SIMPSON THACHER

ANTI-MONEY LAUNDERING REGULATIONS ISSUED PURSUANT TO THE USA PATRIOT ACT

SIMPSON THACHER & BARTLETT LLP

MAY 29, 2002

INTRODUCTION

On October 26, 2001, the President signed into law the "United and Strengthening America by Providing Appropriate Tools Required to Intercept and Obstruct Terrorism Act of 2001" (the "USA PATRIOT Act", which is referred to in this memorandum as the "Patriot Act"). Title III of the Patriot Act made a number of amendments to the anti-money laundering provisions of the Bank Secrecy Act. Pursuant to those amendments, the Financial Crimes Enforcement Network ("FinCen"),[1] the bureau within the United States Department of the Treasury that has primary responsibility for anti-money laundering efforts, has published more than a dozen Federal Register notices containing proposed rules, interim final rules and final rules.[2] These rules impose new requirements on financial institutions and subject some classes of financial institutions—a term that is broad enough to include everything from banks to car dealers—to anti-money laundering regulations for the first time. More regulations are to come. This memorandum provides an overview of Title III of the Patriot Act and the new regulations. Any questions regarding this memorandum may be directed to Gary Rice (212/455-7345 or grice@stblaw.com), Lee Meyerson (212/455-3675 or lmeyerson@stblaw.com) or John L. Walker (212/455-7365 or jwalker@stblaw.com). If you did not receive this memorandum by e-mail and would like to receive this or future memorandums by e-mail, please provide your e-mail address to Sue Bussy (sbussy@stblaw.com).

---

1 The Patriot Act and the Bank Secrecy Act authorize or require the Secretary of the Treasury to take certain actions. In most cases it is FinCEN that issues regulations pursuant to these statutory provisions and, for the purposes of discussing such statutory provisions and regulations, this memorandum uses "FinCEN" to refer to both FinCEN and the Secretary.

2 Interim final rules are rules that take effect immediately but as to which comments from the public are requested.

SUSPICIOUS ACTIVITY REPORTS

SAR REQUIREMENTS FOR BANKING ORGANIZATIONS

For many years, federal (and some state) banking regulators required commercial banks to file a "criminal referral report" if they believed that a crime had been committed or attempted against or involving the bank. In 1992 the Bank Secrecy Act was amended to require depository institutions to file reports concerning suspected violations of any law or regulation (not just anti-money laundering laws or regulations) and provide for centralized processing of such "suspicious activity reports" ("SARs"). SARs are made available to law enforcement agencies as well as federal supervisory agencies. The federal banking agencies subsequently combined the SAR requirement with their own reporting requirement and replaced the criminal referral reports with SARs. The Board of Governors of the Federal Reserve System also amended its regulations to make the reporting requirement applicable not only to state member banks, but to all nonbank affiliates of U.S. banks, to foreign banks with a branch or agency in the United States and to the U.S. affiliates of such foreign banks.

SAR REQUIREMENTS FOR MONEY SERVICES BUSINESSES

As the Bank Secrecy Act made it more difficult to launder money through depository institutions, criminals have sometimes utilized money services businesses for this purpose. In 1999 there was a flurry of enforcement activities in the New York area relating to laundering of funds from Colombia and the Dominican Republic. The New York Banking Department revoked the license of some money transmitters, one of which pleady guilty to, and others of which were indicted for, money laundering. In 1999 FinCEN adopted a regulation requiring money services businesses to register with FinCEN.[3]

On March 14, 2000 FinCEN published regulations that subjected certain money services businesses to suspicious activity reporting requirements.[4] FinCEN subsequently issued an SAR form specifically for money services businesses.[5] The FinCEN regulations define money services business to include currency dealers; check cashers; issuers, sellers or redeemers of traveler's checks and money orders; money transmitters;[6] and the United States Postal Service.

---

3 64 Fed. Reg. 45438 (Aug. 20, 1999).

4 FinCEN, "Requirement that Money Transmitters and Money Order and Traveler's Check Issuers, Sellers and Redeemers Report Suspicious Transactions", 65 Fed. Reg. 13683 (March 14, 2000).

5 FinCEN, "Suspicious Activity Report for Money Services Businesses", 67 Fed. Reg. 9031 (Feb. 27, 2002).

6 The term "money transmitter" is defined as a person that is in the "business" of transmitting funds. FinCEN has stated that the acceptance and transmission of funds as an integral part of the execution and settlement of a transaction other than a funds transfer, such as in connection with the sale of

The FinCEN regulations impose suspicious activity reporting requirements on a subset of these money services businesses: issuers of traveler's checks or money orders, sellers or redeemers of traveler's checks or money orders, money transmitters and the U.S. Postal Service. Check cashers and currency dealers are not generally subject to this requirement because those businesses generally involve disbursement rather than receipt of funds. Money services businesses typically operate through a network of independent agents. Such agents are also subject to the suspicious activity reporting requirement.

