



# AML Guidance on establishing Source of Funds (SOF) and Source of Wealth (SOW)

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## Purpose

This guidance note is prepared to assist ICPAC's members in obtaining a practical and comprehensive approach on establishing the source of funds (SOF) and source of wealth (SOW) of clients. It is primarily based on FATF recommendations and guidance, taking into account the requirements of the Cyprus AML law, the EU AML Directive and ICPAC's Directive on AML compliance. It is not a substitute nor is it intended to be a substitute for these requirements. The guidance provides examples and a list of steps, which are neither absolute nor exhaustive. It is the responsibility of the members to ensure they are able to demonstrate full compliance with these requirements and obtain independent advice from reliable sources, when required.

### A. Understanding the difference between Source of Funds (SOF) and Source of Wealth (SOW)

#### Meaning of Source of Funds

Refers to the origin of the particular funds or assets which are the subject of the business relationship between the firm and its client and the transactions the firm is required to undertake on the client's behalf (e.g. the amounts being invested, deposited or remitted).

Easier to establish than source of wealth but this should not simply be restricted to knowing from which bank or financial institution the funds may have been received. The information obtained should be substantive, relevant and be able to establish the fund's origin and the method/circumstances under which the funds were acquired.

#### Meaning of Source of Wealth

Refers to the origin of the entire body of wealth (i.e. total assets) of the client:

The information that should be obtained should give an indication as to the volume of wealth the client would reasonably be expected to have, and provide a picture of how it was acquired.

Although firms may not have specific information or details about all the client's assets, it may be possible to gather general information from commercial databases or other open sources.

**Source: Paragraphs 86-88 of FATF Guidance on PEPs.**

#### When does the requirement to establish SOW arise

- a) In addition to establishing the source of funds, firms should also take adequate measures to establish the source of wealth of clients and beneficial owners identified as politically exposed persons (PEPs) (paragraph 5.62 of ICPAC AML Directive, paragraph 1(c)(iii) of the AML law & paragraph 4(c), Article 13 of EU third Directive (also required by paragraph b(ii), Article 20 of EU fourth Directive) & FATF Recommendations 12(c)).
- b) Enhanced due diligence (EDD) should also be carried out in respect of clients, other than PEPs, which due to their nature entail a high risk of money laundering or terrorist financing (*ICPAC Directive paragraph 5.66*). The examples of EDD suggested by FATF recommendations for high risk clients on EDD include "Obtaining information on the source of funds or source of wealth of the customer" (*paragraph 20 of the Interpretive Note to Recommendation 10 of the FATF Recommendations*).

- c) Therefore, establishing the source of wealth is a suggested EDD measure for all high-risk clients in addition to PEPs. Additional high-risk categories where the EDD measure of establishing source of wealth is applicable include clients from jurisdictions considered by FATF to have strategic deficiencies in anti-money laundering / countering the financing of terrorism measures, clients in high risk industries, clients with complex structures, etc. A list of factors that may indicate a higher than normal money laundering or terrorist financing risk are provided in Appendix C of ICPAC's AML Directive. The examples provided are non-exhaustive.
- d) Understanding the SOF and SOW of a PEP is also necessary for ongoing Due Diligence (DD) purposes, where the aim should be to ensure that the reason for the business relationship between the firm and the PEP and the transactions undertaken on the PEP's behalf, are commensurate with what one could reasonably expect from that PEP, given his/her particular circumstances (*Paragraph 89 of FATF Guidance on PEPs*).

## B. Establishing the source of wealth as part of Enhanced Due Diligence (EDD)

Firms should follow a risk-based approach when establishing SOW i.e. apply 'reasonable measures' i.e. detail / extent should depend on the client's money laundering and terrorist finance risks (*Glossary in FATF Recommendations*).

Three steps to follow when establishing source of wealth:

1. Obtain information on net worth
2. Obtain information on where that net worth came from
3. Verify the information on a risk sensitive basis

### 1. Obtain information on net worth

Indication of client's net worth should be obtained through representations obtained from the client. It is not required to obtain the exact amount and might be impractical to do so.

