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FEDERAL BANK REGULATORY AGENCIES ISSUE LONG-AWAITED ANTI-MONEY LAUNDERING EXAMINATION MANUAL

SATISH M. KINI, ERIC R. FISCHER, ANDREW B. KALES AND RICHARD F. KERR

The authors review the provisions of the new Bank Secrecy Act/Anti-Money Laundering Examination Manual and its implications for banks and other financial institutions.

On the advent of this past 4th of July weekend, the federal bank regulatory agencies (“Agencies”) joined with the Financial Crimes Enforcement Network (“FinCEN”) to release an extensive Bank Secrecy Act (“BSA”)/Anti-Money Laundering (“AML”) Examination Manual (the “BSA Manual”).¹ The BSA Manual — which is over 300 pages long — at once codifies in one comprehensive document much of the BSA/AML compliance guidance previously issued by the Agencies and FinCEN and clarifies and increases the consistency of various disparate standards applied by banking examiners over the past several years. The BSA Manual provides a combination of narrative guidance, resource materials, and BSA/AML examination procedures. In addition, as discussed below, the

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Manual includes guidance prepared by the Office of Foreign Assets Control (“OFAC”) related to OFAC sanctions and compliance programs. This article provides an overview of the BSA Manual and the implications of its issuance to banks and other financial institutions.

ORIGINS OF THE BSA MANUAL

Since the beginning of 2005, the Agencies and FinCEN have faced significant criticism from many quarters regarding their BSA examination and enforcement efforts. Specifically, bankers have expressed concern that the Agencies’ examiners have been applying a “zero tolerance” approach to AML deficiencies, which approach the banking community has regarded as counterproductive, since it fails to distinguish technical BSA issues from more significant problems.² This approach also was blamed for, among other things, so-called “defensive filings” of Suspicious Activity Reports (“SARs”), which resulted when banks filed SARs not because they found a transaction worthy of reporting but because they feared regulatory criticism or worse for failure to report an activity.

FinCEN Director William Fox and others in the regulatory community took heed of the problems and determined that one way to address the issues would be to issue interagency guidance that would both achieve consistent examination procedures and clarify examination standards.³ The BSA Manual is the product of those efforts.

OVERVIEW OF THE BSA MANUAL

The BSA Manual is designed as a reference manual for both examiners and banks. The purpose of the manual, as noted in its introduction, is to “ensure consistency” in the application of BSA requirements among the Agencies. The BSA Manual also serves to inform banks regarding compliance program requirements and examiner expectations. To this end, the BSA Manual outlines existing BSA requirements. It does not, however, purport to create any new requirements; rather, the BSA Manual aims to clarify existing standards and ensure consistency.

Although it does not impose new standards, the BSA Manual gives important insight as to what the Agencies and FinCEN regard as industry best practices. In addition, by outlining procedures that banks can expect examiners to follow when conducting BSA/AML examinations, the BSA Manual provides a good indicator of the AML practices and controls regulators consider acceptable and, in some regards, necessary. Banks will not be required to follow all of the measures suggested by the BSA Manual, but they should consider whether the practices and controls highlighted in the document are appropriate given their risk profile, activities, and customers.

ORGANIZATION OF THE BSA MANUAL

The BSA Manual is organized into five main sections:

- 1) an Introduction;
- 2) a Core Overview;
- 3) an Expanded Overview;
- 4) Core Examination Procedures; and
- 5) Expanded Examination Procedures.

Additionally, the manual contains significant appendices, which provide relevant and useful tools for use in developing and maintaining a BSA/AML compliance program. The following is a brief description of each section and the topics covered.

Introduction

The “Introduction” to the BSA Manual is designed to provide an overview and offers a description of the structure of the BSA Manual and how its sections work together. Additionally, the Introduction contains a useful history of AML statutes and regulations and a description of the role each of the Agencies plays in the fight against money laundering and terrorist financing.

In the Introduction, the BSA Manual makes clear that banks must adopt a risk-based approach to AML compliance. The BSA Manual's guidance on the risk-based approach is explained more fully below.

