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Compliance with Regulation 7(1)(c) by Company Service Providers when Providing Company Formation Services

Thematic Review 2023



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1 Executive Summary

In December 2020, the FIAU issued the Implementing Procedures Part II – Company Service Providers (IPs Part II for CSPs) which details how Company Service Providers (CSPs) should adhere to their obligations under the Prevention on Money Laundering and Funding of Terrorism Regulations (PMLFTR). In view of this, during the first quarter of 2023, the FIAU carried out a thematic review to assess CSPs' level of compliance with Regulation 7(1)(c) of the PMLFTR, more specifically, when providing company formation services¹. The thematic review covered 15 CSPs providing company formation services and included checks on 75 Maltese-registered companies incorporated during the period 1st July 2021 to 31st December 2022.

The results of the thematic review indicated that, in general, there is a good level of compliance by CSPs with the obligations stemming from Regulation 7(1)(c) of the PMLFTR when providing company formation services. In fact, it is positive to note that following the publication of the IPs Part II for CSPs, CSPs have taken steps to implement the customer due diligence (CDD) outlined in this document. As further explained in the document, checks carried out also suggest some areas for improvement that CSPs should apply to achieve a better level of compliance. This enables CSPs to play a more effective role when acting as gatekeepers to prevent the misuse of corporate vehicles for money laundering and funding of terrorism (ML/FT) purposes.

¹For this document, the term 'company' refers to companies and other legal entities.



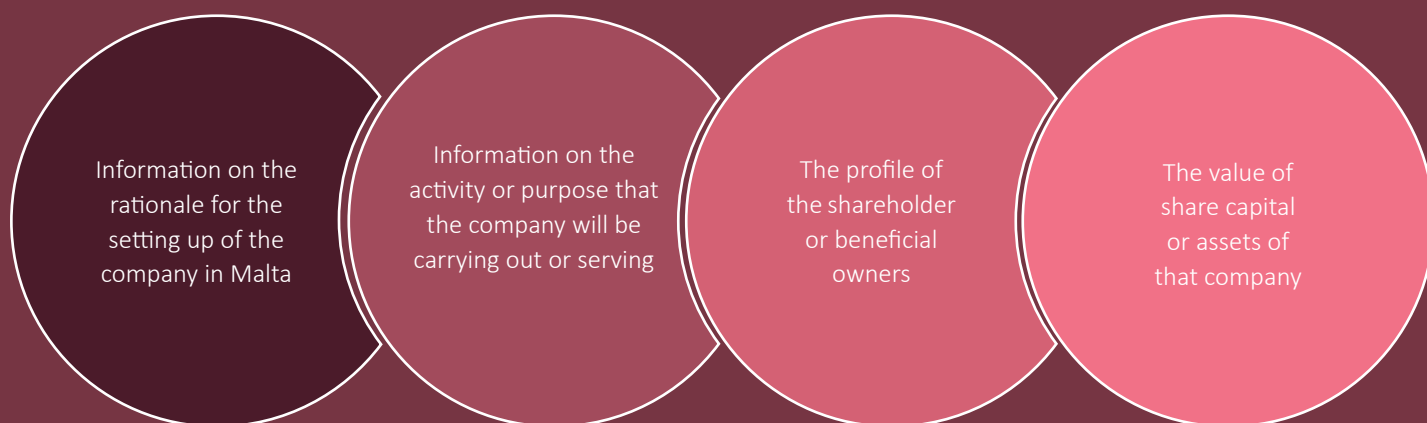
2 Scope of Thematic Review

Corporate vehicles incorporated or established as legal persons may be used by perpetrators to conceal beneficial ownership or to launder proceeds of crime. In view of this, CSPs play a crucial role in acting as gatekeepers to prevent the misuse of legal persons for these purposes by implementing a robust AML/CFT control framework in line with the PMLFTR, Implementing Procedures Part I (IPs Part I), and IPs Part II for CSPs. Whilst a thematic review focusing on the adherence to beneficial ownership obligations by CSPs was carried out in 2021, this thematic review aimed to gauge how CSPs assess, and as appropriate, obtain information on the intended purpose of the company being set up, and to ensure that their services are not misused for ML/FT purposes.