In adopting the requirement, FinCEN provided some examples of the type of activity that should be reported:

- For example, an individual's seeking regularly to purchase or redeem instruments in bulk, or to purchase transmissions to multiple overseas locations, all to the same named beneficiary should, in the absence of specific qualifying circumstances, place the money services business on notice that a suspicious transaction is underway. Similarly, the fact that a customer (i) refuses to provide information necessary for the money services business to make reports or keep records required by 31 C.F.R. 103 or other regulations, (ii) provides information that a money services business determines to be false, or (iii) seeks to change or cancel the transaction after such person is informed of currency transaction reporting or information verification or recordkeeping requirements relevant to the transaction or to the money services business' intent to file a currency transaction report with respect to the transaction, would all indicate that a suspicious activity report should be filed. [7]

SAR REQUIREMENTS FOR REGISTERED BROKER-DEALERS

The Patriot Act amended the Bank Secrecy Act to impose suspicious activity reporting requirements on brokers and dealers that are registered with the Securities and Exchange Commission (the "SEC"). The impact of this amendment is diminished by the fact that Federal Reserve regulations already subjected many of the largest brokers and dealers to the SAR requirement by extending the requirement to affiliates of U.S. banks and U.S. affiliates of non-U.S. banks that have banking operations in the United States. FinCen issued a proposed rule to implement this requirement on December 31, 2001.[8] The Patriot Act requires that a final rule be adopted by July 2, 2002.

---

securities, does not cause a person to be a money transmitter. FinCEN, "Definitions Relating to, and Registration of, Money Services Businesses", 64 Fed. Reg. 45438, at 45443 (Aug. 20, 1999).

7 65 Fed. Reg. At 13689-13690. Additional examples are provided at pages 18-23 of the third issue of "SAR Activity Review" (Oct. 2001).

8 FinCEN, "Requirement of Brokers or Dealers in Securities to Report Suspicious Transactions", 66 Fed. Reg. 67670 (Dec. 31, 2001) (proposed rule).

It is not clear that registered brokers and dealers will have much to report in the way of suspected money laundering violations in view of the fact that most do not accept significant amounts of currency from customers. However, the requirement to report suspicious transactions is not limited to those that may involve money laundering; it extends to any suspected violation of federal law or regulation in which the broker-dealer was an actual or potential victim of the violation or was used to facilitate the actual or potential violation, although securities law violations need not be reported if they are reported to the SEC or a self-regulatory agency. The regulation, which is based on the federal banking agencies' SAR regulations, draws a distinction between money laundering violations, which must be reported if the broker-dealer knows, suspects or <u>has reason to suspect</u> a violation, and violations of other laws, which must be reported if they are known or suspected. Thus, in the case of money laundering violations, there is a due diligence requirement.

The suspected violation must be reported within thirty calendar days of "the date of the initial detection by the reporting broker-dealer of facts that may constitute a basis for filing" a suspicious activity report. This language, which is also included in the federal banking regulations, presents difficulties in cases where the complexity of the transactions makes it impossible to complete an internal investigation within thirty days. Regulators sometimes take the position that the investigation itself indicates suspicion, which should result in a filing within 30 days of its commencement. Regulated organizations, however, are reluctant to relay suspicions of employee or customer criminality to a broad array of enforcement agencies unless they have determined that an innocent explanation for the transactions in question is unlikely, a process that in complex cases often takes much longer than 30 days.

PATRIOT ACT AMENDMENTS TO SAR REQUIREMENTS

The Patriot Act amended several provisions in the Bank Secrecy Act that relate to the requirement to report suspicious activity. First, it made SARs available to a broader range of governmental authorities, including the intelligence agencies, state financial regulators and self-regulatory organizations. Second, the provision that protects a financial institution that files such a report from legal liability to the subject for such disclosure and for not notifying the subject of such filing was broadened to include potential liability under any contract or arbitration agreement. The Patriot Act also clarified that the protection against liability to the subject of the report for disclosure does not constitute immunity against civil or criminal action brought by the government.

The prohibition on disclosing to the subject of a SAR that such a report has been filed is supplemented in the Patriot Act by a prohibition on government employees disclosing the filing of such a report to a person involved in a reported transaction, other than in the course of official duties. The Act also clarifies that the prohibition on telling the subject of an SAR that a report has been filed does not prevent the financial institution from including in an employment reference provided in accordance with 12 U.S.C. §1828(w) a statement that the former employee may have been involved in unlawful activity.[9]

ANTI-MONEY LAUNDERING PROGRAMS

TEMPORARY EXEMPTION FOR NEWLY COVERED FINANCIAL INSTITUTIONS

The Bank Secrecy Act, as amended in 1992, authorized FinCEN to require "financial institutions" to adopt anti-money laundering programs with the following features: the development of internal policies, procedures and controls; the designation of a compliance officer; an ongoing employee training program; and an independent audit function to test programs. The term "financial institutions" in the Bank Secrecy Act is extremely broad, including not only banks and broker dealers but also a wide range of other businesses, such as pawnbrokers, car dealers, and travel agencies.[10] However, because the initial focus of anti-money laundering efforts was on the point at which cash enters the financial system, those efforts focused on depository institutions and FinCEN relied upon the federal banking agencies to adopt anti-money laundering requirements for the institutions they supervise. Casinos were the only type of financial institution that FinCEN itself required to adopt anti-money laundering programs[11] (although banks and certain other types of financial institutions were subject to other FinCEN regulations such as currency transaction reporting requirements).

