

SDNY Ruling Highlights Fed's Broad Master Account Power

By **Peter Hardy, Ronald Vaske and Siana Danch** (January 3, 2024)

Having a master account with a Federal Reserve bank is critical to any bank operating in the U.S. financial system.

A recent and complicated order issued by the U.S. District Court for the Southern District of New York in *Banco San Juan Internacional Inc. v. Federal Reserve Bank of New York*^[1] exemplifies just how much discretion the Federal Reserve banks can have over such accounts, and how access to a master account can turn upon regulators' perceptions of alleged anti-money laundering failures.

The Oct. 27 order denied a motion for preliminary injunction by Banco San Juan Internacional Inc., a Puerto Rican bank entity, against the Federal Reserve Bank of New York and the Federal Reserve Board.

The case arose out of the New York Fed's decision to close BSJI's master account for alleged deficiencies in its AML compliance program, which, according to the New York Fed, posed undue risk.

The court held, among other rulings, that there is no statutory right to a so-called master account with a Federal Reserve bank.

Given the critical role of having a master account, the FRBNY's decision, and the court's order, in effect prevent BSJI from operating, subject to a reversal on appeal.

Although understanding the facts is important, the order makes broad legal pronouncements, many of which are not necessarily tied to the precise alleged facts. Thus, the order emphasizes the significant and unilateral powers of a Federal Reserve bank and its broad discretion to provide or deny master accounts.

These powers apply to all financial institutions, which must take a serious approach to meeting their AML obligations under the Bank Secrecy Act.

Background

This matter does not arise out of a vacuum. In 2020, BSJI and the U.S. Department of Justice reached an agreement^[2] that the DOJ would return approximately \$53 million in seized funds to BSJI, and that BSJI would pay \$1 million.

The agreement settled the DOJ's investigation into the adequacy of the bank's BSA/AML compliance program, particularly in regard to the filing of suspicious activity reports.

BSJI is neither a federally insured institution nor subject to prudential federal supervision. Rather, it is an international banking entity under Puerto Rican law.

Based on BSJI's status as an international banking entity, it is subject to the strictest level



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of review and must demonstrate that it has implemented an effective BSA/AML compliance program through "the submission of independent consultants' assessment reports of BSJI's compliance program" to maintain a master account.

The Puerto Rico Office of the Commissioner of Financial Institutions supervises and regulates Puerto Rico's financial sector for safety and soundness issues, as well as all other applicable laws and regulations.

As the order observed, the U.S. Department of the Treasury has claimed that the OCIF has "severe resource constraints" and that international banking entities are "attractive money laundering vehicles, potentially allowing nefarious actors to misuse them to facilitate illicit financial activity."^[3]

Also, the order found that international banking entities pose heightened risk to the FRBNY, because their access to master accounts could cause the FRBNY to facilitate illicit activity.^[4]

The Powers of a Federal Reserve Bank

The order laid out several key principles and powers governing Federal Reserve banks. For one, the order underscored that Congress gave Federal Reserve banks "the authority to accept or reject deposits from depository institutions" — commonly called "master accounts."^[5]

That statutory power provides that "[a]ny Federal reserve bank may receive from any of its member banks, or other depository institutions ... deposits of current funds in lawful money."^[6]

The order further explained that master accounts are created when an account holder executes a master account agreement setting forth the terms under which a master account can operate, including — and crucial to BSJI's motion disposition — "the Federal reserve bank's right to terminate a Master Account 'at any time.'"^[7]

This wording strongly foreshadowed the court's emphasis on the role of contract law principles, in regard to a nonnegotiable contract written by the government, which banks must accept in order to function.

The Powers of the Board

The order explained that the Board of Governors, unlike the Federal Reserve banks, does not have the authority to provide services relevant to banking, and instead, provides general oversight of the activities of the Federal Reserve banks, including guidance with respect to master accounts.^[8]

The board has no authority to open or terminate a master account.^[9]

The order mentioned the board's Guidelines for Evaluating Account and Service Requests, published in August 2022.^[10]

As relevant to BSJI, the court did not find clear error that BSJI violated Principle 5 of the guidelines: the "provision of an account and services to an institution should not create undue risk to the overall economy by facilitating activities such as money laundering, terrorism financing, fraud, cybercrimes, economic or trade sanctions violations, or other illicit activity."^[11]

Warnings to BSJI

Based on the facts recited in the order, BSJI's troubles began in 2019 when, as previously noted, the DOJ seized a substantial amount of funds at BSJI. The FRBNY suspended BSJI's master account at that time.

In 2020, BSJI agreed to pay a penalty to the DOJ and improve its AML policies.

To that end, in March 2020, BSJI and the FRBNY entered into supplemental terms which, in the order's words, "reconfirm[ed] the FRBNY's right to close BSJI's account." The FRBNY restored BSJI's master account in December 2020.

In 2022, the FRBNY notified BSJI that it had breached the supplemental terms: BSJI had failed "to submit on time three mandated assessments attesting to the effectiveness of its compliance programs."

