Legal Backgrounder

Washington Legal Foundation
Advocate for freedom and justice®
2009 Massachusetts Ave., NW
Washington, D.C. 20036
202.588.0302

Vol. 18 No. 27 June 27, 2003

TREASURY DEPARTMENT MUST CORRECT INEQUITIES IN MONEY-LAUNDERING RULES

by

Thomas D. Hughes

On October 26, 2001, President Bush signed into law the USA Patriot Act. Uniting and Strengthening America By Providing Appropriate Tools Required To Intercept and Obstruct Terrorism (USA Patriot Act) of 2001, 31 U.S.C. § 5318, *et. seq*. Section 352 of the Act, which is designed to bolster our nation's ability to combat terrorism, amends the Bank Secrecy Act to require that every "financial institution," including banks, broker-dealers, and most importantly for our purposes, insurance companies, establish anti-money laundering programs. On September 26, 2002, the United States Treasury Department's Financial Crimes Enforcement Network promulgated its proposed rule for the insurance industry. 67 Fed. Reg. 60625 (Sept. 26, 2002). In that rule, Treasury proposed limiting the Patriot Act's definition of "insurance company" to those entities that sell life insurance and annuity products,[1] concluding that these products possess deposit, investment, and transfer features that imbue them with "the greatest risk of money laundering and terrorist financing" in the insurance industry.

This narrow definition of "insurance company," however, has two important consequences. First, it exempts from the Patriot Act both companies that sell property and casualty policies and the independent life-insurance agents and brokers that sell the life-insurance products included within the proposed rule. Second, it makes life insurers solely responsible for any violations of the Patriot Act committed by the independent agents and brokers through which they sell their products.[2]

---

[1]Under the proposed rule, a company that sells life insurance and annuity products must develop and implement an anti-money laundering compliance program that is "reasonably designed" to prevent the insurer from being used to launder money in the United States. Each insurer must develop a flexible, risk-based program that realistically assesses the money laundering and terrorist-financing risks associated with its products, customers, distribution channels, locations, and methods of payment. Minimally, companies must maintain a written compliance program that (1) incorporates internal policies, procedures, and controls based on the company's assessment of its money laundering risks; (2) designates a compliance officer; (3) establishes an ongoing employee training program; and (4) establishes an independent audit function to test programs. 67 Fed. Reg. at 60625.

[2]In addition to products sold by property-casualty companies, Treasury exempted from the rule products sold by health, title, and mortgage companies. However, these non-life insurers, as well as property-casualty carriers, must still comply with the Patriot Act's expanded currency reporting requirements and with all applicable Federal trade laws relating to the transportation

---

Thomas D. Hughes is Senior Vice President & General Counsel, and Assistant Secretary, to the Greater New York Insurance Companies, a group of property-casualty companies in New York City. Mr. Hughes is also an Adjunct Professor of Law at New York Law School.

Treasury's proposal to include life-insurance products in the rule and to exclude property-casualty products from the rule rests on solid statutory and practical grounds. However, Treasury should also exempt from the rule life-insurance products that do not have deposit, investment, and transfer features, since these, like property-casualty products, do not present viable money-laundering opportunities. In addition, Treasury should permit life insurers to hold their independent agents contractually responsible for violations of the insurers' anti-money laundering compliance programs.

The Exemption of Property-Casualty Insurance Products. Treasury's proposal to limit the Patriot Act to life insurance and annuity products is grounded in the Act's predominate concern with banking practices and procedures that permit individuals and groups to invest money, store value, and transfer cash into and through bank "accounts." Patriot Act §§ 311, 312, and 326. Though life-insurance companies do not open bank-like "accounts" for their customers, they do sell policies having income-saving and -producing characteristics akin to those associated with bank accounts. For example, universal life-insurance policies peg interest credits to external market factors, and variable life-insurance policies tie the amount and duration of benefits to investment experience. 67 Fed. Reg. at 60625. These and similar life-insurance policies permit an insured to, among other things, redeem the cash value in such policies or use the cash value as collateral for a loan. *Id*. at 60628. Indeed, it is because of these investment-like features that many life-insurance products are "marketed to investors as part of diversified portfolios" and as "tax" benefits. *Id*. at 60625. In short, these kinds of life-insurance products provide "living benefits" for insureds, which permit them to "store value and to transfer that value to another person" as one might do through a bank account. *Id*. at 60625-26. In this respect life-insurance products are very different from property-casualty products, which "indemnify" or pay compensation to an insured only upon the happening of a specified contingency covered by the policy.

