



## Customer Due Diligence – The Essentials of CDD in financial services

### Module 1 The Essentials of CDD

Many firms find it challenging to implement and apply the compliance function in a financial services firm well. One factor compounding the challenge is evolving regulatory requirements. Compliance staff and other key stakeholders are continually challenged to remain up-to-date, implement, check and correct compliance measures within a firm. Uncertainty on the level of compliance can bring anxiety to the Board of Directors, who have ultimate responsibility for the compliance function. Where the ‘tone from the top’ strongly endorses good compliance practices, this anxiety can filter to senior and middle management and other staff. In the best of circumstances, a firm may have a high level of perceived compliance, but the actual level of compliance, if scrutinized, may have gaps. Certain compliance requirements can have serious regulatory consequences if not thorough and consistently applied. This course focuses on one of the most critical requirements that has challenged many firms’ compliance systems – the conduct customer due diligence.

Core requirements that you should be aware of

The primary driver for customer due diligence requirements can be found in the Recommendations<sup>1</sup> promulgated by the Financial Action Task Force (“FATF”) that established international standards for anti-money laundering (“AML”), counter-terrorist financing (“CFT”) and proliferation financing (“PF”). A glossary of key definitions is also provided with this course to aid in the familiarization with common terms found in the compliance industry in financial services.

As a brief overview, it is important to understand what is customer due diligence. In a concise statement, customer due diligence is the process that obtains data that provides information that identifies who a firm intends to engage in business with or provide services. A customer can be an individual or a company or other legal structure. For the purposes of this course, focus will be largely on individuals.

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<sup>1</sup> An electronic copy of the FATF Recommendations can be found at <http://www.fatf-gafi.org/publications/fatfrecommendations/documents/fatf-recommendations.html>. Recommendation 10 is directly relevant to the topic of customer due diligence. However, it is important to recognize that other Recommendations are relevant, and include Recommendations 11, 12 and 17. Additionally, the accompanying Interpretative Notes and Methodology also produced by FATF are relevant in your in-depth research.



It is also important to understand the reason for firms and other relevant persons and institutions to carry out customer due diligence. Persons may be more familiar with customer due diligence when it is referred to as KYC (i.e., to 'know your customer'). However, the purpose of customer due diligence goes beyond simply knowing who your customers may be. The purpose of customer due diligence is to ascertain the customer's identity and connected businesses, verify that the customer is in fact the person with whom you are engaging in a business arrangement (and that the subject customer is not acting as a 'straw man' or 'fronting' for other persons), risk assess the customer based on information gathered, and the identification of other relevant factors that can impact other regulatory requirements needed to satisfy full customer due diligence. All of these factors will be discussed in greater detail in this course.

How a firm would carry out customer due diligence usually involves obtaining at least one government issued identification to evidence name, age, nationality, and other data points that may be required by a firm. It is important to collect data on how you can contact the compliance subject. In the past decade, firms relied on checklists that sought the phone, fax (facsimile machine) and mailing and/or residential address of a compliance subject. As we continue to see the varied lifestyles that buck traditional models, the information to collect for contacting a compliance subject should also adapt. At this stage, due diligence should collect and document information that also identifies any idiosyncrasies that will help in future due diligence efforts. For example, is the compliance subject a dual national with regular travel between two or more jurisdictions? If so, will the compliance subject be using your services or products from both jurisdictions? These questions are simply a start and demonstrate how the 'check-list' approach can give a false sense of complete compliance. Based on these two questions, many outdated customer due diligence approaches may not be able to adapt and capture information as needed.

At the onboarding stage of a client engagement, different firms will have different approaches, in part driven by the nature of the business and inherent risks present with that type of business. Conducting business risk assessments can present high levels of complexity, and should not be a cursory assessment. Understanding the risks that a client's business may present will aid in determining whether the activity is benign or of extreme risk. To continue, the due diligence collection process also involves obtaining a utility bill or other document to confirm the subject person's place of residence. In many cases, firms stick very rigidly to requiring a utility bill for this purpose. However, there are scenarios where a person will not have a utility bill that is in their name for wholly legitimate purposes. For example, a past victim of domestic violence may not list their name for fear of being targeted by past abusers.



