

INTERNATIONAL BANKING

Expert Analysis

Is Every Politically Exposed Person a Kleptocrat?

Over the past few months, upheaval in the Middle East has resulted in the ouster of long-standing authoritarian rulers of at least two countries, Tunisia and Egypt. Once a ruler is forced out, the successor government may freeze the deposed rulers' known assets and begin searching for hidden assets.¹ Unfortunately, throughout history many deposed rulers have looted their government treasuries and secreted funds and assets in other countries. This may be a good time for banks, particularly large internationally active banks, to review the requirements for maintaining accounts for Politically Exposed Persons (PEPs). This month's column will review the requirements for banks who maintain accounts for PEPs.

Kleptocracy

"Kleptocracy" is a word used to describe the theft by a government leader from the official funds or other property of the government for his or her own use. For these persons, there may be little distinction between personal and government funds. The United States and international organizations have developed international standards on how to deal with accounts established and maintained by PEPs.

Pre-Sept. 11, 2001

PEP accounts are a subset of private banking accounts, which provide personal financial services to high net worth clients. Prior to the promulgation in the United States of formal "know your customer" rules, the United States and other countries had long urged that banks and other financial institutions put into place policies and procedures to know their customers, with special attention to be given to private banking accounts.² In January 2001, the U.S. government issued guidance ("2001 Guidance") specifically with respect to enhanced due diligence of accounts established and maintained for PEPs, as such accounts may pose a higher risk of money laundering and other financial crimes.³

The 2001 Guidance specifically states that its purpose is not to discourage or prohibit financial institutions from opening accounts for PEPs, but instead to provide assistance to financial institutions on specific steps it can take

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in conducting due diligence on accounts opened or maintained by PEPs, and "red flags" to look for with respect to these accounts that might indicate evidence of kleptocracy on the part of the account holder or other users of the account.

The 2001 Guidance does not actually use the term "PEP"; it introduces the term "senior foreign political figure," which is defined as a senior official in the executive, legislative, administrative, military or judicial branches of a foreign government (whether elected or not), a senior official of a major foreign political party, or a senior executive of a foreign government-owned corporation and any corporation, business or other entity that has been formed by, or for the benefit of, a senior foreign political figure.

This column will continue to use the generic term PEP.

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In addition, the 2001 Guidance also includes the "immediate family" and "close associates" of the senior foreign political figure as requiring heightened due diligence. Immediate family includes the PEP's parents, siblings, spouse, children and in-laws. A "close associate" is "a person who is widely and publicly known to maintain an unusually close relationship with the senior foreign political figure, and includes a person who is in a position to conduct substantial domestic and international financial transactions on behalf of the senior foreign political figure."

In addition to the usual recommended steps when opening an account for any new customer, such as viewing or obtaining documentation of the customer's identity, with respect to opening

an account for a PEP, the bank should document the purpose for opening the account and the anticipated account activity, including whether the PEP has any legitimate business or investment activity reason so that it would be logical for the PEP to establish the U.S. account. In addition, an effort should be made to determine the source of wealth of the customer to determine that it comes from legitimate sources. Once the account is opened, the financial institution must have procedures for heightened oversight of the PEP's account and the transactions flowing through such accounts.

The 2001 Guidance also included examples of "red flags" peculiar to a PEP account that deserve further review and analysis, such as a request by a PEP to route a financial transaction through a financial institution not known for doing business with foreign figures or one located in a secrecy jurisdiction, or use of a country's central bank's accounts as the source of funds for a financial transaction.

