

Date of Hearing: April 9, 2013

ASSEMBLY COMMITTEE ON JOBS, ECONOMIC DEVELOPMENT AND THE ECONOMY

Jose Medina, Chair

AB 978 (Blumenfield) – As Introduced: February 22, 2013

SUBJECT: Financial Institutions: Iran Sanctions

SUMMARY: Requires the Commissioner of Financial Institutions (CFI) to prescribe regulations for licensees that maintain a correspondence account or a payable-through account with a foreign institution for the purpose of compliance, as specified, under the federal Comprehensive Iran Sanctions, Accountability, and Divestment Act of 2010 (Iran Sanctions Act). Specifically, this bill:

- 1) Makes findings and declaration that, among other things, state:
  - a) The U.S. has determined that the Government of Iran's continued development of unconventional weapons and ballistic missiles and its support of international terrorism represent a serious threat to the U.S., Israel, and other U.S. allies around the world.
  - b) The federal Iran Sanctions Act strictly limits the ability of foreign financial institutions to open or maintain correspondent accounts or payable-through accounts with U.S. financial institutions, if they are found to be assisting the Government of Iran in acquiring weapons of mass destruction, supporting terrorist organizations, subverting U.N. Security Council sanctions on Iran, launder money for the Government of Iran, or provide financial services for Iran's Revolutionary Guard Corp. These limits include civil and criminal penalties on U.S. financial institutions found to be assisting in Iran Sanctions Act violations.
  - c) It is within California's best interest to not engage in business with foreign companies that have business activities that benefit foreign states that commit egregious human rights violations, aid nuclear weapons proliferation, and supports terrorism.
  - d) In 2010, California enacted statute that prohibits companies with certain investments in Iran from entering into contracts for goods and services with state or local governments.
- 2) Requires the CFI to develop regulations that require certain licensees to establish due diligence policies, procedures, and controls that will assist them in recognizing when the Secretary of the U.S. Treasury has determined that the foreign financial institution is knowingly engaged in activities that are subject to sanctions under the Sanctions Act. These regulations would apply to licensees that maintain correspondence accounts and payable-through accounts with a foreign financial institution.
- 3) Requires licensees that maintain a correspondence account or a payable-through account with a foreign financial institution to annually certify that, to the best of their knowledge, the foreign institution is not knowingly engaged in activities that are subject to sanctions under the Iran Sanctions Act.
- 4) Includes a crimes and infractions disclaimer.

EXISTING FEDERAL LAW, the Iran Sanctions Act, requires the U.S. Department of the Treasury to prohibit, or impose strict conditions on, the opening or maintaining in the U.S. of a correspondent account

or a payable-through account for a foreign financial institution which the U.S. Department of the Treasury finds knowingly facilitates the efforts of the government of Iran to acquire or develop weapons of mass destruction, or provide support for organizations designated as foreign terrorist organizations. This includes the efforts of the Central Bank of Iran or any other Iranian financial institution, Iran's Islamic Revolutionary Guard Corps, and other individuals or third parties. In enforcement of this law against U.S. persons (including corporations), the law requires that the person accused knew or should have known that they were violating the act.

EXISTING STATE LAW:

- 1) Specifies that the CFI is responsible for the regulation and supervision of financial institutions licensed by the Department of Financial Institutions.
- 2) Defines a licensee to mean any bank, savings association, credit union, transmitter of money abroad, issuer of payment instruments, issuer of traveler's checks, insurance premium finance agency, and business and industrial development corporation that is authorized by the commissioner to conduct business in this state.

FISCAL EFFECT: Unknown

COMMENTS:

- 1) Author's Purpose: According to the author, "California continues to aid Congress in its efforts to increase economic pressure on Iran to cease its pursuit of nuclear weapons – one of the gravest threats to security in the Middle East and the world. In 2012, the Legislature passed AB 2160 which that became law to disallow investments in Iran from assets that would otherwise contribute to the evaluation of financial solvency of insurers operating in California. In 2010, the Legislature passed AB1650 that became law to prohibit state and local governments from contracting with companies known to be doing restricted business in Iran's energy sector, ensuring that California tax dollars do not support companies whose investments support Iran's nuclear program.

AB 978 would codify into state law the federal requirement that all state financial institutions certify that they have adopted policies, procedures and controls in accordance with rules established by the Office of Financial Regulation to detect and assure the financial institution does not knowingly maintain any correspondent accounts or payable-through accounts with any financial institution that does business with Iran or any other terrorist organization designated by the US Government. By requiring state-chartered financial institutions to follow a state certification process, California would continue to aid Congress in sanctions against Iran."