3 Regulatory Requirements

As explained in Sections 2.2 and 2.3 of the IPs Part II for CSPs, CSPs are required to understand, and, as appropriate, obtain information on the intended purpose of the company or other legal entity being set up and establish their customer's business and risk profile. This serves as a mitigating measure vis-à-vis the risk that the CSP's service is misused for the setting up of a company or other legal entity intended to facilitate the laundering of proceeds of crime or the funding of terrorism. In view of this, CSPs are expected to obtain the following information with respect to the prospective company, even when providing solely company formation services:



Further guidance on CSPs obligations is also set out in Title 2 of the “Supplementary Rules for all CSPs providing the service of company formation” of the CSP Rulebook issued by the Malta Financial Services Authority.



4 Thematic Review Methodology

The thematic review included compliance assessments of 15 CSPs providing company formation services during the period under review. In terms of Article 3 of the Companies Service Providers Act (Chapter 529 of the Laws of Malta) (CSP Act), a natural or legal person seeking to provide company services as defined in the CSP Act, operating in or from Malta, by way of business to third parties, needs to obtain authorisation from the Malta Financial Services Authority. In the case of company formation services, CSP authorisation can be of two types:

Class A CSP

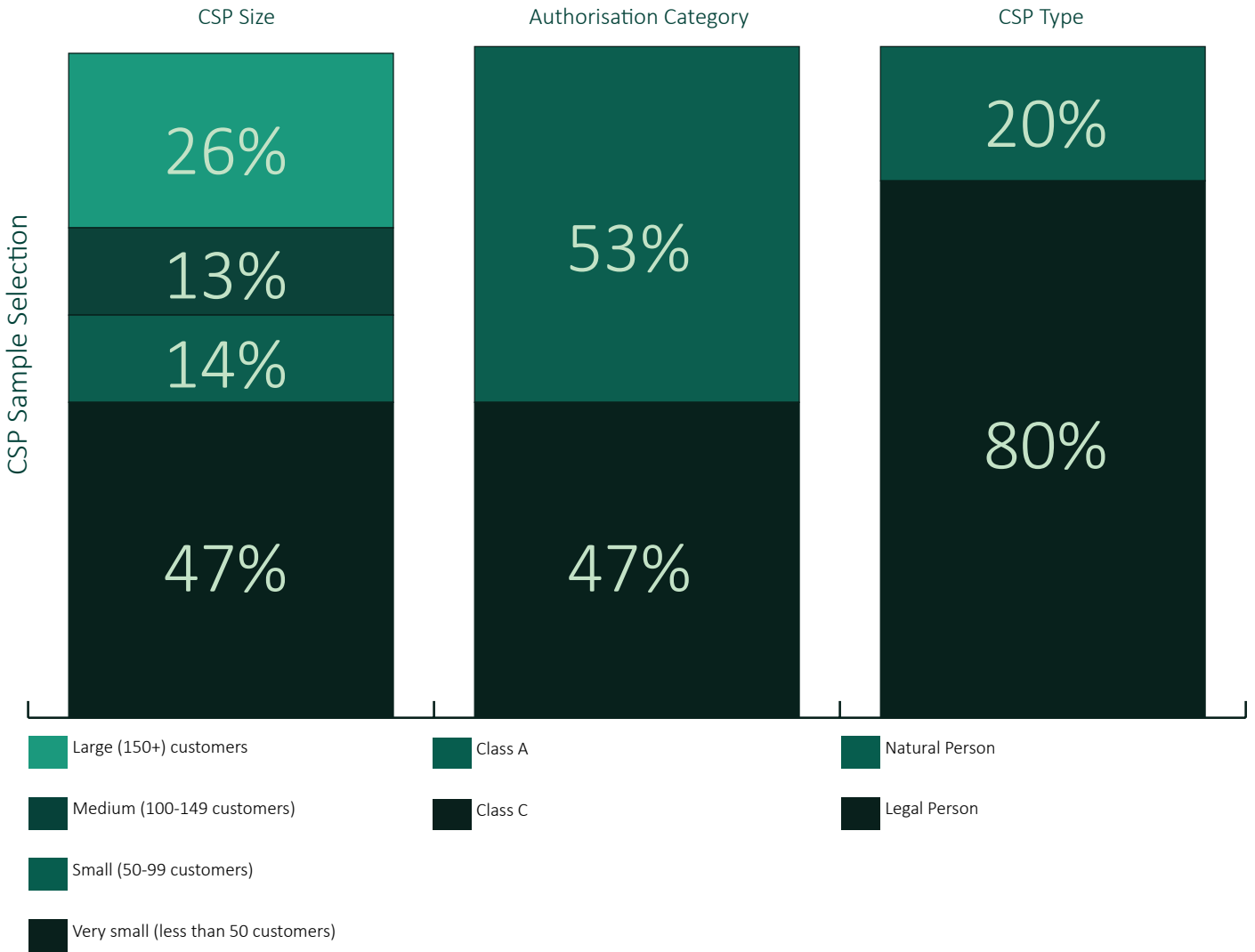
A CSP authorised to provide services related to the formation of companies and other legal entities and/or provision of a registered office, a business correspondence or administrative address, and other related services for a company, a partnership, or any other legal entity.