Core Overview

The "Core Overview" section provides narrative guidance relating to the legal and regulatory elements of BSA compliance that the Agencies and FinCEN have determined to be core elements of a BSA/AML compliance program. Among other things, examiners are instructed that a bank's board of directors, acting through senior management, is ultimately responsible for ensuring that the bank maintains an effective BSA/AML internal control structure.

The Core Overview also prescribes a scoping and planning process that all examiners should go through in preparing for an examination prior to commencing an examination of a bank. This part of the BSA Manual can be a significant tool for banks planning for BSA/AML examinations. Among other things, examiners should review the applicable bank's internal risk assessment to evaluate whether it is commensurate with the risk undertaken by the bank. Examiners also are directed to assess the results of the applicable bank's independent testing as part of their scoping and planning and process, which serves to emphasize the importance that the Agencies place on independent testing.⁴

Expanded Overview

The "Expanded Overview" section of the BSA Manual is organized to address certain higher-risk products, services, and entities and, in some instances, contrasts these higher-risk arrangements with those that pose less money laundering concern (for example, domestic correspondent banking services, which are low risk, vs. foreign correspondent banking, which are high risk). Among the products and services mentioned are correspondent banking, electronic banking, private banking, and trust and asset management services. The types of persons and entities discussed in the Expanded Overview include politically exposed persons, embassies and foreign consulates, professional service providers, and cash-intensive businesses.

The Expanded Overview provides a description of the relevant risk factors associated with each of the identified areas. The overview then suggests certain compensating controls and risk mitigants. For example, the discussion of foreign correspondent banking states that a bank offering correspondent accounts to foreign financial institutions should, among other things, assess the risks posed by these relationships, conduct up-front and on-going due diligence on a foreign correspondent, including possible site visits, and establish *a priori* criteria for closing the foreign financial institution's accounts.

The Expanded Overview also outlines the concept of Enterprise-Wide BSA/AML compliance programs, which (presumptively larger) banking organizations may choose to implement to manage risks in integrated fashion across affiliates, business lines, and risk types. The BSA Manual's guidance regarding Enterprise-Wide BSA/AML compliance programs is discussed in more detail below.

Core Examination Procedures

The "Core Examination Procedures" section prescribes specific examination procedures relating to the core elements of a bank's BSA/AML compliance program identified in the Core Overview. Guidelines for transaction testing for each core element are outlined. This section also includes procedures for examining a bank's policies, processes and procedures for ensuring compliance with OFAC regulations.

The Core Examination Procedures also prescribe a process for examiners to develop conclusions, communicate findings to bank management, write report comments, develop appropriate supervisory responses, and finalize examinations. During discussions with management, examiners are instructed to address both strengths and weaknesses of the bank's BSA/AML compliance program.

Expanded Examination Procedures

The "Expanded Examination Procedures" section prescribes specific procedures to be followed by examiners in their review of banks that engage in the specific functions that are identified by the Expanded Overview. Like the

Core Examination Procedures, this section also includes guidelines for transaction testing.

Appendices

Lastly, the BSA Manual contains 17 appendices identifying documents and tools relevant to a bank's BSA/AML compliance program. Several of the documents contained in the appendices are highly useful. Among them is Appendix H, which sets forth the elements that may be included in a request letter from examiners to banks. This appendix, thus, gives institutions a road-map to the types of documents, controls and procedures that examiners will expect to find in institutions.

Also of note are appendices that assist banks in developing an effective BSA/AML risk assessment process. Appendix I provides a graphic depiction of how an adequate risk assessment would map to the requirements. Additionally, a "Quantity of Risk Matrix" and a "Quantity of Risk Matrix OFAC Procedures" are designed to assist banks in determining the risk of the attendant products, services, and business and can be found at Appendices J and M of the BSA Manual, respectively.

KEY TOPICS ADDRESSED

The BSA Manual addresses and provides useful guidance on many topics relevant to banks' BSA/AML and OFAC compliance programs. The following is an outline of some of the key topics addressed and the guidance provided.