### 2. Obtain information on the source of the net worth

- a) Once the client's net worth is established, information should be obtained on where it came from i.e. inheritance, employment, business, investment etc. If from corporate/legal entities, should ensure this came from profits generated from legitimate business and commercial activities.
- b) Generally, no single source is likely to account for the total value of net worth; but categories are likely to be few and generally well understood. It is often difficult to specifically identify the wealth from all the different sources, and there is no expectation to do so. The level of detail should be based on the client's risk profile (reasonable measure).
- c) Firms could rely on publicly disclosed information if such information is available. While only a summary of the information filed by officials is generally made publicly available, this may include categories such as values of income, real estate, stock holdings, sources of income, positions on boards of companies, etc. (*Paragraph 91 of FATF guidance on PEPs*).
- d) In the absence of publicly available information, firms are only able to primarily rely on declarations made by the client; however, the inability to verify such information should be taken into account in establishing the true value.

- e) Firms should try and obtain specific information as far as possible, on how much wealth the client has or controls. However, it may not be possible to do so, on every aspect of the client's entire body of assets, especially when this information is not voluntarily disclosed, but should cover those aspects that form the major part of the net worth. Firms should bear in mind that failure by a client to voluntarily disclose information about how much wealth he or she controls could be a red flag (*Paragraph 92 of FATF guidance on PEPs*).

### 3. Verify the information on a risk sensitive basis

- a) Once the firm has information on how the wealth was generated and a description of it, it should consider the validity of this information.
- b) It is not necessary to find evidence to corroborate every source or to verify the entire net worth (which is most likely to be impossible).
- c) Depending on the level of risk posed by the client, firms should seek to find some evidence from a reliable, independent source that corroborates the essence of how the wealth was generated. Firms should focus on the sources that generated the major proportion of the wealth.
- d) In summary, SOW can be established through a combination of sources, such as publicly available information, external confirmations and information provided by the client. Examples:
- publicly available property registers, land registers, asset disclosure registers, company registers
  - past transactions (in the case of existing clients)
  - sources of information, where available, about legal and beneficial ownership
  - internet searches (from reputable sources), including social media, may reveal useful information about a PEP's wealth, lifestyle and official income
  - confirmation from regulated professionals with knowledge of the client (accountants, lawyers etc.)
  - evidence of title, copies of trust deeds, audited documents (annual reports containing information on dividends)
  - documents confirming salary, tax returns and bank statements

The level of corroboration (proof/evidence) should reflect the client's risk profile and be able to resolve any red flags.

- **High risk:** copies of trust deeds, audited accounts, reliable and independent third-party information (e.g. lawyer, accountant).
- **Low risk:** public information, open sources, official documents provided by client.

#### Record Keeping

- All relevant information should be obtained/collected and appropriately recorded.
- Records maintained should enable an independent reviewer (whether internal or external) to understand the SOW and how it was acquired, on the basis of the information recorded.
- How a summary of SOW is presented is also important - assessment, rationale for assessment, justification.
- It is very important to document the questions asked of, and the answers given by, the client and retain copies of any supporting material the client has provided or independently obtained.

#### Examples of poor practice

- SOW requirements, particularly around verification, are not risk-based - applying the same inadequate measures to clients of varying risks.
- Always accepting a client's explanation for SOW at face value – no further investigation is performed, even where multiple red flags are present.
- Over-reliance on unverified information.
- Not able to distinguish between a customer's source of funds and source of wealth - this can be because of poorly designed forms or software or procedures which offer no real guidance to staff.

#### Examples of good practice

- Establish and document the SOW of PEPs and other high-risk business relationships.
- Undertaking of effective escalation and advisory procedures (e.g. Money Laundering Compliance Officer (MLCO) approval).
- Ability to provide evidence that relevant SOW information is challenged (where appropriate) during the client due diligence (CDD) process - there will be cases where more objective information is required.
- Proactive follow up on gaps in updates on SOW information for PEPs and other higher risk clients during the course of the relationship.
- Clear risk-based policies and procedures - e.g. setting out the nature and extent of EDD required for higher risk and PEP customers, particularly on SOW.
- Demonstration of risk-based approach – performance of enhanced validation and corroboration for PEPs and other higher risk clients, and, where required, collection of evidence of challenge.

### **C. Understanding the risk associated with Politically Exposed Persons (PEPs)**

#### Risk associated with Politically Exposed Persons

PEPs are predominately considered by many as a group of people that are prone to money laundering activities, corruption and embezzlement. And although PEPs are classed as high-risk clients, their status alone does not dictate that they are involved in illegitimate business, rather it refers to the increased risk attached to being entrusted with a prominent function, or their association to political officeholders that provides access to corrupt activities. However, failure to identify a prospective client as a PEP, could lead to significant regulatory exposure for a firm, and ultimately a reputational risk.