Class C CSP

A CSP authorised to provide all the services of a CSP specified in the definition of “company service provider” contained in Article 2(1) of the CSP Act, including formation of companies.

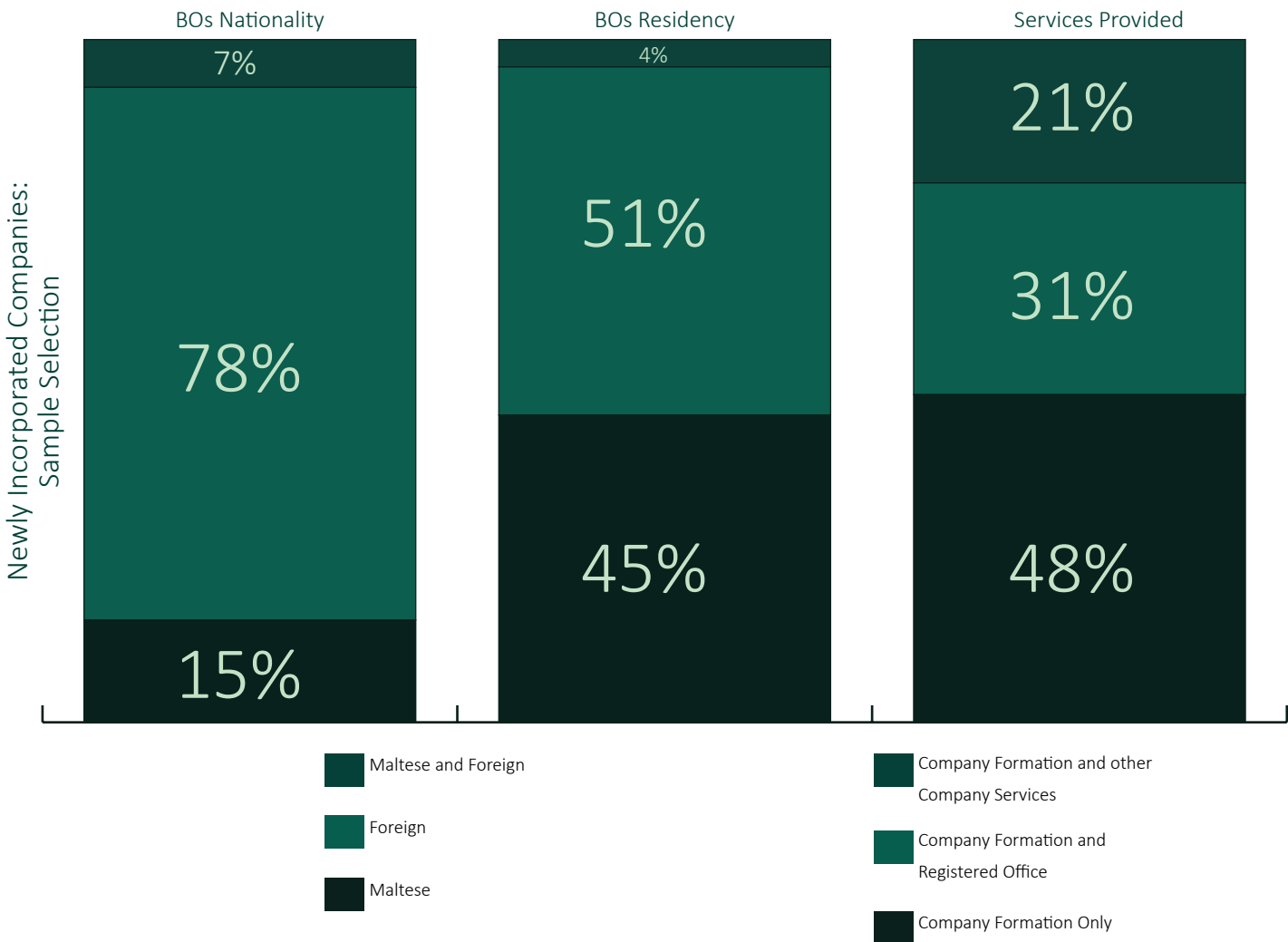


The FIAU sought to have a sample that reflects the Maltese CSP sector in terms of CSP type (legal or natural person), size and category of authorisation, as indicated in the below chart.



During the thematic review, a total of 75 companies incorporated between 1st July 2021 and 31st December 2022 were reviewed by the FIAU. This review period was selected to assess how CSPs fulfilled their obligations under Regulation 7(1)(c) of the PMLFTR following the issuing of the IPs Part II for CSPs in December 2020, where specifically Section 2.3 of the latter document explains how CSPs should comply with Regulation 7(1)(c) of the PMLFTR when providing company formation services.

There is a higher risk of ML threats associated with foreign beneficial owners (BOs) when there is no apparent connection to the jurisdiction in which they carry out their business. As a result, the nature and extent of the connection between BOs and Malta as the jurisdiction where they carry out the business was relevant for the sample selection. Hence, as depicted in the table below, the sample selection mostly focused on company formation services provided to foreign customers². Furthermore, the FIAU also aimed to assess whether the provision of other company services apart from company formation had a bearing on the level of information/documentation gathered by CSPs to fulfil their obligation under Regulation 7(1)(c) of the PMLFTR.



² In terms of Section 1.3.3 of the IPs Part II for CSPs, in the case of formation of a company or a commercial partnership, the customer is the prospective shareholder as for BO and partner, for whom the company or other legal entity will be set up.

Each CSP examined by the FIAU underwent two phases:

Phase 1: Controls Design Testing

This phase mainly consisted of assessing the adequacy of the design of the CSP's controls, policies, and procedures to address their obligations under Regulation 7(1)(c) of the PMLFTR, and Sections 2.2 and 2.3 of the IPs Part II for CSPs when providing company formation services. An introductory meeting was held with the CSP's MLRO and other management members where necessary.

Phase 2: Controls Implementation Testing

