ALERTS

FinCEN and Banking Agencies Provide Clarification on PEP Screening Best Practices

October 5, 2020

On Aug. 21, 2020, in response to inquiries from various banks, the Financial Crimes Enforcement Network ("FinCEN"), a bureau of the U.S. Department of the Treasury ("Treasury") and four U.S. banking agencies ("Agencies")[1] released joint guidance on anti-money laundering ("AML") due diligence expectations for bank customers who may be considered "politically exposed persons" or "PEPs" ("Statement").[2] The Statement does not create any new regulatory or supervisory requirements but rather provides an interpretive gloss that largely reaffirms best practices in this area. While it applies predominately to banks and their customers, it will no doubt be followed by broker-dealers. It is also relevant to private equity and hedge fund managers, most of which presently have procedures for conducting enhanced due diligence for PEPs and Senior Foreign Political Figures ("SFPFs")[3] either directly or through their administrators. Moreover, such fund managers are often counterparties to financial transactions with regulated entities, such as banks and broker-dealers, and may therefore be subject to enhanced due diligence resulting from any PEPs invested (directly or indirectly) in the funds.

Background

Since at least 2001, the Agencies have focused on a bank's treatment of foreign political figures. In their January 2001 *Guidance on Enhanced Scrutiny for Transactions that May Involve the Proceeds of Foreign Corruption*, Treasury and the banking agencies (together with the U.S.

Copyright © 2024 Schulte Roth & Zabel LLP

Department of State) outlined their expected approach to "working closely with the financial services industry to develop guidance for financial institutions to conduct enhanced scrutiny of those customers and their transactions that pose a heightened risk of money laundering and other financial crimes" such as senior foreign political figures.[4] The Bank Secrecy Act ("BSA") implementing regulations issued in 2005 under Section 312 of the USA PATRIOT Act [5] prescribed requirements relating to certain accounts for SFPFs, for example "enhanced scrutiny of such account[s] that is reasonably designed to detect and report transactions that may involve the proceeds of foreign corruption." [6] And in 2013, the Financial Action Task Force ("FATF") issued Recommendation 12 which requires countries to ensure that financial institutions implement policies and procedures to detect and stop abuse of the financial system by PEPs.[7] FATF's guidance defines a PEP as an "individual who is or has been entrusted with a prominent public function." [8] Although the BSA and its implementing regulations[9] do not use the term PEPs, as the Statement notes, firms sometimes refer generally to "foreign individuals who are or have been entrusted with a prominent public function, as well as their immediate family members and close associates" as PEPs.[10]

In 2016, FinCEN released the Customer Due Diligence ("CDD") rule which requires certain financial institutions[11] to adopt risk-based procedures for conducting CDD that enables those financial institutions to: (i) understand the nature and purpose of customer relationships for the purpose of developing a customer risk profile (i.e., information "gathered about a customer at account opening used to develop a baseline against which customer activity is assessed for suspicious activity reporting"); and (ii) conduct ongoing monitoring to identify and report suspicious transactions and, on a risk basis, to maintain and update customer information.[12] In some instances, legal entity customers may be controlled by PEPs; banks have therefore requested clarification of the application of a risk-based approach to conducting CDD on PEPs consistent with the CDD rule's requirements.

All bank accounts, including those of PEPs, are subject to the BSA and other AML regulatory requirements.[13] Because of their connections and authority, PEPs present a relatively high subject of AML concern from a risk-based perspective, as PEPs are especially suited to use financial services firms and other persons as conduits for laundering misappropriated public funds or the proceeds of bribery and corruption.[14] The federal AML laws, applicable to all financial services firms and all

Copyright © 2024 Schulte Roth & Zabel LLP

other persons, make it a crime to knowingly engage in a transaction with the proceeds of official corruption.[15] This includes not only violations of U.S. bribery laws (including the Foreign Corrupt Practices Act), but also offenses under foreign laws involving bribery of a public official or misappropriation of public funds.[16]

While not mentioned in the Statement, the Federal Financial Institutions Examination Council's BSA/AML Examination Manual[17]("BSA Manual"), which guides banking examiners' review of banks' compliance with the BSA, already acknowledges the importance of CDD for PEPs.[18] The BSA Manual recognizes that "not all PEPs present the same level of risk" and that due diligence and risk mitigation measures may be proportionate with the level of risk posed by the PEP's particular circumstances, such as "geographic location, industry, or sector, position, and level or nature of influence or authority" and "[r]isk may also vary depending on factors such as the purpose of the account, the actual or anticipated activity, products and services used, and size or complexity of the account relationship."[19] The BSA Manual also provides that, "[a]s a result of these factors, some PEPs may be lower risk and some may be higher risk for foreign corruption or money laundering."[20] Accordingly, a general expectation applies that financial institutions will engage in a risk assessment, as well as corresponding and ongoing CDD for PEPs insofar as this may be necessary to establish a customer risk profile, that reflects the risk the PEP relationship presents.

