PEP-Talk: A Guide to Managing Risk from Politically Exposed Persons

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Trust is one of a company’s most important assets. A firm’s success relies on the trust of customers, investors, regulators, and employees. If that trust is lost, it suffers financial, legal, and reputational consequences. Sometimes it never recovers at all—just ask Mossack Fonseca, the company at the center of the Panama Papers scandal which folded in March.¹

A major risk to a company’s trustworthiness is how it deals with Politically Exposed Persons, or PEPs. Dealing with PEPs is very common—they can be a company’s customers and investors, or the officials deciding on its bid for a state contract. Most PEPs act lawfully. But their public positions expose them to a much higher risk of bribery and corruption than the average customer, investor, or third party. How much higher? Well, the U.S. Financial Crimes Enforcement Network (FinCEN) analyzed 1,300 reports of suspicious activity in the securities and future industries, money services businesses, and casinos and card clubs filings in 2009 and 2010. PEPs were involved in more than 90 percent of the reports.²

PEPs are individuals who have been entrusted with prominent public positions so if they fall short of the public’s expectations of their behaviour, they will lose people’s trust. Any company associated with an unethical PEP will also lose trust. Moreover, PEPs acting illegally are a major reason for corruption in a country, which can hold back its economy and political system and worsen the lives of its citizens. That is a heavy burden for a company to have on its conscience.

How can a company lessen this risk? Read on.
What is a PEP?

A person can be regarded as a PEP if they fall into any of the following categories:

- Legislative body members of parliament (or similar legislative bodies), members of the governing bodies of political parties
- Executive body heads of state, heads of government, ministers, deputy ministers, and assistant ministers
- Central financial auditors members of courts of auditors or of the boards of central banks
- Judicial body members of supreme courts, constitutional courts, or other high-level judiciaries
- Armed forces high-ranking officers
- Diplomatic body ambassadors, chargés d’affaires
- International organizations directors, deputy directors, and members of the board (or equivalent function) of an international organization
- State-owned enterprises members of the administrative, management, or supervisory bodies
- Known close associates of PEPs close business relations or joint beneficial owners of legal entities or legal arrangements, sole beneficial owners of legal entities which are set up for benefit de facto of the PEP
- Immediate family members of PEPs—parents and children, siblings, spouses/partners, in-laws, uncles and aunts

What is a PEP? A person can be regarded as a PEP if they fall into any of the following categories:
The clampdown on money laundering and corruption is the common responsibility of all the countries in the world.

Wang Zhaowen, formerly Bank of China

What are the risks of PEPs?

Bribery

PEPs hold powerful public positions and often make decisions over which companies should receive lucrative state-funded contracts. As a result, they are targeted by companies or individuals looking to influence where these contracts go by paying bribes.

The Monaco-based company Unaoil is facing a major ongoing investigation into bribery of PEPs. In May, the UK’s Serious Fraud Office brought new charges in their investigation into allegations that Unaoil made multi-million dollar payments to senior politicians in Iraq. The payments were said to help secure a $733 million contract for Leighton Contractors Singapore PTE Ltd to build two oil pipelines in the country. Unaoil has been the subject of a joint investigation involving regulators in the U.S., the UK and Australia.
Money laundering

PEPs who have taken bribes seek to launder this money to conceal it from the tax officials. PEPs are constantly finding new and sophisticated ways of money laundering, but the Australian government’s financial intelligence agency AUSTRAC has identified the five most common:

1. Using corporate vehicles and trusts to hide the PEP's beneficial ownership of illicit funds
2. Using third parties, often family members or close associates, to access the financial system
3. Using professional facilitators like lawyers, accountants and financial adviser
4. Using international fund transfers to move illicit funds outside their home jurisdiction
5. Using international trade in services payments to conceal foreign bribery payments, perhaps by disguising bribes as lucrative contracts to companies linked to PEPs
PEPs are prime targets of terrorist groups seeking a respectable front to help them to launder their funds. A bank might accept money from a PEP without realizing that it came from terrorism or will be used to support further terrorist activity. If a bank is found to have helped terrorist activity, even inadvertently, this could be a critical blow for its reputation.