During this phase, the FIAU evaluated the effectiveness of the CSP's implementation of its controls as per the obligations set under Regulation 7(1)(c) of the PMLFTR when providing company formation services. Therefore, a sample of five newly formed companies was chosen from the customer list provided by each CSP. The CSP was required to provide information and, where applicable, documentation for each selected company. The documents received were assessed to understand and evaluate the level of compliance by CSPs with Regulation 7(1)(c) of the PMLFTR, and Sections 2.2 and 2.3 of the IPs Part II for CSPs.

During this thematic review, results of the examinations carried out were used to assess the level of compliance by CSPs with Regulation 7(1)(c) when providing company formation services and to communicate the common findings and areas for improvement to CSPs through this guidance document. The aim is also to allow CSPs to review their policies and procedures in this context and implement measures to address any gaps identified. Whereas no enforcement action was taken in cases where shortcomings were identified during this thematic review, the FIAU aims to carry out further examinations at a later stage which may lead to enforcement action, should shortcomings be identified.



5 Key Findings from the Thematic Review

Overall Analysis

Analysis of the findings identified during the thematic review demonstrated that, in general, CSPs carry out adequate CDD in terms of Regulation 7(1)(c) of the PMLFTR when providing company formation services. The assessors did not identify any newly formed companies that were not subject to such CDD, albeit some exceptions were noted where the information collected in this context was insufficient, or where the CSP concerned did not follow up on any inconsistent or incomplete information collected from customers.

The assessors also concluded that when CSPs provide additional company services such as directorship services, the level of CDD performed includes more detailed information when compared to those instances when stand-alone company formation services are provided. This is because such information would allow CSPs to carry out ongoing monitoring of the business relationship.

The thematic review also indicated that the procedures applied by CSPs in terms of Regulation 7(1)(c) of the PMLFTR when providing company formation services are, at times, inconsistent. This was most noticeable for CSPs who do not have written procedures that clearly detail the type of CDD to be carried out.