The Cyprus AML law and ICPAC Directive do not distinguish between foreign, domestic and international PEPs and therefore the compliance requirements should be the same for all PEPs. Definitions of PEP's provided by the FATF and the 4<sup>th</sup> EU AML Directive can be found in **Appendix I**.

## Identifying and assessing a PEP

It is very important for a firm, before accepting a client, to have in place appropriate risk management systems to establish whether the client is a PEP, to assess, through applying appropriate due diligence procedures, the level of risk associated with that client and to consider whether it has adequate controls to mitigate the risk.

More specifically, during the risk assessment phase, a firm should, in addition to assessing the client, country and service risk, consider the nature of the prominent public function held by the PEP (e.g. level of seniority, access to or control of public funds and the nature of the position).

In assessing the nature of the prominent function, firms should consider whether the PEP:

- has business interests which are related to his/her public functions (conflict of interest).
- is involved in public procurement processes; whether the PEP holds several (related or unrelated) prominent public functions which may enable the PEP to exert influence at several key decision-making points in a process, especially in spending departments.
- is from a country which has been identified by the FATF or other organisations as having ineffective or deficient AML/CFT legislation and regime, or is known to have a high level of corruption.
- has a prominent public function in sectors known to be exposed to corruption, such as the oil and gas, mining, construction, natural resources, defence industries, sports, gaming, gambling sectors.
- has a prominent public function that would allow him/her to exert a negative impact on the effective implementation of the FATF Recommendations in his/her country. The exact range of prominent public positions that this would apply to will likely differ from country to country, but could include the Head of State, key ministers and other political or parliamentary leaders.

(Paragraph 96 of FATF Guidance on PEPs)

The FATF offers some guidance with respect to identifying PEP clients as follows (paragraphs 58-78 of FATF Guidance on PEPs):

- a) Ensure client's due diligence information is up to date as existing clients sometimes become PEPs after they enter a business relationship;
- b) Ensure internal procedures include employee ongoing training programmes, addressing effective ways of determining whether clients are PEPs;
- c) Use the Internet and media as source of information for the determination, monitoring and verification of information in relation PEPs;
- d) Use available commercial databases but do not fall into the trap of wrongfully assuming that if a name is (not) in such a database then the client is (not) a PEP;
- e) Use countries' published lists of domestic PEPs;
- f) Use in-house developed databases as a tool to assist in the determination of who is a PEP;
- g) Use countries' asset disclosure systems applying to those individuals who hold prominent public functions;
- h) Use self-declarations by a client of their PEP status, while noting that such procedures would shift the financial organisation's obligation to their client, which is not an acceptable practice; and
- i) Use general information publicised by competent authorities (e.g. the level of corruption in the

country, the level of income for certain types of positions).

Once a client is identified as a PEP, then he/she should be automatically classified as a high-risk client. The due diligence process should take into consideration the particular characteristics of the public function the client has been entrusted with and appropriately perform enhanced due diligence. (Article 20 of the 4<sup>th</sup> EU AML Directive and paragraph 20 of the Interpretive Note to Recommendation 10).

Attention must also be paid to immediate family members and close associates of PEP's as they should equally be considered as PEP's by virtue of their relationship with a PEP.

#### Time limit of PEP status

According to the 4<sup>th</sup> EU AML Directive, article 22, where a politically exposed person is no longer entrusted with a prominent public function by a Member State or a third country, or with a prominent public function by an international organisation, obliged entities shall, for at least 12 months, be required to take into account the continuing risk posed by that person and to apply appropriate and risk-sensitive measures until such time as that person is deemed to pose no further risk specific to politically exposed persons.

However, it is important, before declassifying a person as a PEP, to take into consideration, the seniority level once held by the person and whether the person still has the ability to exercise the level of (informal/indirect) influence as when he/she held the prominent public function.

### **D. Establishing Source of Funds**

#### Matters to consider

Source of funds will most often be a bank account that can be related directly to the client but even then, this knowledge is not adequate to confirm that the funds are from a legitimate source and appropriate due diligence procedures should be applied, based on the firm's understanding of the client's circumstances and risk profile.

The fact alone that, the money comes from a client's bank account does not mean it is legitimate, as:

- (i) the bank may have filed a suspicious activity report (SAR) with its FIU and received consent to send that money, while its FIU monitors how that money is being used and gathers more evidence, or
- (ii) the bank may not have applied proper due diligence measures (eg. a bank not regulated within the EU or third equivalent country, or a bank with weak AML controls).

