

Client Alert

Financial Markets Developments

Lloyds TSB Bank plc must pay US\$350 million for violating US economic sanctions laws. The penalties were imposed as a result of “deferred prosecution agreements” entered into on January 9, 2009. The underlying conduct involved “stripping” information from US dollar payment instructions that would have revealed to US banks that USD payments originated by Lloyds were for certain of its Iranian and Sudanese customers. This conduct, according to the charges, resulted in willful exportation of services from the United States to Iran and Sudan, which is prohibited by US economic sanctions regulations. The severity of the penalty in this case demonstrates that financial institutions, including non-US institutions that avail themselves of the US payment systems, must establish effective compliance programs to prevent these types of situations.

“Deferred Prosecution Agreements” (“DPA”) permit putative defendants in criminal matters to avoid charging and/or conviction by agreeing to financial penalties and certain standards of conduct for a specified period. Such agreements often require that the subject entity employ an independent outside monitor or consultant to report to the authorities on compliance with the terms of a DPA. Lloyds has agreed as part of its DPA to employ an independent consultant approved by the NY County District Attorney’s office to review and report on five years of transactions.

US Sanctions, Export Controls and Foreign Investment Controls

Lloyds Bank Pays US\$350 Million and Agrees to Deferred Prosecution for US Sanctions Violations, Other Banks May Follow

The United States Department of Justice (DOJ) and the New York County District Attorney’s Office recently revealed DPAs with Lloyds TSB Bank plc (Lloyds) requiring Lloyds to pay US\$350 million for violating US economic sanctions regulations targeting Iran and Sudan, as well as New York State Penal Law. The NY County District Attorney’s Office noted criminal probes are underway of other banks for similar conduct.

Background

The United States maintains comprehensive economic sanctions against Iran and Sudan that are administered by the United States Department of the Treasury’s Office of Foreign Assets Control (OFAC).

US sanctions targeting Iran prohibit US persons and entities from engaging in most business transactions relating to Iran, including importing or dealing in goods or services (including financial services) from Iran, investing in Iran, exporting goods, technology or services to Iran from anywhere in the world and facilitating, approving or assisting non-US persons with Iran-related transactions that US persons could not otherwise perform directly. These sanctions furthermore require financial institutions that qualify as “US persons,” whether or not located in the United States, to block assets of persons or entities that have been “specially designated” by OFAC. Moreover, OFAC



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regulations prohibit any transaction by US persons or persons within the United States that evades or avoids, or has the purpose of evading or avoiding, or attempts to violate any of the Iranian sanctions regulations. The sanctions restrictions also can apply to non-US entities and individuals in more limited circumstances. For example, where, as in this case, the activity of a non-US entity/person has a sufficient nexus with the United States, OFAC and other US authorities may find that such activity is brought within the prohibitions of the OFAC regulations.

US sanctions targeting Sudan are similar in most respects to those targeting Iran, except the restrictions apply to only part of that country and not to certain regions of Southern Sudan.

Lloyds' Dealings with Iran and Sudan

The following fact recitation is based on the publicly available documents regarding this case.

Lloyds in the UK maintained USD correspondent accounts for various London-based Iranian banks, providing USD payment processing services for these banks through relationships with other correspondent banks in New York and elsewhere in the United States.

Lloyds in the UK, along with the Tokyo and Dubai branches, also engaged in some 300 USD trade finance transactions valued at around US\$321 million (US\$300 million relating to Iran) involving banks from Iran and Sudan, as well as other OFAC-sanctioned countries. A number of the transactions involved exports of goods originating in the United States to Iran through third countries.

None of the payment processing or trade finance transactions on behalf of sanctioned countries were processed by Lloyds' US operations.

Following OFAC sanctions imposed against Iran in 1995, Lloyds in the UK began manually reviewing and altering payment messages received through the Society for Worldwide Interbank Financial Telecommunication (SWIFT) messaging system from UK subsidiaries of Iranian banks. In a process laid out in internal documents, Lloyds' staff was instructed to ensure that payment instructions sent to the United States did not contain the UK Iranian bank names—a process termed by Lloyds' staff as

“stripping.” Lloyds' Dubai and Tokyo branches also stripped Iranian bank information from transactions sent to US correspondent banks.