Section 352(a) of the Patriot Act revised the Bank Secrecy Act so that all financial institutions are required to establish anti-money laundering programs within 180 days of the enactment of the Patriot Act (April 24, 2002). Such programs are required to include, at a minimum: the development of internal policies, procedures and controls; the designation of a

---

9 12 U.S.C. §1828(w), which was added by the Patriot Act, permits (but does not require), notwithstanding any other provision of law, an insured depository institution to include in a written employment reference information concerning the possible involvement of a former employee in "potentially unlawful activity".

10 The term "financial institution" is defined in the Bank Secrecy Act to include: an insured bank; a commercial bank; a private banker; a U.S. branch or agency of a foreign bank; a credit union; a thrift institution; a registered broker or dealer; a broker or dealer in securities or commodities; an investment banker; an investment company; a currency exchange; an issuer, redeemer or cashier of travelers checks, money orders, or similar instruments; an operator of a credit card system; an insurance company; a dealer in precious metals, stones, or jewels; a pawnbroker; a loan or finance company; a travel agency; a licensed sender of money; a telegraph company; a business engaged in vehicle sales; persons involved in real estate closings and settlements; the U.S. Postal Service; a casino, gambling casino or gaming establishment; and any similar business designated by the Secretary. 31 U.S.C. §5311(a)(2).

11 31 C.F.R. §103.64.

compliance officer; an ongoing employee training program; and an independent audit function to test programs. The Bank Secrecy Act, as amended, also authorizes FinCEN to establish minimum standards for such programs and to exempt from such standards those financial institutions that are not subject to FinCEN regulations. When the Patriot Act was enacted, FinCEN regulations applied to the following subset of financial institutions: banks, thrifts, credit unions, U.S. offices of foreign banks, broker-dealers, money services businesses, telegraph companies, casinos and card clubs.

On April 29, 2002, FinCEN published in the Federal Register an interim rule pursuant to Section 352 of the Patriot Act that provides that banks, savings associations, credit unions, registered broker-dealers, futures commission merchants and casinos will be deemed to be in compliance with Section 352 if they establish and maintain anti-money laundering programs as required by existing FinCEN regulations or their respective federal regulator or self-regulatory organization.[12] On the same date, FinCEN published in the Federal Register interim final rules (discussed below) that require money services businesses, operators of credit card systems and mutual funds to establish anti-money laundering programs.

FinCEN temporarily exempted all other financial institutions, a group that includes private equity funds, insurance companies and finance companies, from the requirement that they establish an anti-money laundering program. FinCEN interpreted its authority to exempt financial institutions not currently subject to FinCEN regulations from the minimum standards the Patriot Act authorized it to prescribe for anti-money laundering programs[13] as authority to exempt such financial institutions, at least temporarily, from the requirement to establish anti-money laundering programs,[14] which does not by its terms authorize such exemptions. This interpretation is not entirely supported by the statutory language, but the policy rationales provided by FinCEN for granting the temporary exemption are sensible and, in our view, would be upheld by a court. First, FinCEN noted the need to specifically define what is included in each category of "financial institution" listed in the Bank Secrecy Act that has not previously been the subject of any FinCEN regulation. As an example, "dealers in precious metals" needs to be defined to indicate whether it includes shopping center jewelry kiosks as well as diamond merchants. A related FinCEN concern is the need to devise regulations that do not unduly burden businesses many of which have a single or a few employees.

Second, FinCEN stated that it needed to analyze the nature of these various businesses, assess the nature of any threat that they could be used to facilitate money laundering or terrorism, and design anti-money laundering program standards that are tailored to the various

---

12 FinCEN, "Anti-Money Laundering Programs for Financial Institutions", 67 Fed. Reg. 21110 (April 29, 2002) (interim final rule).

13 31 U.S.C. §5318(h)(2).

14 31 U.S.C. §5318(h)(1).

types of businesses. This is a laudable objective, but the degree of tailoring, at least initially, is likely to be quite limited. The anti-money laundering regulations issued by the federal banking regulators and the rule recently adopted by the New York Stock Exchange do little more than recite the minimum statutory requirements: the development of internal policies, procedures and controls; the designation of a compliance officer; an ongoing employee training program; and an independent audit function to test programs.[15] In the case of banks, the federal banking regulators have provided additional guidance as to what is expected through examination manuals and supervisory letters.[16] It appears likely that, to the extent relevant, this guidance will be carried over to other types of financial institutions. In particular, "know your customer" policies that have been encouraged for private banking relationships, may be emphasized for private equity funds and broker-dealers.

FinCen stated that it intends to adopt anti-money laundering program standards for insurance companies in the near future. It also stated that it intends to adopt program standards for other categories of temporarily exempt financial institutions over the next six months. Finally, it stated that every financial institution will be subject to the requirement that it establish an anti-money laundering program by October 24, 2002, whether or not FinCEN has adopted anti-money laundering program standards for that category of financial institution before that date.

