

Update on International Initiatives Affecting The Bahamas

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FOUR years ago, The Bahamas responded to a number of international initiatives which affected its financial services industry. Specifically, the initiatives of:

- The *Financial Stability Forum* - regarding banking regulatory oversight, cross-border supervision and related international cooperation;
- The *Financial Action Task Force* - regarding anti-money laundering rules, including know-your-customer (KYC) procedures and related matters; and
- The *Organisation for Economic Development and Cooperation* - regarding transparency and information exchange in tax matters.

Concurrently, The Bahamas had to address the implementation of the so-called Qualified Intermediary system within the United States of America (US), under which The Bahamas sought to become a Qualified Jurisdiction. This too required KYC rules and was, in that sense similar, to the FATF initiative. Regarding tax matters, the US keenly pursued a tax treaty with The Bahamas.

Several legislative revisions and enactments, amongst other things, resulted in enhanced regulatory supervision of financial institutions, cross-border supervision in The Bahamas of foreign banks by their home regulators, and the implementation of comprehensive KYC rules. Respecting fiscal matters, in January 2002 a tax treaty was entered with the US and in March 2002 a commitment to the OECD was given for tax information exchange in criminal and civil matters, expressly conditional upon a level playing field amongst OECD and non-OECD countries and territories with which The Bahamas is in material competition in the provision of financial services.

Developments Regarding KYC

By 2003, in relation to KYC, the FATF's focus had progressed from the rather prescriptive rule-based approach of the year 2000, to a risk-based approach. (For example, The risk-based approach may apply basic KYC requirements for low-risk retail banking customers and enhanced measures for higher risk customers and transactions, including correspondent banking.)

The risk-based approach was adopted at a Plenary Meeting of the FATF in June 2003 and expressed in the revised 40 Recommendations issued 20 June 2003. Correspondingly:

- January 2004 The Bahamas implemented revised *Financial Transactions Reporting Regulations* (the KYC requirements), which extended the range of low-risk facilities exempted from the full application of the KYC requirements and allowed for flexibility to facilities generally in the application of the list of KYC requirements [*Financial Transactions Reporting (Amendment) Regulations, 2003* dated 31.12.03].
- April 2004 the Central Bank of The Bahamas issued guidelines regarding the risk-based approach in the application of the AML-KYC requirements.

The risk-based approach provides flexibility in customer due diligence and may require greater investment in technology, quality staff and staff training than the former rule-based approach. Its effective implementation requires clear and unambiguous internal procedures to guide staff as to how to assess risk. The level of due diligence required for a particular customer should be objectively determined by application of the procedures, as opposed to the subjective view of a bank officer.

BCBS Initiative on KYC & Cross-border Supervision

The Basel Committee on Banking Supervision (BCBS) formulates broad supervisory standards and guidelines and recommends statements of best practice for banking supervisory authorities to implement in ways best suited to their own national systems. Three years ago it addressed KYC matters. The BCBS has stated that its approach to KYC is from a wider prudential perspective, not just the anti-money laundering perspective of the FATF. Its interest in sound KYC standards is said to originate from its concerns for market integrity and has been heightened by the direct and indirect losses incurred by banks due to their lack of diligence in applying appropriate procedures.

In October 2004 (following a consultative document of the previous year) the BCBS issued a paper (*Consolidated KYC Risk Management*) calling for consolidated KYC risk management. It defined consolidated KYC risk management as "an established centralized process for coordinating and promulgating policies and procedures on a groupwide basis, as well as robust arrangements for the sharing of information within the group".

Group Information Sharing: The BCBS stated that subsidiaries and branches should be required to proactively provide information concerning higher risk customers and activities relevant to the global management of reputational and legal risks, and respond to requests for account information from the head office or parent bank in a timely manner. Further, the BCBS states that head office should be able to require all offices to search their files against a list of

individuals or organizations suspected of aiding and abetting terrorist or money laundering, and report matches.

Clearly such group information sharing facility may assist in the fight against terrorist financing or money laundering. However, there is potential for abuse of that facility, which must receive the most careful consideration by Bahamian officials regarding its implementation:

