

SECTION 312 Final Regulation

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LONG AWAITED

and (except for the enhanced foreign

bank due diligence provisions)¹ final regulation under

Section 312 of the USA PATRIOT Act arrived in early January 2006.

Coming two years after Financial Crimes Enforcement Network (FinCEN) issued the final interim regulation in July 2002, the final regulation implements two of Congress's top anti-money laundering (AML) priorities: accounts maintained at U.S. financial institutions by foreign financial institutions, and accounts of government officials.

Unlike the customer identification program (CIP) regulations, there are no grandfathering provisions for existing customers or reliance opportunities for customers with accounts at more than one institution. Banks, broker-dealers, and other U.S. institutions covered by the regulation have to comply for all of their applicable accounts (new customers starting in July; at least a plan for the remediation of existing customers by October 1). Given that these are categories of customers deemed "high risk" by statute, banks would be well advised to pay close attention to these regulations. (Note: remediation of existing accounts may not be completed by October for large institutions, but the agencies want an official plan and proposed timeline for such remediation to be in place.)

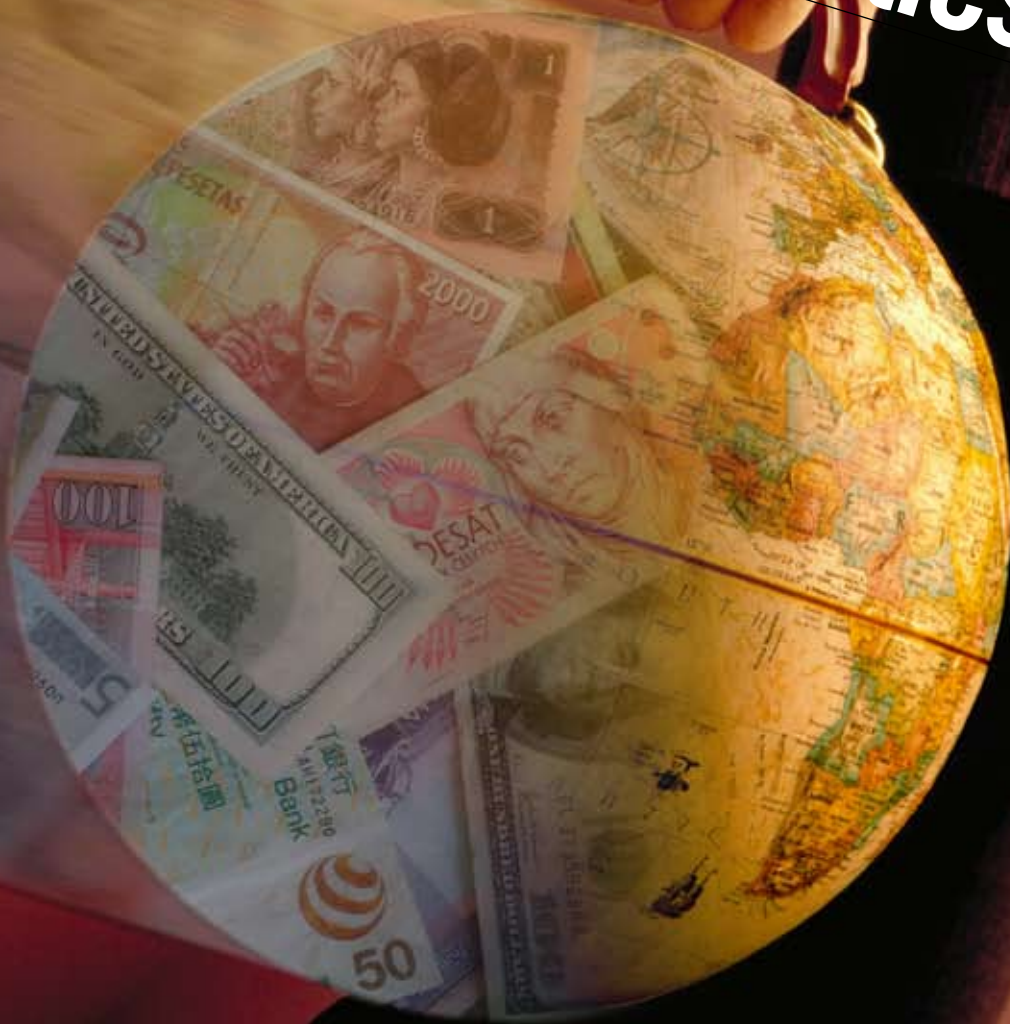
Shortly before the issuance of the final rule, FinCEN issued a fact sheet² that described the general requirements of the regulation. U.S. banks (and some other types of United States financial institutions, including U.S. branches of foreign banks), must identify foreign financial institutions (generally defined as foreign banks and the foreign branches of U.S. banks, the foreign equivalent of broker-dealers and mutual funds, and some foreign commodities companies and money service businesses), determine whether they have "correspondent accounts" (accounts for effecting payments, including all deposit accounts) and if so, conduct due diligence and in some cases enhanced due diligence (EDD). Banks must also perform due diligence on certain private bank accounts (accounts that require a minimum of \$1 million in assets on deposit, have an assigned liaison to service the