It should also be noted that each trade or business, except a financial institution that is subject to FinCEN's currency transaction reporting requirement, is subject to the requirement that it report to the Internal Revenue Service ("IRS") transactions in cash, currency or certain monetary instruments that exceed $10,000.[17] This is not a new requirement. The Patriot Act amended the Bank Secrecy Act to require that such reports also be filed with FinCEN. On December 31, 2001, FinCEN adopted regulations that are virtually identical to the IRS regulations and provide that transactions may be reported on a joint FinCEN/IRS form that is filed with the IRS. [18]

ANTI-MONEY LAUNDERING PROGRAMS FOR MUTUAL FUNDS

On April 29, 2002, FinCEN issued a regulation requiring open-end investment companies (commonly referred to as mutual funds) to develop and implement an anti-money

---

15 See, e.g., 12 C.F.R. §208.63(c); New York Stock Exchange Rule 445.

16 See, e.g., Federal Reserve Board, Bank Secrecy Act Manual; "Payable Through Accounts", SR 95-10 (FIS).

17 26 U.S.C. §60501; 26 C.F.R. §1.60501.

18 FinCEN, "Requirement That Nonfinancial Trade or Businesses Report Certain Currency Transactions, 66 Fed. Reg. 67680 (Dec. 31, 2001) (interim final rule).

laundering program by July 24, 2002.[19] The Bank Secrecy Act applies to "investment companies" generally, and FinCEN indicated that it expects to adopt regulations in the future that are applicable to investment companies other than mutual funds, including investment companies that are exempt from the Investment Company Act of 1940. However, the Patriot Act required FinCEN, the Federal Reserve and the SEC to jointly study and make recommendations to Congress by October 26, 2002 as to how the Bank Secrecy Act should be applied to investment companies other than mutual funds and FinCEN is delaying its rulemaking pending completion of that report.

The text of the new FinCEN regulation requiring mutual funds to establish anti-money laundering programs merely requires that a program be established and that it contain the four minimum features mandated by statute: the development of internal policies, procedures and controls; the designation of a compliance officer; an ongoing employee training program; and an independent audit function to test programs. In adopting the new regulation, FinCEN acknowledged that mutual funds are not likely to be used by money launderers to place illegal proceeds into the financial system through the purchase of mutual fund shares with cash and currency. Money launderers are more likely to use mutual funds to distance illegal proceeds that already have been placed in a depository institution from the criminal source of the proceeds by investing, redeeming and reinvesting proceeds in various mutual funds. FinCEN expects mutual funds to adopt programs, policies and internal controls that are designed to address such "layering" activities and the information accompanying the regulation provides examples of a number of "red flags" that may indicate money laundering, such as frequent purchases of fund shares followed by large redemptions, particularly if the resulting proceeds are wired to unrelated third parties or bank accounts in foreign countries, and transfers to countries where drugs are known to be produced or other high-risk countries.

FinCEN noted that investments in mutual funds are often made indirectly, through sponsors of fund supermarkets, insurance agents, financial planners and banks. In such cases, the investment is made through an omnibus account and the mutual fund does not know the identity of the underlying investor. FinCEN stated that mutual funds are not expected to obtain information regarding individual transactions that are processed through such an omnibus account. However, the funds are expected to analyze the risk posed by omnibus accounts based on such matters as the identity and location of the sponsor, and the viability of its anti-money laundering program.

ANTI-MONEY LAUNDERING PROGRAMS FOR OPERATORS OF A CREDIT CARD SYSTEM

On April 29, 2002, FinCEN issued a regulation requiring operators of credit card systems to develop and implement an anti-money laundering program meeting the prescribed

---

19 FinCEN, "Anti-Money Laundering Programs for Mutual Funds", 67 Fed. Reg. 21117 (April 29, 2002) (interim final rule).

standards by July 24, 2002.[20] A credit card system typically includes issuing banks that issue the credit cards to customers, acquiring banks that are authorized to accept credit card purchases from merchants, and an operator that determines which entities may serve as issuing and acquiring institutions and prescribes rules that member institutions must follow. In the course of the authorization, clearance and settlement of credit card transactions, information and funds are passed to and from the acquiring and issuing bank through the operator. There are relatively few such operators in the United States, including MasterCard International, American Express Travel Related Services Co., and VISA International.

The regulation defines the term "credit card" by reference to the definition in the Truth in Lending Act. The regulation applies to operators of credit card systems in which the credit card also functions as a debit card, but it does not include operators of debit card systems in which the debit card functions solely as a debit card. Nor does the regulation apply to operators of a merchant or vendor card system in which the card may only be used to purchase goods or services from a particular merchant or vendor.

FinCEN stated that credit cards have the potential to be used to access illicit funds located in money laundering havens if the operator of the credit card system gives banks in such jurisdictions permission to issue the credit cards. The regulation is intended to ensure that operators conduct sufficient due diligence on issuing institutions. [21] The regulation establishes a presumption that certain categories of foreign banks or other institutions pose heightened risks of money laundering or terrorist financing, including foreign shell banks that are not regulated affiliates, and banks operating under a license issued by a government that has been identified by a government agency as a sponsor of international terrorism or as noncooperative with international money laundering principles.[22] Although an operator is not prohibited from including such an institution as an issuing bank, it would be expected to take comprehensive steps to ensure that its credit card is not being used for money laundering or terrorist financing. The listed categories of institutions that pose heightened risks are not exclusive: operators are expected to do their own assessment of the risk posed by various institutions.