USA PATRIOT Act

After the terrorist attacks in the United States on Sept. 11, 2001, Congress passed the USA PATRIOT Act, Title III of which is the International Money Laundering Abatement and Antiterrorist Financing Act of 2001, which strengthened the ability of the Secretary of the Treasury to impose recordkeeping and reporting requirements with respect to accounts maintained by financial institutions for their customers.⁴ For the first time, the Department of the Treasury, through its agency the Financial Crimes Enforcement Network (FinCEN), was directed to promulgate regulations that banks and certain other financial institutions establish customer identification programs and apply enhanced due diligence with respect to private banking accounts and correspondent accounts for non-U.S. banks.⁵

BSA Exam Manual

In 2006, FinCEN issued regulations requiring enhanced due diligence of private banking accounts and non-U.S. correspondent accounts. The internal controls and practices are to enable the bank, to the greatest extent possible, to avoid unknowingly or unwittingly assisting the PEP in hiding wealth gathered as a result of foreign corruption by the PEP, or the PEP's family or close associates.

When applying enhanced due diligence to a

private banking account, the bank must determine whether the customer is a "senior foreign political figure," and if so, its enhanced scrutiny over the account must include procedures reasonably designed to detect and report transactions that may involve the proceeds of "foreign corruption," which is defined as "any asset or property that is acquired by, through, or on behalf of a senior foreign political figure through misappropriation, theft, or embezzlement of public funds, the unlawful conversion of property of a foreign government, or through acts of bribery or extortion, and shall include any other property into which any such assets have been transformed or converted."⁶ A "senior official or executive" is defined as, for purposes of determining whether someone is a PEP, "an individual with substantial authority over policy, operations, or the use of government-owned resources."⁷

The definitions of "senior foreign political figure," "immediate family" and "close associate" track closely the definitions of those terms in the 2001 Guidance. The definition of the term "close associate" now is more general and refers to a person who is "widely and publicly known (or is actually known by the relevant covered institution) to be a close associate of" a PEP, rather than the more detailed definition in the 2001 Guidance.

The Bank Secrecy Act/Anti Money Laundering (BSA/AML) Examination Manual (BSA Exam Manual) issued by the Federal Financial Institutions Examination Council (FFIEC) is a very useful tool for banks to use in developing policies and procedures for complying with the BSA/AML regulations.⁸ More particularly, the BSA Exam Manual advises that "Banks should exercise reasonable judgment in designing and implementing policies, procedures and processes regarding PEPs."⁹

The BSA Exam Manual's detailed discussion of accounts for PEPs, and a bank's obligations with respect to those accounts, is a good reference for banks not only in establishing the required internal controls regarding establishment and monitoring of these accounts, but as a useful reference should a bank become concerned that suspicious activity is taking place through that account that would require the filing of a Suspicious Activity Report (SAR).

On April 17, 2008, FinCEN issued guidance to banks and other financial institutions filing SARs on PEPs. When filing a SAR on a PEP-related account or transaction, the reporting institution is to include the term "foreign corruption" in the narrative portion of the SAR to allow law enforcement to identify potential foreign corruption cases as early as possible.

International Efforts

Regulators worldwide also have long been concerned about PEPs. The Financial Action Task Force (FATF), an international intergovernmental organization that sets global AML and anti-terrorism standards, has its 40 Recommendations, originally issued in 1990 and refined several times since then. Regarding PEPs, FATF recommends, in addition to the normal account opening and maintenance due diligence steps, that the financial institution

have appropriate risk management systems to (i) determine whether a customer is a PEP, (ii) obtain senior management approval for establishing business relationships with such customers, (iii) take reasonable measures to establish the source of wealth and source of funds, and (iv) conduct enhanced ongoing monitoring of the business relationship.¹⁰

PEPs are defined by the FATF as "individuals who are or have been entrusted with prominent public functions in a foreign country, for example Heads of State or of government, senior politicians, senior government, judicial or military officials, senior executives of state owned corporations, important political party officials." Family members and close associates of PEPs also could involve reputational risks similar to those with PEPs themselves. The definition is not intended to cover mid- or junior-level persons.