accounts, and are maintained for the direct or beneficial ownership of foreign individuals) that have any nominal or beneficial owners that are senior foreign political leaders. Banks must perform appropriate account monitoring on all of these accounts, focusing particularly on transactions that might be indicative of foreign corruption.

While the broad application of the 312 regulations and their applicability to existing customers might be bad news for AML compliance professionals, the good news is that most banks should already have a head start due to other regulations and regulatory developments of the past few years. Besides having to comply with the July 2002 final interim 312 regulations, banks have had compliance requirements for their foreign bank accounts under Sections 313 and 319 of the USA PATRIOT Act and (as described in the interagency AML examination manual) accounts maintained by politically exposed persons (PEPs) for some time. Indeed, the 312 regulations may actually help banks focus their general PEP compliance efforts on accounts held by individuals who fall within the regulation's definition of "senior foreign political leader." Unlike some categories of financial institutions covered by the 312 regulations (most notably mutual funds), banks have had high-risk customer compliance expectations for years, and they should be in a relatively good position to adapt their established risk management programs to the regulation's new requirements.

Described below are some suggestions on how banks should focus their efforts to meet the July and October compliance dates.

Reflects Top AML Priorities



Foreign Financial Institution Accounts

By now all United States banks should have established due diligence programs for their foreign bank correspondent accounts, obtaining shell bank certificates from all foreign banks and conducting risk-based due diligence that takes into account a variety of factors in assessing the risk associated with maintaining such accounts. Banks should be following generally accepted industry guidelines in conducting this due diligence, which can include determining whether the foreign bank (or the activity that is conducted in its correspondent account) is from a high-risk jurisdiction; gathering negative publicly available information regarding the foreign bank; confirming that the foreign bank has an AML program, and in some cases obtaining a copy; or obtaining information concerning the foreign bank's products and services. This information needs to be evaluated in the context of the type of correspondent account maintained with the bank, and as necessary, additional due diligence should be performed on foreign banks where the risks are greater. Banks whose correspondent accounts are used exclusively to support trade finance for commercial customers with counterparties in lower-risk countries would have a different due diligence program from those who maintain payable through-accounts for South American banks.

In every case, appropriate account and transaction monitoring should accompany the due diligence program to ratify the normal and expected use of the correspondent account and, as applicable,

New Accounts: Where Are They Opened?

To address these requirements, banks should formulate strategies that distinguish the new-customer (July) and existing-customer (October) deadlines. One approach is to identify areas within the bank where foreign financial institution accounts might be opened and determine whether there are adequate processes within those areas to flag such accounts. A place to start might be the bank's deposit businesses, where basic information about a customer (perhaps designed to identify domestic money service customers) is already obtained for new relationships. If feasible, the bank can adapt these account-opening processes to cover the additional types of entities covered by the 312 regulations, perhaps using address as a variable. (Note: Caution should be exercised using address as a sole factor to exclude otherwise applicable customers; some may use a U.S. address at account opening but conduct their business from foreign locations).

Other businesses within the bank should also be examined, including the lending, trust, trade finance, and commercial areas. In every area where a foreign financial institution could conceivably (and reasonably) become a customer, appropriate measures should be taken to identify them through the account opening internal control structure. The goal, of course, should be to have risk-based controls that apply the greatest amount of resources (human and technology) where there is the greatest likelihood that an account subject to the regulation might be opened.

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report unexplained, unusual transactions that warrant suspicious activity reports (SARs).

Banks with effective compliance programs that address these fundamental requirements should have an easier road to Section 312 compliance than banks that have failed to address these concepts. In fact, they should take this opportunity to revisit their foreign bank compliance processes to make sure they have identified all areas within the bank where foreign banks may have accounts. The major challenge the 312 regulations present for banks is not their foreign bank customers, but rather the additional categories of financial institutions that are swept into the due diligence and monitoring requirements. These include foreign entities that if located within the United States would be securities broker-dealers, commodity futures commission merchants, or mutual funds. They also include foreign entities that are engaged in the business of currency dealing, currency exchanging, or money transmission, and are readily identifiable as being in these businesses (presumably based on the activities identified in their accounts, or other information obtained by the U.S. bank). FinCEN included the types of financial institutions it believes pose a higher risk of enabling money launderers to access the U.S. financial system (foreign check cashers, for example, are not included). Despite these exclusions, the new categories of foreign financial institutions that are now subject to identification and due diligence present new compliance requirements.