Treasury makes its point about how the "living benefits" feature of life-insurance products "allow [money launderers] to place large amounts of funds into the financial system and [to] seamlessly transfer [the funds] to disguise their true origin" by citing an actual case. *Id*. at 60626. Drug cartels purchased life-insurance policies with cash-surrender values through several brokers in an offshore jurisdiction. Cartel associates were named as beneficiaries on the policies, which were funded by narcotics proceeds forwarded to the insurance companies by third parties from around the world. The beneficiaries waited a few years and then surrendered the policies. Although the liquidation penalties rendered the cash-surrender value of the policies far less than the amount invested, this financial loss was outweighed by the fact that the cartels now had in hand laundered funds in the form of insurance proceeds.[3]

The same deposit, investment, and value-transfer features "do not exist in insurance products offered by property and casualty insurers." 67 Fed. Reg. at 60626. The holder of a property-casualty policy pays a premium to the carrier in exchange for a policy protecting that insured from third-party liability and first-party property claims covered by the policy. The premium paid for these policies, like payments made to purchase a car or a toaster, is *never* deposited or invested for the purchaser's benefit or use. The property-casualty insured has no right to a return of earned premium, no right to earned income on the premium, and no right to borrow against or transfer this premium to another. In fact, except for the return of unearned premium upon the mid-term limitation or cancellation of coverage, the policyholder has no monetary claim on the carrier absent a covered peril or loss:

> Property insurance indemnifies an insured whose property is stolen, damaged, or

---

of currency across U.S. borders.

[3]Note that the criminals in this case followed the paradigmatic money-laundering scheme. They "placed" or introduced illegal proceeds into the financial system, "layered" them, that is, disguised their origins by transferring them from one place to another, and then "integrated" or reintroduced them back into the economy in a sanitized form.

Note, too, that the "liquidation penalty" paid by the drug lords is precisely what distinguishes money laundering from fraud. The person committing fraud, unlike the money launderer, does not even pay this minimal amount into the economy as tribute to his dishonesty, but simply steals money or goods without paying for the privilege of having done so.

  ISBN 1056 3059

> destroyed by a covered peril. Casualty insurance provides coverage primarily for the liability of an individual or organization that results from negligent acts and omissions that cause bodily injury and/or property damage to a third party.

Id. at 60625

In addition, a property-casualty insurer's payment to the policyholder is fixed by the lower of the policy's limits or by the policyholder's actual loss. There is no mechanism in the property-casualty context, as there is in the life-insurance context, for "overpay[ing] the premium" in return for increased indemnity or investment payments.

In sum, Treasury took a practical, "functional approach" to the money-laundering possibilities inherent in these two kinds of insurance products and prudently included within the proposed rule life-insurance products possessing stored value and transferability and excluded from the rule property-casualty products not possessing these features.[4] The same functional approach, however, argues for excluding from the final rule those life-insurance products that do not possess stored value and transferability; for example, group-life insurance, credit-life insurance, and reinsurance.[5]

The Exemption of Independent Life Insurance Agents and Brokers. Although it acknowledged that insurance companies typically "conduct their operations through agents and third-party service providers," 67 Fed. Reg. at 60626, 60627, and 60628, Treasury exempted independent life-insurance agents and brokers from the Patriot Act. In so doing, it made life insurers "fully responsible" for these producers' violations of the Act, *id*. at 60628, and therefore requires them to "incorporate policies, procedures, and internal controls integrating its [independent] agents and brokers into its anti-money laundering program." *Id*. at 60627. Insurers in fact remain absolutely liable under the proposed rule even if they "delegate contractually" to producers, as the rule permits them to do, those aspects of their compliance programs that can "best be performed" by the producers. *Id*. at 60628.

Imposing absolute liability on insurers for the misdeeds of independent agents and brokers raises some concerns, however. As Treasury itself states, the independent producer "is in a unique position to observe the kind of activity that may be indicative of money laundering."[6] In fact, the independent producer acts as the eyes and ears of the insurance company during the most critical anti-money laundering moment of a carrier's compliance program: the point-of-sale of the policy. It is the independent producer who acquires insurance-related information from the buyer, who assesses the buyer's requirements, who recommends policies and companies, and who generally assesses the customer's *bona fides*. The insurer's obligation to "know your customer" and to meet other compliance obligations under the Act will therefore depend largely on the quality of the information supplied by the independent producer.

---

[4]Fed. Reg. at 60627. This "functional approach" also means that any property-casualty products that may in the future meet the money-laundering criteria set forth in the proposed rule would be subject to the rule. *Id*. at 60626.