The FATF periodically revisits the 40 Recommendations to ensure that they stay current and relevant. In October 2010, it proposed to include the United Nations Convention Against Corruption 2003 (UNCAC) as one of the international conventions that should be adopted by member countries.¹¹ Article 52 of UNCAC relates to the prevention and detection of transfers of crime, including by PEPs, but it does not distinguish between foreign or domestic PEPs, as the FATF definition does. FATF has recommended that the current FATF requirements related to foreign PEPs stay the same, on the theory that foreign PEPs are always considered to be higher risk. FATF also is recommending that financial institutions take "reasonable measures" to determine whether a person is a domestic PEP and if so, apply enhanced due diligence if the domestic PEP is considered a higher risk customer.

Current Events

FinCEN has been issuing guidance to financial institutions on the recent events in Tunisia, Egypt and Libya.¹² Each FinCEN advisory recommends, when evaluating risks related to particular transactions and customers, that banks and other financial institutions be sensitive to, and take "reasonable risk-based steps" in order to address, the possibility that there may be increased movement of assets or other changes in patterns of financial activity involving accounts from those countries.

The advisories remind each financial institution of its responsibility to apply enhanced due diligence and monitoring of PEP customers and their accounts for any sign that the financial institution is being used to hide misappropriated or stolen assets. If the financial institution knows or suspects or has reason to suspect that a transaction relating to PEPs may involve misappropriated or stolen assets, or meets one of the other thresholds for SAR reporting (e.g., transaction appears to have no business or lawful purpose), then it should file a SAR and indicate in the narrative "foreign corruption," and describe in detail in the narrative the basis for the financial institution's belief that a SAR reporting requirement had been triggered.

Finally, as part of a G-20 global action plan

issued last fall to strengthen global anti-corruption efforts, the U.S. Justice Department has established the Kleptocracy Asset Recovery Initiative to track money and other assets stolen from other countries and hidden in the United States.¹³

Conclusion

While every PEP may not be a kleptocrat, banks and other financial institutions must remain alert and follow their internal controls and risk-based practices to lessen the chance that they will be misused by rulers who rob their countries blind to enrich themselves at the expense of their citizenry.

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1. "Don't make it easier to steal," Financial Times, Feb. 24, 2011; "U.S. ratchets up pressure on Gaddafi," The Washington Post, Feb. 26, 2011.

2. See, for example, SR Letter 97-19(SUP), Board of Governors of the Federal Reserve System, June 30, 1997.

3. "Guidance on Enhanced Scrutiny for Transactions That May Involve the Proceeds of Foreign Official Corruption," issued by the Department of the Treasury, The Board of Governors of the Federal Reserve System, The Office of the Comptroller of the Currency, The Federal Deposit Insurance Corporation, The Office of Thrift Supervision and the Department of State, January 2001.

4. Pub. L. No. 107-56, Oct. 26, 2001.

5. 31 U.S.C. §5318(i).

6. 31 C.F.R. §§1010.620, 1020.620, previously 31 C.F.R. §103.178. On March 1, 2011, FinCEN reorganized and reissued the BSA regulations in title 31 as new Chapter X.

7. 31 C.F.R. §§1010.605, 1020.605, previously 31 C.F.R. §103.175.

8. The 2010 BSA Exam Manual may be accessed at www.ffiec.gov.

9. 2010 BSA Exam Manual, page 299.

10. "Forty Recommendations," accessible on the FATF website, www.fatf-gafi.org.

11. FATF, "The Review of the Standards—Preparation for the Fourth Round of Mutual Evaluations."

12. FinCEN Advisory FIN-2011-A001, Jan. 20, 2011, "Guidance to Financial Institutions on Recent Events in Tunisia," FinCEN Advisory FIN-2011-A002, Feb. 16, 2011, "Guidance to Financial Institutions on Recent Events in Egypt," FinCEN Advisory FIN-2011-A004, Feb. 24, 2011, "Guidance to Financial Institutions on Recent Events in Libya," all accessible through the FinCEN website, www.fincen.gov.

13. "G-20 Fact Sheet on a Shared Commitment to Fighting Corruption," Nov. 12, 2010, press release issued by the White House and accessible through the White House's website, www.whitehouse.gov.