The Statement's Clarification

As noted, the Statement emphasizes that the Agencies are not altering existing BSA and AML legal or regulatory requirements and are not establishing new supervisory procedures. Moreover, the Statement does not impact the regulatory obligation of financial institutions to do enhanced due diligence on SFPFs using private banking accounts under Section 312 of the PATRIOT ACT, although it would appear that the guidance sheds some light on the thinking of the regulators with respect to SFPFs. Nor does the Statement diminish the serious concern of corruption posed by PEPs, including SFPFs, who engage in illicit acts.

At the outset, while recognizing that PEPs present significant AML concerns, the Statement notes "[t]here is no regulatory requirement in the CDD rule, nor is there a supervisory expectation, for banks to have unique, additional due diligence steps for PEPs."[21] Moreover, banks are

Copyright © 2024 Schulte Roth & Zabel LLP

not required "to screen for or otherwise determine whether a customer or beneficial owner of a legal entity customer may be considered a PEP."[22] The Statement acknowledges that PEP relationships vary in their level of risk, and that "not all PEPs are automatically higher risk" individuals.[23] Accordingly, the "level and type of CDD should be commensurate with the risks presented by the PEP [customer] relationship."[24] The Statement's point of clarification is that there is no need for "banks to have *unique*, *additional* due diligence steps for PEPs."[25] Rather "the level and type of CDD should be appropriate for the customer risk."[26] The Statement notes with respect to banks' AML programs that:

- "Banks may leverage existing processes for assessing geographic-specific money laundering, corruption, and terrorist financing risks when developing the customer risk profile, which may also take into account the jurisdiction's legal and enforcement frameworks, including ethics reporting and oversight requirements."
- "When developing the customer risk profile, and determining when and what additional customer information to collect, banks may take into account such factors as a customer's public office or position of public trust (or that of the customer's family member or close associate), as well as any indication that the PEP may misuse his or her authority or influence for personal gain."
- "A bank may also consider other factors in assessing the risk of these relationships, including the type of products and services used, the volume and nature of transactions, geographies associated with the customer's activity and domicile, the customer's official government responsibilities, the level and nature of the customer's authority or influence over government activities or officials, the customer's access to significant government assets or funds, and the overall nature of the customer relationship."[27]

Further, the Statement notes that SFPFs are a subset of PEPs and that the term PEP does not "include U.S. public officials"[28] and describes certain relevant characteristics of PEPs that the bank should consider, such as:

- "PEPs with a limited transaction volume, a low-dollar deposit account with the bank, known legitimate source(s) of funds, or access only to products or services that are subject to specific terms and payment

Copyright © 2024 Schulte Roth & Zabel LLP

schedules could reasonably be characterized as having lower customer risk profiles."

- "For a PEP who is no longer in active government service, banks may also consider the time that the customer has been out of office, and the level of influence he or she may still hold."[29]

Customers that are nominally PEPs but who have lower indicia of risk may not require exceptional investigative procedures and research, and might be adequately accommodated by less extensive, and more routine, AML diligence. For example, a PEP who has been out of office for many years and previously served in a governmental role in a jurisdiction with a relatively strong AML regime may present a subject of relatively reduced concern and require only marginally more investigation than a standard investor.

Although PEPs should be evaluated on a risk basis, there is no automatic requirement for PEPs to be subject to intensive AML review or become the subject of an extensive research dossier. But banks are still required to have appropriate risk-based procedures for conducting CDD on PEPs and the Statement does not suggest dispensing with any preexisting enhanced procedures they view as reasonably necessary.

Banks are reminded in the Statement of the history of PEPs in high profile cases over the years in using banks as conduits for illegal activities, including corruption, bribery, money laundering and related crimes and further of their obligation to identify and report suspicious activity including transactions that may involve the proceeds of corruption. The customer information and risk profile may impact how the bank complies with these requirements, as well as its monitoring obligations.

Key Takeaways

As noted, although the Statement provides some insight into how a regulated financial institution should assess the risk profile of a PEP, the Agencies' guidance does not create new AML requirements. Rather, it clarifies that there is not a supervisory expectation for banks to have unique, additional due diligence steps for PEPs. Banks and broker-dealers should deal cautiously with PEPs. So should managers of hedge funds and private equity funds, to protect themselves from charges of laundering corruption proceeds, even though they, unlike banks and broker-dealers, are not yet directly subject to an AML program requirement under the

Copyright © 2024 Schulte Roth & Zabel LLP

BSA.[30] The Agencies' guidance affirms that any such enhanced diligence need not consist of automatically applied, exceptionally deep research and review procedures, but may be reasonably tailored to the circumstances of the individual investor. As a practical matter, the policies and procedures that guide the process for banks and broker-dealers for screening for PEPs and SFPFs are unlikely to change as a result of the Statement and should continue to reflect an appreciation for the special risks posed by these investors. Likewise Fund managers subject to U.S. criminal money laundering laws should continue (either themselves or through their administrators) to screen for PEPs and SFPFs and subject such individuals to enhanced due diligence.

Authored by Betty Santangelo, Gary Stein, Joseph P. Vitale, Melissa G.R. Goldstein, Kyle B. Hendrix, Hannah M. Thibideau and Joshua B. Wright.