---

[20] FinCEN, "Anti-Money Laundering Programs for Operators of a Credit Card System", 67 Fed. Reg. 21121 (April 29, 2002) (interim final rule).

[21] FinCEN suggested that the technology that operators use to identify fraud may be adoptable to identifying money laundering and terrorist financing, and stated that it intended to explore this possibility with operators, but for the moment the regulation does not require operators to use such techniques.

[22] The Financial Action Task Force on Money Laundering has designated the following countries as being non-cooperative: Cook Islands, Dominica, Egypt, Grenada, Guatemala, Hungary, Indonesia, Israel, Lebanon, Marshall Islands, Myanmar, Nauru, Nigeria, Niue, Philippines, Russia, St. Kitts and Nevis, St. Vincent and the Grenadines, and Ukraine.

ANTI-MONEY LAUNDERING PROGRAMS FOR MONEY SERVICES BUSINESSES

On April 29, 2002, FinCEN issued a regulation requiring money services businesses to develop and implement anti-money laundering programs that meet the prescribed standards by July 24, 2002.[23] The text of the regulation merely requires that an anti-money laundering program be established and that it contain the four minimum features mandated by statute: the development of internal policies, procedures and controls; the designation of a compliance officer; an ongoing employee training program; and an independent audit function to test programs. FinCEN stated its intention to provide additional guidance to money services businesses in the future.

REGULATION OF ACCOUNTS MAINTAINED FOR NON-U.S. PERSONS

"COVERED FINANCIAL INSTITUTION" CORRESPONDENT ACCOUNTS FOR FOREIGN BANKS

Sections 313 and 319(b) of the Patriot Act amended the Bank Secrecy Act to add restrictions on the maintenance by "covered financial institutions" of correspondent accounts for foreign banks. These provisions took effect on December 25, 2001. On November 27, 2001 the Treasury Department published interim rules that provided guidance on how to comply with the provisions.[24] On December 28, 2001 the Treasury Department published a proposed egulation that would transform the previous guidance into a detailed regulation.[25] The proposed regulation has not been finalized but it would be reasonable to regard it as reflecting the Treasury Department's view as to appropriate compliance with Section 313 and 319(b).

Section 313 of the Patriot Act prohibits "covered financial institutions" from maintaining "correspondent accounts" for a "foreign shell bank" (other than a "regulated affiliate") and requires covered financial institutions to take reasonable steps to ensure that any correspondent account maintained in the United States for a foreign bank is not being used to indirectly provide banking services to a foreign bank that does not have a physical presence in any country. The interim and proposed rules provide definitions of the terms placed in quotations

---

23 FinCEN, "Anti-Money Laundering Programs for Money Services Businesses", 67 Fed. Reg. 21114 (April 29, 2002) (interim final rule).

24 Department of the Treasury, "Interim Guidance Concerning Compliance by Covered U.S. Financial Institutions with New Statutory Anti-Money Laundering Requirements Regarding Correspondent Accounts", 66 Fed. Reg. 59342 (Nov. 27, 2001) (interim final rule).

25 Department of the Treasury, "Counter Money Laundering Requirements—Correspondent Accounts for Foreign Shell Banks; Recordkeeping and Termination of Correspondent Accounts for Foreign Banks", 66 Fed. Reg. 67459 (Dec. 28, 2001) (proposed rule).

and in the preceding sentence and provide a certification process as a safe harbor for what constitutes "reasonable steps".

The term "covered financial institution" is statutorily defined to mean insured banks (including their non-U.S. branches), U.S. branches and agencies of non-U.S. banks, thrifts, private banks, credit unions and registered broker-dealers.

A "foreign shell bank" is a bank that does not have, in any country, a physical location with one or more employees that is subject to inspection by the authority that licensed it. The term "foreign shell bank" excludes any "regulated affiliate", which is defined as an affiliate of a "foreign bank" that is supervised by the foreign bank's regulator. A "foreign bank" is any organization that is organized under the laws of a foreign country, engages in the business of banking, is recognized as a bank by the bank supervisory authority of its home country, and receives deposits in the regular course of its business. The term does not include a U.S. branch or agency of a foreign bank, a foreign central bank, or certain international development banks listed in the proposed rule.

A "correspondent account" is an account established to receive deposits from or make payments on behalf of a foreign financial institution, or handle other financial transactions related to such institution." FinCEN interprets the term to include clearing, settlement, custody and escrow accounts, as well as transactions in securities, derivatives, repurchase agreements, foreign exchange and other instruments if such transactions involve an account. In the case of broker-dealers, FinCEN also includes accounts to purchase, lend or hold securities, prime brokerage accounts, accounts for trading foreign exchange, over-the-counter derivatives accounts and accounts to purchase futures contracts.

With regard to the "reasonable steps" that are required to ensure that correspondent accounts with foreign banks are not used to indirectly provide banking services to foreign shell banks, the interim rule establishes a safe harbor that enables a financial institution to rely upon a certification from a foreign bank to the effect that the correspondent account maintained for the foreign bank is not being used to provide banking services for a foreign shell bank that is not a regulated affiliate. Model forms of certification are included with the interim rule. In order to come within the safe harbor, a covered financial institution must close the correspondent account if it has not received the certification within 90 days of publication of the final rule (which has not been published yet) with respect to accounts established prior to the such date of publication, and within 60 days with respect to accounts established after such publication. After December 31, 2002 this period will be reduced to 30 days. Re-certification must be obtained every two years.

