Special Due Diligence Programs for Certain Foreign Accounts

An Assessment of the Final Rule Implementing Enhanced Due Diligence Provisions for Accounts of Certain Foreign Banks Issued August 9, 2007

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Table of Contents

Purpose

The Financial Crimes Enforcement Network (FinCEN) has committed to providing affected industries with written feedback within 18 months from the effective date of a new regulation or significant change to an existing regulation. This report looks at the impact of final rules concerning Special Due Diligence Programs for Certain Foreign Accounts, which implement Section 312 of Title III of the USA PATRIOT Act: the International Money Laundering Abatement and Financial Anti-Terrorism Act of 2001 ("Title III").

On August 9, 2007, FinCEN issued a Final Rule (herein referred to as the 2007 Rule) implementing the enhanced due diligence provisions of Section 312, requiring that covered financial institutions apply risk-based procedures to the accounts of three categories of foreign banks.[1] The 2007 Rule supplemented the Special Due Diligence Final Rule published on January 4, 2006 (herein referred to as the 2006 Rule), which implemented due diligence requirements for correspondent accounts for foreign financial institutions.[2] Because the 2007 Rule requirements are dependent on the 2006 Rule requirements, we have included information relative to some of the correspondent provisions of the 2006 Rule in this study. This study does not, however, address the broader beneficial ownership provisions relative to the 2006 Rule. The 2007 Rule became effective on September 10, 2007, with other provisions applicable from either February or May 2008. The Appendix to this report provides a link to the FinCEN website for both the 2006 and 2007 Rules and related guidance.

A key aspect of FinCEN's review is to provide an initial indication as to whether a regulation appears to be achieving its intended result. Other benefits from such a review might include identifying areas where further guidance from FinCEN to the regulated industry is warranted, such as with respect to ambiguities in the rule or its application that were not developed through the public notice and comment period;

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1. The three categories of foreign banks include those operating under (1) an offshore banking license; (2) a license issued by a country designated as being non-cooperative with international anti-money laundering principles or procedures; or (3) a license issued by a country designated by the Secretary of the Treasury (through the Director of FinCEN under Section 311 of Title III) as warranting special measures due to money laundering concerns.
2. The 2006 Rule also implemented due diligence and enhanced scrutiny requirements for private banking accounts for non U.S. persons, but because those requirements are not relevant to the 2007 Rule, they are not generally a part of this assessment.

raising awareness of risks of vulnerabilities to fraud, money laundering, terrorist financing or other financial crimes so as to better protect financial institutions and their customers; or helping to focus law enforcement resources in investigating and prosecuting criminal activity.

More generally, as FinCEN attempts to provide additional feedback to the industry on changes to our regulations and/or trends we find in overall Bank Secrecy Act (BSA) filings, we encourage financial institutions to respond with reactions and comments to these products. We provide these reports so that financial institutions can improve the effectiveness and efficiency of their BSA and general fraud programs. Accordingly we want to make these products as beneficial to industry as possible. Please provide FinCEN with any feedback regarding the contents of this study by contacting Webmaster@fincen.gov.

Executive Summary

This analysis sought to provide an initial indication as to whether the Special Due Diligence provisions adopted through the 2006 Rule and 2007 Rule appear to be achieving their intended results. Congress required FinCEN under Section 312 of Title III of the USA PATRIOT Act to adopt regulations requiring financial institutions to apply due diligence to correspondent accounts for foreign customers to address the risks of abuse of such account relationships for money laundering and terrorist financing.

FinCEN analyzed the effects of these rules by analyzing three different information streams available to FinCEN: inquiries from financial institutions to FinCEN's Regulatory Helpline, Suspicious Activity Report (SAR) filings, and feedback from the Federal Banking Agencies that exercise delegated authority from FinCEN to examine for compliance with these and other FinCEN regulations. The information received from all three of these sources has been consistent with expectations for a risk-based approach as set forth in these rules.

