Message from the Chair

To the Members of the Committee on Banking Law:

I am pleased to send you another quality edition of the Banking Law Committee Journal that will be posted on our Committee website. Many if not all of the authors of the current and prior articles will also appear in person at the meeting of the Committee in Washington D.C. on November 2 and 3, 2007, at the Ritz-Carlton. They will be available there to discuss these articles in more detail and to autograph copies of the articles for your personal collection. Walk-ins can register to attend the meeting at the Ritz.

I commend these and the now extensive set of prior articles on our website to you, both in terms of the relevance of the topics covered and the quality of the articles. These articles provide examples of the blending of legal expertise and practical experience that make the Committee very useful for lawyers who represent financial institutions, trade associations, and government regulatory agencies. Hopefully, this Journal will be the initial step you take in your use of the Committee as well as be helpful in acquiring practical insights in how to understand and address the legal, policy and compliance issues with which you are dealing.

Please also feel free to contribute to the dialogue, including by providing your opinion or analysis on current topical issues. Write a short article for the next edition and send it to any of the editors listed here. You will be speaking to the 1600 members of the Committee. Also, feel free to contact Chris Bellini at cbellini@gibsondunn.com or at our meetings if you want to discuss a proposed article or have other material suitable to be posted on our website for our members.

Jim Scott
Chair, Committee on Banking Law
scottj@citigroup.com

Featured Articles

The Current Crisis in Subprime Lending - Is a Regulation on Unfair Deceptive Acts or Practices the Answer? OTS issues ANPR
Charlotte M. Bahin

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In response to the calls from Congress and others, the Office of Thrift Supervision ("OTS") has issued an advance notice of rulemaking to implement its authority under the Federal Trade Commission Act ("FTC Act") in the area of Unfair or Deceptive Acts or Practices. While any rule issued by the OTS would apply...
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Travis P. Nelson

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Money Laundering and Criminal Prosecutions of Banks: A Focus of Bank Enforcement Activity in Recent Years
Thomas P. Vartanian and Dominic A. Labitzky

Bank Secrecy Act and Anti-Money Laundering (BSA/AML) related enforcement actions have grown to become a significant focus of the federal bank regulators’ enforcement activity over the course of the last few years. With the enactment of the USA PATRIOT Act, the role of banks in combating terrorist financing has only sharpened this focus. In 2004, the bank regulators undertook 437 enforcement actions, 66 of which were BSA/AML related. The following year, bank enforcement actions totaled 410 of which 53 were BSA/AML related actions. The trend of BSA/AML related enforcement actions constituting approximately 15 percent of total bank enforcement actions continued last year when bank regulators undertook 56 BSA/AML enforcement actions out of a total of 369 enforcement actions. As a result of the focus on BSA/AML compliance, BSA/AML related enforcement actions have also led to record civil money penalties (CMPs) ranging from $10 million to $100 million. However, civil enforcement actions are not the only penalties banks may face for BSA/AML violations.
The Current Crisis in Subprime Lending -
Is a Regulation on Unfair and Deceptive Acts or Practices the Answer?

OTS issues ANPR

by
Charlotte M. Bahin
Locke Lord Bissell & Liddell LLP

In the past few months there has been much discussion on what could have been done differently or whether additional regulation of banks and thrifts could have prevented the current subprime lending meltdown. There are suggestions that the federal banking regulators could have taken actions that would have mitigated, if not prevented, the problems that have surfaced.

In response to the calls from Congress and others, the Office of Thrift Supervision (“OTS”) has issued an advance notice of rulemaking to implement its authority under the Federal Trade Commission Act (“FTC Act”) in the area of Unfair or Deceptive Acts or Practices. While any rule issued by the OTS would apply only to savings associations and possibly their affiliates, the issues raised in the advanced notice are instructive and provide a useful guide to some of the factors that need to be addressed in this area.

The OTS has authority under Section 5 of the FTC Act to issue regulations for savings associations to implement the requirement that unfair and deceptive acts or practices be prevented. The agency also asserts its authority to ensure the safe and sound operation of savings associations under the Home Owners’ Loan Act (“HOLA”) in the ANPR. The Federal Reserve and the NCUA have similar authority for their constituencies. The OTS had issued a regulation in the mid 1980’s that addresses credit practices in the consumer lending area but these regulations have not been updated and do not address mortgage lending. This rule is similar to Regulation AA issued by the Federal Reserve.

