WILMER, CUTLER & PICKERING

Financial Institutions Group Newsletter

JUNE 11, 2002

TREASURY ISSUES PROPOSED "SPECIAL DUE DILIGENCE" RULE FOR CORRESPONDENT AND PRIVATE BANKING ACCOUNTS

On May 30, 2002, the U.S. Treasury Department ("Treasury") published a proposed rule that requires a broad range of U.S. financial institutions to apply special anti-money laundering measures to the "correspondent" and "private banking accounts" that they maintain for non-U.S. persons. Treasury's proposed rule, which implements section 312 of the USA PATRIOT Act ("Patriot Act"), imposes substantial new compliance obligations on covered financial institutions and likely will affect many (perhaps most) accounts maintained by such institutions for foreign businesses and individuals.

Comments on the proposed rule are due no later than July 1, 2002. The Patriot Act provides that section 312 takes effect on July 23, 2002, and applies to accounts covered by the requirements of this statutory provision regardless of when they were opened, a requirement that raises the first of many problematic compliance issues. Whatever due diligence standards Treasury ultimately adopts for correspondent and private banking accounts, it will be extraordinarily difficult for U.S. institutions to apply those standards retroactively to all existing accounts. Treasury has not provided any indication as to whether it will extend the compliance deadline either for new or pre-existing accounts.

I. Scope of the Proposed Rule

The breadth of several of the key definitions in this rule proposal ensures that the rule will affect not only traditional correspondent and private banking accounts (the types of accounts that most industry participants would consider to be covered by these two terms), but also a wide array of other accounts and relationships that U.S. financial institutions maintain for foreign counterparts and high net worth customers.

Covered financial institutions. To begin with, the proposed rule applies to all financial institutions that are required to establish anti-money laundering programs under section 352 of the Patriot Act.[1] The rule refers to these institutions as "covered financial institutions."[2] This list of covered financial institutions currently includes banks

[1] *See* WCP Financial Institutions Group Newsletter, "Treasury Issues Regulations on Anti-Money Laundering Programs," May 22, 2002.

[2] The term "covered financial institution" is used differently here from the way it is used in the Patriot Act itself, where the term generally is limited to depository institutions and broker-dealers.

and other depository institutions, securities broker-dealers, mutual funds, credit card system operators (e.g., Visa and MasterCard), futures commission merchants, casinos, and money services businesses (e.g., money transmitters, currency dealers and check cashers). As in the earlier proposed regulation on shell banks and recordkeeping that Treasury issued to implement sections 313 and 319 of the Patriot Act, the foreign branches of U.S. banks also are treated as "covered financial institutions." This treatment may create serious competitive problems for these foreign branches because they will face Patriot Act regulatory burdens that their foreign competitors will not.

Treasury has indicated that, within the next few months, it likely will expand the coverage of the anti-money laundering program requirement of section 352 to include insurance companies, hedge and private equity funds, and others. As these institutions are covered by section 352, they also will have to comply with the special due diligence requirements of this correspondent and private banking account rule.

<u>*Covered accounts*</u>. The accounts covered by the rule are "correspondent accounts" and "private banking accounts" maintained for non-U.S. financial institutions and persons, respectively. Treasury has proposed to define both terms quite broadly.

1. <u>*Correspondent account*</u>. Treasury has proposed to define the term "correspondent account" as "an account established to receive deposits from, make payments on behalf of a *foreign financial institution*, or handle other financial transactions related to such institution" (emphasis added). As drafted, the definition captures not only the sorts of transaction accounts that are typically regarded as correspondent accounts, but also clearance and settlement accounts, fiduciary accounts, time deposit accounts, and others.

This broad definition mirrors the controversial definition Treasury proposed in the sections 313/319 regulations, but its impact here is far greater because it applies not only to accounts established for foreign *banks* (as is the case under the earlier proposed regulation) but also to accounts established for "foreign financial institutions," a term that includes banks as well as broker-dealers, mutual funds and many other entities (see discussion of foreign financial institution below).[3]

2. <u>*Private banking account*</u>. Treasury has proposed to define "private banking account" as an account that (i) requires a minimum aggregate of $1,000,000; (ii) is established on behalf of one or more individuals; and (iii) is administered or managed by a person who acts as a liaison between the covered financial institution and the direct or beneficial owner of the account.