5.1 Key Findings | Policies and Procedures

Regulatory Obligation

Regulation 5(5)(a) of the PMLFTR and Section 3.4 of the IPs Part I require subject persons to have in place and implement measures, policies, and controls including CDD procedures and record-keeping procedures. Section 3.4 of the IPs Part I also requires that these measures, policies, controls, and procedures are clearly documented and, where applicable, approved by senior management.



Findings

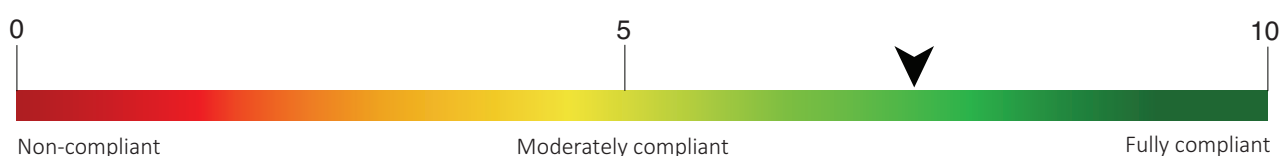
- It was positively noted that most CSPs examined had updated their written policies and procedures within a few months following the publication of the IPs Part II for CSPs, except for one CSP where the update was carried out after almost two years.
- Obtained results showed that all CSPs have written procedures that, in general, define how obligations in relation to Regulation 7(1)(c) of the PMLFTR are implemented. However, certain instances were noted whereby the written procedures did not cover all the requirements listed in Sections 2.2 and 2.3 of the IPs Part II for CSPs and what procedures are to be followed to enable compliance in this context. As explained further in the findings below, it was noted that sometimes the procedures lacked sufficient details to clearly explain how and what type of information is required to be collected when providing company formation services. Notwithstanding this, most CSPs have in place customer onboarding forms used for the purpose of company formation services.
- In one case, the written procedures incorrectly stated that when providing solely company formation services, Regulation 7(1)(c) of the PMLFTR does not apply given that, in such cases, a business relationship is not established.



Areas for Improvement

- The IPs Part II for CSPs clarify that Regulation 7(1)(c) of the PMLFTR also applies when providing solely company formation services, as this will ensure that the services of CSPs are not misused for the setting up of a company intended to facilitate the laundering of proceeds of crime or financing of terrorism. It is therefore imperative that CSPs update their written policies and procedures to reflect these requirements. In addition, it is essential that policies and procedures are reviewed in a timely manner when new regulatory obligations come into force or when these are updated.
- Written procedures should sufficiently explain the measures to be applied by the CSP's employees to fulfil AML/CFT obligations, thereby allowing a consistent application of measures. For example, during this thematic review, it was observed that in the case of CSPs whose written procedures did not sufficiently explain the method of collecting information in relation to Regulation 7(1)(c) of the PMLFTR, this often resulted in an inconsistent application. Furthermore, since the effectiveness of controls depends on their proper application, it is imperative that the subject person informs and trains the employees on how procedures are to be applied.

Compliance Level: Policies and Procedures



5.2 Key Findings | Information on the Rationale

Regulatory Obligation

As per Section 2.2 of the IPs Part II for CSPs, CSPs should gather information on the rationale for setting up a company in Malta and/or for the provision of the requested service/s. CSPs need to understand that there is a legitimate economic/business rationale for the company being set up. Moreover, when a company forms part of a larger group of companies, CSPs need to understand the company's purpose within the larger group and gather information on the commercial/trading activities pursued by the larger group of sub-groups that own a Maltese company. Furthermore, when the company is set up to hold shares in another company, CSPs should also seek to understand the rationale for that set-up.

Findings

- Whereas 70% of the reviewed CSPs do not have written procedures defining how to collect information from customers on the rationale for setting up the company in Malta, through inquiries with the sampled CSPs it was confirmed that the majority of CSPs collect this information through meetings held with customers, onboarding forms and from intermediaries.
- Moreover, through the sample used, it was noted that all CSPs collected some information on the rationale for the shareholders or BOs to set up the company in Malta. Furthermore, where applicable information about the purpose of the company within the larger group, the commercial/trading activities pursued by the group, and, in the case of holding companies, the rationale for the set-up were obtained. Although the information collected was deemed to be sufficient to understand the rationale for the setting up of the company, there were a few exceptions where no further information/documentation was requested by the CSP from the customer, even though the rationale for setting up the company was not clear.
- Additionally, it was noted that records of the information collected were not always retained, however, the CSPs provided clarification on the rationale through their replies to the queries and requests posed by the FIAU.