On inception of a business relationship with the client, firms should establish the client's economic profile (e.g. declared activities, economic rationale of these activities and resulting transactions, expected turnover, main counterparties whose activities should be in line with the client's activities, etc). Any transaction performed on behalf of the client should be aligned with the client's economic profile.

Where the funds come from a third party, the risk is even greater and further enquiries should be made about the relationship between the client and the ultimate underlying principal of the funds (i.e. the actual provider of the funds) as well as assessing whether the purpose of the transaction is in line with the documented economic profile of the client.

Where cash is involved it becomes more challenging, as a bank statement showing a large withdrawal does not necessarily mean that the cash in the client's possession is actually the money withdrawn. Equally a bank statement showing large cash deposit does not provide information about where that cash came from.

Firms need to ensure that the source of funds is logical and backed by supporting documentation (e.g. a deed of sale) - See **Appendix II** for examples of details required when assessing the source of funds, together with suggested documentary evidence.

Firms need to be alert to any possibility that the funds may not be from a legitimate source or are not destined for a legitimate purpose. For example, when funds are sourced from a high-risk third country with inadequate AML/CFT legislation and regime, it is probably appropriate to obtain more information before proceeding with any transactions.

The purpose of ongoing DD is to scrutinise future transactions to ensure that the transactions being conducted are consistent with the firm's understanding of the client's circumstances, business/economic and risk profile. In order to ensure this is done effectively, firms should also ensure that the client documents, data and information are up-to-date as part of ongoing due diligence, such that any unusual or suspicious instructions or transactions can be identified.

#### Record Keeping

The firm's records should include information, including reliable documentary evidence, obtained from prospective and existing clients, along with information obtained from other sources, as part of risk assessment and client due diligence. These records should be able to support the steps that the firm has taken to illustrate why it had agreed to act or continue acting for a client, that it has undertaken enhanced due diligence, where required, and that it has established the source of funds which are the subject of the business relationship between the firm and the client and the transactions the firm is required to undertake, or has undertaken, on behalf of the client.

## Appendix I

### PEP Definition

The **FATF** distinguishes the PEPs in three separate types and defines them as follows:

- **Foreign PEPs:** individuals who are or have been entrusted with prominent public functions by a foreign country, for example Heads of State or of government, senior politicians, senior government, judicial or military officials, senior executives of state owned corporations, important political party officials.
- **Domestic PEPs:** individuals who are or have been entrusted domestically with prominent public functions, for example Heads of State or of government, senior politicians, senior government, judicial or military officials, senior executives of state owned corporations, important political party officials.
- **International organisation PEPs:** individuals who are or have been entrusted with a prominent function by an international organisation - refers to members of senior management, i.e. directors, deputy directors and members of the board or those persons with equivalent functions. An international organisation is one that is established by formal agreement between member states (international treaty) and recognised in the law of member states, e.g. UN, International Maritime Association, NATO, WTO, Council and institutions of EU etc.

The **4<sup>th</sup> EU AML Directive** does not distinguish PEPs in separate categories, rather uses one definition as follows:

Article 9: '**Politically exposed person**' means a natural person who is or who has been entrusted with prominent public functions and includes the following:

- (a) heads of State, heads of government, ministers and deputy or assistant ministers;
- (b) members of parliament or of similar legislative bodies;
- (c) members of the governing bodies of political parties;
- (d) members of supreme courts, of constitutional courts or of other high-level judicial bodies, the decisions of which are not subject to further appeal, except in exceptional circumstances;
- (e) members of courts of auditors or of the boards of central banks;
- (f) ambassadors, chargés d'affaires and high-ranking officers in the armed forces;
- (g) members of the administrative, management or supervisory bodies of State-owned enterprises;
- (h) directors, deputy directors and members of the board or equivalent function of an international organisation.

No public function referred to in points (a) to (h) shall be understood as covering middle-ranking or more junior officials;

It must be noted that in the both the FATF and the 4<sup>th</sup> EU AML Directive, immediate family members and close associates of PEP's are equally considered as PEP's by virtue of their relationship with a PEP.