Add Due Diligence to Account Opening Procedures

After the universe of potential new-account opening areas with the bank is identified, the next step should be to leverage both the new-account internal control and current foreign-bank due diligence processes in completing the new-account Section 312 requirements. These steps will probably require training in the new-account internal control area so that employees know what to look for when these accounts are opened.

Because the vast majority of U.S. banks will probably open few (if any) accounts requiring Section 312 scrutiny, this training will need to be regularly reinforced. Upon detection, the bank should apply its due diligence processes, leveraging its foreign correspondent bank program and tailoring it to the type of foreign institution that opened the account. While the enhanced due diligence requirements for foreign bank accounts are still unresolved (comments were due on this proposed regulation by March 6), banks should apply more stringent processes any foreign financial institution whose risk factors warrant additional, significant scrutiny. Banks whose account opening systems are automated may find it difficult to develop, implement, and test necessary technology changes in advance of the July new-customer deadline; in these cases, interim steps should be taken to provide adequate coverage while these technology requirements are completed (banks should avoid skipping steps in their technology project cycles due to the impact changes may have on other system applications).

Existing Customers

When the new-account processes have been developed, banks can turn to the October deadline for existing foreign financial institution customers. Initial steps in this component of the project can follow the new-account study, where businesses who were identified as having potential new customers subject to the regulation can examine their existing customer bases for applicable relationships. When identified, the bank can apply its due diligence and expanded due diligence programs, adding a review of account activity as a factor in the analysis. Besides this business-by-business approach, banks should also consider some sort of bank-wide customer information file review in their existing customer search. There may very well be long-term relationships or accounts that were acquired in mergers or acquisitions that fall outside of the active management processes of a particular business but require analysis from a 312 perspective. And of course, if a foreign bank account is identified, the bank should immediately apply its 313/319 compliance processes.

Monitoring

For both new and existing customers that “pass” their due diligence evaluation, the final step in the 312 regulation compliance effort is account and transaction monitoring. Banks that maintain relationships covered by the regulation need to consider these to be high-risk customers and conduct appropriate monitoring on the transactions

Foreign Branches of U.S. Banks

Banks that have foreign branches should expect that U.S. financial institutions that have accounts for these branches will be conducting due diligence (and even enhanced due diligence, in some cases) to comply with the 312 regulation. Anticipating this, some banks are placing AML-related information on their corporate Web sites (and in some cases their 313/319 shell bank certificates) to expedite their responses to inquiries from other U.S. institutions. U.S. banks that have accounts with these foreign U.S. bank branches should remember to include them in their 312/313/319 compliance procedures.

Private Bank Accounts

A quick read of the private banking component of the 312 regulation might lead an AML compliance officer to think that the “PEP problem” now applies only to very large relationships, and that as a result this part of the regulation will not apply to many banks. While the latter conclusion may be technically true, the former is certainly incorrect. In fact, the biggest mistake a bank could make in complying with the regulation might be ignoring accounts that are not covered by the regulation but are otherwise high risk for money laundering. We’ll identify some of these pitfalls as we provide strategies for compliance, understanding that the same compliance deadlines for the foreign financial institution component of the regulation (July for new customers, October for existing customers) apply to the private bank component.

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to ensure that the activities conducted in the accounts are consistent with the normal and expected transactions identified during the due diligence process. As with the due diligence step, this account monitoring can leverage the foreign bank monitoring already conducted, with a twist: Banks will need to understand what types of account activities are “normal and expected” for these nonbank financial institutions, both for monitoring the appropriateness of transactions conducted by their identified foreign institution customers, and for flagging other customers that may be within the coverage of the regulation.

It is important to remember that in adding the currency dealer and exchanger and money transmitter categories of financial institutions, FinCEN indicated that the customer had to be “readily identifiable” as being in these businesses, and it is likely that this would not be apparent to a U.S. bank until transactions are processed through the account. Many U.S. banks have established means of identifying similar money service businesses (MSBs) in their transaction monitoring; others might need to develop more defined criteria so that potential covered accounts are escalated when identified. The transaction monitoring needs to be risk-based, and institutions with a greater likelihood of opening accounts subject to the regulation would need to take more comprehensive measures than banks whose risk assessments indicate a remote chance of a foreign financial institution opening or maintaining an account.