Background

Congress intended through Section 312 and related provisions of Title III of the USA PATRIOT Act to address certain transactions and financial relationships, in many instances involving correspondent activity for foreign entities, that Congress believed posed risks and vulnerabilities to the abuses of money laundering and terrorist financing.[3] On January 4, 2006, FinCEN issued a final rule requiring that covered financial institutions implement due diligence procedures for correspondent accounts and private banking accounts for non-U.S. persons.[4] On August 9, 2007, FinCEN completed the last phase of that rulemaking process with the issuance of a final rule requiring that covered financial institutions implement enhanced due diligence procedures for correspondent accounts for certain foreign banks. Collectively, these two rules set forth the Special Due Diligence requirements implementing Section 312.

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3. *See* USA PATRIOT Act § 302 ("Findings and Purposes"), P.L. 107-56 (Oct. 26, 2001), 115 Stat. 272, 296.

4. 31 C.F.R. 103.176 and 178. Special Due Diligence Programs for Certain Foreign Accounts, 71 FR 496-515 (January 4, 2006). U.S. financial institutions subject to these requirements are banks, securities broker-dealers, futures commission merchants and introducing brokers in commodities, and mutual funds.

The 2006 Rule required that financial institutions take reasonable steps to conduct the appropriate level of scrutiny on their correspondent accounts to determine whether the account is subject to enhanced due diligence (see the 2007 Rule); assess the money laundering risk posed, based on a consideration of relevant risk factors; and apply risk-based policies, procedures and controls to each such correspondent account reasonably designed to detect and report known or suspected money laundering activity.

The 2007 Rule required that financial institutions apply enhanced due diligence provisions to a correspondent account for a foreign bank that operates under: (1) an offshore banking license; (2) a license issued by a country that has been designated as non-cooperative with international anti-money laundering principles or procedures; or (3) a license issued by a country designated by the Secretary of the Treasury (through the Director of FinCEN under Section 311 of Title III) as warranting special measures due to money laundering concerns.[5]

In addition, covered financial institutions were required to conduct risk-based enhanced due diligence as to whether these foreign respondent bank customers in turn maintain a correspondent account for other foreign banks that would allow those third party banks to gain indirect access to the respondent bank's correspondent account with the covered financial institution. If so, financial institutions must take reasonable steps to assess and mitigate the money laundering risks associated with such accounts, including conducting the appropriate due diligence to identify those foreign banks. Further, for foreign banks that are not publicly traded, financial institutions must take reasonable steps to identify the owners of such respondent banks.

As with the due diligence requirements issued in January 2006, enhanced due diligence is designed to be risk-based. The 2007 Rule also provided financial institutions with flexibility in implementing the enhanced due diligence procedures for these foreign accounts. For instance, financial institutions may elect to use a questionnaire, or conduct a review of the transaction history for the respondent bank in collecting the information required in this section. Financial institutions may also incorporate the enhanced due diligence method into their certification process under the rules implementing sections 313 and 319 of Title III (prohibiting U.S. correspondent accounts for foreign shell banks and establishing recordkeeping requirements with respect to correspondent accounts for foreign entities, respectively).[6]

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5. 31 C.F.R. 103.176(b)-(e). Special Due Diligence Programs for Certain Foreign Accounts, 72 FR 44,768-44,775 (August 7, 2007).

6. 31 C.F.R. 103.177

Methodology

FinCEN analyzed the effects of these rules by analyzing three different information streams available to FinCEN: inquiries from financial institutions to FinCEN's Regulatory Helpline, Suspicious Activity Report (SAR) filings, and feedback from the Federal Banking Agencies. Such information provides an indirect indication of the effects of the rules, as it would not be possible to quantify direct impacts such as the value of money laundering transactions that were thwarted or otherwise could not occur as a result of the implementation of these regulations. As such, this review differs from other FinCEN reviews of regulatory changes, in particular with respect to changes in regulatory reporting requirements, the results of which can be analyzed both in quantitative and qualitative terms.[7]

