

An hourglass-shaped graphic with a globe inside. The top bulb is dark blue, and the bottom bulb is light blue. The globe is a light blue color. The hourglass is centered on the page.

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Banking's Proposed "Know Your Customer" Rules

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Abstract. On December 7, 1998, the federal banking regulators invited comments on proposed regulations that would require banks and thrifts to develop formal policies and procedures whereby they could identify unusual transactions in customers' accounts to report as suspicious activity in conjunction with the federal laws outlawing money laundering. Small banks criticized the increased costs of screening. Individuals and businesses raised privacy concerns. Although there were varied proposals before the 106th Congress on the issue, no legislation was enacted. The issue likeliest to command attention in the 107th Congress is international money laundering. There have been recent instances in which banking regulators imposed corrective action comparable to the Know Your Customer requirements on the several international banking institutions after unearthing potential money laundering activity.

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Banking's Proposed "Know Your Customer" Rules

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Summary

On December 7, 1998, federal banking regulators proposed regulations that would have required banks and thrifts to develop formal policies and procedures to identify unusual transactions in customers' accounts to report as suspicious activity in conjunction with the federal laws outlawing money laundering. Since 1996, banks have been required to report suspicious activity. Many institutions have maintained know-your-customer procedures on an informal basis. Formal procedures subject to regulatory scrutiny would have been, however, an innovation. On March 23, 1999, the regulators issued a joint statement withdrawing the proposal, having received an unprecedented number of comments.¹ Small banks criticized the increased costs of screening. Individuals and businesses raised privacy concerns. Although there were varied proposals before the 106th Congress on the issue, no legislation was enacted. The issue likeliest to command attention in the 107th Congress is international money laundering. There have been recent instances in which banking regulators imposed corrective action, comparable to the Know Your Customer requirements, on several international banking institutions after unearthing potential money laundering activity.

Anti-Money Laundering Laws. Money laundering involves concealing illegally obtained income and recycling it until its illegal origin is completely obscured. It is addressed primarily by four types of federal law: (1) recordkeeping and reporting requirements with civil and criminal sanctions, (2) substantive criminal offenses, (3) procedural protections against federal access to financial records, and (4) agreements with foreign countries with respect to procedures and conditions under which financial records may be secured for law enforcement purposes. The Bank Secrecy Act of 1970² and its

¹ The FDIC received 254, 394 comments with an "overwhelming majority" "strongly opposed." 64 *Fed. Reg.* 14845 (March 29, 1999).

² 12 U.S.C. §§ 1829b and 1951-1959, and 31 U.S.C. 5311-5322.

major component, the Currency and Foreign Transactions Reporting Act,³ require reports and records of cash, negotiable instrument, and foreign currency transactions and authorize the Secretary of the Treasury to prescribe regulations to insure that adequate records are maintained of transactions that have a “high degree of usefulness in criminal, tax, or regulatory investigations or proceedings.”⁴ The regulations set civil and criminal penalties for their violation. There are also substantive federal criminal statutes that define as offenses, laundering of monetary instruments⁵ and engaging in monetary transactions in property derived from unlawful activity.⁶ The Right to Financial Privacy Act⁷ details the procedures that federal agencies, including law enforcement agencies, must use to gain access to financial records of individuals. Treaties of mutual assistance with foreign governments detail the conditions under which each signatory government may obtain judicial assistance for access to financial information from institutions within the other signatory’s jurisdiction.⁸

The Supreme Court upheld the constitutionality of the Bank Secrecy Act in *California Bankers Association v. Schultz*, 416 U.S. 21 (1974), as a valid exercise of federal power under the commerce clause. It ruled that the Bank Secrecy Act’s recordkeeping and reporting burden was not so onerous as to deprive the institutions of due process, did not involve an illegal search and seizure in violation of the Fourth Amendment, and did not invade associational interests protected by the First Amendment. Subsequently, in *United States v. Miller*, 425 U.S. 435 (1976), the Court held that the Fourth Amendment does not recognize an expectation of privacy in a person’s financial records held by a bank *vis-a-vis* a governmental agency’s interest in examining those records. Thereafter, the federal Right to Financial Privacy Act of 1978⁹ was enacted with a dual purpose: “protect[ing] the customers of financial institutions from unwarranted intrusions into their records [by federal government authorities] while at the same time permitting legitimate law enforcement activity.”¹⁰ It sets procedures for the federal government’s access to bank customer records.¹¹ One of the exceptions to these

³ 31 U.S.C. §§ 5311-5322.