“Terrorist groups use all the possibilities offered by our societies to guarantee their survival and to set up their operations. Tackling the anonymity of financial transactions is a difficult but terribly effective goal to identify actors and punish them but also to anticipate their projects.”

French President Emmanuel Macron, International Conference on Combating the Financing of Daesh and Al-Qaeda: No Money for Terror April 25-26, 2018
Global corruption and inequality

So far, we have looked at the financial risks of illegal conduct by PEPs, which exposes companies to enforcement action, fines, and reputational damage. If a PEP is seen to have laundered illicit funds through a bank or business enterprise, the organization will face serious questions about its due diligence process. It only takes one corrupt customer to bring down a financial institution or company.

But PEPs expose firms to an even wider risk of responsibility for holding back the development of poorer countries. By diverting and misusing public funds, PEPs entrench corruption and inequality around the world. The average income in countries with a high level of corruption is about a third of that of countries with a low level of corruption, according to the World Bank. In 2016, the World Bank found that $818 million worth of contracts and agreements to help countries had been affected by corruption. Illicit financial flows often fund drug and human trafficking in developing countries, which makes ordinary people’s lives even worse. Corrupt economies are unable to function properly, and all of society suffers.

By having a business relationship with an unethical PEP, a company can indirectly harm the lives of ordinary people in developing countries and spread global poverty and inequality. While many companies are pledging support to the United Nations’ Sustainable Development Goals, which aim to end poverty, unethical PEPs are a major obstacle to these goals being achieved. Customers, investors, and third parties increasingly expect companies to contribute positively to society. Associating with an unethical PEP can put a company on the wrong side of perhaps the biggest issues facing the world today.

“Corruption is a cancer, a cancer that eats away at a citizen’s faith in democracy, diminishes the instinct for innovation and creativity; already-tight national budgets, crowding out important national investments.”

Former U.S. Vice President Joe Biden, Remarks to Romanian Civil Society Groups and Students Bucharest, Romania, May 21, 2014
Financial institutions are obviously on the front line of determining who is a PEP, what the risks are, and what transactions may involve the proceeds of corruption.

James H. Freis Jnr, ex-director of FinCEN

The challenge for companies is that although the term has been written into many pieces of legislation, there exists no single, globally-agreed definition of a PEP. It differs depending on which law you consult and which country you are in. Companies have expressed concerns about this—in a consultation by the UK’s Financial Conduct Authority (FCA) last year, many responses called for more clarity on the definition and treatment of a PEP, noting that small firms do not have easy access to commercial lists of PEPs. The term is not even used in the U.S. Foreign and Corrupt Practices Act (FCPA) or the UK Bribery Act, which refer instead to “foreign officials” and “foreign public officials.”
The Financial Action Task Force (FATF) offers a broad definition of a PEP as “an individual who is or has been entrusted with a prominent public function.”\(^8\) A PEP can be any of the following:

- Individuals who are entrusted with prominent public functions. This includes heads of state, senior politicians, judicial or military officials and senior executives of state-owned corporations. Foreign PEPs are individuals who have been given these functions by a foreign country, domestic PEPs have these roles in their own country.

- PEPs in international organizations — these are individuals who have been entrusted with a prominent function by an international organization, such as senior management, directors and members of the board.

- Family members of a PEP, whether related through blood or marriage.

- Close associates who are connected to a PEP socially or professionally.

Further guidance comes from The Wolfsberg Group, an association of thirteen global banks which develops financial industry standards. It defines a PEP as anyone with the ability to divert public funds. This includes heads of supranational bodies like the UN and the World Bank, members of the boards of central banks, and ambassadors and diplomats. It warns that the definition of a PEP “should not be diluted by the inclusion of persons who may be in public life, but are not in a position to enrich themselves improperly.”\(^9\)

**Executive falls to PEPs risk**

The head of Samsung Group was imprisoned in South Korea in 2017 after being convicted of bribery, moving assets abroad illegally, and concealing evidence of criminal profit. Lee Jae-yong allegedly paid $37 million to a close friend of the president in order to secure regulatory approval for a merger of two Samsung units in 2015 and his smooth succession to the head of Samsung.\(^10\)
### Regulatory definitions of PEPs

