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Analyzing Section 312 Issues for Correspondent Banks

Background Materials for Panel Discussion

Anti-Money Laundering Audit and Compliance Forum

Connie M. Friesen

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Section 312 and AML Requirements for Correspondent Accounts

- Section 312 of the PATRIOT Act amended the Bank Secrecy Act to add new subsection (i) to 31 U.S.C. §5318.
- This provision requires each covered financial institution (e.g., a bank, U.S. branch or agency of a foreign bank, or registered broker-dealer) that establishes, maintains, administers or manages a correspondent account in the United States for a foreign financial institution to subject such account to certain anti-money laundering measures.
- Section 312 also requires “special due diligence” with respect to correspondent accounts for foreign banks in jurisdictions of money laundering concern or operating under offshore licenses.

Issuance of Final Section 312 Rule and Proposed Rule

- On January 4, 2006, FinCEN published a final rule (31 C.F.R. 103.176) (the “Final Rule”) implementing the due diligence provisions of 31 U.S.C. §5318(i)(1).
- FinCEN also published on January 4, 2006, a Notice of Proposed Rulemaking (the “Proposed Rule”) to implement 31 U.S.C. §5318(i)(2), which focuses exclusively on enhanced due diligence measures for certain foreign banks. Until such time as a final rule is published, financial institutions that are not otherwise exempt must follow the enhanced due diligence requirements set forth in the statute.

Due Diligence to Detect Money Laundering Through Correspondent Accounts

- General due diligence requirements apply to all correspondent accounts for foreign financial institutions.
- A “covered financial institution” must establish appropriate, specific, and, where necessary, enhanced due diligence policies, procedures and controls that are reasonably designed to enable the covered financial institution to detect and report instances of money laundering through any correspondent account established, maintained, administered or managed by such covered financial institution in the U.S. for a foreign financial institution.

Enhanced Due Diligence

- “Enhanced due diligence” requirements apply when correspondent accounts are maintained for certain foreign banks:
 - foreign banks operating under an offshore license;
 - foreign banks operating under license issued by a country designated as being non-cooperative with international AML principles or procedures by an intergovernmental organization of which the U.S. is a member and with which designation the U.S. concurs.
 - foreign banks operating under a license issued by a country designated by the Secretary of the Treasury as being of special money laundering concern.

Requirements Under Enhanced Due Diligence

When additional standards for enhanced due diligence apply, a financial institution must take reasonable steps to - -

1. Conduct enhanced scrutiny of a correspondent account maintained for or on behalf of such a foreign bank to guard against money laundering and to report suspicious activity.
2. Ascertain whether such a foreign bank provides correspondent accounts to other foreign banks.
3. Identify the owners of such a foreign bank if its shares are not publicly traded.

What is a “Correspondent Account”?

“Correspondent account” means an account established for a foreign financial institution to receive deposits from, or to make payments or other disbursements on behalf of, the foreign financial institution, or to handle other financial transactions related to such foreign financial institution.

What Types of Accounts and Contracts may be “Correspondent Accounts”?

For banks, correspondent accounts established on behalf of foreign financial institutions include:

- any transaction account
- any savings account or asset account
- any account involving extension of credit
- any other relationship with foreign financial institution to provide ongoing services
- accounts to purchase, sell, lend or otherwise hold securities, including securities repurchase agreements
- accounts that clear and settle securities transactions for clients
- “due to” accounts
- accounts for trading foreign currency
- foreign exchange contracts
- custody accounts for holding securities or other assets in connection with securities transactions as collateral
- over-the-counter derivatives contracts

What Types of Contracts and Accounts may be “Correspondent Accounts”?

For broker-dealers, correspondent accounts established on behalf of foreign financial institutions include:

- any formal relationship established with a broker or dealer in securities to provide regular services to effect transactions in securities, including, but not limited to, the purchase and sale of securities and securities loaned and borrowed activity and to hold securities or other assets for safekeeping or as collateral.

What is an "Account"?

"Account" means:

"any formal banking or business relationship established by a bank to provide regular services, dealings, and other financial transactions; and. . . includes a demand deposit, savings deposit, or other transaction or asset account and a credit account or other extension of credit."

Note that - - single or occasional wire transfers not included

Issuance by a bank of a funds transfer to, or receipt by a bank of a funds transfer from, a foreign bank does not, by itself, create an account relationship on behalf of the foreign bank under the rule.

What is a “Foreign Bank”?; What is a “Foreign Financial Institution”?

“Foreign bank” is a bank organized under foreign law or an agency, branch or office located outside the United States of a U.S. bank.

“Foreign financial institution” is defined to include:

- foreign banks; the foreign offices of covered financial institutions; non-U.S. entities that, if they were located in the United States, would be a securities broker-dealer, futures commission merchant, or mutual fund; and non-U.S. entities that are engaged in the business of, and are readily identifiable as, a currency dealer or exchanger or a money transmitter.

Risk-Based Due Diligence for Correspondent Accounts

The Final Rule requires each covered financial institution to include in its due diligence program procedures for assessing the anti-money laundering risks posed by correspondent accounts it maintains for foreign financial institutions based on a consideration of relevant factors, as appropriate to the particular jurisdiction, customer and account.