Two observations about this definition are in order. First, it does *not* capture an account simply because it, in fact, has over $1 million of assets; it applies only where there is a requirement that the account have at least $1 million of assets. Second, there are a number of ambiguities in the term "private banking account" that the proposed regulation does not address. For instance: Does the minimum balance requirement apply when the account is opened or throughout the life of the account? What if there is no explicit requirement that there be a $1 million balance, but, as a practical matter, virtually all the accounts in an institution's high net worth area contain more than that amount? What precisely is meant by acting as a "liaison"? Does the term cover accounts established for trusts or other business entities (and not directly for individuals)? These issues call for clarification.

<u>*Foreign financial institution*</u>. Treasury proposes to define "foreign financial institution" as an entity organized under foreign law that would be

[3] Many industry trade associations and participants urged Treasury to narrow the definition of correspondent account in the section 313/319 context. Treasury acknowledged those comments in the preamble to the instant rulemaking and said that it was continuing to study the issue.

subject to the anti-money laundering program requirement of section 352 if that foreign entity were organized under U.S. law. Thus, non-U.S. banks, broker-dealers, mutual funds, and money service businesses would all be foreign financial institutions. And, as additional U.S. institutions – such as insurance companies or pooled investment vehicles like hedge funds and private equity funds – are required by Treasury to have section 352 anti-money laundering programs, their foreign counterparts also will be deemed "foreign financial institutions" within the meaning of the section 312 regulation.

As discussed below, the accounts held by foreign financial institutions in covered financial institutions are subject to the due diligence standards of section 312. Thus, for example, an account maintained by a U.S. bank, broker-dealer, or mutual fund for foreign company X would be subject to the due diligence requirements of the rule if company X were engaged in a check cashing business, because check cashing is a "money services business" covered by section 352, and thus company X would be deemed a foreign financial institution.

One of the significant compliance issues presented for many U.S. covered financial institutions will be to determine whether the foreign companies with which they deal are foreign financial institutions covered by the rule. Many U.S. covered financial institutions have not heretofore coded their accounts with foreign entities in a manner that makes possible an easy determination of the foreign entities' lines of business.

II. Baseline Due Diligence Requirements for Correspondent Accounts

Under Treasury's proposed rule, all covered financial institutions that maintain correspondent accounts for foreign financial institutions must establish an anti-money laundering program to guard against money laundering through the correspondent account. That program must include the following five elements:

(1) a determination as to whether the correspondent account is maintained for an "offshore bank" or a bank located in a blacklisted jurisdiction, in which case the enhanced due diligence requirements described below will apply;

(2) an assessment of the money laundering risk posed by the foreign financial institution;

(3) a consideration of information available from U.S. agencies and multinational organizations regarding the supervision of the foreign financial institution;

(4) a review of guidance from Treasury or the relevant federal functional regulator regarding risks associated with the particular foreign financial institution (if any) and the risks associated with correspondent accounts generally; and

(5) a review of public information to ascertain whether the foreign financial institution has been the subject of any criminal action or any regulatory action relating to money laundering.

The second element is interesting in a couple of respects. First, the preamble to the proposed rule clearly contemplates a rather thorough assessment of risk. It identifies the following potentially relevant factors to consider: the foreign financial institution's line or lines of business, size, customer base, location, and products and services offered, as well as the nature of the correspondent account and the type of transaction activity for which it will be used. Note that while the language of the rule refers only to the risk posed by the foreign financial institution itself, the list of factors in the preamble makes clear that the nature of the account and the type of activity in it must also be considered.

Second, after making clear that a serious risk assessment is required, the proposed rule does not vary the other due diligence requirements in light of the assessment in step two. The other three required elements are mandated irrespective of what the risk assessment shows. Treasury might have said, instead, that the need to conduct the reviews called for by elements three and five depend on the risk assessment in step two, so that if a foreign financial institution is deemed to be low risk – e.g., a major U.K. bank – then those other reviews could be dispensed with. But this is not the course Treasury has chosen, at least at this stage.

The fifth element of the baseline due diligence requirement also contains an important ambiguity that, if it is not resolved, could create compliance difficulties. The rule proposal requires a covered financial institution to "review . . . public information" concerning the foreign financial institution, but neither the rule nor the preamble specifies what "public information" must be consulted. Is a Nexis review sufficient? Must a covered financial institution review foreign language newspapers and magazines? If so, how far back? In many countries, court records are publicly available; must they be obtained and reviewed? Additional clarification would clearly be helpful here.

III. Enhanced Due Diligence for Correspondent Accounts with Offshore Banks and Banks in Blacklisted Jurisdictions

Under Treasury's proposed rule, enhanced scrutiny is required for "offshore banks" and banks located in blacklisted jurisdictions, though not for other types of foreign financial institutions.