Companies should adopt a broad and flexible understanding of PEPs, but they must also be aware of their legal definitions in different jurisdictions. In recent years there have been significant additions to the law and guidance relating to PEPs. Here are the most significant developments:

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<th>The U.S. FCPA and UK Bribery Act 2010</th>
<th>The European Union’s Fourth Anti-Money Laundering Directive (4AML), which companies were required to implement last year, expanded the definition of a PEP to include persons with a prominent public position domestically, as well as domestic PEPs who work for international organizations. The new directive requires companies to consider if a beneficial owner is a PEP, and to continue to apply enhanced due diligence on an individual for 18 months after they are no longer in public position, rather than the previous 12 months.¹²</th>
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<td>both make it illegal to bribe a foreign public official. The UK’s definition is narrower, but both agree that a PEP is anyone who holds a foreign legislative or judicial position, exercises a public function for a foreign territory, or is an official or agent of a public organization. The FCPA requires proof that the person offering the bribe did so with a “corrupt” intent, while the Bribery Act does not.¹¹</td>
<td>The EU’s Fifth Anti-Money Laundering Directive (5AML), which was published in June, requires EU member states to create a list of national public offices and functions that qualify as politically exposed. The European Commission will publish a new list of types of PEPs across the EU.¹³ This should make it easier for companies to determine who should be considered as a PEP.</td>
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The U.S. Financial Crime Enforcement Network (FinCEN) regulations require companies to carry out ongoing monitoring of customers who have carried out suspicious transactions. Guidance released in 2011 specified "enhanced due diligence obligations for private banking accounts that are established, maintained, administered or managed in the US for senior foreign political figures."\(^{14}\)

The UK’s Financial Conduct Authority released guidance last year that firms must apply a risk-sensitive approach to identifying PEPs, then apply enhanced due diligence measures. It advises that in the UK, firms should only treat individuals who hold prominent positions as PEPs, not officials in local government or more junior members of the senior civil service.\(^{15}\)

The UK Criminal Finances Act came into force in September 2017 to help enforcement agencies to prevent terrorist financing and tackle money laundering. It allows regulators and prosecutors to apply to the High Court for an ‘unexplained wealth order’ (UWO), which requires a PEP or other individual to explain the origin of assets valued greater than £50,000 if these appear to be disproportionate to their lawful income. This assists investigators by shifting the burden of proof from investigators to the investigated.\(^{16}\)
Where is PEP Risk the Greatest?

Not all PEPs are equal in terms of their risk of committing financial crime. When deciding whether to do business with a PEP, a company should consider the country in which the PEP operates, and the industry in which they work.

By country

Transparency International’s Corruption Perceptions Index shows that the risk of public sector corruption is higher in emerging economies, where bribery is often seen as a cost of doing business. Countries in Africa and the Middle East are the highest risk.17 Countries with the lowest levels of public sector corruption tend to have stronger press freedom, access to information about public expenditure, and independent judicial systems.

The FATF publishes a list of jurisdictions at the highest risk of money laundering and terrorist financing, which it updates three times a year.18 In its latest updates, it raised Pakistan to a “grey” level of risk as a potential a source of terrorism financing and warned of the risk of financing weapons of mass destruction in the Democratic People’s Republic of Korea.

The top ten countries rated lowest and highest for public sector corruption:

Lowest:
- New Zealand
- Denmark
- Finland, Norway, Switzerland
- Singapore, Swede
- Luxembourg, Netherlands

Highest:
- Somalia
- South Sudan
- Syria
- Afghanistan
- Yemen, Sudan
- Libya, North Korea, Guinea-Bissau, Equatorial Guinea
By industry

In late 2014 the OECD released an analysis of the 427 foreign bribery cases it concluded since its Anti-Bribery Convention was enacted in 1999. It found that the highest percentage of bribery cases occurred in the industries of extraction, transport and storage, and construction. Additionally, bribes made up more than 15 percent of the total value of transactions within the retail and manufacturing sectors. Health, communication and public administration and defense were also singled out as sectors at risk.¹⁹