- 2) Framing the Policy Issues: This bill directs the CFI to develop regulations requiring licensees to establish policies to prevent the maintenance and opening of correspondent accounts and payable-through accounts with foreign financial institutions that knowingly assist Iranian institutions subject to sanctions under the Iran Sanctions Act. As increasingly sophisticated techniques are used by Iran to subvert economic sanctions, it is important that California establish a sufficient regulatory environment to address this matter of international concern, without disrupting legitimate commerce.

In making the case for higher scrutiny, the author states that subversion of U.S financial sanctions by Iran is a recognizable threat to national and international security. This analysis provides background

on the scope of economic sanctions imposed on Iran and their enforcement procedures, and details on techniques used by foreign financial institutions to subvert financial sanctions.

- 3) Resolution 1929 and the Iran Sanctions Act: In June of 2010, the United Nations Security Council adopted Resolution 1929, the fourth in a series of resolutions imposing sanctions on Iran for nuclear activities. Among its measures, Resolution 1929 calls on nations to prevent any financial service and to freeze any asset that could contribute to Iran's nuclear activities. More specifically, nations are also called upon to prohibit new banking relationships with Iran, including correspondent banking relationships, if there is a suspected link to proliferation. Since the adoption and implementation of the recommendations in Resolution 1929 by the European Union, U.S., Canada, Japan, South Korea, and others, Iran's access to the international financial system has been significantly limited.

One month following the approval of Resolution 1929, President Barak Obama signed the Iran Sanctions Act (July 2010), which further strengthened U.S. sanctions against Iran by specifically targeting its energy and financial industries.

- 4) Economic and Financial Sanctions: Under the Sanctions Act, imports of goods and services of Iranian origin into the U.S. (either directly or through a third country) are generally prohibited, with limited exceptions for personal items. Exports from the U.S. of goods, technologies, or services (either directly or indirectly) to Iran are also generally prohibited, unless licensed by the Office of Foreign Assets Control (OFAC). Exceptions are made for articles intended to relieve human suffering, such as clothing, food, and medical supplies. U.S. persons are also prohibited from facilitating any transactions with the intent of subverting the Iran Sanctions Act.

Financial transactions between U.S. and Iranian financial institutions are also generally prohibited. In some cases, funds transfers through third-country banks are permitted for several types of underlying instances, including: noncommercial family remittances, travel-related remittances, and transactions authorized by OFAC. U.S. persons are prohibited from engaging in any transactions with banks OFAC has identified for their involvement in the financing of either weapons of mass destruction or terrorism.

- 5) Use of Correspondent and Payable-Through Accounts: While targeted and coordinated efforts among nations have severely limited legal access to the international financial system, Iranian financial institutions continue to gain illegal access to U.S. financial institutions. OFAC has identified several evasive practices including the use of third-country exchange houses and trading companies and the use of correspondent accounts and payable-through accounts.

Lawful uses of correspondent accounts are important for international and foreign businesses because they allow these businesses to take advantage of services that may be performed more economically or efficiently by U.S. banks, which ultimately facilitates international trade and commerce. Though important to the international finance structure, these types of accounts are also susceptible to abuse because the end users of these accounts are not necessarily subjected to the same level of scrutiny that a U.S. financial institution would use on its own customers.

OFAC has found specific instances where Iranian institutions have accessed the U.S. financial system through the use of third-party financial intermediaries and other evasive practices. Examples include omitting references to an Iranian address, omitting Iranian persons from the originator or beneficiary fields, and through transferring funds through a third-country institution on behalf of an Iranian institution without referencing their involvement.

- 6) Types Financial Institutions Subject the Sanctions Act: The Sanctions Act is applicable to all banks that operate within the U.S., including foreign financial institutions that operate branches within the U.S. The Iran Sanctions Act also applies to money service businesses, trust companies, insurance companies, securities brokers and dealers, commodities exchanges, clearing corporations, investment companies, employee benefit plans, and U.S. holding companies, U.S. affiliates, or U.S. subsidiaries of any of these entities.
- 7) Enforcement procedures: The Iran Sanctions Act enforcement has two components with a different federal agency responsible for the implementation and enforcement of those sanctions:
- a) International Enforcement: Identification and subsequent blacklisting of foreign financial institutions that are acting as third-party intermediaries for prohibited Iranian interests is the responsibility of OFAC. OFAC enforces economic and trade sanctions against targeted foreign countries and regimes, terrorists, international narcotics traffickers, those engaged in activities related to the proliferation of weapons of mass destruction, and other threats to the national security, foreign policy, and the U.S. economy.

When alerted, OFAC investigates the foreign financial institution and makes a determination. If the foreign financial institution is found to be in non-compliance with the Sanctions Act, it is added to the list of Foreign Financial Institutions Subject to Part 561, also known as the "Part 561 list." U.S. financial institutions are prohibited from opening or maintaining a correspondent account or payable-through account with any institution on the Part 561 List.

