

**LESSONS TO BE LEARNT REGARDING PEP'S FROM RECENT FSA
ENFORCEMENT ACTION**

On the 26th of March, The Financial Services Authority (FSA) announced that it had issued a fine for failing to take reasonable care to establish and maintain effective anti money laundering (AML) checks relating to high risk customers and Politically Exposed Persons (PEPs).

While the fine was not the first for this type of offence it was the largest of its kind and is the sixth largest levied by the FSA to date.¹ The penalty followed publication of the FSA's review into banks' management of high money laundering risk situations and their warning that they were ready to launch a "crack-down" on bank AML practices after finding serious weaknesses in systems and an unwillingness of some banks to turn away, or exit, profitable business relationships with high risk customers when there appeared to be unacceptable risks of handling the proceeds of crime.² The FSA determined that the controls used in the current case for new high risk customers were not tough enough, nor were they monitored consistently, which gave rise to a breach of their rules relating to Senior Management Arrangements, Systems and Controls (6.1.1R and 6.3.1R) as well as Principle 3 of the FSA's Principles for Businesses, which states that "a firm must take reasonable care to organise and control its affairs responsibly and effectively, with adequate risk management systems."³

We have set out below the key lessons to be learnt for firms and our views on whether this decision has effectively raised the regulatory bar for firms which to date have benchmarked their policies and procedures against the Joint Money Laundering Steering Group's ("JMLSG") notes.

The other question which this and other enforcement actions spark is in what circumstances will the FSA bring enforcement action against those in the relevant controlled functions, CF 10 and 11. For some time it was felt, perhaps, that the FSA would be reluctant to take action against those Money Laundering Reporting Officer's ("MLRO's") struggling to ensure that firms comply with the ever-changing and increasing regulatory requirements designed to minimise the risk that firms are being used to further financial crime.

However, following the FSA's first enforcement action in 2008, against Michael Wheelhouse, the MLRO of Sindicatum Holdings, there have been a number of cases where CF 10s or 11s have been pursued. This has culminated in the latest case involving Syed Itrat Hussain, MLRO of Habib Bank AG Zurich, who was fined £17,500 for failing to take reasonable care to establish and maintain adequate anti-money laundering (AML) systems and controls.

¹ <http://www.fsa.gov.uk/about/media/facts/fines>

² www.fsa.gov.uk/pubs/other/aml_final_report.pdf

³ www.fsa.gov.uk/static/pubs/final/coutts-mar12.pdf

It is therefore important for those discharging the strategy which is in place to ensure it is constantly kept up to date. Those in CF 10 and 11 roles should benchmark their organisation's systems and controls against these findings and ensure that any "lessons to be learnt" are implemented quickly.

Lessons to be learnt

1. Firms need to ensure that prospective and existing customers are assessed for being potential PEPs, either under the definition set out in the Money Laundering Regulations ("MLR's") or by reference to a wider definition. In the present case, the definition was extended to include domestic PEPs i.e. those who held office in the UK. We consider this to be sensible in the same way that a lot of institutions continue to treat customers as PEPs even if they have left office over a year ago. The proceeds of corrupt activity do not change after a year and such customers continue to pose a financial crime risk.

In this regard it is important to remember that PEPs include those who are family members or "known associates" of PEPs. Again we would recommend a risk based approach to the meaning of close associate such that the joint ventures, one of whose shareholders is a PEP, are also treated as a "known associate" even though they would technically fall outside the definition in the MLRs.

2. Firms need to gather sufficient due diligence information in order to adequately and meaningfully understand the money laundering risk. All too often, the focus on due diligence is on identification documents to prove that a customer exists or is who they say they are. However, that does not eliminate all money laundering risk as it is also necessary to understand a customer's business generally and the business they will bring to the firm.

That can include asking questions on why a client has structured their affairs in the way they have, for example, why is the corporate structure so complex or opaque or why is the control structure so unusual. In one case we have come across, all day-to-day control was exercised by loan note holders. They were also the main recipients of profits, but were not your typical beneficial owner.

3. Firms should ensure they have understood the source of wealth and the source of funds to be used in specific transactions. For example, whilst the source of funds may be "bank finance" for the majority of the purchase price, it is still necessary to understand the customer's source of funds more generally, which could, in particular, be relevant to repayments on the account.