⁴ 12 U.S.C. § 1829b.

⁵ 18 U.S.C. § 1956.

⁶ 18 U.S.C. § 1957.

⁷ 12 U.S.C. § § 3401 - 3422.

⁸ See Michael Abel and Bruno A. Ristau, 3 *International Judicial Assistance* §§ 12-4-1 and related appendices (1990)

⁹ P.L. 95-630, Tit. XI, 92 *Stat.* 3641, 3697-3710; 12 U.S.C. §§ 3401 -2422.

¹⁰ H.Rept. 95-1383, 95th Cong., 2d Sess. 33; 1978 U.S.Code Cong. & Ad. News 9305.

¹¹ RFPA’s application is extensive in terms of the information it covers and limited in terms of the customers to which it applies. It defines “financial record” to include information derived from records held by a financial institution pertaining to an individual or partnership of five or fewer individuals. 12 U.S.C. §§ 3401(2), (4), and (5). It defines “financial institution” to mean “any office of a bank, savings bank, card issuer..., industrial loan company, trust company, savings association, building and loan, or homestead association (including cooperative banks), credit union, or consumer finance institution, located in any State or territory of the United States, the

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procedures states that “[n]othing in this ... [law] shall authorize the withholding of financial records or information required to be reported in accordance with any Federal statute or rule promulgated thereunder.”¹² It, thus, effectively incorporates the Bank Secrecy Act into the Right to Financial Privacy Act.

Implementing Regulations. The Currency and Foreign Transactions Reporting Act requires financial institutions and other specified businesses to maintain records of foreign domestic financial transactions and to report to the Secretary of the Treasury certain currency transactions in excess of \$10,000. A subsequent amendment, section 1359 of the Anti-Drug Abuse Act of 1986,¹³ ordered the federal banking regulators to prescribe regulations “requiring insured banks to establish and maintain procedures reasonably designed to assure and monitor the compliance of such banks with the requirements of” the Bank Secrecy Act. Under the implementing regulations, promulgated by the Financial Crimes Enforcement Network of the Department of the Treasury (FinCen), the following types of reports are required: (1) Currency Transaction Reports (CTR’s) on currency transactions of more than \$10,000;¹⁴ and (2) reports relating to the physical transportation of currency or monetary instruments from or into the United States; regarding foreign financial accounts, or transactions with foreign financial agencies.¹⁵ The regulations also require maintaining various records in connection with purchases of bank checks, money orders, and traveler’s checks in excess of \$3,000,¹⁶ as well as copies of records of various other transactions that the Secretary of the Treasury has determined to have a high degree of usefulness in investigative proceedings.¹⁷ Since April, 1996,¹⁸ the regulations require that banks and other depository institutions submit Suspicious Activity Reports (SARs)¹⁹ of any transaction involving at least \$5,000, which the institution suspects: to include funds from illegal activities; to have been conducted to hide funds from illegal activities or designed to evade the BSA requirements; which have “no business or apparent lawful purpose;” or are “not the sort [of transaction] in which the particular customer would normally be expected to engage, and the bank knows of no

¹¹ (...continued)

District of Columbia, Puerto Rico, Guam, American Samoa, or the Virgin Islands.”

¹² 12 U.S.C. § 3412(d).

¹³ P.L. 99-570, 100 Stat. 3207, 3207-27; 12 U.S.C. § 1818s.

¹⁴ 31 C.F.R. § 103.22(a).

¹⁵ 12 C.F.R. §§ 103.23 -.25.

¹⁶ 31 C.F.R. § 103.29.

¹⁷ 31 C.F.R. §§ 103.31 - 103.39.

¹⁸ 61 Fed.Reg. 4326 (February 5, 1996). Included in the notice were implementing regulations applicable to national banks and to state chartered member banks. 12 C.F.R. §§ 21.11 and 208.20. Promulgated soon thereafter were regulations applicable to state chartered nonmember banks; 12 C.F.R. § 353.3; federally insured credit unions (12 C.F.R. § 748.1); and federally insured savings associations, 12 C.F.R. § 563.180.