Section 319(b) of the Patriot Act amended the Bank Secrecy Act to require a covered financial institution that maintains a correspondent account in the United States for a foreign bank to maintain records in the United States identifying the owners[26] of the foreign bank and the name and address of a United States resident that is authorized to accept service of legal process for records regarding the correspondent account. The model certifications that are included in both the interim rule and the proposed rule include sections that cover the information that is required to comply with Section 319(b). Although Section 319(b) took effect on December 25, 2001, a covered financial institution is not required to close an account for a foreign bank for which it has not received the required certification until the same dates as described in the preceding paragraph (90 days after publication of the final rule, etc.).

Section 319(b) did not include a definition of "covered financial institution" and the Treasury Department decided, for purposes of the portion of the interim final rule that implements Section 319(b), that the term "covered financial institution" does not include registered broker-dealers. However, the proposed rule would treat registered broker-dealers as covered financial institutions for purposes of all aspects of the rule.

Section 319(b) of the Patriot Act authorizes the Secretary of the Treasury and the Attorney General to issue a summons or subpoena to any foreign bank that maintains a correspondent account in the United States and request records related to such correspondent account, including records maintained outside of the United States relating to the deposit of funds into the foreign bank. A covered financial institution must terminate any correspondent account with a foreign bank within 10 days if it is notified by the Secretary or the Attorney General that the foreign bank has failed to comply with, or to challenge in court, such a summons or subpoena.

ENHANCED DUE DILIGENCE FOR PRIVATE BANKING AND CORRESPONDENT ACCOUNTS

Section 312 of the Patriot Act added to the Bank Secrecy Act provisions requiring financial institutions that maintain private banking or correspondent accounts in the United States for non-United States persons to establish appropriate due diligence policies and controls that are "reasonably designed" to detect and report instances of money laundering through those accounts. Additionally, if a correspondent banking account is maintained for a foreign bank operating under an offshore banking license (a license to conduct banking activities that prohibits the licensed entity from conducting banking activities with the citizens of, or with the local currency of, the country that issued the license) or under a banking license issued by a foreign country that has been designated as noncooperative with international anti-money laundering principles,[27] then the additional due diligence measures must include: identifying

[26] The "owners" of foreign banks that must be identified are persons that directly or indirectly own 25% or more of the voting shares of a foreign bank and 25% or more of the shares of which are not owned by another person.

[27] Those countries are listed in footnote 22 of this memorandum.

each of the owners of the foreign bank; enhanced scrutiny of the account; and ascertaining whether such foreign bank provides correspondent accounts to other foreign banks.

On May 23, 2002, FinCEN issued proposed regulations pursuant to Section 312 (the "Section 312 Regulations").[28] Section 312 takes effect on July 23, 2002, whether or not the Section 312 Regulations have been finalized by that date.

Section 312 by its terms applies to all financial institutions.[29] The Section 312 Regulations proposed by FinCEN would apply to financial institutions for which FinCEN has adopted anti-money laundering program standards. This list includes U.S. depository institutions (including U.S. branches and agencies of non-U.S. banks and non-U.S. branches of insured U.S. depository institutions), registered broker-dealers and futures commission merchants, mutual funds, money service businesses, operators of credit card systems and casinos. Additional types of financial institutions will be added as FinCEN adopts anti-money laundering program standards for them. Although all financial institutions will be required to adopt an anti-money laundering program by October 24, 2002, FinCEN will not adopt anti-money laundering standards for all of them and it appears that the Section 312 Regulations will not apply to those for which no FinCEN standards are adopted. Section 312 does not explicitly grant FinCEN the authority to exclude classes of financial institutions from its scope, but it is reasonable for FinCEN to take the position that the exclusion of some classes is inherent in a provision that only applies to "correspondent accounts" and "private banking accounts". The Section 312 Regulations unfortunately use the term "covered financial institutions" to refer to institutions that are subject to the Section 312 Regulations, the same term that is used in the regulations issued pursuant to Section 313 to refer to a different subset of financial institutions. In this memorandum, financial institutions that would be subject to the Section 312 Regulations are referred to as "subject financial institutions".

The Section 312 Regulations are risk-based: there are relatively few required due diligence elements; instead subject financial institutions are expected to assess the risks posed by different types of accounts and account holders, and to increase or decrease due diligence accordingly. The Section 312 Regulations provide guidance to subject financial institutions on structuring the risk analysis, on diligence techniques where greater diligence is warranted, and on dealing with accounts for which appropriate diligence cannot be done.

The Section 312 Regulations would require subject financial institutions to maintain a due diligence program that includes policies, procedures and controls that are reasonably

---

[28] FinCEN, "Due Diligence Anti-Money Laundering Programs for Certain Foreign Accounts", 67 Fed. Reg. ____ (May __, 2002) (proposed rule). As of the date of this memorandum, the Section 312 Regulations were available on the FinCEN web site but had not yet been published in the Federal Register.