4. To the extent that procedures require enhanced due diligence, which should be the case for high risk customers, it should also be indicated what that enhanced due diligence consists of. Similarly, training should be given on the level of depth of information staff are expected to obtain and record, perhaps with the assistance of completed pro formas. Otherwise there is a risk that there will be a disconnect between the expectations of those in compliance and the actions of those in the business which could lead to the FSA concluding the systems themselves were inadequate in their design or in their implementation, a "heads you win, tails we lose" scenario. Whilst training on these procedures may be dry, in our experience it is essential.

5. The FSA has suggested in their findings that it is necessary not only to understand the source of funds but also to obtain evidence to support it. This suggests that in high risk cases the FSA is looking to see a quasi-verification of the source of funds. The failures in this case highlighted by the FSA were failures to establish the ownership or prior ownership of an asset where it was linked to the source of funds. In our view, this represents a shift in the regulatory standards expected of firms, and goes beyond the current MLR's, which do not refer to verification of this information.

6. Where staff are incentivised through appraisal or remuneration structures to generate business, then in high risk cases, there should be an independent aspect to the approval process for new customers. Where the AML team is involved, great care should be taken in relying upon the reputation and experience of the business generator. Whilst businesses may be trusted to be honest and competent in their field, AML staff need to question their experience in assessing AML risk before blindly relying upon them.

7. Where due diligence reveals adverse comments about a client's source of funds, reputation or business more generally, staff, including the AML staff, should document how they have become comfortable with the AML risk. In appropriate cases that may mean that they consider the intelligence to be untrustworthy since in some jurisdictions it is easy to become subject of adverse press comment. In others the information may be outdated or just inconsistent with facts known to the firm to be true and therefore just "wrong" on its face.

8. PEP relationships should be approved by senior management and that responsibility should not be delegated to the AML team.

9. Where due diligence materials obtained are subject to checking by an independent team, that team should be given sufficient training to discharge that role; otherwise they may fail to identify deficiencies. This point is true of all internal reviews across the financial crime sphere. If, for example, internal audit are to conduct a review of the implementation of AML, ABC or sanctions systems and controls, staff would need to undergo training on the issues to be identified, particularly when assessing some of the more "opinion" based assessments e.g. AML risk.

10. Once on board, it goes without saying that customers need to be subject to ongoing monitoring to ensure that changes in beneficial owner or money laundering risk are identified and further due diligence undertaken as appropriate. This can be done through discussion with the customer and checking appropriate public sources of information as well as relevant registries. Where, for example, adverse intelligence becomes available, it needs to be assessed and the conclusions documented as set out at paragraph 7 above. Of course, that intelligence should then also be assessed by reference to the firm's experience in operating the account.

11. It is important to ensure that when reviews are being done, those conducting them have sufficient information to do so. That includes being able to review all aspects of a customer's relationship with the firm, wherever held.

12. The AML team should sample-check those reviews to ensure they have been properly completed. It is therefore important to recognise that the regulatory standards do not require the AML team to conduct the reviews. However, it is advisable for the AML teams to sample check the reviews to ensure that the firm's systems and controls are being complied with.

13. The FSA also criticised the extent of the review by senior management of the firm's PEPs. The reviews did not consider the enhanced due diligence held or whether any adverse intelligence had emerged. The FSA were critical of the fact that the reviews were not sufficiently robust to ensure that any change in AML risk had been identified and considered appropriately. We believe that with respect to this criticism the FSA has, once again, raised the regulatory expectations placed upon senior management.

14. In terms of transaction monitoring, it is of course necessary to consider whether transactions on an account are inconsistent with the expected activity. In this case, that included instances where payments were made to a customer from a third party with no clear connection to that customer. This shows the level of information which will need to be gathered at the outset so that subsequent transactions can be properly assessed.

The above lessons show the level and rigour of due diligence which is expected in high risk cases. However, a number of the points would equally apply to lower risk customers.

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If you have any questions regarding this memorandum, please contact Peter Burrell (+44 207 153 1206, pburrell@willkie.com) or the Willkie attorney with whom you regularly work.

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