If you have any questions concerning this *Alert*, please contact your attorney at Schulte Roth & Zabel or one of the authors.

---

[1] The banking Agencies are the Board of Governors of the Federal Reserve System, the Federal Deposit Insurance Corporation, the National Credit Union Administration, and the Office of the Comptroller of the Currency ("OCC").

[2] *Joint Statement on Bank Secrecy Act Due Diligence Requirements for Customers Who May Be Considered Politically Exposed Persons* (Aug. 21, 2020), available here.

[3] The term "senior foreign political figure" or "SFPF" is defined in the USA PATRIOT ACT and its implementing regulations, 31 C.F.R. § 1010.605(p), as "(i) A current or former: (A) Senior official in the executive, legislative, administrative, military, or judicial branches of a foreign government (whether elected or not); (B) Senior official of a major foreign political party; or (C) Senior executive of a foreign government-owned commercial enterprise; (ii) A corporation, business, or other entity that has been formed by, or for the benefit of, any such individual; (iii) An immediate family member of any such individual; and (iv) A person who is widely and publicly known (or is actually known by the relevant covered financial institution) to be a close associate of such individual."

[4] Treasury, *Guidance on Enhanced Scrutiny for Transactions that May Involve the Proceeds of Foreign Corruption* (January 2001), available here. By issuing the Statement, the Agencies rescinded the 2001 Guidance.

Copyright © 2024 Schulte Roth & Zabel LLP

Attorney Advertising

[5] 31 C.F.R. §§ 1010.605, 1010.610 - 1010.620.

[6] 31 C.F.R. § 1010.620(c).

[7] FATF, *International Standards on Combating Money Laundering and the Financing of terrorism & Proliferation* (June 2019), available here; *see also*, *FATF Guidance: Politically Exposed* Persons *(Recommendations 12 and 22)* (June 2013), available here; FinCEN, *Advisory on Human Rights Abuses Enabled by Corrupt Senior Foreign Political Figures and their Financial Facilitators* (June 12, 2018), available here.

[8] *International Standards on Combating Money Laundering and the Financing of terrorism & Proliferation* at 123 (defining the term "PEP" in its entirety as follows, "*Foreign PEPs* are individuals who are or have been entrusted with prominent public functions by 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. *Domestic PEPs* are individuals who are or have been entrusted domestically with prominent public functions, 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. Per*sons who are or have been entrusted with a prominent function by an international organisation* refers to members of senior management, i.e. directors, deputy directors and members of the board or equivalent functions. The definition of PEPs is not intended to cover middle ranking or more junior individuals in the foregoing categories."); *see also FATF Guidance: Politically Exposed Persons (Recommendations 12 and 22)* at 3.

[9] 31 U.S.C. §§ 5311-5330; 31 C.F.R. Chapter X.

[10] Statement, p. 1.

[11] *See* Customer Due Diligence Requirements for Financial Institutions, 81 Fed. Reg. 29,398 (May 11, 2016), which applies to banks, brokers and dealers in securities, mutual funds, futures commission merchants and introducing brokers in commodities.

[12] *Id.*

[13] Statement, p. 2.

[14] *Id.*, p. 4.

Copyright © 2024 Schulte Roth & Zabel LLP

[15] *See* 18 U.S.C. §§ 1956-1957.

[16] *See* 18 U.S.C. § 1956(c)(7)(B)(iv).

[17] *See BSA/AML Examination Manual* (last accessed Aug. 24, 2020; sections subject to incremental updates), available here.

[18] *BSA/AML Examination Manual* ("Politically Exposed Persons — Overview") (Feb. 27, 2015), p.291-292.

[19] *Id.*

[20] *Id.*

[21] Statement, p. 2.

[22] *Id.*

[23] *Id.*, p. 1.

[24] *Id.*, p. 2.

[25] *Id.*, p. 1-2 (*emphasis added*).

[26] *Id.*, p. 2.

[27] *Id.*, p. 3.

[28] *Id.*, p. 1.

[29] *Id.*, p. 3.

[30] *See* e.g., 18 U.S.C. §§ 1956-1957.

This communication is issued by Schulte Roth & Zabel LLP for informational purposes only and does not constitute legal advice or establish an attorney-client relationship. In some jurisdictions, this publication may be considered attorney advertising. ©2020 Schulte Roth & Zabel LLP.

All rights reserved. SCHULTE ROTH & ZABEL is the registered trademark of Schulte Roth & Zabel LLP.

Copyright © 2024 Schulte Roth & Zabel LLP

Related People

Betty Santangelo

New York

Melissa Goldstein

Partner

Washington, DC

Kyle Hendrix

Associate

Washington, DC

Hannah Thibideau

Special Counsel

New York

Copyright © 2024 Schulte Roth & Zabel LLP

Attorney Advertising

Joshua
Wright
Associate
New York

Practices

LITIGATION

SEC ENFORCEMENT AND WHITE COLLAR DEFENSE

BANK REGULATORY

Attachments

Download Alert

Copyright © 2024 Schulte Roth & Zabel LLP

Attorney Advertising