Areas for Improvement

- Whilst the checks carried out by the FIAU concluded that CSPs have a good level of awareness in relation to the rationale behind the setting up of the newly formed companies, record keeping of the information collected in this context needs to be improved.
- In instances where the information collected from the customers does not provide a clear understanding behind the setting up of the company in Malta and/or an economic/business rationale, CSPs should ask for further clarifications and, where applicable, documentation. This may include business plans, tax advice-related documentation, information collected by the intermediary on the customer, or the group's annual report or financial statements.

Compliance Level: Information on the Rationale



5.3 Key Findings | Information on the activity or purpose

Regulatory Obligation

Section 2.2 of the IPs Part II for CSPs, specifies that CSPs are expected to collect information on the activity or purpose that the company will be carrying out or serving by understanding the trading/commercial activity that will be carried out by the company to be formed. Moreover, when the company is not set up to carry out a commercial/trading activity but rather to hold assets (e.g., a shareholding in another entity), CSPs need to understand and gather information on the trading/commercial activity carried out directly by the holding company's subsidiary or indirectly by subsidiaries of these subsidiaries in the ownership chain. This is for the CSP to get a holistic understanding of what purpose or activity the holding company will be linked to.



Findings

- Notwithstanding the fact that 55% of the CSPs reviewed do not have written procedures on how to collect information on the activity or purpose of the company to be formed, from clarifications provided by the sampled CSPs, it transpired that all CSPs collect this information in practice. This was also confirmed by the companies tested since in most instances, CSPs collected this information through a number of measures, including:
 - discussions with the customer during meetings;
 - correspondence with the customer;
 - information detailed in onboarding forms;
 - requesting copies of business plans;
 - group financial statements;
 - annual reports;
 - press release or certificates prepared by other professionals servicing the group; and/or
 - requesting information from the intermediary.
- However, some exceptions were noted wherein the CSP was unable to provide records of the information collected in relation to the activity or purpose of the company to be formed. Nonetheless, the CSPs concerned were in general, able to explain the latter following inquiries posed by the assessors.
- Moreover, where company formation services were provided in relation to the incorporation of companies set up to hold shares in other entities (holding companies), in 15% of the cases under review, CSPs failed to collect information to understand the trading/commercial activity carried out by the entities in the ownership chain. In fact, the information collected was simply that the company would hold shares in other entities.
- Overall, the FIAU concluded that the information collected was sufficient to establish the activity or purpose of the company to be formed.



i Areas for Improvement

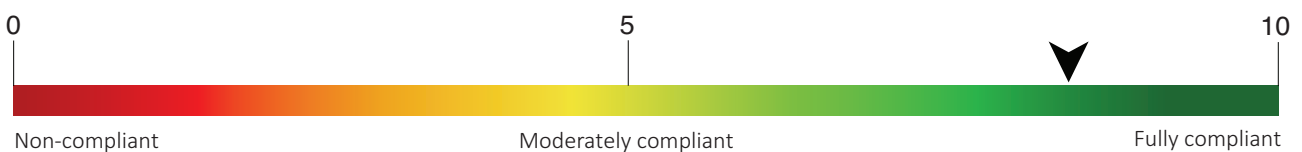
- CSPs need to retain better records of the information on the activity or purpose of the prospective company. For example, following the collection of information from their customers, some CSPs prepared a company profile document detailing the company’s activity and purpose including:
 - the commercial activity of the company
 - target customers/suppliers/jurisdictions
 - the estimated turnover
 - the nature of expected transactions
 - expected number and type of employees
 - the company’s organisation structure
 - the group structure

In cases where the company is set up to hold shares in other entities, it is not sufficient to simply determine that the purpose is to hold shares in subsidiaries. A holistic understanding of what purpose or activity the holding company would be linked to needs to be obtained by gathering information on the trading/commercial activity of the subsidiaries in the ownership structure. This understanding should be appropriately documented by CSPs.