General Due Diligence Requirements for Correspondent Accounts

General due diligence policies, procedures and controls for correspondent accounts are required to include:

- Determining whether any such correspondent account is subject to enhanced due diligence.
- Assessing the money laundering risk presented by such correspondent account, based on assessment of risk factors.
- Applying risk-based procedures and controls to each such correspondent account reasonably designed to detect and report known or suspected money laundering activity, including a periodic review of the correspondent account activity sufficient to determine consistency with information obtained about the type, purpose and anticipated activity of the account.

Risk Factors to be Considered in Connection with General Due Diligence for Correspondent Accounts

1. The nature of the foreign financial institution's business and the markets it serves;
2. The type, purpose and anticipated activity of such correspondent account;
3. The nature and duration of the covered financial institution's relationship with the foreign financial institution (an any of its affiliates);
4. The AML and supervisory regime of the jurisdiction that issued the charter or license to the foreign financial institution (and, if available, the jurisdiction in which any owner is incorporated or chartered)
5. Information known or reasonably available to the covered financial institution about the foreign financial institution's anti-money laundering record.

Developing a Risk-Based Due Diligence Program for Correspondent Accounts

- An effective risk-based due diligence program will provide for a range of due diligence measures, based on a covered financial institution's risk assessment of a correspondent account.
- Starting point for financial institutions should be a stratification of their money laundering risk based on a review of the relevant risk factors to determine which accounts may require increased measures.
- Final Section 312 rule does not specify particular due diligence measures that must be adopted by a covered financial institution; a risk-based due diligence program is to be based on a covered financial institution's own risk assessment.

Ongoing Monitoring and Due Diligence Requirements

- The Final Rule states explicitly that covered financial institutions must apply ongoing risk-based correspondent account procedures and controls reasonably designed to detect and report money laundering.
- Periodic review of correspondent accounts is required.
- Monitoring will not ordinarily involve scrutiny of every transaction within the account, but should instead involve a review of the account sufficient to ensure that the covered financial institution can adequately identify suspicious transactions.

Steps Required When Appropriate Due Diligence Cannot be Performed

Section 103.176(d) requires a covered financial institution to have special procedures to address the issue of what a financial institution should do when appropriate due diligence cannot be performed.

- when institution should refuse to open account.
- when institution should suspend transactions activity.
- when institution should file a suspicious activity report.
- when institution should close account.

Effective Dates for Due Diligence Requirements

Applicability of due diligence requirements for correspondent accounts:

General requirements

- Effective July 5, 2006, the requirements of 31 C.F.R. 103.176 apply to each correspondent account established on or after July 5, 2006.
- Effective October 2, 2006, the requirements of 31 C.F.R. 103.176 apply to each correspondent account established before July 5, 2006.

Proposed rule for enhanced due diligence

- Until issuance of a final rule for enhanced due diligence, most banking organizations must continue to comply with 31 U.S.C. §5318(i)(2), which requires enhanced due diligence for certain correspondent accounts.
- Broker-dealers and certain other financial institutions continue to be exempt from compliance with the enhanced due diligence provisions for correspondent accounts until a final rule is issued.

Proposed Rule for “Enhanced Due Diligence”: Applicability

Proposed rule with respect to “enhanced due diligence” for covered financial institutions that maintain correspondent accounts for foreign banks deemed to be of particular AML concern, would be applicable to foreign banks operating under - -

1. an offshore banking license;
2. a license issued by a country designated as being non-cooperative with international anti-money laundering principles or procedures by an intergovernmental group or organization of which the United States is a member and with which designation the United States concurs;
3. a license issued by a country designated by the U.S. Secretary of the Treasury as warranting special measures due to money laundering concerns.

Proposed Rule for “Enhanced Due Diligence”: Requirements

Among the “enhanced due diligence” requirements that would be imposed on covered financial institutions under the Proposed Rule are the following:

1. Obtain and review documentation relating to the foreign correspondent bank’s AML program and evaluate the extent to which that program appears to be reasonably designed to detect and prevent money laundering.
2. Monitor transactions to, from or through the correspondent account in a manner reasonably designed to detect money laundering and other suspicious activity.
3. For “payable-through accounts,” obtain information about the identity of persons with authority to direct transactions through the correspondent account and the sources and beneficial ownership of funds or other assets in the account.

“Payable through account” is an account opened at a covered financial institution by a foreign financial institution by means of which the foreign financial institution permits its customers to engage, either directly or through a subaccount, in banking activities usual in connection with business of banking in the United States.

Proposed Rule for “Enhanced Due Diligence”: Requirements

(continued)

4. Determine whether the foreign correspondent bank in turn maintains correspondent accounts for other foreign banks (“nested banks”) for which the U.S. correspondent account is used to process transactions.
5. Obtain the identity of owners of any foreign correspondent bank whose shares are not publicly traded and the nature and extent of each owner’s interest (10% or more of any class of securities).

Implementation Issues

- Are there “best practices” for using technology as part of a due diligence program for correspondent accounts?
- What type of training and employee education programs should be developed by banks?
- How can an international bank develop a global program that will effectively meet U.S. requirements and foreign requirements?