Offshore banks. An offshore bank generally is defined as a bank that is not permitted to do business with the citizens of, or in the local currency of, the jurisdiction that issued the bank's license. Enhanced due diligence is required for correspondent accounts with such offshore banks unless the bank or other banks in the jurisdiction have been found by the Federal Reserve to be subject to comprehensive consolidated supervision. (The Federal Reserve has found that one or more foreign banks chartered in 24 countries meet this test. The countries are noted in footnote 9 of the proposed rule.)

Banks in blacklisted jurisdictions. Enhanced due diligence also is required for any bank operating under a license issued by a country that (i) has been designated as "non-cooperative" by an international organization of which the United States is a member and with which designation the United States concurs; or (ii) has been identified by Treasury as warranting "special measures" because of money laundering concerns. Currently, the only relevant international blacklist is the one maintained by the Financial Action Task Force ("FATF"). The United States has concurred with all FATF blacklist designations, including the designations of Israel and Russia. Thus, covered financial institutions that maintain correspondent accounts for banks in Israel and Russia, among other jurisdictions, must engage in enhanced due diligence with respect to those banks.

Enhanced due diligence requirements. For all correspondent accounts maintained for offshore banks and banks in blacklisted jurisdictions, covered financial institutions must conduct enhanced due diligence including, at a minimum, the following steps:

(1) Obtain and review documentation regarding the foreign correspondent bank's anti-money laundering program and consider the effectiveness of the program. If the money laundering risk seems sufficiently high, enhanced due diligence must include (i) monitoring transactions through the correspondent account to detect money laundering, and (ii) obtaining information from the foreign bank regarding the identity of any person who will have authority to direct transactions through the correspondent account and about the sources and beneficial ownership of any such person's funds in the correspondent account.

(2) Determine whether the foreign bank maintains correspondent accounts for other foreign banks – the second tier correspondents – and, if so, conduct due diligence that includes (i) obtaining documentation regarding the identity of those second tier correspondents, and (ii) developing policies and procedures for assessing and minimizing money laundering risks associated with the correspondent accounts that the foreign bank maintains for those second tier correspondents.

(3) With respect to any foreign correspondent bank whose shares are not publicly traded through a regulated market (and that is either an offshore bank or is located in a blacklisted jurisdiction), obtain the identity of each owner of the foreign bank and the nature and extent of the ownership interest. For this purpose, an "owner" is a person who directly or indirectly owns or controls 5% or more of any class of securities of the foreign correspondent bank. (This definition of owner is simpler but generally more expansive than what Treasury proposed in its rule under sections 313 and 319 of the Patriot Act.)

Several aspects of this enhanced due diligence regime are worth noting:

First, the specific enhanced due diligence steps listed in the proposed rule are supposed to be undertaken "to guard against money laundering *and to ensure* detection and reporting of known or suspected illegal activity" (emphasis added). This appears to be a considerably higher standard than the more common one – found, for example, in section 352 – of guarding against money laundering. As such, this standard may put still more pressure on covered financial institutions to do rigorous due diligence.

Second, the requirement in the first enhanced due diligence step to "consider the effectiveness" of the correspondent bank's anti-money laundering program" is quite vague. It is not clear, for example, how that assessment is to be made, whether that obligation could be discharged simply by examining the correspondent bank's written anti-money laundering procedures, or whether some further action would be required to assess how effective the program is as implemented.

Third, the obligation in the second enhanced due diligence step to "assess and minimize" certain risks raises questions. By its terms, it asks the U.S. covered financial institution to develop policies to assess and minimize the money laundering risk that its foreign correspondent bank presents to the U.S. institution when providing correspondent services to other foreign banks. What a U.S. institution would be expected to do to minimize such risks is unclear. For example, would it be enough to require the foreign correspondent to certify that it will not direct transactions from its second tier correspondents to the U.S. correspondent account? Or would the U.S. institution be expected to propose improvements to the foreign bank's own due diligence policies in dealing with its second tier correspondents?

IV. Due Diligence for Private Banking Accounts

Covered financial institutions that maintain private banking accounts for foreign persons must establish a due diligence program designed to detect and report money laundering conducted through these accounts. As part of the program, covered financial institutions must take "reasonable steps" to do the following:

(1) ascertain the identity of all nominal account holders and holders of beneficial ownership interests, including information on their lines of business and source of wealth;

(2) ascertain the source of funds deposited into the account;

(3) ascertain whether any account holder or beneficial owner is a senior foreign political figure; and

(4) report, in accordance with applicable law and regulation, any known or suspected violation of law conducted through or involving the private banking account.