¹⁹ 31 C.F.R. § 103.21. The authority to require suspicious activity reports derives from 31 U.S.C. § 5314(h), authorizing the Secretary of the Treasury to require financial institutions to report suspicious transactions, originally enacted as section 1518 of the Housing and Community Development Act of 1992, P.L. 102-550, 106 Stat. 3672,4059.

reasonable explanation for the transaction after examining the available facts, including the background and purpose of the transaction.”²⁰ The banking regulators have also issued rules requiring the institutions that they supervise to “establish and maintain procedures reasonably designed to assure and monitor their compliance” with the Bank Secrecy Act and regulations.²¹ One portion of these regulations requires that each institution develop a written compliance program with internal controls, independent testing, training of personnel, and designating individuals to coordinate and monitor an institution’s program. The proposed “Know Your Customer” regulations would have expanded upon these requirements. The Money Laundering Suppression Act of 1994²² sets forth mandatory exemptions to the currency reporting requirements that include other depository institutions and governmental entities. It authorizes the Secretary of the Treasury to issue regulations to permit institutions to designate business customers in certain categories as exempt from the currency reporting requirements. Under the regulations that have been issued, institutions are authorized to exempt banks, government entities, and publicly traded companies according to one set of procedures, and companies not publicly traded and business entities that use cash for their payrolls according to another set of procedures which include biennial renewals.²³

The “Know Your Customer” Proposed Regulations. In promulgating the proposed “Know Your Customer” regulations, the bank regulators cited their authority under the Bank Secrecy Act and their general authority to prevent practices that threaten the safety and soundness of the institutions they supervise. They expected that the regulations would decrease the likelihood that banking institutions would collude with money launderers and jeopardize the reputations of their institutions. The regulators also indicated that they saw formal regulatory requirements as support for institutions that already have Know Your Customer policies in place when their customers question their authority to inquire into transactions. The proposals would have meant regularized, systematic increased scrutiny of documentation of customer’s identity, both individual and corporate, and possible further investigation of persons, including private banking clients,²⁴ who begin or maintain relationships with regulated institutions.

²⁰ 31 C.F.R. § 103.21(a)(2).

²¹ 52 Fed. Reg. 2858 (January 27, 1987), promulgating 12 C.F.R. § 21.21 (Office of the Comptroller of the Currency, applicable to national banks); 12 C.F.R. § .208.14 (subsequently, 12 C.F.R. § 208.63) (Board of Governors of the Federal Reserve System, applicable to state member banks); 12 C.F.R. § 326.8 (Federal Deposit Insurance Corporation, applicable to federally insured state nonmember banks); 12 C.F.R. § 563.17-7 subsequently 12 C.F.R. § 563.177 (Federal Home Loan Bank Board, the predecessor of the Office of Thrift Supervision, regulator of savings associations, applicable to federally insured thrift institutions); and 12 C.F.R. § 742.2 (National Credit Union Administration, applicable to federally insured credit unions).

²² P.L. 103-325, tit. 4, sec. 402 (a), 108 Stat. 2243, 31 U.S.C. § 513(d).

²³ See 63 Fed. Reg. 50147 (September 21, 1998); 31 C.F.R. § 103.22.

²⁴ Private banking includes “personalized services such as money management, financial advice, and investment services for high net worth clients,” that “have become an increasingly important aspect of the operations of some large, internationally active banking organizations.” Board of Governors of the Federal Reserve System, SR 97-19 (SUP), at 1 (June 30, 1997)[<http://www.federalreserve.gov/boarddocs/SRLETTERS/1997/SR9719.HTM>]. The Know

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Since June 1998, various banking institutions operating internationally have been subjected to regulatory requirements by the Federal Reserve Bank of New York following money laundering investigations calling into question their ability to monitor international transfers as required under the Currency and Foreign Transaction laws and regulations.²⁵ The extent of the regimes imposed on these institutions to enhance their due diligence procedures with respect to private banking clients and international clients bears considerable relationship to the Know Your Customer regime.

Legislation. In the 105th Congress, H.R. 4005, the Money Laundering Deterrence Act of 1998, was passed by the House. It would have required the Secretary of the Treasury to promulgate Know Your Customer regulations. H.Rept. 105-611, Part 1, indicated that the House Banking Committee believed that law enforcement would be enhanced by “strong legal mechanisms for detecting the flows of ...illicit proceeds” of “the international drug trade and other global criminal enterprises,” and that detection was most likely at the point of entry into the financial system.²⁶ A dissenting member of the Committee, Representative Paul, raised concerns about the effectiveness of the reporting requirements in stemming drug traffic, the paperwork and cost burdens of increased reporting requirements, the potential for legal liability in connection with errors in reporting, and vulnerability to abuse by employees and penetration by hackers.²⁷