As a result, the FRBNY "concluded BSJI poses undue risk to the New York Fed due to, among other things, this noncompliance," and informed BSJI that its master account would be closed in September 2022.

In the following months, BSJI continued to provide more information on its AML program. The New York Fed conducted an internal review of BSJI's compliance programs and ultimately determined that "BSJI posed undue risk under Principle 5 of the Board's Guidelines and that this risk could not be effectively mitigated with additional controls."

One notable deficiency was that BSJI did not file any suspicious activity reports on any transaction activity reviewed by an outside consultant. The court found this "particularly concerning given the 'large inflows from shell companies in high-risk jurisdictions, owned by related parties of BSJI's owners.'"

BSJI was informed of the master account termination in an April 2023 letter, which listed compliance deficiencies that led the FRBNY to conclude that "continuing to provide a master account and financial services to BSJI poses undue risk to the overall economy by facility activities such as money laundering, economic or trade sanctions violations, or other illicit activities."

BSJI commenced suit. BSJI filed a complaint against the FRBNY and the board seeking, among other causes of action, a preliminary injunction against the FRBNY and a declaratory judgment that its Fifth Amendment due process rights were violated.

BSJI Did Not Meet Heightened Standard for Preliminary Injunction

A moving party seeking to stay government action taken in the public interest must satisfy a heightened standard: irreparable injury plus a likelihood of success on the merits.

The heightened standard applied in this case because the FRBNY, a federal instrumentality, determined to close BSJI's master account to mitigate alleged risk to the overall economy.

With respect to irreparable harm, BSJI contended that closing its master account and terminating access to the Federal Reserve System's services would cause BSJI to lose customers and cease existing.

The court found BSJI's reliance on a reduction in customers during the 22-month

suspension period — February 2019 to December 2020 — unavailing because it was BSJI's strategic decision to reduce certain customer accounts.

BSJI's customer base was now closely allied with the bank's owner, and BSJI's argument of irreparable harm was, in the court's view, self-serving speculation.

The order concluded that BSJI also failed to meet the second requirement because Title 12 of the U.S. Code, Section 342 "makes clear that Federal reserve banks are authorized to maintain Master Accounts, but are not required to do so." [12]

The court found none of BSJI's statutory arguments under Title 12 of the U.S. Code, Section 248 — a statute setting a fee schedule — and Section 342 convincing, and further found that no statute provides that the Federal Reserve banks lack power to terminate a master account.

Furthermore, by executing the master account agreement and the supplemental terms, BSJI "specifically agreed that the FRBNY had the right to terminate that account" and the FRBNY "specifically relied on its contractual rights when it terminated BSJI's Master Account in 2023."

The court therefore denied BSJI's motion for preliminary injunction against the New York Fed.

The court also agreed with the board that BSJI did not have standing to seek a preliminary injunction against the board. While the board exercises supervision over Federal Reserve banks, it has no power to open, administer or terminate master accounts — that is the purview of a Federal Reserve bank, and the New York Fed in this case.

BSJI's Due Process Rights Not Violated

In its complaint, BSJI asserted that it had a property interest in the master account under the Fifth Amendment, and that the FRBNY and the board had not afforded BSJI the requisite procedures, including a meaningful opportunity to be heard.

The order rejected the argument as an erroneous statutory interpretation. According to the order, the relevant statutes provide the FRBNY with discretion to open and terminate a master account, which meant that BSJI was not entitled to a master account and did not have a protectable property interest in the account. [13]

The order further found that the FRBNY had given BSJI opportunities to be heard, and, contrary to BSJI's claim, it was not denied a full and fair opportunity to be heard on the FRBNY's decision to close the master account. [14]

Even though the court already held that there was no protectable interest, it went out of its way to make a finding as to the account closing process. [15]

Takeaways

It is obviously important that this case involved an international banking entity located in Puerto Rico. They are subject to the strictest level of review and have been specifically identified — fairly or not — by the Treasury Department as "attractive money laundering vehicles," and therefore, have become the subject of unwelcome scrutiny.

Nonetheless, the legal conclusions of the order are broad and are not necessarily limited to the specific context of this case. In particular, the order stresses that Federal Reserve banks may terminate master accounts at any time under the express language of the general master account agreements — which are used for all banks regulated by the Federal Reserve, not just international banking entities.

These include bank holding companies, state member banks, savings and loan holding companies, and foreign banks operating in the U.S.

If the order is not overturned on appeal, the Federal Reserve banks obviously will rely on it heavily to insulate decisions to revoke, or deny in the first instance, master accounts.[16]

Relatedly, the order reiterates the concerns of the New York Fed regarding transaction activity reviewed by an outside consulting firm.

The implicit message is that the outside consulting firm identified potential AML compliance failures — here, a lack of required suspicious activity report filings — about which the bank failed to act in an adequate fashion.

This is a perennial issue in AML compliance and enforcement. The BSA requires covered financial institutions to undergo independent testing as to AML functions, which often leads financial institutions to hire outside consultants. Nonprivileged reports are generated.

