

White Paper

Anti-Money Laundering controls in Mergers & Acquisitions

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Caveat emptor... let the buyer beware. An integral element in today's corporate transactions such as Mergers/Acquisitions is due diligence that includes anti-corruption, anti-money laundering, sanctions, and criminal and regulatory risk. Its importance only increases as governments and international regulators expand their enforcement efforts.

Due diligence is a term used for a number of concepts involving either an investigation of a business or person prior to signing a contract, or an act with a certain criteria of review. It can be a legal obligation, but the term will more commonly apply to voluntary investigations. A common example of due diligence in various industries is the process through which a potential acquirer evaluates a target company or its assets for acquisition. Another process, which is often looked over, but we strongly suggest for consideration is the process of evaluating the background of vendors and senior level management of that target company. In simple terms, due diligence is the process applied to understanding who you are doing business with and what potential risks do they pose to your organization. Asking tough questions is key to the due diligence process.

In Mergers/Acquisitions considerable analysis needs to be done to assess the financial performance, risk management practices, and the quality of its assets. While the primary focus is usually on asset quality and earnings, one area that may not get the appropriate attention is the target's compliance program.

Ignoring compliance risks is really at your liability. The best-case scenario can lead to surrendering ill-gotten profits and payment of penalties. At worst, it can lead to brand damage, litigation and constraints on your operations.

Compared with a decade ago, there is greater potential today for unseen and undervalued risks that could delay an otherwise sensible merger or acquisition.

With the aggressive timelines that companies often take on for the closing of transactions—which are more compressed now than they were in the past—due diligence may be condensed. This accelerates the M&A process but also increases the risks that the acquiring company will not fully identify the target company's historical and ongoing obligations, in addition to the risk of entering into a relationship that is plagued with poor vendor and employee oversight and knowledge, which will undoubtedly translate into the need for greater investment than anticipated or negotiated.

Regulators in several jurisdictions have heightened their awareness of the legal and financial risks accompanying M&A transactions. Economic uncertainty has led both the Securities and Exchange Commission (SEC) and regulator groups to become increasingly vigilant in pursuing their concerns about the anti-competitive implications of potential M&A deals. The implementation of the Dodd-Frank Act and the JOBS Act (Jumpstart Our Business Startups) require target companies to provide their prospective acquirers with greater financial statement information. These are considerable obstacles that M&A participants 10 years ago did not confront.

If successor liabilities are not identified, assessed, and mitigated, they may remain concealed and become issues for the acquirer later on. They also may create surprises that were not accounted for in the purchase price and sale agreement which might have resulted in a different price or prevent the transaction to occur.

Adding to these regulatory implications, the FATF-GAFI makes it a priority, as an essential criteria of its 40 Recommendations, to know the **ultimate beneficial owners** of a transaction or relationship, a process that inherently requires an enhanced due diligence methodology.

M&A transactions fail for many reasons: regulatory issues, integration issues, economic factors and market factors. Another key reason is post-closing disputes. This could be a result of **unidentified risks** at the target company. Most research indicates that M&A activity has an overall success rate of about 50%. While economic and market factors are not controllable, certain factors leading to transaction disputes can often be mitigated with careful due diligence and attention to detail prior to signing the purchase agreement. The list below includes areas to be considered.

Compliance Program Risk Inventory:

- Accounting Fraud/Earnings Management
- Antitrust/Competition Law
- Confidential Information
- Conflicts of Interest
- Consumer Protection
- Document Management/Retention
- Employment/Labor
- Environmental
- Government Contracting
- Harassment
- Intellectual Property
- Money Laundering
- Political contributions/Bribery/Lobbying
- Privacy
- Product/Service Safety
- Purchasing
- Securities
- Taxes
- Wages
- Workplace Safety and Health
- Workplace Violence and Security

Every institution has a unique risk profile, reflecting its distinctive style and organizational structure, control environment, and business activity. Each institution should conduct its own analysis of the risks involved in its activities and ensure that it has adequate resources to identify and manage those areas with the greatest risks. To this end, institutions should implement **dedicated compliance programs** and ensure they are customized to the organization's **risk profile** and business operations.

An initial question that must be asked in reviewing M&A transactions from a risk management point of view is whether the constituent institutions have formal risk management systems and frameworks in place. A **formalized risk assessment** and analysis process should be in place for identifying, understanding, prioritizing, measuring, monitoring and reporting on risk. This process should be done on a continual basis.