These sectors are especially vulnerable because of the central role of PEPs in business operations. Extraction and construction firms cannot explore or build in new areas unless they receive permits from local, regional and national government officials, so bribes are used to get permissions. Similarly, transportation and storage companies need to move goods across many countries, some of which are highly regulated. Officials and agents have the authority to block or approve this movement.²⁰

Where PEPs hold powerful roles, bribery often follows.
Costs of missing PEPs risk

PEPs and beneficial ownership

In 2016, 11.5 million documents of shareholder information created by the Panama-based law firm Mossack Fonseca were leaked to the media. The documents included the names of 140 politicians from more than 50 countries. Although most PEPs had done nothing illegal, the Papers highlighted the ways in which offshore entities can be used for crimes such as tax evasion and money laundering.

It was revealed that Iceland’s Prime Minister Sigmundur Davíð Gunnlaugsson had not disclosed that he used to hold a 50 percent stake in a company which owned bonds of one of Iceland’s bankrupt banks. He later sold this share to his wife, who should also be treated as a PEP according to FATF guidelines. This was seen as a conflict of interest given that the Prime Minister had negotiated with creditors of the failed banks on behalf of the country, and he resigned in shortly after the disclosure. The Papers also revealed that Rami Makhlouf, a cousin of Syrian president Bashar al-Assad, circumvented U.S. sanctions against him by setting up six businesses through Mossack Fonseca.

PEPs, money laundering & real estate

London’s property market has long been a target for PEPs looking to launder illicit funds. But that is becoming harder thanks to the new Criminal Finances Act. Earlier this year, the National Crime Agency secured its first UWO over two properties worth £22 million that were believed to be ultimately owned by a politician from central Asia. The PEP’s assets have been frozen while the investigation takes place. “UWOs ... enable the UK to more effectively target the problem of money laundering through prime real estate in London and elsewhere,” said the NCA’s head of economic crime, Donald Toon.
Hiring PEPs to gain advantages

Cash isn’t the only way a PEP can take a bribe. Companies sometimes seek to influence PEPs by giving jobs to their associates in reward for unethical behaviour. Banking group Credit Suisse agreed to pay $47 million to the U.S. Justice Department in June 2018 to end an FCPA investigation into its hiring practices in Asia. Credit Suisse allegedly hired people who had been referred by government agencies or other state-owned entities in exchange for business or regulatory approvals.

Allegations like this are increasingly common in the banking sector. In 2016 JPMorgan Chase agreed to pay a penalty of $264 million after awarding jobs to relatives and friends of Chinese government officials to win banking deals. A year earlier, BNY Mellon paid $14.8 million after providing internships to family members of officials connected to a Middle Eastern sovereign wealth fund.²³

“Awarding prestigious employment opportunities to unqualified individuals in order to influence government officials is corruption, plain and simple.”

Leslie R. Caldwell, former Assistant Attorney General
Criminal Division, U.S. Department of Justice
PEPs a bitter pill for pharma company

In 2016, Teva Pharmaceuticals, the world’s largest manufacturer of generic drugs, was subject to the second largest FCPA settlement ever—a criminal fine of $283 million, as well as a $236 disgorgement of profits. The enforcement action was a result of FCPA offenses related to PEPs in the Ukraine, Russia, and Mexico. In the Ukraine, the cause was a government official who received $200,000 in monthly consulting fees and travel expenses. Similarly, in Russia, Teva used a repackaging company owned by a Ministry of Health, funneling nearly $65 million to the official. And in Mexico, Teva’s payments to 10 government doctors ended up a major PEP headache.

“Public interest is not just the responsibility of public authorities like regulators; rather it is firstly the responsibility of firms, their managers and owners.”

Andrew Bailey, Chief Executive of the UK Financial Conduct Authority (FCA), Transforming Culture in Financial Services Speech, March 19, 2018
Recovering from a PEP Scandal: Operation Car Wash/Odebrecht

One of the biggest PEP bribery cases in history involved the Brazilian construction firm Odebrecht. Last year, it paid $3.5 billion to the American, Brazilian and Swiss anticorruption authorities to settle allegations of paying hundreds of millions of dollars in bribes to secure lucrative state contracts from PEPs in Brazil. It was claimed that senior figures in the company were too close to PEPs.