- Authorities in the jurisdiction of the head office/parent bank may elect to access information held by the foreign branches or subsidiaries of a bank in other jurisdictions for purposes wholly unconnected with terrorism or money laundering. For example, it might be used for discovery purposes in ordinary civil proceedings transpiring in the jurisdiction of the head office/parent bank. The customer information of the foreign branch or subsidiary, as a practical matter, would be information accessible at the head office/parent bank.
- The scope of money laundering might be wider in the jurisdiction of the head office/parent bank than it is in the places where branches/subsidiaries are located. For example, the head office/parent bank jurisdiction might include a fiscal offence as a predicate offence, while the jurisdiction of the branch/subsidiary might not. The group information sharing facility might be misused to get tax information via a branch/subsidiary from a jurisdiction with which no tax treaty arrangement is in place.
- Foreign authorities may use the group information sharing facility to bypass legal safeguards in the jurisdiction of the branch/subsidiaries. For example: The *Evidence (Proceedings in Other Jurisdictions) Act, 2000* of The Bahamas contains anti-fishing provisions where Bahamian information is being accessed for use in foreign proceedings. The anti-fishing provisions guard against wide-ranging roving inquiries. The group information sharing facility may bypass Bahamian anti-fishing provisions to access information on Bahamian bank accounts.

Certainly, the BCBS proposal has implications for bank confidentiality in The Bahamas both from a common law and statutory perspective. The *Tournier* principle from the 1924 English case, long adopted in The Bahamas, held that as a matter of contract, a banker owes his customer of duty of confidentiality, subject to limited exceptions. The *Bank & Trust Companies Regulations Act, 2000*, statutorily stipulates that a bank or trust company may not disclose its customer's affairs, subject to a number of exceptions. Those exceptions were recently expanded by the 2000 revision to that statute. Moreover, *Data Protection (Privacy of Personal Information) Act, 2003* (when brought into force) would prohibit disclosure of personal data, subject to certain exceptions. Also, the Data Protection Commissioner, to be established under that Act, may prohibit the transfer of personal data from The Bahamas to a place outside of The Bahamas in cases where

there is a failure to provide protection either by contract or otherwise equivalent to the protection under that statute [s. 13 & 17 DP(PPI)A]. A violation of any of the abovementioned statutory measures gives rise to criminal liability.

No existing exception to the common law or statutory duties of bank confidentiality contemplates the group information sharing facility proposed by the BCBS. Measures may be taken to achieve the group information sharing facility in two ways: Namely, customer consent and/or an exception under Bahamian law. Those options would require suitably drafted confidentiality waivers in the banking mandates or a statutory expansion of circumstances in which a bank may disclose information.

Cross-border supervision: The BCBS states that there should be no impediments to the home supervisor verifying a branch or subsidiary's compliance with groupwide KYC policies and procedures during on-site inspections. And that this may include access to customers' names and balances for the purpose of evaluating how the KYC standards and risk management practices have been applied.

This too is problematic for the reasons earlier mentioned. While the *Banks & Trust Companies Regulations Act, 2000* made possible (for the first time) cross-border supervision of foreign banks by their home supervisor in The Bahamas, expressly, it prohibits (save in limited and specific circumstances) the home supervisor from having access to customer information and assets under management [s.14 BTCRA]. Here too, appropriate confidentiality waivers in the banking mandates and/or statutory revision would be necessary.

The BCBS has urged the removal of all laws that restrict access by head office/parent bank and the home country supervisors to local records, including customers' names and balances, or else the branch/subsidiary of the foreign bank may close or be required to close its operations.

In addition to the matters already mentioned, if The Bahamas determines to provide for the implementation of Consolidated KYC Risk Management by statutory revision, regard should be had to the question of timing. There is an obvious risk of competitive disadvantage should The Bahamas act in advance of its competitor jurisdictions.

Developments Regarding Anti-terrorism

The FATF's revised 40 Recommendations issued in June 2003 was accompanied by eight *Special Recommendations on Terrorist Financing*, which, when combined with the FATF 40 Recommendations on money laundering, set out the basic framework to detect, prevent and suppress the financing of terrorism and terrorist acts. The Special Recommendations address:

I. Ratification and implementation of UN instruments

- II. Criminalising the financing of terrorism and associated money laundering
- III. Freezing and confiscating terrorist assets
- IV. Reporting suspicious transactions related to terrorism
- V. International cooperation
- VI. Alternative remittance
- VII. Wire transfers
- VIII. Non-profit organisations

Towards implementation in The Bahamas of the eight *Special Recommendations on Terrorist Financing*, during late November 2004 a Bill for an Anti-terrorism Act passed in the lower house of Parliament. It is expected to soon complete the legislative process.

Developments Regarding Tax Matters

The Bahamas/US Tax treaty became operational in criminal matters for the tax year that commenced in 2004. It will become operational with respect to civil matters for the tax year commencing in 2006.

