

STEPTOE & JOHNSON LLP

The USA PATRIOT Act and Financial Institutions

Who does it cover? What does it require? And what does it mean for your Company?

On October 26, 2001, in the wake of the September 11 attacks, President Bush signed into law the USA PATRIOT Act¹ (“the Act”), which includes provisions designed to ferret out and terminate international money laundering efforts and advance the U.S. government’s war against terrorism. Title III of the Act, the “International Money Laundering Abatement and Anti-Terrorism Financing Act of 2001,” makes significant changes to the Money Laundering Control Act of 1986 (“MLCA”) and the Bank Secrecy Act of 1970 (“BSA”) that directly affect all financial institutions in the United States, defined broadly to include all banks, brokers and dealers of securities, insurance companies, investment firms, those involved in real estate settlements and closings, currency exchanges and money transmitters, and many other industry sectors not generally considered to be “traditional” financial institutions. The Act, some provisions of which are already in effect, while the others are taking effect on a rolling schedule, imposes new compliance and due diligence obligations on covered entities, greatly expands U.S. extraterritorial jurisdiction over money laundering, compels the production of documents both here and abroad, and clarifies the extent of safe harbor from civil liability.

Financial Institutions: Who is covered by the USA PATRIOT Act?

The legislation applies to “financial institutions,” defined broadly to include:

- United States depository institutions, including commercial banks, insured banks, thrift institutions, trust companies, U.S. branches of foreign banks, and all private banks and bankers;
- Credit card issuers or operators;
- Credit Unions;
- Brokers or dealers in securities or commodities;

¹ Uniting and Strengthening America by Providing Appropriate Tools Required to Intercept and Obstruct Terrorism Act, Pub. L. No. 107-56, 115 Stat. 296-342 (2001).

- Currency exchangers or parties involved in the transmission of funds;
- Futures commission merchants, commodity trading advisors, and registered commodity pool operators;
- Investment banks and bankers;
- Insurance companies;
- Loan and finance companies;
- Individuals involved in real estate closings and settlements;
- Dealers in precious metals or gems;
- Gaming establishments with annual revenues exceeding \$1 million; and
- Other institutions, including travel agencies, and those engaged in the sale of cars, boats, and airplanes.

Key Components of the New Legislation: What is Required?

Section 352 of the USA PATRIOT Act requires each “financial institution” to establish anti-money laundering programs. These programs need to include, at the very least, the following:

- Development of **internal anti-money laundering procedures, policies, and controls** designed to detect and prevent money laundering -- this should include a “Know Your Customer” program designed to identify prospective customers/clients and the source of their assets;
- Designation of an **internal compliance officer**;
- Institution of an **ongoing employee training program** which covers applicable legal requirements, policies and procedures for monitoring client relationships, acceptable record-keeping measures, and the identification of suspicious transactions or money laundering activities; and
- Implementation of an **independent audit function** to test and review the company’s due diligence programs.

Since most major banks and other regulated financial institutions should already have anti-money laundering programs in place under existing BSA regulations, the new legislation will, at most, require a reassessment and fine tuning of existing programs to ensure compliance with the

new features of the Act. But the obvious question is how far into the realm of “non-traditional financial institutions” will the Act be applied?

On April 23, 2002, the Treasury Department provided some guidance on the breadth to which it intends to enforce the Act. The Secretary issued regulations that specify the requirements for more “traditional” financial institutions, including banks, savings associations, credit unions, registered brokers and dealers in securities, futures commission merchants, and casinos. These entities “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.” The Secretary also issued separate rules specifically governing the establishment of anti-money laundering programs by money services businesses, operators of credit card systems, and mutual funds.²

Other “financial institutions,” as defined under the Act that are not specifically subject to Treasury’s April 23, 2002 regulations are temporarily exempt from the Act’s requirements. The Secretary has deferred, for a period of no more than six months, the application of the Act to the other categories of financial institutions under the Act, as it considers the appropriateness of the requirements and unique circumstances of each industry sector. Most notably, this includes insurance companies, loan or finance companies, automobile and other vehicle dealers, and persons involved in real estate closings and settlements. As these businesses look to the future, they should keep in mind that 31 U.S.C. § 5312(h)(2) provides that the Secretary may grant exemptions to any financial institution not already subject to the reporting obligations set forth in 31 C.F.R. Part 103. While the USA PATRIOT Act defines financial institutions quite broadly, 31 C.F.R. §103.11(n) defines financial institutions more narrowly to include banks and similar entities. Once the Secretary issues rules governing these non-traditional financial institutions, many entities covered by the guidelines that believe they are not at risk of being utilized in money laundering efforts might be advised to seek refuge under this provision. However, it is almost certain that the Secretary will promulgate regulations under the Act applicable to these “non-traditional” financial institutions within the next six months -- and companies falling into this category would be advised to begin evaluating their policies and anticipating the need for compliance in the near future.