But in the last year, Odebrecht has been praised for transforming its approach to compliance. At the heart of these changes are measures to limit the influence of PEPs within the company. Members of the Odebrecht family are no longer be eligible to be chairperson of its board of directors. Board members cannot serve for more than four two-year terms. One fifth of the members of Odebrecht companies’ boards of directors must be independent, and a new ethical and compliance hotline is managed by an outside firm. Time will tell if this commitment pays off but within the last year the company has halted its sharp decline in profits since the scandal emerged.
What should companies do?

In view of the risks posed by PEPs, you might wonder whether you should associate with them at all. But refusing to associate with PEPs altogether, a practice known as ‘derisking’, can hobble an organization from achieving its strategic goals. For example, PEPs can be some of banks’ wealthiest customers. Companies must take a risk-based approach to engaging with PEPs, seeking as much information as possible on PEPs and the level of risk they pose. Higher-risk PEPs merit enhanced due diligence checks and ongoing risk monitoring. Here are some ways to mitigate PEP risks effectively.

Know your customer — A corrupt customer can ruin a financial institution’s reputation and expose it to legal and financial penalties. Companies must do all their can to identify PEPs among their lists of current and prospective customers and associates. This presents a challenge because, although governments maintain lists of sanctioned individuals, there is no universal list of PEPs. But there are commercial PEP-screening databases which monitor sources including global media and public records to provide information about thousands of high-risk and sanctioned individuals and entities.

Defining your PEP policy:

1. Identify which titles you consider to be ‘politically exposed’, taking into account your local regulator’s definition of a PEP.
2. Assess how prominent each PEP is. Are they heads of state, diplomats, judges?
3. Consider where the PEP is based. Are they in a high-risk jurisdiction or are they in a country with a reputation for strong anti-bribery and AML policies?
Establish a PEP’s source of wealth — This is not only a recommendation of the FATF but increasingly expected by regulators. For example, the FFIEC Bank Secrecy Act/AML Examination Manual recommends identifying the account holder and its beneficial owner, asking the individual directly about their PEP status, their employment or other sources of funds, the purpose of the account, and the expected volume and nature of account activity. Accessing corporate hierarchy data can help identify indications of beneficial ownership, such as shell companies.

Take a risk-based approach to assessing PEP risk — Where accounts with a PEP risk are identified, they should be subject to enhanced monitoring to detect suspicious activity. Enhanced due diligence should be carried out on PEPs whose accounts show suspicious activity, or who operate in high-risk jurisdictions and industries. For example, the UK’s FCA advises companies that domestic PEPs carry a lower risk of money laundering and corruption than foreign PEPs.

Carry out ongoing monitoring — Relationships with existing PEPs should be regularly reviewed and due diligence information should be updated. A decision should then be made on whether the risk assessment for a particular PEP remains the same. If an individual loses their position which made them a PEP, monitoring of them should continue for 18 months afterwards.

Train staff, and set a clear tone from the top — Staff members should learn how to identify clients who are PEPs as part of an AML training program. They should be encouraged to consult with senior management before beginning or renewing a relationship with a PEP.

Harness technology — Firms should take advantage of technology to support the monitoring of information from a wide range of sources. Databases can quickly and cost-effectively screen thousands of customers against sanctions lists, PEP lists, adverse media, and enforcement data. They can provide enriched data on PEPs and use analytics techniques to increase the accuracy of screening rates and reduce the impact of false positives. Machine learning and natural language processing can also enable firms to spot suspicious transactions and assess their risk.26
**How can LexisNexis® help?**

Our versatile technology and comprehensive global intelligence empower companies to identify, assess, and mitigate PEP risk.

- Screen financial transactions and customer files and look up individuals against a global collection of sanctions lists, PEPs, adverse media, and enforcement data.

- Reduce false positives with enriched data that drives the highest level of AML compliance.

- Improve your screening processes using the industry’s largest database of high-risk entities involved with money laundering, arms proliferation, drug trafficking, and other high-risk activities.

- Provide access to the data firms need to remain compliant – some of this data is not found on public lists.

With better insights, companies can make informed, data-driven decisions. Because good profit comes from making the right strategic decisions.
Endnotes


Endnotes Continued


For More Information

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