As regards the OECD initiative, developments in Europe during late January 2003 substantiated the concerns The Bahamas held at the time of its commitment letter in 2002: namely, that the proponents of tax information exchange within the OECD were either not prepared or were then (and for sometime to come) unable to ensure a level playing field amongst all financial centers. On the matter of the EU Savings Directive, the European Council determined to exempt 3 (Austria, Belgium and Luxembourg) of the 15 EU members from a requirement to exchange information for tax purposes. Instead, they may withhold a percentage of savings income that would gradually rise from 15% to 35%. Additionally, Switzerland, an OECD member but non-EU member that continue to reject information exchange for tax purposes was given the withholding tax option. In short, these European financial centers may maintain banking confidentiality in tax matters thereby having a distinct competitive advantage over jurisdictions that would engage in tax information exchange.

The exemptions from information exchange for purposes of the EU Savings Directive has seriously complicated the OECD's efforts to obtain a level playing field, which is required to satisfy the conditional commitment made by The Bahamas and several other non-OECD financial centers.

The OECD is likely to find it difficult to deliver in the near to medium term a level playing field for tax information exchange. The Bahamas may anticipate that the OECD may press for tax information exchange arrangements to be proceeded with, notwithstanding the absence of a level playing field.

Other Developments

USA Patriot Act: Following the events of 9/11 2001, the United States enacted the *USA Patriot Act* of 2001, amongst other things, to strengthen US anti-money laundering laws by focusing on offshore banking and related facilities that protect anonymity; correspondent banking which was considered susceptible to manipulation by money launderers; and private banking, which was considered susceptible to manipulation by corrupt foreign government officials. As a consequence of the Patriot Act, financial institutions in the US were required to establish due diligence policies, procedures and controls reasonably designed to detect and report money laundering through correspondent accounts established, maintained, administered or managed in the US for foreign financial institutions, such as Bahamian licensed financial institutions [s. 312 USA Patriot Act]. This Act contains far-reaching powers for US authorities.

Sarbanes-Oxley Act: Following the Enron corporate scandal, the US enacted the *Sarbanes-Oxley Act* of 2002 ("SOX"). SOX provides a comprehensive regime addressing corporate governance matters relating to US public companies. Amongst other things, it established a Public Company Accounting Oversight Board ("PCAOB") to regulate and oversee public accounting firms that prepare and issue audit reports on US public companies, whether or not listed on an exchange in the US, and non-US private issuers, that have either registered or are in the process of registering a class of securities with the Securities Exchange Commission ("SEC") of the US, or are otherwise subject to the SEC reporting requirements (collectively, "US entities").

Of impact to Bahamian accounting firms engaged in audit work for local interests of US entities, SOX (s. 106) provides that each foreign accounting firm that issues an opinion or otherwise performs material services upon which a registered US public accounting firm relies in connection with the issuance of its audit report or any opinion contained in an audit report shall be deemed to have consented to:

- Produce its audit workpapers for the PCAOB or the SEC in connection with any investigation by either body with respect to that audit report; and
- Be subject to the jurisdiction of the US courts for purposes of enforcement of any request for the production of workpapers.

SOX is an example of the extraterritorial application of US law and, depending on the information sought pursuant to a request for production of workpapers and the extent of waivers obtained, may give rise to conflict of laws issues for a Bahamian accounting firm caught within the scope of that Act in several regards. They include the confidentiality duties existing under the *Public Accountants (Rules of Professional Conduct) Regulations, 1993*, the *Banks & Trust Companies Regulations Act, 2000*, the *Investment Funds Act, 2003*, and the *Data Protection (Privacy of Personal Information) Act, 2003*, when in force.

European Union Savings Directive: On 3 June 2003 the Council of European Union passed the *Council Directive on Taxation of Savings Income in the Form of Interest Payments* ("the Savings Directive"). The aim of the Savings Directive is to enable a Member State, which is the place of residence of an individual who is the beneficiary of an interest payment made in another Member State, to apply effective taxation to that interest payment according to its (the place of residence) laws.

The Savings Directive commences 1 January 2005 and affects all EU residents. Such persons will face disclosure of their investments to their home country or a withholding tax starting at 15% eventually increasing to 35%. Belgium, Luxembourg, Austria, Switzerland, Jersey, Guernsey, the Isle of Man have elected the withholding tax route.

The Savings Directive is to be applied to UK Dependent Territories, such as the Cayman Islands. The extent to which it would reach into non-EU states/territories via branches or subsidiaries of EU based banks is not clear and must be monitored.

Conclusion

For the financial services industry, now is, indeed, the information age. International demands for the collection and provision of financial information is and will remain at the forefront of issues affecting The Bahamas and other international financial centers for some time to come. The challenge for The Bahamas will continue to be to ensure that its response safeguards the legitimate commercial interests and privacy rights of customers, maintains this jurisdiction's relative competitiveness with others, and satisfies its duty as a responsible member of the international community.