[5]Group life policies are issued only to statutorily defined groups, usually employers. They limit eligibility for coverage and the amount of coverage per person. In addition, the policy, which pays only in the event a covered employee dies, is not transferable; nor is there typically any cash value. Credit life insurance pays off the bank or lending institution upon default occasioned by the borrower's death or disability; it is never paid to the borrower or to his heirs. Like property-casualty policies, coverage is only triggered upon the occurrence of a covered event. Though the borrower indirectly benefits from this insurance, the actual beneficiary is the bank or lending institution that receives the proceeds. Finally, reinsurance involves the transfer of risk from one insurer to another; policyholders are not parties to the reinsurance contract, which exists only between the two insurance companies. Though not impossible, money laundering would be extremely difficult through the use of reinsurance contracts.

[6]*Id*. Treasury states elsewhere that "In some cases, suspicious activity detected by agents — such as the lump-sum purchase of a life-insurance policy with multiple money orders or the purchase of annuity contracts by customers who express little or no interest in the details of such products, like surrender charges — may not be information that is normally known by the insurance company." *Id*.

  ISBN 1056 3059

Such reliance is problematic in today's marketplace. Unlike years past, when life insurers employed career agents who were completely loyal to the insurer and who were exclusively controlled by the insurer, life insurers today sell their products through multi-channel independent distribution systems. Life insurers typically permit their general agents to contract on their behalf with independent agents, brokers, and sub-brokers. However, these independent producers are one to three steps removed from the life insurer. Insurers absolutely liable for the money-laundering transgressions of their independent producers must now grapple with the real possibility that the information communicated to them has been intentionally or unintentionally compromised by one or more of the participants in this multi-tiered distribution system.

A related problem is that life insurers and independent producers must undertake a multi-dimensional approach to the analysis of information concerning a prospective insured, an approach that was largely irrelevant before September 11th. It is no longer enough, as it was before September 11th, to view information about an insured from purely a business or an underwriting perspective. Insurers and producers must view that same information from a money-laundering perspective as well. For example, a licensed scuba diver and airplane pilot presents not only an underwriting risk, but also, given today's realities, a terrorist or money laundering risk as well. Independent agents and brokers, whose commissions are based on the size and number of policies they sell, may be disinclined to look beyond the strictly economic dimension of a risk, or may be dissuaded from reporting suspicious information or observations. Indeed, an independent producer might be tempted to turn a blind eye to evidence of money laundering or to ignore such evidence altogether.

Because the proposed rule makes insurers solely responsible for the money-laundering mistakes of their independent producers, insurers must make determined efforts to ensure that their producers are complying with their anti-money-laundering programs. However, independent producers may be disinclined to abide by the compliance dictates of an insurer because they will not be liable for having failed to do so. In addition, independent producers simultaneously have contracts with many different insurers. This could generate confusion among independent producers as to their precise anti-money laundering responsibilities for any one insurer, invite a diluted allegiance to any one insurer, or tempt producers to rationalize away violations of one insurer's compliance program as not being a violation of another insurer's program.[7]

Detecting the connivance of independent producers in a money-laundering scheme is also difficult for the life insurer. The producer could, for example, compromise the "know your customer" information provided to the insurer to hide his or her illegal activities. Or he or she could "structure" a transaction by breaking down the customer's cash into numerous payments below $10,000, which do not trigger governmental reporting requirements or an insurer's money-laundering suspicions. A producer could also camouflage his activities by splitting the transactions among multiple insurers, making it difficult for any one insurer to detect the money laundering.

The American Council of Life Insurers states that it is impossible for life insurers to comply with the proposed rule because it "'completely relies on a mistaken assumption that life insurers have control over independent [agents]'" and "'inaccurately assumes the nature of various business relationships.'" But Treasury need not correct these and other inequities in the proposed rule by further regulating insurers or newly regulating independent producers. Rather, Treasury may activate a remedy embedded in the proposed rule: permit insurers that "delegate contractually" responsibilities to the independent producers to include in those contracts "hold harmless" or "indemnification" provisions. These would permit the insurer to shift liability to the producer for a producer-based violation of an insurer's compliance program that renders the insurer liable under the Patriot Act.

Conclusion. In sum, Treasury should reexamine if, how, and to what extent, life insurers can have recourse against independent agents and brokers whose compliance violations render them liable under the Patriot Act.

---

[7] Treasury has recognized this multiplicity of contracts and obligations between insurers and producers in stating that "The specific means to obtain such [relevant customer] information is left to the discretion of the insurance company, although Treasury anticipates that the insurance company may need to amend existing agreements with agents and brokers to ensure that the company receives necessary customer information." 67 Fed. Reg. at 60628.

ISBN 1056 3059