FinCEN accessed its Regulatory Helpline database to retrieve inquiries relative to Section 312, correspondent accounts and other related topics, and compiled the results to identify the quantity and nature of the calls received after the publication of the 2006 and 2007 Rules. The Regulatory Helpline received 12,402 calls between January 4, 2006, when the 2006 Rule was published, and August 8, 2007, the day preceding the publication of the 2007 Rule. From August 9, 2007 to December 31, 2008, the last date of activity included in this study, the Regulatory Helpline received a total of 11,467 calls for a combined total of 23,869 calls. A total of 62 calls (0.259% of all calls) were identified as relevant to correspondent accounts, private banking accounts, foreign bank accounts and Section 312. Of those 62 calls, 44 (0.184% of all calls) were received after the 2007 Rule was published.

In studying the potential impact of the 2007 Rule, FinCEN also used BSA database tools to retrieve suspicious activity reports (SARs) filed by depository institutions from January 1, 2008 through December 31, 2008 using specified search terms associated with the 2007 Rule. In isolating these SARs, FinCEN searched the BSA database for SARs referencing "EDD," "enhanced due diligence," "shell banks," "nested accounts," and other related Section 312 terms and returned 7,231 matches. FinCEN then isolated a limited sampling of 108 SARs (1.5% of the total) for further review.

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7. *See, e.g.,* Insurance Industry Suspicious Activity Reporting: An Assessment of Suspicious Activity Report Filings (04/02/200/) *and* Casino Industry Currency Transaction Reporting: As Assessment of Currency Transaction Reports Filed by Casinos between July 1, 2006 and June 30, 2008 (12/26/2008)

In addition, FinCEN contacted the Federal banking regulators – the Board of Governors of the Federal Reserve System (FRB), the Federal Deposit Insurance Corporation (FDIC), the National Credit Union Administration (NCUA), the Office of the Comptroller of the Currency (OCC) and the Office of Thrift Supervision (OTS) (collectively, the Federal Banking Agencies, or FBAs), which exercise delegated authority from FinCEN to examine for compliance with these and other FinCEN regulations.[8] FinCEN also met with representatives of the FBAs to solicit their observations on the impact of the final rule to their regulated institutions. It should be noted that the timeframe for this study to provide feedback on the first year of experience after the effective date of the rule meant that the FBAs had not yet completed a standard examination cycle with respect to all the institutions they supervise.

8. *See* 31 C.F.R. 103.56.

Research and Analysis

Inquiries to FinCEN's Regulatory Helpline

FinCEN's Regulatory Helpline[9] is the primary means for the financial industry to obtain regulatory information and answers to specific questions related to the Bank Secrecy Act and USA PATRIOT Act. This report shows but one example of how, in addition to being responsive to the needs of regulated industries, FinCEN is increasingly using the information obtained from Regulatory Helpline inquiries to identify issues, provide additional guidance and provide input to our analytical products and other reports.

Since the publication of the 2006 Rule, the most frequently asked questions of FinCEN's Regulatory Helpline relative to that rule and to the 2007 Rule have been requests for clarification on what constitutes a correspondent account and whether the regulations applied to particular types of accounts or relationships of the financial institution. From the publication of the 2006 Rule on January 4, 2006 through August 8, 2007, FinCEN received only five such calls (0.021% of all calls). In contrast, FinCEN received 26 such calls (0.108% of all calls) after the 2007 Rule was published on August 9, 2007.

While many of the inquiries sought general clarification of the definition of a correspondent account, some were specific as to certain types of relationships or activities, such as accepting letters of credit or cashing negotiable instruments. This indicates that financial institutions that were potentially affected by the rule may have been looking at a variety of accounts, relationships and transactions to determine whether they required enhanced scrutiny. In a number of cases, the financial institution sought to clarify whether a relationship the institution had with another entity – as distinct from a service provided to customers – would constitute a correspondent account, such as accounts the financial institution maintained at other banks as well as accounts maintained with a parent or subsidiary company.