In the 107th Congress, H.R. 1114, offered by Rep. LaFalce for himself and Rep. Velazquez, and a substantially similar bill, S. 398, introduced by Sen. Kerry, like H.R. 3886 of the 106th Congress (H.Rept. 106-728), addresses the problem of international money laundering. The approach it takes is to authorize the Secretary of the Treasury to impose special recordkeeping and reporting requirements regarding financial transactions between domestic institutions and those in foreign jurisdictions determined to be of primary money laundering concern. Such requirements would be directed at securing information on the identity of beneficial owners of funds being held for, transferred to, or transferred from persons and financial institutions in the foreign jurisdiction. The Secretary would also be empowered to place conditions on the establishment of correspondent accounts with U.S. financial institutions by the banking organizations of such a jurisdiction. Primary money laundering concern would be determined by weighing such factors as the jurisdiction’s bank secrecy and tax laws, its banking supervision and

²⁴ (...continued)

Your Customer rules follow revelations of how the private banking services of Citibank were employed to aid Raul Salinas de Gortari, brother of Carlos Salinas, former president of Mexico, in transferring large sums from Mexico to Swiss banks. See U.S. General Accounting Office, “Private Banking: Raul Salinas, Citibank, and Alleged Money Laundering,” GAO/OSI-99-1 (October 1998).

²⁵ These included a cease and desist order directed against the Banco Nacional de Mexico, Banka Serfin, Banco Internacional, Bancomer, and Banco Santander in June 1998; and written agreements, sometimes with state regulators or other Federal Reserve banks, with the Bank of New York, the Banco Popular de Puerto Rico, and the Banco Bilbao Vizcaya Argentaria. See Harold Adams Crawford, “managing Reputation Risk: Bank Secrecy and Bank Privacy,” 19 *Banking and Financial Services Policy Report* 1 (December 2000).

²⁶ H.Rept. 105-611, Part 1, 9.

²⁷ H.Rept. 105-611, Part 1, Dissenting View of Representative Ron Paul.

counter-money laundering laws, and its reputation as a tax haven or off-shore banking haven. The legislation includes provisions to insulate financial institutions and personnel from liability for reporting suspected violations of law. Also included are criminal penalties for violating and structuring to avoid geographic targeting orders issued under the authority of the Currency and Foreign Transactions Reporting Act.. The measure also includes a provision permitting depository institutions to include information relating to the possible involvement of an institution-affiliated person in potentially unlawful activity in response to an employment inquiry from another financial institution. Federal regulators are to provide Congress with a report reconciling the penalties under the Currency and Foreign Transaction Reporting Act with those under the enforcement provisions of the Federal Deposit Insurance Act. Included are statements respecting the sense of Congress on measures to be taken respecting corruption of foreign governments and how the United States should support the activities of the Financial Action Task Force on Money Laundering.

Included in S. 16, introduced by Sen. Daschle, as sections 2201 to 2223, is “The Money Laundering Enforcement Act of 2001,” containing various amendments to the substantive money laundering provisions. One permits forfeiture of a money transmitting business operating with a state license upon proof that the defendant knew that the business lacked such a license. Others authorize procedures for the Attorney General to seek restraint of the U.S. assets of persons arrested or charged in a foreign country of money laundering or Controlled Substances Act offenses; provide authority for asserting jurisdiction over foreign persons committing a money laundering offense involving a transaction occurring in part in the United States; extend the coverage of the criminal money laundering statutes to foreign banks; and add various crimes to the list of money laundering predicate offenses. Also included are various amendments to criminal procedure respecting the prosecution and presentation of evidence in money laundering cases, encouraging financial institutions to notify law enforcement officer of suspicious transactions, amending the substantive money laundering criminal statute to reach conduct that involves funds commingled with the proceeds of illegal activity, and extending criminal penalties to violations of geographic targeting orders.

S. 1371, introduced by Sen. Levin, would add foreign corruption offenses to the list of predicates under the federal money laundering statutes, require financial institutions to keep records of the owners of interests in accounts held in the name of foreign entities, prohibit correspondent accounts with offshore shell banks, require enhanced due diligence procedures for private banking relations with foreign persons, provide federal court jurisdiction over foreign persons committing money laundering offenses, provide jurisdiction over money laundering through a foreign bank, prohibit false statements to a financial institution regarding the identity of a customer, require the Secretary of the Treasury to issue regulations regarding concentration accounts held in U.S. depository institutions in the name of foreign banks, permit charging multiple instances of money laundering in a single count of an indictment, allow seizure of funds held in a U.S. bank’s interbank accounts for a foreign bank, and enhance procedures for law enforcement access to bank records and to forfeit substitute property.