Risk Based Approach to BSA Compliance

The BSA Manual repeatedly advocates a risk-based approach to BSA/AML compliance. As explained above, the BSA Manual states that each bank must have a compliance program tailored to the particular money laundering risks it faces. In determining risks, the bank must weigh a number of factors, including its customer base, its product offerings, and its geographic reach. The risk analyses — both process and results — must be clearly doc-

umented. Each risk factor must be weighted in accordance with the relevant circumstances. Banks must be certain to consult with all business lines to have a comprehensive view of the risk of money laundering and terrorist financing *across the organization*.⁵

Underscoring the importance placed on the risk-based nature of banks' compliance programs by the Agencies, FinCEN and OFAC is the requirement that if, in the course of an examination, an examiner finds that a bank has not made a risk assessment of its businesses, the examiner must discuss this fact with management before proceeding to complete a risk assessment on his or her own. Additionally, the BSA Manual provides that a risk assessment cannot remain static and that banks must periodically reassess the risk of each account, product, or service depending on the relevant factors and circumstances.

Suspicious Activity Reports

The BSA Manual also includes an extensive discussion concerning the filing of SARs. The BSA Manual stresses that SAR filing policies, procedures and processes should take into account all information concerning the subject of the potential SAR available to a bank from all lines of the bank's business and that, where applicable, information to be evaluated and considered includes criminal subpoenas, National Security Letters, and other governmental requests for information.

The BSA Manual also instructs that examiners "should focus on evaluating a bank's policies, procedures, and processes to identify and research suspicious activity," rather than on a bank's decision with respect to any individual SAR. Accordingly, a bank "should not be criticized for the failure to file a SAR unless the failure is significant or accompanied by evidence of bad faith," and an examiner should not substitute his or her own judgment for the bank's as to the propriety of filing an individual SAR. This guidance is intended to alleviate concerns that are leading banks to make "defensive SAR filings," and the Agencies and FinCEN explicitly recognize the subjective nature of a bank's judgments in determining whether or not to file any particular SAR.⁶

Enterprise Wide Program

The BSA Manual does not specifically distinguish between small banks and larger banking organizations, but the manual does provide specific guidance and procedures for (presumptively larger) banking organizations that choose to enter into “Enterprise Wide” BSA/AML compliance programs. While there currently are not any, and the BSA Manual does not create any, mandates to create such an Enterprise Wide solution, many large banking organizations have found such a program to be integral to protecting the overall institution from money laundering and to the mitigation of the overall organization’s risk of violating BSA/AML regulatory requirements. Much like the consolidated credit, market, and operational risk systems that large banking organizations have implemented, an Enterprise Wide BSA/AML compliance program can coordinate the specific regulatory requirements across a broad organization, allowing the banking organization to have a consolidated understanding of its AML risk.

For those institutions that choose to implement an Enterprise Wide approach, the BSA Manual gives some guidance as to what the program should include. Specifically, the Enterprise Wide program should contain the designation of a central point where the BSA/AML risks can be aggregated and reviewed. An Enterprise Wide program, as that of an individual bank, must be risk based and take into account all the relevant factors, including the accounts and services, customers or entities, and size and complexity of the organization, as well as its legal structure. Additionally, the program must either account for all of the relevant regulatory requirements specific to each branch or subsidiary or be clear that each branch or subsidiary is responsible for those requirements. The program also must consider the requirements of all the jurisdictions within which the banking organization operates (including international requirements). The BSA Manual notes that it is critical that examiners understand what elements of the BSA/AML compliance program are managed on an Enterprise Wide basis and which elements are managed at the individual institution level.

Foreign Branches

Another area addressed by the BSA Manual is the Agencies' expectations with regard to AML compliance by foreign branches and offices of U.S. banks. The BSA Manual states that AML policies, procedures, and processes at foreign offices or branches of a U.S. bank should comply with local requirements and be consistent with the U.S. bank's standards. As with its U.S. operations, a bank will be expected to have policies and procedures for foreign offices or branches that are appropriate to their respective risk profile. However, the BSA Manual also explains that the bank may need to tailor its AML program to address specific local or business practices.