Another item commonly obtained for customer due diligence purposes is the reference letter. Reference letters have been historically a component to the customer due diligence process. Dependent on the nature of the service or financial product being sought, at times, 2 separate references were sought – one from a professional and one from a banking institution. The utility of obtaining reference letters has been long debated. Personal and professional reference letters are often provided by close colleagues and associates of the compliance subject. Over the years, bank references have devolved to little more than sterile confirmations of whether an individual has a relationship with the banking institution. Whether a firm requires reference letters is a decision to be taken by the Board of Directors, ideally with objective input from the Chief Compliance Officer.

Most critical to the due diligence process is the step of verification. The documents being collected are of little value if the compliance subject is acting as a 'front' for another person. The process of verification can be varied. For example, verifying that a person is who they say they are is relatively simple and can be done by carrying out checks with popular search tools and paid compliance databases. However, to determine whether the compliance subject is actually the person seeking to engage in business with your firm, and not acting at the behest of another, perhaps for illicit purposes, may present a bigger challenge. The verification process must then go beyond the 'normal' verification process where there are doubts or suspicions. It is important to note that the documentation of any doubts or suspicions are critically important to help identify any new threats and trends. The amplified investigations to aid verification could also be determined by risks inherent to the service or product being requested. Any suspicion must be reported (in writing) to the firm's Money Laundering Reporting Officer.

The certification process is also a step that can evidence gaps in the due diligence process. While certification can be performed internally where documents are presented directly to staff within the firm, or by an external party, there are some points that must be covered. The certifier must be independent from the compliance subject. Ideally, the certifier should be a professional that is subject to conduct provisions (i.e., be required to maintain high standards of conduct and business ethics). Whether the certifier is internal or external, the firm must ensure that all certifications adhere to regulatory compliance requirements within their jurisdiction. Gathering due diligence information on the certifier is often a requirement that is supported by law. As a best practice, this due diligence information should be collected for all certifiers for those internal to the firm as well as those external to the firm. This information can be vital to support a regulatory review or other similar analysis, especially if an internal certifier is no longer employed with the firm. In all cases, the certification should evidence information on the certifier, including their location, date of certification and a descriptor of the document being certified.



As a reminder, it may be useful to consider the following questions when you review your due diligence efforts to ensure that you have all that you need for a new or existing client.

- Is the client on-boarding process clear and includes all steps?
- Is there an established approach to capture names of persons and entities in a consistent manner?
- Is the risk assessment complete to help determine what information should be collected from the compliance subject?
- Are the policies and procedures for updating due diligence clear and include both steps and scenario-based approaches?
- Do you have a copy valid identification document that is legible (i.e., information can be clearly read and picture can be clearly seen and is free from distortion), and evidences date of birth, nationality and other useful information (for example, passports often detail gender, identifying marks and other details)?
- Has the due diligence information been recently obtained and checked to ensure no information is dated?
- Were documents properly certified?
- Do you have due diligence information in relation to the certifier?
- Has verification been carried out on the compliance subject and the certifier?
- Do you have the contact information you need?
- Are there any separate issues that should be documented that gives context for future due diligence efforts?

To distill the client onboarding process to its simplest terms, the decision tree in Diagram 1 below provides the binary options in this process. The decision to accept or reject a client are the only options; however, the actions taken under each scenario are vital to getting the onboarding process right. Where you opt to take on a client, the documentation must capture all relevant due diligence information, including the reason that the client was accepted.

However, where you opt to not take on a client, the work is not done after simply refusing the business. The rejection should be recorded. This ensures that future staff are aware that business was rejected from named persons and the reasons why. As such, recording any identifying information of the subject (this may or may not include identification documents), the date of application, date of rejection and the reason for rejection. In some instances, senior management may also be involved in the decision and their sign-off should also be captured. Rejections should ideally be kept in a log that is accessible to the Chief Compliance Officer and the Money Laundering Reporting Officer (if it is a separate person) as the information being captured may also lead to the filing of a suspicious transaction report to relevant authorities.