The 4<sup>th</sup> EU AML Directive provides a definition for both family members and close associates as follows:

Paragraph 10 of Article 3: '**family members**' includes the following:

- (a) the spouse, or a person considered to be equivalent to a spouse, of a politically exposed person;
- (b) the children and their spouses, or persons considered to be equivalent to a spouse, of a politically exposed person;
- (c) the parents of a politically exposed person;

Paragraph 11 of article 3: '**persons known to be close associates**' means:

- (a) natural persons who are known to have joint beneficial ownership of legal entities or legal arrangements, or any other close business relations, with a politically exposed person;
- (b) natural persons who have sole beneficial ownership of a legal entity or legal arrangement which is known to have been set up for the de facto benefit of a politically exposed person.

## Appendix II

**List of examples of appropriate information and/or supporting documentation required to establish Source of Wealth and Funds:**

Source of funds/wealth	Information / Documents that may be required
Employment Income	<ul style="list-style-type: none"> <li>- Nature of employer's business</li> <li>- Name and address of the employer</li> <li>- Annual salary and bonuses for the last couple of years</li> <li>- Last month/recent pay slip</li> <li>- Confirmation from the employer of annual salary</li> <li>- Latest accounts or tax declaration if self employed</li> </ul>
Savings / deposits	<ul style="list-style-type: none"> <li>- Bank statement and enquiry of the source of wealth</li> </ul>
Property Sale	<ul style="list-style-type: none"> <li>- Details of the property sold (i.e. address, date of sale, sale value of property sold, parties involved)</li> <li>- Copy of contract of sale</li> <li>- Title deed from land registry</li> </ul>
Sale of shares or other investment	<ul style="list-style-type: none"> <li>- Copy of contract</li> <li>- Sale value of shares sold and how they were sold (i.e. name of stock exchange)</li> <li>- Statement of account from agent</li> <li>- Transaction receipt/confirmation</li> <li>- Shareholder's certificate</li> <li>- Date of sale</li> </ul>
Loan	<ul style="list-style-type: none"> <li>- Loan agreement</li> <li>- Amount, date and purpose of loan</li> <li>- Name and address of Lender</li> <li>- Details of any security</li> </ul>
Company Sale	<ul style="list-style-type: none"> <li>- Copy of the contract of sale</li> <li>- Internet research of Company Registry</li> <li>- Name and Address of Company</li> <li>- Total sales price</li> <li>- Clients' share participation</li> <li>- Nature of business</li> <li>- Date of sale and receipt of funds</li> <li>- Media coverage</li> </ul>
Company Profits / Dividends	<ul style="list-style-type: none"> <li>- Copy of latest audited financial statements</li> <li>- Copy of latest management accounts</li> <li>- Board of Directors approval</li> <li>- Dividend distribution</li> <li>- Tax declaration form</li> </ul>

Inheritance	<ul style="list-style-type: none"> <li>- Name of deceased</li> <li>- Date of death</li> <li>- Relationship to client</li> <li>- Date received</li> <li>- Total amount</li> <li>- Solicitor's details</li> <li>- Tax clearance documents</li> </ul>
Gift	<ul style="list-style-type: none"> <li>- Date received</li> <li>- Total amount</li> <li>- Relationship to client</li> <li>- Letter from donor explaining the reason for the gift and the source of donor's wealth</li> <li>- Certified identification documents of donor</li> <li>- Donor's source of wealth</li> </ul>
Maturity/surrender of life policy	<ul style="list-style-type: none"> <li>- Amount received</li> <li>- Policy provider</li> <li>- Policy number/reference</li> <li>- Date of surrender</li> </ul>
Other income sources	<ul style="list-style-type: none"> <li>- Nature of income, amount, date received and from who</li> <li>- Appropriate supporting documentation</li> </ul>

## References

1. The Prevention and Suppression of Money Laundering Activities Law of 2007 as amended in 2010, 2012 and 2013
2. Directive to the Members of ICPAC on AML, September 2013
3. FATF Recommendations of February 2012, as updated in October 2016
4. FATF Guidance on Politically Exposed Persons
5. VinciWork webinars on AML compliance (Modules 1,2,3 and 4)
6. Directive (EU) 2015/849 of the European Parliament and Council on the prevention of the use of the financial system for the purposes of money laundering or terrorist financing, amending Regulation (EU) No 648/2012 of the European Parliament and of the Council, and repealing Directive 2005/60/EC of the European Parliament and of the Council and Commission Directive 2006/70/EC
7. Accountancy Magazine – Article: Politically Exposed The Misunderstood