Senior Lloyds' staff raised concerns about the USD payment processing for the Iranian banks, which led to a review by senior management of Lloyds' policy. Following a risk analysis in 2003, Lloyds terminated its USD correspondent accounts business on behalf of Iranian bank customers by 2004. Lloyds continued “stripping” information about Sudanese banks from USD payment messages until January 2007, finally closing its Sudanese USD correspondent accounts by September 2007.

According to the NY County District Attorney, it discovered Lloyds' activities with banks in US-sanctioned countries through a criminal probe of an alleged Iranian front charity in New York.

Lloyds' Actions Found Criminal

Lloyds' removal of data from payment messages in order to avoid detection by US depository institutions of the fact that the payments related to Iran and Sudan, Lloyds has admitted, violated US law/OFAC sanctions and NY State law. The removal of this information prevented Lloyds' US correspondent banks from identifying certain payment messages as originating from Iranian and Sudanese banks. If the US correspondent banks had this information, they would have been required to reject or block the transactions in compliance with OFAC regulations.

Lloyds admitted violating the Iranian Transactions Regulations and Sudanese Sanctions Regulations that prohibit exportation of services from the United States to Iran and Sudan, respectively. While the principal sanctions restrictions against Iran and Sudan apply to US entities and individuals, the prohibition on exportation of services has been deemed to apply more broadly.

The DOJ concluded that Lloyds' use of US banks to service its Iranian and Sudanese customers constituted an exportation of services from the United States by Lloyds—even though none of Lloyds' US branches were involved. Further, Lloyds' systematic “stripping” of material information from the payment messages sent to banks primarily located in New York was found to constitute falsification of these banks' business records, in violation of New York law.

Lloyds' Agreements with the DOJ and NY County District Attorney

In its agreements with the DOJ and New York County District Attorney's office, Lloyds agreed to waive indictment, agreed to the filing of a one count criminal information in the United States District Court for the District of Columbia and acknowledged responsibility for its criminal actions. Lloyds further agreed to comply with the Wolfsberg Anti-Money Laundering Principles for Correspondent Banking.

Lloyds also agreed to employ independent consultants to conduct extensive reviews of its transactions from August 2002 through the closure of its US correspondent accounts for customers in Iran, Sudan and other sanctioned countries, among other things to verify whether any funds transfers related to OFAC "specially designated" persons or entities. Lloyds also agreed to take further steps to enhance its sanctions compliance programs.

The DOJ in turn has agreed to defer prosecution for two years and recommend dismissal of the charges at the end of that term provided Lloyds fully abides by the terms of the deferred prosecution agreements. Lloyds will pay half of the US\$350 million to the DOJ and the other half to the New York County District Attorney's Office.

A Lloyds' filing with the Securities and Exchange Commission indicates that discussions with OFAC regarding Lloyds' violations of US sanctions regulations are underway, which could result in further penalties. According to Lloyds, however, OFAC has agreed to credit the US\$350 million payment toward any OFAC-imposed fine, so Lloyds does not anticipate any payment to OFAC.

Financial Institutions Face Enormous Compliance Risk

Both US and non-US financial institutions face enormous compliance risk in connection with the US restrictions on commercial and financial dealings with countries subject to US economic sanctions. In today's financial transactions environment, compliance with US law and OFAC regulations are essential to appropriate risk management. Compliance with these requirements necessitates having, and closely observing, comprehensive compliance procedures. This should include having risk management compliance reviews conducted by credible outside sources. Non-US institutions with USD correspondent accounts or other business with USD payments must be especially cognizant of US sanctions rules, as the restrictions are not necessarily limited to transactions involving those institutions' affiliates in the United States. Any individual US persons working for a non-US financial institution also may be subject to OFAC sanctions no matter where in the world they work.

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