What Accounts Are Covered?

First, a bank needs to determine which of its accounts are covered by the regulation. Congress defined “private bank account” in the USA PATRIOT Act, and consequently FinCEN was required to follow this definition in the 312 regulation. To be covered, an account must (1) require an aggregate of at least \$1 million in funds or assets on deposit in the bank, (2) be established on behalf of one or more non-U.S. persons who are direct or beneficial owners of the account, and (3) have a “liaison” assigned by the bank to the account. Multiple accounts that constitute a single relationship should be aggregated for purposes of the \$1 million minimum, and to have a liaison, a bank employee must provide personalized service to the customer in a manner that typically requires the employee to obtain detailed information about the customer (typically seen with the appointment of account or relationship managers).

The “direct or beneficial ownership by non-U.S. persons” prong of the definition is somewhat confusing and to some extent surprising because of what it excludes from coverage. Unless the person is the direct owner of the assets (“direct” is undefined, but it should be interpreted to be any person who is the named customer of the bank), the non-U.S. person must do more than have the opportunity to deposit funds or claim ownership of the assets to be a “beneficial owner”; he or she must have the ability to control, direct, or manage the account. However, because the due diligence requirements include

ascertaining the identity of both nominal and beneficial owners, this distinction may not be significant.

Using this definition, a bank should follow the same strategy outlined for the foreign financial institutions. By July, banks should determine what businesses may open private bank accounts. This may be a relatively easy task if the bank is small and does not have a wealth management or affluent customer segment where traditional private banking is offered. Banks should examine not only their stated minimum relationship guidelines (remembering to aggregate them for multiple account relationships) but also documents such as fee schedules and account agreements to determine whether they have accounts where documentation generally requires \$1 million for qualification. It may be that these documents are not meant to define the account terms, but there may be places that examiners focus on when evaluating 312 compliance. If a bank uses a document that suggests a \$1 million minimum, the presumption could be that the account is a private bank account for 312 purposes.

Smaller accounts may grow to over a \$1 million over time, but these are not private bank accounts solely because of this growth. Note, however, that banks typically use customer balance data to sell new products to large-balance customers; if these customers are sold a new account that might fall within the 312 private bank definition, they may become private bank customers.

previously. The due diligence standards include the following:

- Ascertain the identity of all nominal and beneficial owners of the account. (Note: The regulation does not add these persons as CIP “customers.”)
- Determine whether any of the persons in (1) is a senior foreign political leader.
- Ascertain the source of funds for the account and the purpose/expected use of the account.
- Review the activity to determine whether it is consistent with the purpose/expected use and report suspicious or inconsistent cases to law enforcement.
- For senior foreign political figures, report any transactions that may be indicative of corruption or other stated illegal activities.

Technically, a bank could not perform this due diligence on strictly domestic accounts and remain in compliance with the 312 regulations. As a practical matter, however, it will be necessary for the bank to ascertain at least the nationality of all beneficial owners in accounts that would otherwise fall within the 312 private bank account definitions simply to determine whether the regulation even applies.

Finding Senior Foreign Political Figures

Whenever the bank identifies foreign individuals who are “actual,” “nominal,” or “beneficial” owners of a private bank account, it needs

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Caution Against Avoiding Compliance Using Technicalities

A word of caution is warranted before we move to the due diligence steps of the 312-compliance strategy. Based on the somewhat narrow definition of a private bank account, bankers might be tempted to employ a strategy that changes account minimums to less than \$1 million, or to overlook accounts where the beneficial owners play no role in the management of the account. Following these tactics ignores the fact that the 312 regulation does not relieve a bank of its overall AML risk management responsibilities, where accounts maintained for high-risk individuals (such as PEPs) that may be less than \$1 million, with no assigned liaison, may well present much greater risks to the institution than its defined private bank accounts. It should be expected that examiners will take a dim view of compliance efforts that are centered primarily on avoiding the regulation instead of substantive risk management enhancements. While the private bank 312 strategy should focus on applicable relationships, banks should also take into account general risk management requirements for PEP accounts that fall outside of the definition. Just as a bank can use the foreign financial institution component to reinforce its USA PATRIOT Act Section 313/319 compliance, so too can it leverage its private bank efforts to fine-tune compliance efforts for individual account due diligence, and especially its PEP strategy.