- When the information obtained from customers in relation to the activity or purpose of the company is not clear or where the risk relating to the company formation service provided is assessed to be high, CSPs are expected to obtain documentation to support the information provided by the customers.



Compliance Level: Information on the Activity or Purpose



5.4 Key Findings | The profile of the shareholders or BOs

Regulatory Obligation

Section 2.2 of the IPs Part II for CSPs, requires CSPs to assess whether the shareholder's or BO's profile tallies with the company's activity or purpose. In addition, Section 2.3 of the IPs Part II for CSPs also requires CSPs to carry out open-source checks on the individuals involved in the prospective company or partnership (i.e., directors, partners, shareholders, or BOs) or make use of commercial databases to ensure that there is no adverse information that might link these individuals to criminal activities or participation in criminal organisations.

Findings

- 55% of the reviewed CSPs do not have written procedures on how to assess whether the profile of the shareholders or BOs tallies with the prospective company's activity or purpose. Through clarifications provided by the sampled CSPs and from the reviewed companies, it was concluded that CSPs do obtain information to build the profile of the shareholders or BOs of the prospective company. This is done by collecting information from their customers via onboarding forms, through initial meetings or correspondence with their customers, by carrying out open-source searches, or by requesting curriculum vitae or professional references.
- Although information to build the shareholders' or BOs' profiles was always collected by the reviewed CSPs (apart from a few cases), occasionally, the CSP did not seek sufficient clarification from the customer in situations where the shareholder's or BO's profile was not consistent with the prospective company's activity or purpose. For example, in one case, a CSP was requested to incorporate a company that would be involved in the provision of recruitment and IT services, with the BOs' backgrounds being a sales assistant in an outlet and a pharmacist respectively. Both BOs claimed that they would retain their jobs as a sales assistant and a pharmacist, whereas a third person would be involved in the activities of the company to be formed. Even though there might have been a reasonable justification for this arrangement, the assessors deemed that in such a scenario the CSP should have obtained more information and clarifications in this context.
- Moreover, all CSPs demonstrated that they have systems in place to screen the individuals that will be involved in the company to be formed, to ensure that there is no adverse information that might link them to criminal activities or participation in criminal organisations. In fact, it was noted that all CSPs have automated screening tools to facilitate this process.

Areas for Improvement

- CSPs are reminded that the rationale for obtaining information enabling them to build the shareholders' or BOs' profile is to ensure that their profile tallies with the proposed activities or purpose of the company. Therefore, in instances where the assessment carried out reveals a mismatch between the shareholders' or BOs' profiles and the proposed activities or purpose of the company, it is imperative that CSPs ask for further clarification and information.

Compliance Level: Profile of Shareholder or BOs



5.5 Key Findings | The value of share capital or assets of the prospective company or entity

Regulatory Obligation

Section 2.2 of the IPs Part II for CSPs, requires CSPs to obtain information on the value of the share capital or assets, and, depending on the ML/FT risks identified, obtain documentation evidencing the source of funds (SOF) and/or assets forming the capital of the company or partnership. These checks require gathering information on the source of wealth (SOW) of the shareholder or BO who will contribute to the capital of the company. When companies are incorporated with a low share capital, CSPs should also seek to establish how the company will continue to be financed, including whether any other capital injections are projected once the company is incorporated.