Of particular note for those reviewing their compliance program are the USA PATRIOT Act’s amendments to the Money Laundering Control Act. Section 315 expands the scope of predicate criminal acts for money laundering offenses to include the Foreign Corrupt Practices Act, as well as any act of foreign public corruption, theft and embezzlement of public funds in a foreign country, export control violations, and smuggling. Even more dramatic, the Act adds to the list of predicate offenses any violation of foreign law which would be an extraditable offense under a

² We would be happy to provide you with these materials at your request. Many of the relevant regulations and other guidelines are also available on the Treasury Department’s website: www.treasury.gov.

treaty between the United States and the foreign jurisdiction. Therefore, the scope of potential money laundering offenses, and the corresponding compliance response, has expanded.

Penalties: What is at Stake For Your Company?

Failure to comply with the regulations promulgated under the USA PATRIOT Act -- most notably the implementation of adequate anti-money laundering programs -- can subject a company to fines of \$25,000 per day civilly or up to \$250,000 per day for a willful criminal violation. A company can also be criminally liable for up to \$500,000 for willful violations of the Act if the company fails to implement proper anti-money laundering programs and the company is involved in a pattern of illegal activity involving more than \$100,000.

The USA PATRIOT Act also increased the available civil and/or criminal penalties for violations of the due diligence requirements for United States private banking and correspondent accounts (previously covered by the BSA) to “not less than two times the amount of the [illegal] transaction, but not more than \$1,000,000.” Other penalties previously proscribed by the BSA and the MCLA also remain in place.

Timing: When Do the Rules Take Effect?

The Act mandates that all industries defined as financial institutions were to have had anti-money laundering programs in place by April 24, 2002, unless specifically exempted by the Secretary.

Other Key Features of the USA PATRIOT Act

In addition to the compliance program requirements set forth above, the Act also contains a number of other provisions that will have a significant effect on covered financial institutions. This is by no means an exhaustive list but highlights the most striking provisions:

- **Prohibition on Accounts for Shell Banks:** Banks and securities broker dealers are not allowed to maintain correspondent accounts with so-called “shell banks” that lack a physical presence in any country.³ The provision

³ “Physical presence” requires more than a post office box, e-mail address, or physical location housing a server. The term requires that a bank have an actual place of business, at a fixed address, with at least one full time employee, in a location where a bank regulatory authority had licensed the operation of the bank and has audit authority.

exempts (1) “shell banks” that are affiliated with a bank that maintains a physical presence in the United States or a foreign country; provided that (2) the “shell bank” is subject to regulation by the banking authority in the country that regulates the affiliate. On November 27, 2001, the Secretary issued “Interim Guidance” on compliance with the new prohibitions.⁴ The proposed rule issued by the Secretary on December 28, 2001 would also require: (1) a foreign financial institution to certify that it has a “physical presence” and that its accounts are not used to indirectly provide banking services to “shell banks” that do not qualify as regulated affiliates; and (2) the U.S. institution to verify all information provided by the foreign institution at least once every two years. The Interim Guidance contains a model certification designed to assist financial institutions with compliance with these requirements.

- **Due Diligence on Foreign Private Banking and Foreign Correspondent Relationships:** The Act requires financial institutions to institute enhanced due diligence policies and internal controls for foreign correspondent accounts and foreign private banking clients. For example, financial institutions must now maintain records regarding the ownership of a foreign bank with which it has a correspondent relationship. Given that this requirement is implemented through a certification process, the foreign bank itself will shoulder the principal burden in meeting this requirement.
- **Production of Records Located Outside the United States:** The Secretary and the Attorney General may issue a subpoena or a summons to a foreign financial institution that maintains a correspondent relationship with a U.S. banking entity, requiring it to produce records located outside the U.S. Non-compliance with the subpoena authorizes the U.S. government to order termination of the correspondent relationship. Failure to terminate the relationship exposes the U.S. institution to a fine of up to \$10,000 per day.
- **Suspicious Activity Reports:** The Act widens the application of the BSA by requiring not only traditional financial institutions, but also securities brokers and dealers, “underground banking systems,” and licensed senders of money to file Suspicious Activity Reports (“SARs”). The Act also provides a safe harbor from civil liability in connection with disclosure of a possible violation of law through an SAR. Recommendations for regulations concerning

⁴ See Interim Guidance Concerning Compliance by Covered U.S. Financial Institutions with New Statutory Anti-Money Laundering Requirements Regarding Correspondent Accounts Established or Maintained for Foreign Banking Institutions, 66 Fed. Reg. 59,342 (Nov. 27, 2001).

reporting and recordkeeping requirements for investment companies are due no later than October 26, 2002.