Elements of the risk evaluation:

- The level of management commitment and oversight to risk management
- The extent of buy-in to the risk management process at the board of directors' level

- The adequacy of policies, procedures and limits and the extent to which they are documented, detailed and actually implemented
- The description of risk responsibilities and accountability and whether risk management is built-in at business unit and enterprise levels
- The adequacy of the monitoring and reporting processes and the related integration of information systems.
- The existence of business interruption plans and back-ups
- The level of compliance and internal controls

By integrating a risk management focus into the due diligence process it changes the focus in very important ways:

- The objective is to gain insight, not merely information
- It analyzes the information, not merely extract
- Strategic approach versus a transactional approach
- Proactive and offensive, rather than defensive
- It is concerned with risk prioritization, not just issue identification
- It takes a contextual approach toward tasks, rather than just a documentation approach
- It undertakes to evaluate and test information, not just verify
- It looks toward the integration of the entities, not just their combination

A key step in the due diligence process is the review of the seven elements of an effective compliance program, as described in the Federal Sentencing guidelines:

- Establish policies, standards, and controls
- Board oversight – Tone at the top
- Reporting
- Education, training and communication
- Monitor compliance programs for effectiveness.
- Consistent enforcement
- Respond to violations – Disciplinary process

And when it comes right down to dotting the “i’s” and crossing the “t’s” here is what we have found to be important questions acquirers often fail to ask:

1. What legal and financial exposures will accompany the acquisition?
2. Will the acquired company’s insurance policies be adequate in terms of absorbing prospective and retrospective financial liabilities?
3. What type of environmental liabilities does the target company face?
4. Will the company need an environmental cleanup in the future?
5. What are the terms and conditions of the target company’s Director’s & Officer’s (D&O) policy?
6. Are there any statute of limitation issues affecting the target company’s D&O policy?
7. Does the new company now have a different risk appetite?

Here are a few warning signs to look for during the due diligence process:

- Ineffective compliance program elements
- Company in financial difficulty

- Frequent breach of policies and procedures
- Inactive compliance and ethics committee
- No access to the Board
- No regular reports to the Board
- CCO not allowed direct access to the Chief Executive Officer (CEO)
- Lack of independence
- Frequent requests to waive policies
- No consistent consequences for violations from management

A critical area to include in the due diligence process is a thorough review of the organization's BSA/AML compliance practices, as its clients will become your clients, and its transactions will be flowing through your organization.

Specific AML Due Diligence:

- Evaluate BSA/AML/Fraud risks of the target entity when considering a merger or acquisition
- AML/CFT review should be part of your due diligence process, similar to loan review
- Read prior examination reports
- Assessment of the target's AML/CFT compliance program. At a minimum, an AML/CFT program should provide the following:
 - A system of internal controls to ensure ongoing compliance
 - Independent testing of AML/CFT compliance program
 - Designation of an individual or individuals responsible for managing AML compliance
 - Adequate training for appropriate personnel
 - Periodic review of monitoring system and procedures
- Gauge the compliance culture; tone at the top
- Assess if the acquisition or merger changes your AML/CFT risk profile
- Develop a plan and timeline to incorporate the target organization's AML/CFT program into your own program
- Acknowledge and plan for additional Customer Due Diligence and Enhanced Due Diligence after acquisition

Due diligence is an integral aspect of a merger and acquisition transaction. Being proactive and ensuring Compliance has a seat at the table during M&A planning; conducting the proper due diligence and digging deeper into the detail is what **separates successful transactions from expensive failures**. Recent cases of M&A have shed some light on the need to dig deeper and perform various levels of due diligence; for instance the merger between Washington Mutual, a savings and loan association in the US, and JP Morgan Chase resulted in years of extensive customer due diligence endeavors that, given the resulting regulatory issues facing JP Morgan Chase today, it is obvious that the quality of customer due diligence was not fully addressed and adequately represented at the negotiating table.

About the authors

Ana Maria H. de Alba is the President and CEO of CSMB, a risk management and banking consultancy headquartered in Miami, Florida and offices in Panamá, Republic of Panamá. Her experience spans more than 28 years in the financial services and consulting industries leading projects in financial crime investigations, risk and risk mitigation, due diligence in support of mergers and acquisitions, and independent evaluations of internal controls, as well as a broad range of employee and Board of Director training. As a former senior banking officer, Ms. de Alba worked in both domestic and international banking. As a consultant she has led and participated in multiple engagements, providing her services to internationally recognized business intelligence and security firms, in a wide range of business sectors that include the financial services industry as well as government entities throughout the USA, Latin America, and the Caribbean. Ms. de Alba is a recognized and frequent speaker at numerous international conferences, where she has exposed on issues related to risk mitigation and internal controls.

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