Other Items of Note

In addition to the issues noted above, the BSA Manual addresses other BSA compliance requirements, including other reporting requirements, customer identification program elements, rules applicable to foreign correspondent accounts, and procedures for sharing information with law enforcement agencies and other financial institutions.

The BSA Manual also addresses special areas not addressed directly by BSA regulations. In particular, the BSA Manual outlines examination procedures for specific types of activities and business lines, including electronic banking and payment services, various deposit and non-deposit account services, lending activities, trade finance, private banking, and trust and asset management services. For each of these areas, the BSA Manual's guidance to examiners should be viewed as an indicator of regulatory expectations for the activity or business.

OFAC COMPLIANCE

As noted above, the BSA Manual contains a useful discussion of OFAC rules and sanctions. OFAC collaborated with the Agencies and FinCEN in developing the overview of OFAC requirements and OFAC examination procedures. While recognizing that there are no specific regulations explicitly requiring banks to establish an OFAC program, the BSA Manual states

that OFAC compliance requirements overlap with BSA/AML requirements and provides for the first time that, as a matter of sound banking practice, a bank should establish and maintain an effective, written OFAC program that reflects its OFAC risk profile.⁷ Since OFAC compliance and BSA/AML compliance issues overlap and often are the responsibility of the same group of bank employees, it is significant and helpful to the banking industry that the BSA Manual reflects OFAC compliance issues. It also is significant because prior to the issuance of the BSA Manual, written material covering OFAC compliance was sparse.

In discussing the internal controls that a bank should employ when establishing and maintaining an OFAC compliance program, the Agencies stress:

- 1) the flagging and review of suspect transactions;
- 2) the timely updating of OFAC lists;⁸
- 3) the timely reporting of validly blocked or rejected items under OFAC sanction programs⁹ and the filing of SARs, where appropriate; and
- 4) the maintenance on file of copies of customers' OFAC licenses.

The BSA Manual states that OFAC will take into consideration the strength of a bank's OFAC compliance policy, procedures and program when it determines whether to impose sanctions against a bank for doing business with a prohibited entity or person.

LAW ENFORCEMENT RESPONSE TO THE BSA MANUAL

Shortly after the issuance of the BSA Manual, the Department of Justice, in response to concerns from the Agencies and banks over the lack of consistency in the treatment of the BSA compliance violations between law enforcement and the Agencies, amended its guidelines for criminal money laundering prosecutions (the "Amended Guidelines").¹⁰ The Amended Guidelines direct U.S. Attorneys to clear all criminal prosecutions for violations of the BSA with the Asset Forfeiture and Money Laundering Section ("AFML") of the Justice Department's Criminal Division. Requiring clear-

ance by AFML of criminal prosecutions for violations under the BSA extends a protection that was already in place for non-BSA related criminal money laundering prosecutions and creates consistency in the treatment of money laundering prosecutions under the criminal code and the BSA. The issuance of the Amended Guidelines by the Justice Department and the BSA Manual by the Agencies and FinCEN should create an increased level of consistency and cooperation among law enforcement and the Agencies relating to BSA violations.

RELEVANCE TO NON-BANK FINANCIAL INSTITUTIONS

The BSA Manual, by its terms, does not apply to Securities Exchange Commission ("SEC")-registered entities, such as broker-dealers, mutual funds, and investment advisers, and the SEC is not a co-signatory to the BSA Manual. Accordingly, as a legal matter, the SEC and its examiners are not bound by the document.

That said, the BSA Manual evidences careful thinking by the Agencies and FinCEN on various BSA/AML and OFAC issues and is the most explicit statement to date on best practices and regulatory expectations. Moreover, FinCEN has repeatedly indicated its interest in ensuring that BSA requirements apply uniformly across the financial services industry and has issued rules, such as with respect to customer identification programs, that are the same for broker-dealers, banks, mutual funds, and other financial services providers.¹¹ To this end, the BSA Manual should also be viewed as a valuable resource tool for non-bank financial institutions.