- **Currency Transaction Reports:** The obligation to file Currency Transaction Reports (“CTRs”) for receipts of more than \$10,000 is expanded to any person engaged in a trade or business, even non-financial, for any transaction except checks drawn on the writer’s account in a financial institution and to transactions occurring entirely abroad.
- **Information Sharing and Immunity from Civil Liability:** Also, upon notice provided to the Secretary, two or more financial institutions or any association of financial institutions may exchange information with one another and with law enforcement about suspected terrorist or money laundering activities and are protected from civil liability from customers based on this information sharing.
- **120-Hour Rule:** Financial institutions will have to produce account information and documentation to the government within 120 hours of a request relating to anti-money laundering compliance or a particular customer.
- **Identity Verification:** Institutions are required to implement reasonable procedures for verifying customer identities, maintaining detailed customer records, and consulting lists of known or suspected terrorists or terrorist organizations when opening new accounts.
- **Prohibition Against Disclosure of Filing of Suspicious Activity Report:** An institution is prohibited from disclosing to anyone that it has filed or intends to file a Suspicious Activity Report (“SAR”).
- **Suspicious Activity Reporting for Securities Broker-Dealers and Commodities Businesses:** The Secretary must, after consultation with the Federal Reserve Board and the Securities and Exchange Commission, publish final regulations by July 1, 2002, requiring suspicious activity reporting by securities broker-dealers. On December 28, 2001, the Treasury Department published a proposed regulation that would require registered brokers and dealers to report suspicious transactions that involve or aggregate \$5,000 in funds or assets on a new Suspicious Activity Report-BD (SAR-BD”) form -- similar to the SAR already used by banks. The proposed regulation would also apply to U.S. insurance companies that are licensed by the SEC to sell

variable annuity products. The final rule may also apply to commodity trading advisors, futures commission merchants, and other investment operations.⁵

- **Impact on Potential Mergers and Acquisitions:** The Federal Reserve Board will take into consideration the anti-money laundering programs and records of a bank holding company of a bank (domestic or foreign) as a condition to authorize a merger or an acquisition in the United States under section 3(c) of the Bank Holding Company Act of 1956 and the Federal Deposit Insurance Act.

Step toe & Johnson’s Capabilities

Step toe & Johnson LLP (“Step toe”) is available to provide your Company with expert legal advice on all aspects of the anti-money laundering rules and regulations. Step toe has a team of attorneys with an in-depth understanding of the new requirements of the USA PATRIOT Act, as well as the previously existing requirements of FinCEN and other regulatory regimes such as the asset blocking and reporting requirements administered by the Treasury Department’s Office of Foreign Assets Control. Anti-money laundering requirements, counter-terrorist financing regimes, and asset blocking and reporting requirements are increasingly complicated and comprehensive. Our attorneys are well-prepared to evaluate your Company’s existing anti-money laundering policies and procedures or to assist your Company in setting up and implementing new programs. Step toe is also able to provide ongoing guidance with respect to requests for assistance from government agencies and/or other financial institutions. Our firm, with over 350 attorneys in offices in the United States and abroad, has the resources to respond quickly under the tight time restrictions mandated by the Act. The firm’s Law Enforcement and Technology group helped draft many provisions of the USA PATRIOT Act and has an extensive practice advising companies on how to respond to law enforcement requests. Finally, our firm offers a nationally-recognized white collar criminal defense practice should your Company become involved in an investigation or enforcement action relating to allegations of money laundering by your clients or customers.

⁵ On October 23, 2001, the SEC provided a glimpse of a “framework for evaluating cooperation” by SEC-regulated institutions that suggests it will consider the following major factors when determining the extent of a company’s cooperation: (1) self-reporting of misconduct when it is discovered; (2) self-policing before the discovery of the misconduct; (3) remediation; and (4) cooperation with law enforcement. *See* Report of Investigation and Statement Setting Forth Framework for Evaluating Cooperation in Exercising Prosecutorial Discretion; SEC Release No. 44969 (October 23, 2001).

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The full text of the USA PATRIOT Act, proposed and final regulations, and agency statements containing guidelines for compliance will soon be available to clients on our firm's website: www.step toe.com.