For these purposes, "beneficial ownership interest" means (i) the legal authority to fund, direct, or manage an account; or (ii) a legal entitlement to all or any part of the corpus or income of the account, as long as the interest is at least as large as the smaller of $1,000,000 or 5% of the corpus or income of the account.

The identification requirement in the first step adds two elements not found in the statute: information about an account holder's lines of business and source of wealth. The preamble advises that "reasonable steps" to ascertain identity "may include" such measures as confirming information provided by account holders or their agents and contacting beneficial owners to confirm their ownership interests and source of funds. The extent of confirmation necessary should depend upon a consideration of the risk factors that apply to a particular customer. Reasonable steps to determine whether a private bank customer is a senior foreign political figure are generally supposed to include some review of public information available on databases and the Internet.

The requirement to report suspected violations of law includes an interesting ambiguity. The currently applicable requirement to report such conduct, contained in the suspicious activity reporting regime, applies to a small subset of financial institutions – basically depository institutions, broker-dealers (starting at the end of 2002), and money services businesses. But the private banking regulation applies to many more kinds of institutions and, by October, will apply to still more. Thus, the reporting requirement in this proposed rule would appear to extend an obligation to report (though a much narrower obligation than found in the SAR rules) to large new categories of institutions. On the other hand, the rule says that covered financial institutions are supposed to report, "in accordance with applicable law and regulation" – which might be read to apply only to those institutions that already have a SAR reporting requirement. As a prudential matter, however, it would be unwise to rely on that reading absent further clarification from Treasury.

V. Additional Due Diligence for Senior Foreign Political Figures

As noted above, as part of their private banking due diligence efforts, covered financial institutions must take steps to determine whether a nominal or beneficial owner of a private banking account is a senior foreign political figure ("SFPF"). An SFPF is defined broadly to include (a) a current or former senior official in the executive, legislative, administrative, military, or judicial branches of a foreign government, a senior official in a major political party, or a senior executive of a foreign government owned enterprise; (b) a business that has been formed by, or for the benefit of, such an individual; (c) an immediate family member of a political figure (which includes his or her spouse, parents, siblings, children, and spouse's parents and siblings); and (d) a person who is widely and publicly known to maintain a close personal or professional relationship with the political figure.

The rule states that, if a covered financial institution learns of information that a particular individual may be an SFPF, the institution must conduct reasonable diligence to determine whether the individual is, in fact, such a political figure. On the other hand, if an individual states that he or she is not a "former SFPF" and the covered financial institution does not learn of any information to the contrary, the covered financial institution may rely on the individual's statement disavowing SFPF status.

If an SFPF is a nominal or beneficial owner of a private banking account, the covered financial institution must apply additional due diligence to the account to "detect and report transactions that may involve the proceeds of foreign corruption." The proceeds of foreign corruption include, among other things, assets or property acquired through misappropriation, theft or embezzlement of public funds.[5] The preamble advises that the decision to open an account for an SFPF should generally be approved by senior management, and that the level of enhanced scrutiny should vary according to risk factors. Those factors should include the location of the account holder, the source of his funds, the purpose and use of the account, the type of transactions engaged in through the account and the jurisdictions involved in those transactions. The preamble says that particular circumstances, such as the SFPF's tenure in office or the fact that a given jurisdiction is known for large-scale public corruption, should also be considered.

VI. Procedures When Due Diligence Cannot Be Performed

The proposed rule states that covered financial institutions must adopt procedures that will be followed if any of the above-noted required due diligence measures cannot be performed. In particular, the procedures for each covered financial institution must indicate "when the institution should refuse to open the account, suspend transaction activity, file a suspicious activity report, or close the account." Treasury has left for covered financial institutions to determine which response is appropriate for which circumstances.

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[5] This aspect of the proposed rule is quite similar to the interagency guidance on dealings with foreign political officials that was issued in 2001 by the Treasury and State Departments in conjunction with the federal banking regulators. *See* Guidance on Enhanced Scrutiny for Transactions that May Involve the Proceeds of Foreign Official Corruption (Jan. 2001).

This letter is for general informational purposes only and does not represent our legal advice as to any particular set of facts, nor does this letter represent any undertaking to keep recipients advised as to all relevant legal developments. For further information on these or other financial institutions matters, please contact one of the lawyers:

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