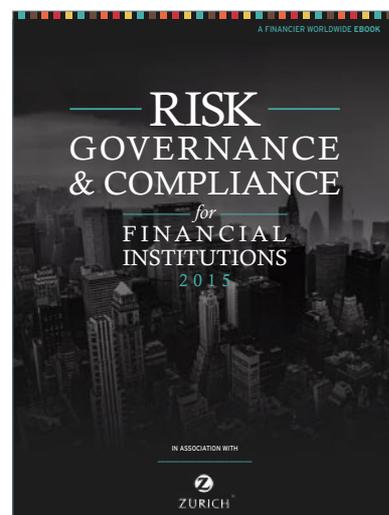


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AML AND SANCTIONS COMPLIANCE RISK MANAGEMENT FOR FINANCIAL INSTITUTIONS

BY PAULA ANDERSON AND COLIN VAUGHN-CASEY
SHEARMAN & STERLING LLP

The war on terror and efforts to resolve international crises increasingly centre, not around military strength, but financial might and the harm that economic sanctions can inflict on designated targets. Financial institutions find themselves on the frontline of the most contentious foreign policy matters as the US uses its economic prowess to solve problems that once would have required physical force. Today, financial services firms must comply with an ever-expanding sanctions regime, rife with potential pitfalls for the unwary. Moreover, because sanctioned entities often use financial institutions to launder their illicit funds, financial institutions are now faced with a more robust and aggressive anti-money laundering (AML) regime. This is an area of special concern as the sector is dealing with the complex and nuanced sanctions aimed at the Russian/Ukraine crisis and the possibility of their expansion in the near future.

US AML regulations stem from a variety of statutes, rules and regulations, based originally in the Bank Secrecy Act (BSA), passed in 1970 and subsequently amended, most significantly by the USA PATRIOT Act of 2001. While complex, they essentially ban attempts to disguise the source or ultimate disposition of funds. Financial institutions find their AML responsibilities regulated and enforced by a variety of US federal agencies, including principally the Office of the Comptroller of the Currency (OCC), the Financial Crimes Enforcement Network (FinCEN) under the Department of the Treasury, the Federal Reserve Bank, the Federal Deposit Insurance Company (FDIC), and others. While the task of complying with BSA/AML regulations may seem onerous, failure to comply can have devastating consequences.

Recently, a representative of the OCC announced that it would be suspending its previous practice of making recommendations to banks on how to fix AML compliance issues and banks will instead face enforcement actions, heralding what could effectively be a zero tolerance policy. In the same vein, back in June 2013, FinCEN created a standalone Enforcement Division and placed a greater focus on corporate and individual responsibility, including by aggressively pursuing admissions of guilt in enforcement actions. The OCC followed suit with statements emphasising a similar focus on individual responsibility. NERA Economic Consulting notes that the ratio of enforcement actions involving AML and sanctions violations that have resulted in monetary penalties has more than doubled since 2012 as compared to 2007-2011, and the penalties have been severe.

The impact of this tougher, more aggressive enforcement of BSA/AML and sanctions regulations has already started to manifest itself. In December 2012, HSBC paid more than \$1.9bn in penalties for allegedly violating the BSA, International Emergency Economic Powers Act (IEEPA)

and the Trading with the Enemy Act (TWEA), in a settlement with federal prosecutors, the Federal Reserve, OCC and FinCEN. The actionable conduct consisted of facilitating transactions on behalf of customers in sanctioned territories (Cuba, Iran, Libya, Sudan and Burma). Reported violations of the BSA also included failure to maintain an effective AML compliance program and insufficient customer due diligence.

The enforcement agencies pointed to a series of insufficient AML compliance measures and HSBC, as part of the settlement, committed to a number of enhancements to its compliance programs. The allegations showed a previously understaffed compliance program ill-suited to the bank's size, complexity and risk profile, and incapable of monitoring suspicious transactions and activities. According to the complaint, identified suspicious activity was either sanctioned by leadership or not reported to affiliate companies. For instance, HSBC Group did not inform HSBC Bank USA of significant AML deficiencies at HSBC Mexico regarding potential laundering of drug trafficking proceeds. Further, staff neglected to collect or maintain crucial customer due diligence information regarding correspondent accounts, did not comply with BSA suspicious activity reporting requirements, and ignored protests within the bank when problematic transactions were identified.

