman Islands. The client would invest money in the name of his family members into this company registered in the Cayman Islands and then entrust the PFM as investment manager to manage this company.

Alice felt that the client’s background, source of funds, and requirements involved suspicious transactions. She decided to seek advice from her supervisor, Bob.

Bob has several options to respond to Alice’s request:
   o Tell Alice he’ll handle it, and ask her to continue designing investment structures for clients
   o Report Alice’s finding to the general manager
   o Discuss with the compliance officer
   o Discuss with business executives how much money customers can invest
   o Ask Alice to report the findings and immediately request the convening of a risk management committee for discussion

After consideration, Bob decided to seek help from the compliance officer.

2. Investigation
After listening to Bob’s description, the compliance officer asked to talk to Alice to learn about her findings and methods of investigation. After the talks, the compliance officer found that Alice only has the client’s name and the investment structure provided by the client’s relationship manager. The investigation result came from the Internet using the Baidu search engine.

The compliance officer finds that there are many problems in Alice's investigation, so it is necessary to reopen the investigation in the following direction:
(1) Client’s basic information
Alice shall acquire the client’s name, birthday, ID, nationality, and proof of income from the client relationship manager. If the client intends to invest in the name of his family members, then the same due diligence standard shall apply to all. If the client wants to use his own company as the investor, he must provide the basic information of the company, including the company name, the copy of the business license, and the latest financial report.

After she obtains the client’s information, Alice can conduct an investigation from the national database and third party data service provider, and she can search negative news from the Internet. By cross-checking the name and birthday, Alice can determine whether the client is involved in any criminal activities or has credit issues. The same information can be used for PEPs and sanction screening. Alice can download the most updated data from the Anti-money Laundering Bureau, compare the list, and check for any matches.

(2) Requirement for Investment Product
There are several private funds managed by the PFM, and all invest in the domestic second market. The PFM has an affiliated company specialized for PE funds. Most of the investment target is water energy and other green energy industries all located in China. The PFM has no experience in overseas investment, especially for setting a company formed with a limited partner model.

3. Report
(1) Investigation Report
Alice re-investigated this case and followed the advice from compliance officer. She prepared a report, below:

Wu tin Yu is 55 years old, and his wife (52 years old) and son (27 years old) live in Xuhui District, Shanghai. Mr. Wu and his wife owned a company that has operated over 15 years and in the most recently audited financial report, the total asset of the company is around RMB 2 billion. His son is working in PwC as a junior accountant.

Mr. Wu's family is in good credit condition. The company owned by Mr. Wu and his wife has no major liabilities and operates well. Its main products are medical equipment. It also cooperates with many famous universities to develop new products. The negative report on Baidu was a person about 30 years old who lives in Shandong province with the same name, but is obviously different from Mr. Wu. By comparing with the existing list, neither Mr. Wu's family nor Mr. Wu's company was listed on the Sanctions list. Mr. Wu is willing to provide a statement to declare that he and his family are not domestic PEPs.
After further communication with the client relationship manager, it is a first approach to Mr. Wu. Mr. Wu doesn't have a deep understanding of the products managed by the PFM, and he is looking for an overall financial service for his family, not short-term return product. The reason Mr. Wu mentioned he wanted to establish a company in the Cayman Islands is mainly to find ways to legally invest in overseas assets and to mitigate the risk of asset concentration in the China market.

(2) Suspicious Report

Bob circulated the investigation report with relevant documents to the compliance officer for further direction. The compliance officer reviewed and confirmed the accuracy of the investigation report. It seems not suspicious of Mr. Wu and his family. However, the compliance officer wants to raise this case in the management meeting. Through this case, the company should face up to the importance of anti-money laundering. The compliance officer suggests that the company establish an internal control system for anti-money laundering, set specialized personnel and authorities, and strengthen anti-money laundering training and investigation skills.
Section V: Conclusion

The industry of private funds is very attractive. With sufficient capital and diversified products, investment managers can achieve high-yield returns with long-term investments. In the private funds industry, professional investment managers can create high value for investors and establish a trust relationship with them. With the vigorous development of the private funds industry, the competent authorities have gradually strengthened supervision. Even though the anti-money laundering has not been included in the scope of regulation, with the development of laws and regulations, I believe that in the near future, anti-money laundering will be included in the scope of regulation.

In the framework of risk management, even if the company can establish risk-based anti-money laundering policy and procedures, relying on professional investigation is far better than checking the list.

The anti-money laundering investigation in mainland China is still in a very early stage. Professional anti-money laundering investigators can be trained according to the characteristics of the industry. The trained investigators should be able to effectively reduce the risk of money laundering and provide more accurate and effective information for the Anti-Money Laundering Monitoring and Analysis Center.
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