- b) Domestic Enforcement: Establishment of due diligence policies for U.S. financial institutions, including state chartered institutions, is the responsibility of Financial Crimes Enforcement Network (FinCEN). FinCEN is charged with the detection and prevention of the misuse of correspondence accounts and payable-through accounts by third-party foreign financial institutions and can apply sufficient penalties to ensure compliance. FinCEN is also the primary agency that prevents and detects domestic and international money laundering and other financial crimes.

Though FinCEN is the agency in charge of determining the standard of due diligence required, FinCEN is well behind schedule for developing these regulations. U.S. financial institutions currently have no affirmative duties regarding the identification of Iran Sanction Act violators. The only enforcement mechanism in place (as of April 4, 2013) is the duty to inquire if FinCEN makes such a request.

Given the lack of affirmative action by the federal regulating agency responsible for U.S. based financial institutions, AB 978 fills a void by mandating the development of appropriate internal controls for state chartered banks. Existing law (§332 of the Financial Code), already authorizes the CFI to make changes through regulation in instances where federal laws or regulations applying to national banking associations are substantively different from the provisions of the state Financial Code. For clarity, the Committee may wish to specify that when the federal FinCEN regulations are adopted, the CFI review state regulations for possible conformity.

- 8) Penalties for Non-compliance with the Sanctions Act: Any foreign financial institution found to be in non-compliance with the Sanctions Act is added to the Part 561 List, severely prohibiting their ability

to engage in financial transactions with U.S. financial institutions. Federal laws also prescribes domestic penalties for any person that violates, attempts to violate, conspires to violate, or causes a violation of Sanctions Act may be subject to both civil and criminal penalties.

- a) Civil Penalty: A civil penalty may be imposed that is not to exceed the greater of \$250,000 or an amount that is twice the amount of the transaction that is the basis of the violation; and
- b) Criminal Penalty: A person that willfully commits, willfully attempts to commit, or willfully conspires to commit, or aids or abets in the commission of a violation shall, upon conviction, be fined no more than \$1,000,000 or if a natural person, may be imprisoned for not more than 20 years, or both.

State law prescribes lesser penalties for licensees including up to \$1,000 a day, provided that the aggregate penalty of all offenses in any one action against any licensee or subsidiary of a licensee shall not exceed \$50,000. Higher penalties may be applied if a licensee or subsidiary of the licensee that has been found to have recklessly (\$5,000 per day not to exceed \$75,000) or knowingly (\$10,000 per day not to exceed the value of 1% of total licensee assets) violated a law, order, condition, or written agreement, as specified. State law also authorizes the CFI to pursue other administrative actions, as well as court actions in order to enforce specified laws.

The author may wish to specify penalties and/or actions which the CFI is to take for violations determined pursuant to this bill, including higher penalties, notice requirements to FinCEN, and cooperating in any federal investigation.

- 9) Financial Privacy under California Law: Under Government Code Section 7470, no officer, employee, or agent of a state or local agency or department may request or receive copies of the financial records of any customer from a financial institution except under limited circumstances. Given California's stringent financial privacy laws, there is the possibility of conflict depending on the regulations.
- 10) Clarifying Amendments: AB 978 proposes the development of regulations to be used by licensees to comply with the Iran Sanctions Act. It may be helpful to more clearly define the purpose of each of the two regulations proposed in AB 978. As currently drafted, the first regulation appears to only address how to track U.S. Treasury actions and the second regulation requires a broad certification that the licensee is not doing business with foreign financial institution that knowingly violates any element of the Sanctions Act. The California's Bankers Association has also asked for more clarity around the certification issue. Further, it may be useful to address the use of third-country financial intermediaries in the regulatory process.
- 11) Related Bills: Below is a list of related legislation.
  - a) AB 1650 (Feuer/Blumenfield) Iran Contract Prohibitions: This bill prohibits California governments from contracting with companies doing restricted business in Iran. Status: Signed by the Governor, Chapter 573, Statutes of 2010.
  - b) AB 2160 (Blumenfield) Iran Investment Prohibitions: This bill prohibits investments in Iran from assets that would otherwise be considered when considering financial solvency to do business in California. Status: Signed by the Governor, Chapter 479, Statutes of 2011.

12) Double Referral: This measure was referred to two policy committees by the Assembly Committee on Rules. Should AB 978 pass the Assembly Committee on Jobs, Economic Development and the Economy, the measure will be referred to the Assembly Committee on Banking for further policy review.

REGISTERED SUPPORT / OPPOSITION:

Support

Jewish Public Affairs Committee of California

Opposition

None received

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