The settlement and deferred prosecution agreement between HSBC and the US enforcement agencies included a commitment by the bank to changes in its compliance program. The bank committed to the creation of a Board of Directors Compliance Committee to oversee the institution and evaluation of BSA/AML procedures. Qualified personnel at adequate staffing levels would perform an annual analysis of products and services and their risk profile, as well as a semi-annual review of the existing policies and procedures and assess their effectiveness. The bank also committed to instituting an audit program that would test compliance

with BSA/AML and sanctions regulations and laws, and to performing ongoing education and training of personnel on these laws and the bank's compliance procedures. Many of these initiatives - adequate staffing with qualified personnel who are continuously trained, a commitment to AML compliance from the top-down, and periodic reviews and audits - have become recognised as best practices for compliance in this area.

HSBC has not been alone in facing enforcement actions for sanctions and AML violations. ING was also hit with a large fine and admitted to conspiracy to violate US sanctions laws in 2012 in connection with its alleged moving of more than \$2bn through the US financial system on behalf of sanctioned Cuban and Iranian entities. In its settlement with federal prosecutors, state prosecutors and the Office of Foreign Assets Control (OFAC), ING paid \$619m for conspiring to violate the IEEPA, the TWEA and state laws when it allegedly scrubbed client details in transaction instructions and other communications to avoid detection and blocks in the US by unaffiliated banks. ING agreed to implement a consolidated sanctions compliance policy for all business units and to install new payment screening software. As with the HSBC settlement, it also agreed to broad-based training for its personnel and to adopting a set of policy guidelines that reinforced existing business principles regarding transparency, as well as emphasised a commitment to full disclosure in payment processing and trade transactions.

Standard Charter Bank also agreed to pay fines and institute a review of compliance procedures in December 2012 for alleged AML and sanctions violations. In this case, the Money Laundering and Bank Integrity Unit of the DOJ, OFAC and the Federal Reserve Board of Governors alleged violations of the IEEPA and the Foreign Narcotics Kingpin Designation Act in connection with Standard Charter Bank's processing of funds linked to Burma, Sudan, Iran and Libya. The bank paid \$227m in fines and OFAC

required a review of existing compliance policies and procedures, as well as implementation of new ones to address compliance gaps.

These actions - and others against global financial institutions - are not only notable for their record-breaking penalties, but also for the emphasis on the creation and maintenance of an effective compliance regime. Federal prosecutors and enforcement agencies seem as focused on the precautions taken as the conduct alleged, and a financial institution that institutes effective compliance procedures not only will minimise its compliance risk but also mitigate potential enforcement action.

An effective compliance program must be robust and commensurate with the size and complexity of the institution. HSBC was faulted for failing to improve its program as its business model evolved. Fundamentally, the first step is the development of internal policies, procedures and controls that are clear and consistent. There should be a designated department responsible for AML/BSA compliance that should be adequately staffed with qualified personnel. A lack of commitment to the compliance program is evident in understaffed or sidelined programs. Ongoing and updated training on BSA/AML and sanctions compliance for all employees tailored to their specific roles is also key. The roles and responsibilities of each employee and the compliance departments should be clearly defined and communicated. Electronic monitoring should be integrated, constantly updated with client information, and supervised by trained staff. Periodic independent testing and reviews of the compliance regime and its effectiveness are also essential. Finally, performing and updating detailed customer due diligence is critical in our increasingly mobile and complex financial system. A Know Your Customer (KYC) program should understand the nature of the business, the purpose of the account, and should be updated with changes to the account or customer profile. This up-to-date KYC information should be accessible across the institution

and integrated with electronic monitoring systems. Global institutions should focus on effective communication across global divisions, ensuring that foreign personnel are equally conversant in the company's compliance policies and procedures.

Finally, as emphasised in an August 2014 FinCEN Advisory, there should be a "culture of compliance" promoted throughout the institution. This commitment is best evidenced from the top-down, with leadership that supports and encourages compliance efforts, and does not allow profit motives to take precedence. Compliance needs to be understood, respected and enforced, and a part of the day-to-day thinking of every employee.

Paula Anderson is a partner and Colin Vaughn-Casey is an associate at Shearman & Sterling LLP.