As stated in the final rule, financial institutions may employ a number of methods to obtain the information needed to assess the risk of money laundering presented by a correspondent bank's account, such as use of a questionnaire, or as part of the certification process under the rules implementing sections 313 and 319 of Title III. FinCEN received 12 calls (0.050% of all calls) regarding "certification" under Section 312 between January 4, 2006, when the 2006 Rule was published, and August 8,

9. Regulatory Toll-Free Helpline, (800) 949-2732 (Monday thru Friday, 8:00 a.m. - 5:00 p.m., E.S.T.).

2007, and six calls (0.025% of all calls) after the 2007 Rule was published on August 9, 2007. None of the calls, however, specifically indicated that the financial institution wanted to rely on the certification process to meet the requirement to obtain the information required under the 2007 rule.

Several financial institutions also asked whether FinCEN had lists that could help institutions in meeting the requirements under Section 312, specifically lists of politically exposed persons (PEPs), foreign shell banks[10] or countries that issue shell bank licenses, central banks of other countries, and FinCEN sanctioned countries. FinCEN received eight requests (0.033% of calls) for lists of topics related to Section 312 and correspondent accounts during the period of this study, with six of those specifically requesting PEP lists. Only three of those requests were received after the publication of the 2007 Rule.

Finally, FinCEN has received nine general questions (0.037% of calls) regarding Section 312 since the 2007 Rule was published. These calls related to general interpretations of the regulation, including whether a financial institution can or should either enter into or maintain certain account relationships and what financial institutions must do to be in compliance with Section 312 regulations in general.

Review of Suspicious Activity Reports

FinCEN reviewed a limited sampling of 108 depository institution SAR forms using selected terms associated with Section 312 to attempt to gain insight into how financial institutions were applying a risk-based approach to their correspondent account activities in identifying potential suspicious activity. While the SAR review did highlight areas of risk identified by the filers where the institution was applying additional scrutiny based on their own internal risk models, no direct link could be made between the additional scrutiny applied in the reported activity and either the 2006 or 2007 Rules. As an example, in some filings referencing "enhanced due diligence" the term was used by the filing institution to describe additional scrutiny placed on a business account where the activity in the account was not as expected for the business. However, these filings are consistent with the application of a risk-based approach in monitoring account activity and identifying potential suspicious activity based on the financial institution's products, customers and geographic locations.

10. See 31 U.S.C. § 5318(j)(1) (describing foreign shell banks as "foreign banks that do not have a physical presence in any country".)

Feedback from Federal Banking Agencies

Representatives from the FBAs indicated that it is difficult to identify for purposes of this study the precise number of regulated institutions to which the 2007 Rule applies. The FBA representatives cited the narrow definition and applicability of the 2007 rule as the principal reason. The FBA representatives also commented on the practice of most of their institutions to have previously identified their high risk accounts and to have implemented the full scope of enhanced due diligence by the effective date of the 2006 Rule.

More generally, the Special Due Diligence provisions complement other risk-based regulatory requirements that have had the overall effect of focusing financial institutions on the management of risks related to correspondent account activity. This in turn makes it more difficult to single out the impact of the 2006 Rule and 2007 Rule. Finally, the FBA representatives indicated that the standard examination cycle may not have provided the opportunity for a regulatory review within the parameters of this study's timeframe.

Significant Findings

The total volume of calls to FinCEN's Regulatory Helpline relative to Section 312 following the publication of the 2006 and 2007 Rules has been very low in comparison to overall call volume. The more notable questions received on the Regulatory Helpline have been from financial institutions attempting to define what constitutes a correspondent account and to determine whether enhanced due diligence should be applied to a particular account or relationship.