A consultant's AML audit report can run the spectrum, from being too high-level because of lack of sophistication or a desire to please the client, to being too critical because the consultant is motivated to obtain remediation work or, if nothing else, justification for its role.

Both are potentially problematic, and a critical report — whether objectively accurate or not — will be turned into a weapon by the government.

More generally, this matter also illustrates how a financial institution can resolve an AML enforcement action with the DOJ, with seeming success, only to find itself still facing an existential threat posed by a regulator for the same underlying activity.

Sometimes, the converse can be true as well — a bank can have years of satisfactory examinations, only to discover that one day, the DOJ believes that the same conduct which regulators did not find objectionable may merit criminal investigation and potential prosecution.

The DOJ and banking regulators are very different creatures with very different standards, agendas and respective skill sets.

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[1] Banco San Juan Internacional, Inc. v. Fed. Reserve Bank of N.Y. ("BSJN"), 23-cv-6414, 2023 U.S. Dist. LEXIS 193296 (S.D.N.Y. Oct. 24, 2023). See order.

[2] Department of Justice, Bank Of San Juan Internacional, Inc. And The U.S. Attorney's Office For The District Of Puerto Rico Resolve Pending Litigation And Related Matters, (Feb. 11, 2020), available at <https://www.justice.gov/usao-pr/pr/bank-san-juan-internacional-inc-and-us-attorney-s-office-district-puerto-rico-resolve>.

[3] BSJN, 2023 U.S. Dist. LEXIS 193296, at *29-30; see also U.S. Department of the Treasury, National Money Laundering Risk Assessment, March 1, 2022, at p. 69, available at <https://home.treasury.gov/system/files/136/2022-National-Money-Laundering-Risk-Assessment.pdf>.

[4] BSJN, 2023 U.S. Dist. LEXIS 193296, at *29-30. See also Financial Crimes Enforcement Network, FinCEN Announces \$15 Million Civil Money Penalty against Bancredito International Bank and Trust Corporation for Violations of the Bank Secrecy Act, Sept. 15, 2023, available at <https://www.fincen.gov/news/news-releases/fincen-announces-15-million-civil-money-penalty-against-bancredito-international>.

[5] BSJN, 2023 U.S. Dist. LEXIS 193296, at *3 (citing 12 U.S.C. § 342, which the Court described as governing master accounts).

[6] Id.

[7] Id. at *3-4.

[8] Id. at *4-5.

[9] Id.

[10] Guidelines for Evaluating Account and Services Requests, 87 Fed. Reg. 68691 (Nov. 16, 2022), available at <https://www.federalregister.gov/documents/2022/11/16/2022-24929/guidelines-for-evaluating-account-and-services-requests>.

[11] BSJN, 2023 U.S. Dist. LEXIS 193296, at *9, *30-31.

[12] Id. at *17.

[13] Id. at *27-28.

[14] Id. at *28.

[15] BSJI also claimed that the FRBNY and the Board violated the Administrative Procures Act, 5 U.S.C. § 706 (the "APA"). The order held that, even if the FRBNY was an "agency" under the APA, judicial review of its decision to close BSJI's master account was foreclosed because the FRBNY had discretion to do so. In any event, the Court found that the FRBNY's decision was not arbitrary or capricious or contrary to law because its conclusions "were

plainly reached after a thorough review of the evidence and pertinent factors and resulted in a decision that explained the FRBNY's rationale." BSJN, 2023 U.S. Dist. LEXIS 193296, at *27.

BSJI also sought relief under the Mandamus Act and a declaratory judgment asserting its right to a master account. Because BSJI raised these causes for the first time in its reply brief, and not in its opening brief, the Court deemed them abandoned. *Id.* at *17 n.5. The Court further noted that these causes would not succeed on the merits because BSJI did not have a clear right to a master account under 12 U.S.C. § 248(a).

Finally, the order addressed BSJI's claims that the FRBNY breached its contractual duty of good care and the implied covenant of good faith and fair dealing under New York law. The order concluded that BSJI was unlikely to prevail on the contractual claims because there was no evidence that the FRBNY acted in bad faith, and the FRBNY had the contractual right to terminate BSJI's master account and had notified BSJI of the alleged insufficiencies in its AML program. *Id.* at *28-29.

[16] Indeed, prior litigation has arisen over the denial of a master account for a so-called "crypto friendly" bank, see order, *Custodia Bank, Inc. v. Fed. Reserve Board of Governors*, No. 22-cv-125 (D. Wyo. June 8, 2023), available at <https://storage.courtlistener.com/recap/gov.uscourts.wyd.61107/gov.uscourts.wyd.61107.164.0.pdf>, and for a federal credit union seeking to provide financial services to the cannabis industry, *Fourth Corner Credit Union v. Fed. Reserve Bank of Kan. City*, 154 F. Supp. 3d 1185 (D. Colo. 2016), rev'd and remand on other grounds, 861 F.3d 1052 (10th Cir. 2017).