Performing Due Diligence

After a bank identifies where private bank accounts might be opened, the next step to meet the July new-account deadline is the implementation of appropriate due diligence processes. Technically, the regulation’s due diligence standards are required only for accounts that meet all three prongs of the private bank account definition discussed

to determine whether any of them are senior foreign political leaders. This process raises one of the most challenging aspects of the regulation and PEP risk management: defining the customer population subject to due diligence and account monitoring as politically exposed persons. The regulation offers some guidance: “a current or former senior official...of a foreign government...a major foreign political party...or a foreign government-owned commercial enterprise,” along with businesses that are formed by or for the benefit of such individuals and their immediate families. Also included are persons who are “widely or publicly known” or who are known by the bank to be close associates of such individuals. As the industry grapples with identifying PEPs and SPPFs, it is interesting to note that one federal regulator opined that the banking agencies do not expect institutions to “engage in a search-and-destroy mission to find PEPs” but are more concerned about appropriate and effective due diligence.

Can banks assume that this is a generally accepted definition of a PEP? This is not clear, although the preamble does indicate that it is “consistent with similar standards adopted by the international community.” Many banks have obtained software that screens customer databases for such persons, and in some cases this software expands the definition to cover private persons whose status in their home countries rises to the level of a PEP (especially when they have derogatory information associated with them), even though they have not actually held public office or been associated with someone who has. Beginning in July, banks should begin to perform this PEP identification process on the beneficial owners of their private bank accounts, either by asking the individual (as was suggested in the interim regulation as an option), by using interdiction software, or by checking public sources such as the Internet.

Monitoring

When accounts that are maintained on behalf of or for the benefit of foreign individuals are identified, the bank must review the account activity to determine whether it is consistent with the source of funds, account purpose, and anticipated activities ascertained during the due diligence process. Presumably a bank may leverage its standard AML monitoring and surveillance processes to perform this function, and it is a good idea to add account monitoring to any periodic business reviews that are conducted on the accounts. If a beneficial or nominal owner is a senior foreign political leader, the bank must conduct special scrutiny over the account to identify transactions that may involve the proceeds of foreign corruption. To provide guidance over what types of transactions might be indicators of corruption, the preamble suggests that wire transfers from a government account into the private bank account and the use of public news media reporting on corrupt foreign leaders are possible means of focusing on this specific type of suspicious activity.

Just as a bank needs to exercise caution when excluding a private bank account from its due diligence process until it confirms the nationality of its nominal and beneficial owners, so should it not be hasty in carving out accounts from account monitoring processes. Because some degree of due diligence is needed to determine whether the definition applies, banks should consider whether private banking generally should receive a greater degree of scrutiny within the overall risk assessment

program requirements, particularly with respect to PEPs in accounts that are not within the private bank account 312 definition that present risks to their institutions. It is hoped the enhanced due diligence regulation and additions to the interagency AML bank examination manual will provide additional guidance to the industry in defining the regulatory expectations for managing these types of high-risk customers. **BC**

ABOUT THE AUTHORS

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Byrne has written extensively on money laundering and privacy issues and is a frequent contributor and adviser to Money Laundering Alert, Bankers Hotline, ABA Bank Compliance magazine, and other banking publications.

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Endnotes

¹www.fincen.gov/finalrule01042006.pdf.

²www.fincen.gov/312factsheet.pdf.

PATRIOT Act Section 313/319 compliance, compliance efforts for individual account due diligence, and especially its PEP strategy.

process the bank uses for its AML program. Banks that use automated account monitoring and surveillance processes may be able to give their entire private banking portfolio priority attention or focus on those accounts within the portfolio that require special scrutiny.

Existing Customers

To meet the October effective date for existing customers, banks will need to make some threshold decisions on characterizing their potential 312 regulation private bank customer bases. Banks that have already identified PEPs within their account bases have an obvious head start, because they presumably have included customers whose assets on deposit meet the \$1 million minimum. These banks may have to evaluate the status of their account beneficiaries or other relationships where there may be parties on record besides the account owner who may have 312 implications. All banks should consider where within their institutions there might be foreign political leaders as account owners or ancillary parties, and to the extent it is reasonable and practicable perform searches of these databases to determine whether they are present. If so, bank senior management should be involved in the decisions to retain or close such accounts, with retention decisions accompanied by appropriate account monitoring that meets the requirements of the regulation.

Conclusion

There is no question that the 312 regulations place new compliance burdens on banks, but by leveraging processes already in place for existing requirements, banks may find some good shortcuts in meeting them. While banks certainly need to prioritize their efforts to address the 312 requirements, they should not do so at the expense of other AML pro-