The most common questions sought clarification in identifying correspondent accounts relationships. The questions included whether accepting letters of credit and cashing negotiable instruments would constitute the establishment of a correspondent account. This finding is consistent with the feedback from the FBAs regarding their observations on the effect of both the 2006 and 2007 Rules. Occasionally, FinCEN issues interpretive guidance clarifying new and existing rules. The Appendix for this study provides links to guidance relative to Section 312, including guidance on applying the correspondent account rule to the receipt of negotiable instruments. In addition to contacting the Regulatory Helpline for general regulatory guidance, financial institutions may submit a request to FinCEN for an Administrative Ruling to address questions specific to their business.[11]

FinCEN also received a number of inquiries that would generally be described as helping financial institutions meet the requirements of the 2007 Rule, such as how to obtain information needed to determine the risk presented by certain accounts and how to obtain lists that would help a financial institution perform its EDD, such as for PEPs and shell banks. FinCEN does not provide such lists, as the information is available through a range of publicly available databases and list services which currently collect and maintain the information. It is believed to be more effective and consistent with a risk-based approach for financial institutions to use the available information relevant to their business model and customer base than to prescribe a single list that by nature would be ever changing.

Conclusions

The Special Due Diligence requirements of the 2006 Rule and 2007 Rule (with respect to enhanced due diligence) appear as a general matter to have been understood by covered financial institutions, and initial indications showed financial institutions generally implementing them as intended. The information received from industry, regulators and SAR filings is consistent with expectations for a risk-based approach to BSA compliance.

FinCEN remains continuously engaged in ensuring that we carry out our mission as administrator of the BSA, including providing more transparency and responsiveness to the financial industry, in ways that meet our common government and industry goal of deterring and detecting criminal activity and safeguarding the financial system from abuse. These efforts include ensuring the requirements on covered financial institutions are efficient while also remaining effective in providing relevant information to law enforcement investigators, regulatory examiners and FinCEN analysts.

11. See 31 C.F.R. 103.81 for information on submitting requests to FinCEN for an Administrative Ruling

APPENDIX A - Guidance, Rules and News Releases

Following are links to previously released information regarding Special Due Diligence Programs for Certain Foreign Accounts. All of the information listed below currently appears on FinCEN's website: http://www.fincen.gov.

Special Due Diligence Programs for Certain Foreign Accounts (Final Rule) – January 4, 2006
(http://www.fincen.gov/statutes_regs/frn/pdf/finalrule01042006.pdf)

Special Due Diligence Programs for Certain Foreign Accounts (Final Rule) – August 9, 2007
(http://www.fincen.gov/statutes_regs/frn/pdf/31_CFR_Part_103_312_EDD_Rule.pdf)

Guidance – Application of Correspondent Account Rules to the Presentation of Negotiable Instruments Received by a Covered Financial Institution for Payment (01/30/2008)
(http://www.fincen.gov/statutes_regs/guidance/pdf/fin-2008-g001.pdf)

Guidance - Application of the Correspondent Account Rule to Executing Dealers Operating in Over-The-Counter Foreign Exchange and Derivatives Markets Pursuant to Prime Brokerage Arrangements (09/05/2007)
(http://www.fincen.gov/statutes_regs/guidance/pdf/312ForexOTCPrimeBrokerage.pdf)

Guidance - Application of the Regulations Requiring Special Due Diligence Programs for Certain Foreign Accounts to Certain Introduced Accounts and Give-Up Arrangements in the Futures Industries (06/08/2006)
(http://www.fincen.gov/statutes_regs/guidance/pdf/futures_guidance_06072006.pdf)

Guidance – Application of the Regulations Requiring Special Due Diligence Programs for Certain Foreign Accounts to the Securities and Futures Industries (05/10/2006)
(http://www.fincen.gov/statutes_regs/guidance/pdf/312securities_futures_guidance.pdf)

Guidance – Application of Regulations regarding Special Due Diligence Programs for Certain Foreign Accounts to NSCC Fund/SERV Accounts (05/03/2006)
(http://www.fincen.gov/statutes_regs/guidance/pdf/guidance05032006.pdf)

www.FinCEN.gov