CONCLUSION

The BSA Manual contains the most well-considered and comprehensive guidance on the Agencies and FinCEN's expectations for a bank's BSA/AML compliance program, and it includes the most complete guidance on OFAC compliance that has been issued to date. The BSA Manual also includes the procedures that will be used by the Agencies in assessing the adequacy of banks' BSA/AML and OFAC compliance programs and by OFAC in deter-

mining the necessity and severity of penalties for violation of OFAC administered sanctions programs.

The BSA Manual should be viewed by banks as a codification of best practices for BSA/AML and OFAC compliance that has been endorsed by the Agencies, FinCEN, OFAC, and several state banking regulators. To ensure compliance with the BSA and OFAC regulations, banks should periodically assess their compliance programs against the “best practices” prescribed in the BSA Manual to determine whether their programs are sufficient or if changes would be prudent. Banks are forewarned, however, that this plain language codification of “best practices” can be a double edged sword, as the Agencies, FinCEN, OFAC, and litigators now have a plainly worded benchmark against which to measure banks’ actions in determining whether there has been a violation of the bank’s regulatory obligations or duties.

NOTES

¹ The BSA Manual is available at <http://www.ffiec.gov/pdf/bsamannual.pdf>.

² *See, e.g.*, Letter from the American Bankers Association to the Federal Deposit Insurance Corporation, Board of Governors of the Federal Reserve System, Office of the Comptroller of the Currency, Office of Thrift Supervision, Department of the Treasury, and FinCEN (Jan. 10, 2005), *available at* <http://www.aba.com/aba/documents/winnews/stexletterrebsa010405.pdf>.

³ FinCEN Director Fox has publicly voiced his concern about the volume of “defensive filings,” and also stated that “[i]t is no great insight to conclude that the conception of a single, clear policy on suspicious activity reporting combined with consistency in the application of that policy is the solution to the defensive filing phenomenon.” *The SAR Activity Review, Trends, Tips & Issues*, Issue 8 (April 2005), *available at* <http://www.fincen.gov/sarreviewissue8.pdf>.

⁴ There is no specific requirement for the frequency of the independent testing; however, the BSA Manual indicates that sound practice requires that testing be conducted on at least an annual basis. The testing program should have a risk-based focus and evaluate the quality of money laundering and terrorist financing risk management for all banking operations, departments and subsidiaries while taking into account the bank’s size, complexity, scope of activities, risk profile, quality of control functions, geographic diversity, and use of technology. Violations and deficiencies must be documented, and findings must be reported to the bank’s board of directors.

⁵ As described above, several appendices provide useful information banks can use

in evaluating their implementation of the risk-based approach.

⁶ While the BSA Manual's acknowledgement that the SAR filing process is an art rather than a science is helpful, it also must be noted that the "significance" of a bank's decision not to file a SAR will be reviewed by the Agencies, FinCEN and the enforcement authorities with hindsight and, in that light, a bank takes a risk — albeit a diminished risk after the issuance of the BSA Manual — when it determines in a "close-call" situation not to file a SAR. The BSA Manual also implicitly recognizes that there is no minimum number of SARs expected to be filed by a bank.

⁷ As noted above, Appendix M to the BSA Manual contains a "Quantity of Risk Matrix — OFAC Procedures" designed to provide examiners with useful guidance on how they should assess a bank's OFAC risk profile. This appendix can, and should, be used by banks as guidance to develop an adequate risk assessment program for OFAC compliance.

⁸ The current version of the list of Specially Designated Nationals can be found at <http://www.ustreas.gov/offices/enforcement/ofac/sdn/>.

⁹ Summaries of the sanctions programs currently administered by OFAC can be found at <http://www.ustreas.gov/offices/enforcement/ofac/sanctions/>.

¹⁰ The Amended Guidelines can be found at http://www.usdoj.gov/usao/eousa/foia_reading_room/usam/title9/105mcrm.htm.

¹¹ See William J. Fox, Director, FinCEN, Address to the Securities Industry Association "Anti-Money Laundering Compliance Conference" (March 4, 2004) available at <http://www.fincen.gov/foxsia030404.pdf>.