[29] The types of businesses that are covered by the term "financial institution" are listed in footnote 10 of this memorandum.

designed to enable the financial institution to detect and report suspected money laundering conducted through a correspondent account. The Section 312 Regulations use the same definition of "correspondent account" as is contained in the statute: "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." This language, which includes any account that handles "financial transactions", is quite broad and FinCEN proposes to interpret it to include not just traditional banking accounts, but also any account that may be used to engage in transfers of funds or financial instruments. The term "foreign financial institution" includes any entity organized under non-U.S. law that, if it were organized under U.S. law, would be subject to the Section 312 Regulations. Therefore, the term includes money services businesses and mutual funds as well as banks. Insurance companies, private equity funds and other classes of institutions will be added to the list of subject financial institutions prior to October 24, 2002, and once they are added their foreign counterparts will be included as foreign financial institutions.

Due diligence programs for correspondent accounts must include the following elements: (i) a determination of whether enhanced due diligence is required because it is maintained for a foreign bank located or licensed by certain jurisdictions; (ii) an assessment, based on a list of factors developed by the subject financial institution, of the money laundering risk posed by the account; (iii) a review of publicly available information regarding the foreign financial institution; and (iv) consideration of any regulatory guidance issued with respect to the same type of account or foreign financial institution.

In the case of correspondent accounts for which enhanced scrutiny is required,[30] due diligence must also include obtaining information from the foreign bank regarding its own anti-money laundering program and determining whether it is reasonably designed to prevent money laundering. Based on the subject financial institution's risk assessment, due diligence may also include monitoring accounts and obtaining information regarding the sources and beneficial ownership of funds in the account and the identity of persons who will have authority to direct transactions through the correspondent account. Subject financial institutions must also determine whether such a foreign bank is publicly traded and, if not, the identity of each owner of 5% or more of the bank. Finally, enhanced scrutiny of these types of correspondent accounts must include taking reasonable steps to determine whether the foreign bank maintains correspondent accounts for other foreign banks, the identity of those banks and, in appropriate circumstances, whether anti-money laundering measures are in place with respect to the usage of such accounts. The subject financial institutions' due diligence program should also prescribe the steps to be taken (such as closing the account) if the foregoing diligence cannot be completed.

The Section 312 Regulations would require certain diligence to be undertaken with respect to private banking accounts. The regulations would adopt the statutory definition of

---

30 See the first paragraph of this subsection.

"private banking account": "an account that requires a minimum deposit of at least $1,000,000, that is established for one or more individuals, and that is assigned to or administered or managed by, in whole or in part, an office, employee, or agent of a [subject] financial institution acting as a liaison between the financial institution and the direct or beneficial owner of the account." If a private banking account is maintained for a non-United States person, then the financial institution must take "reasonable steps" to ascertain the identity of the nominal and beneficial owners of, and the source of funds deposited into, such account.

The Section 312 Regulations would require subject financial institutions to conduct enhanced scrutiny of any private banking account that is maintained by a senior foreign political figure (or a close family member or associate of such person) to detect transactions that may involve the proceeds of foreign corruption. The appropriate level of scrutiny would depend on such factors as whether the jurisdiction is one where it is "well known" from publicly available sources that political figures have been implicated in large-scale corruption.[31]

IDENTITY OF CUSTOMERS

Section 326 of the Patriot Act amended the Bank Secrecy Act to require the Secretary of the Treasury to issue regulations setting forth the minimum standards financial institutions shall apply regarding identification of customers in connection with the opening of an account at a financial institution. These standards shall include a requirement that the financial institution check lists of known or suspected terrorists provided to the financial institution by any government agency. Section 326 does not contain a definition of "financial institution" or "account". The regulations are to take effect on October 26, 2002, but as of the date of this memorandum the Secretary has not proposed any regulations pursuant to Section 326.

INFORMATION SHARING

INFORMATION SHARING AMONG FINANCIAL INSTITUTIONS

Section 314(b) of the Patriot Act permits financial institutions, after notifying FinCEN, to share information with one another regarding individuals or organizations suspected of terrorist or money laundering activities. Information sharing pursuant to this provision is protected from legal liability for disclosure of the shared information or for failure to notify customers that such information will be disclosed, notwithstanding any other agreement or law, including the privacy provisions of the Gramm-Leach-Bliley Act.

[31] See Interagency Guidance on Enhanced Scrutiny for Transactions that May Involve the Proceeds of Foreign Official Corruption (Jan. 2001), which is available on the FinCEN web site.

On March 4, 2002, FinCEN published an interim final rule to implement Section 314(b).[32] Because of privacy concerns, FinCEN defined "financial institution" for purposes of the regulation more narrowly than the definition of that term in the Bank Secrecy Act. For purposes of the Section 314(b) regulations, the term financial institution covers banks, savings associations, credit unions, registered broker-dealers, issuers of traveler's checks or money orders, money transmitters, and operators of credit card systems. Associations of such financial institutions may also participate in the sharing of such information.

The notification provided to FinCEN is general. The notification need not disclose the type of information shared and financial institutions need only notify FinCEN once each year. The notification must include a statement that the financial institution will share information pursuant to Section 314(b) only for the purpose of detecting, identifying or reporting activities that the financial institution or association suspects may involve possible money laundering or terrorist activities, or for determining whether to establish or maintain an account or to engage in a transaction. The financial institution must also certify that they will establish procedures to ensure that they do not use the information for other purposes.