Findings

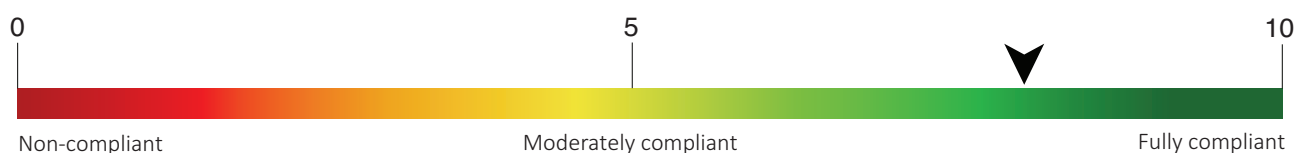
- 23% of the reviewed CSPs do not have written procedures on how to obtain information on the value of the share capital or assets of the company being formed. Furthermore, the written procedures pertaining to 40% of CSPs sampled do not define the requirement to obtain documentation evidencing the SOF and/or source of the assets forming the capital of the prospective company depending on the risks identified. It was also noted that few CSPs had in place written procedures to establish how the company will continue to be financed once it is incorporated, and whether additional capital injections are projected once the company is established.
- Notwithstanding the above, the FIAU positively noted that all CSPs obtain information on the SOF in relation to the share capital or assets of the prospective company, such as, by obtaining information on the BO's employment income, income derived from investments, savings/net worth, sale of property or business, dividends/profits received from other businesses and bank loans. This information was gathered through customer onboarding forms, SOF declarations submitted by the proposed BOs, or through meetings, calls or correspondence with the customer requesting the provision of such information.
- Generally, the information collected by CSPs was sufficient to determine the SOF. There were a few exceptions where the information did not provide sufficient details to justify how the BO or any other persons contributing to the company's capital had generated the funds to raise the proposed share capital of the prospective company. Assessors also noted weaknesses in relation to obtaining documentation evidencing the SOF and/or source of assets forming the capital on a risk-based approach. In fact, in certain instances, it was noted that the CSPs concerned, either did not request supporting documentation to verify the SOF when the risk assessed was high or the CSPs requested several documents despite the occasional transaction having a low/medium risk rating.
- Regarding the information to be collected by CSPs relating to how the newly formed company will continue to be financed and whether there will be any future capital injections, checks carried out on the companies indicated that a number of CSPs were not retaining records in this context. In fact, CSPs clarified that they would have inquired on these topics with their respective customers during calls or meetings held, but no records of this were retained. However, some CSPs were able to provide records that such information was obtained through customer onboarding forms or through correspondence with the customer or intermediaries.

Areas for Improvement

- The thematic review concluded that, in general, all CSPs adequately apply their obligation to obtain information on the SOF in relation to the share capital or assets of the company. However, the application of the risk-based approach to obtain documentation to verify the SOF is an area for improvement. CSPs should consider the risks identified from the CRA carried out, and only if it is assessed that there are higher risks in this context, should they resort to asking for supporting documentation to verify the SOF. For example, if the company is to be incorporated with minimal share capital, there is no need for the CSP to request documentation from customers in this respect.
- If the SOF information gathered highlights gaps between the funds required to finance the initial share capital, future capital injections, or the operating expenses of the newly formed company and the SOF of the BO, CSPs should enquire further and consider whether to request supporting documentation to verify the SOF. For example, if a customer seeks the services of a CSP to incorporate a company to establish an outlet to sell goods, but the SOF information provided by the customer is inconsistent with the funds required to finance the share capital, rent/buy the property from where to run the business and stock acquisition, the CSP should obtain further clarifications from the customer to determine whether there are alternative/additional funding sources involved (e.g., bank loan or other contributors).
- When the initial share capital of the prospective company is minimal, CSPs are reminded to collect information as to how the company will continue to be financed, and whether there will be any future capital injections. This will allow CSPs to form a reasonable conclusion that the shareholder’s or BO’s wealth has been accumulated legally and that subsequent funds used are legitimate.



Compliance Level: Value of share capital or assets of the company



6 Conclusion



Preventing the misuse of a company for ML/FT purposes starts at its inception. It is for this reason that CSPs should effectively apply the measures set out in Regulation 7(1)(c) of the PMLFTR when providing company formation services.

Should the CSP provide additional company services, robust CDD measures carried out at the company incorporation stage are the foundation for effective monitoring of the company's activity once it starts operating. When providing solely company formation services, such CDD checks will also assist in ensuring that the CSP's services are not misused for the purpose of ML/FT, thereby allowing CSPs to play an effective role in safeguarding Malta's reputation and its financial and business sectors. CSPs are reminded to file a suspicious transaction/activity report if there is knowledge, suspicion, or reasonable grounds to suspect that a transaction may be related to ML/FT, or a person may be connected with ML/FT or ML/FT may be committed or attempted.

Whilst this thematic review yielded positive results on CSPs' level of compliance with Regulation 7(1)(c) of the PMLFTR, the FIAU has also concluded that there is room for improvement. To this end, the FIAU encourages all CSPs providing company formation services to review their procedures in this area and assess whether any of the above-mentioned findings are present and, if so, take active steps to implement measures to address the recommended areas for improvement.



Preventing the misuse of a company for ML/FT purposes starts at its inception. It is for this reason that CSPs should effectively apply the measures set out in Regulation 7(1)(c) of the PMLFTR when providing company formation services.

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