INFORMATION SHARING WITH THE GOVERNMENT

Section 314(a) of the Patriot Act required FinCEN to issue regulations designed to encourage regulatory authorities and law enforcement agencies "to share with financial institutions information" regarding individuals and organizations suspected of engaging in terrorist or money laundering activities. The statutory language refers almost exclusively to the receipt of information by financial institutions from law enforcement agencies, rather than the receipt of information by such agencies from financial institutions. The only reference in the statute that even suggests sharing in the opposite direction is language that authorizes FinCEN to adopt regulations that, among other things, establish procedures "focusing on means of facilitating the identification of accounts and transactions involving terrorist groups and facilitating the exchange of information concerning such accounts and transactions between financial institutions and law enforcement organizations."[33] Even this language is limited to terrorist activities and does not extend to money laundering generally.

On March 4, 2002, FinCEN published a proposed regulation pursuant to Section 314(a).[34] The thrust of the regulation is not law enforcement agencies sharing information with financial institutions, but rather their obtaining information from financial institutions. The rule provides that FinCEN, upon request of a federal law enforcement agency, may require any

---

32 FinCEN, "Special Information Sharing Procedures to Deter Money Laundering and Terrorist Activity", 67 Fed. Reg. 9874 (March 4, 2002) (interim final rule).

33 Patriot Act, §314(a)(2)(C).

34 FinCEN, "Special Information Sharing Procedures to Deter Money Laundering and Terrorist Activity", 67 Fed. Reg. 9879 (March 4, 2002) (proposed rule).

financial institution to search its records to determine whether the financial institution maintains or has maintained accounts for, or has engaged in transactions with, any specified individual, entity, or organization. If the search uncovers such accounts or transactions, the financial institution is required to e-mail to FinCEN information relating to the accounts and transactions, including the date and type of each transactions and all identifying information provided by the specified individual, entity or organization, without informing the customer that information has been requested or disclosed to the government.

The Right to Financial Privacy Act of 1978 prohibits the federal government from requesting customer[35] information from financial institutions[36] and prohibits financial institutions from providing such information to government agencies, except in accordance with the procedures or exemptions contained in the statute. As a general matter, in order to obtain such information the government must obtain a warrant or subpoena as specified in the Right to Financial Privacy Act. The customer is generally entitled to challenge such requests. Section 358 of the Patriot Act amended the Right to Financial Privacy Act so as to exempt from it government requests for information if the government agency is authorized to investigate international terrorism and is making a request for that purpose. The Patriot Act did not amend the Right to Financial Privacy Act to provide a similar exemption for requests relating to money laundering investigations.

The Right to Financial Privacy Act has always contained an exemption for providing certain information in response to a law enforcement inquiry, but the type of information that may be provided in response to such an inquiry is more limited than the information that must be provided pursuant to the new FinCEN regulation. The Right to Privacy Act also exempts information that is required to be reported in accordance with a federal statute or regulation promulgated thereunder,[37] and FinCEN relies upon this exemption as the basis for the new regulations adopted pursuant to Section 314(a) of the Patriot Act.[38] However, as noted above, Section 314(a) does not expressly authorize FinCEN to request financial institutions to disclose information requested pursuant to investigations of money laundering (as opposed to terrorism).

---

35 The Right to Financial Privacy Act protects customers that are individuals or partnerships with five or fewer members. Investigations of money laundering and terrorism often focus on the records of individuals.

36 The FinCEN regulation applies to "financial institutions" as it is very broadly defined in the Bank Secrecy Act. The institutions covered are listed in footnote 10 of this memorandum. For purposes of the Right to Financial Privacy Act, the term "financial institutions" is limited to depository institutions, credit card issuers and consumer finance companies.

37 12 U.S.C. § 3413(d).

38 31 C.F.R. §103.100(f).

The Right to Financial Privacy Act provides a defense to civil liability for financial institutions that rely in good faith on a government certification that a request for information is authorized by statute, but this good faith defense is limited to investigations of crimes against financial institutions by insiders.[39] It would apparently not be available if a financial institution responds in reliance on a government certification that erroneously relies upon a statute unrelated to crimes by insiders. The FinCEN discussion of the relationship between the new regulation and the Right to Financial Privacy Act seems to concede that it is at least unclear whether information requests unrelated to terrorism are exempt from the Act.

The FinCEN regulations issued pursuant to Section 314(a) of the Patriot Act apply to "financial institutions" as the Bank Secrecy Act defines that term. Therefore, the regulation applies not only to banks and registered broker-dealers, but also to the broad range of businesses covered by the Bank Secrecy Act, including insurance companies, private equity funds, and car dealers. In practice, FinCEN expects that most requests will be made to the subset of financial institutions that are required to file suspicious activity reports (depository institutions, registered broker-dealers and certain money services businesses). However, on a case-by-case basis, other financial institutions may be required to respond to requests for information.[40]

SIMPSON THACHER & BARTLETT LLP

---

39 12 U.S.C. §3417(c).

40 Financial institutions other than depository institutions, credit card issuers and consumer finance companies are not subject to the Right to Financial Privacy Act.