The OTS’s 1985 Credit Practices regulation describes a number of practices that, if they are engaged in by savings associations, are per se violations unfair or deceptive acts or practices within the meaning of Section 5 of the FTC Act. The current regulation addresses the extension of credit to consumers for the acquisition of goods, services, or money for household or personal purposes.

The provisions of these regulations are relatively narrow and do not address the issues that arise in the context of mortgage lending or servicing. In addition, the current regulation does not permit the agency to take the circumstances of any of the parties or the practices into account. Any rule might include the terms of this regulation with an updated or more flexible approach. If a principles based approach is adopted, the less specific provisions of the current regulation could be adapted to be included in any final rule.

The advance notice poses a number of questions about the possible approaches that the agency may take, including whether the agency should consider a further rulemaking in unfair acts or practices that would cover products and services in addition to consumer credit. The possible approaches include developing a rule that follows the policy and guidance of the FTC model.
Rather than issue regulations establishing definitions for unfair or deceptive acts or practices, the FTC (or the “Commission”) has issued Policy Statements on unfairness and deception that describe the framework the agency uses to determine whether companies or persons are engaging in unfair or deceptive acts or practices. The Commission decided that because the situations are fact specific and do not lend themselves to a regulatory approach, it should issue guidance that describes the factors that it will consider when making an evaluation of unfairness or deception.

The Policy Statements were developed after a review of the decided cases and other decisions and provide the general principles of applicability considered by the Commission. In issuing the statements, the FTC also provides an indication of how it will enforce the standards. The Policy Statements were issued in the 1980’s and have not been amended, but the principles included are the basis of the enforcement actions and cases brought since their issuance. In each case, the statements establish a framework to determine unfairness and deception in every context and for every industry, not just financial services.

**FTC Policy Statement on Unfairness**

The FTC Policy Statement on Unfairness was issued on December 17, 1980. The Policy Statement describes how the Commission examines and enforces unfairness and deception and how the concepts are different. The Policy Statement explains that the FTC Act was drafted to include a general standard rather than a list of unfair trade practices that would easily become out of date or which would be easy for companies to evade. The statute provides that the FTC identify unfair trade practices, subject to judicial review. Early on, three factors were identified that the Commission considers: whether the practice injures consumers, whether it violates established public policy, and whether it is unethical or unscrupulous.

As time went on, the factors have been refined. For example, in order to justify a finding of unfairness, the injury to the consumer must satisfy three tests: it must be substantial; it must be outweighed by any countervailing benefits to consumers or competition that the practice produces; and it must be an injury that consumers themselves could not have reasonably avoided.

For an injury to be substantial in most cases there has to be monetary harm, however, unwarranted health and safety risks may also support a finding of unfairness. Other more subjective forms of harm, for example emotional impact, likely will not produce a finding of unfairness. In determining whether the injury or harm is outweighed by any offsetting consumer or competitive benefits, the FTC also looks at the costs of the remedy. Finally, the injury must be one that cannot be avoided by consumers. The FTC recognizes that certain types of sales techniques may effectively prevent consumers from making their own choices and the market place is not self correcting in those circumstances.

**FTC Policy Statement on Deception**

The Policy Statement on Deception was issued on October 14, 1983 and establishes the elements that are found in the deception cases brought by the Commission. There must be a representation, omission or practice that is likely to mislead the consumer. Further the FTC
examines the practice from the perspective of a consumer acting reasonably in the circumstances. Finally, the representation, omission or practice must be material.

The question that the FTC asks is whether the act or practice is likely to affect the consumer’s conduct or decision with regard to a product or service. If it has, the practice is material and consumer injury is likely. Put another way, the consumer would have chosen differently but for the deception. The FTC will find deception if there is a representation, omission or practice that is likely to mislead the consumer acting reasonably in the circumstances to the consumer’s detriment.

The Banking Agencies Adoption of the FTC Principles

The FDIC, Federal Reserve and the OCC have each adopted the principles for determining unfairness or deception. In addition to using unfair or deceptive acts or practices as a basis for enforcement actions, the FDIC and the Federal Reserve issued guidance on March 11, 2004 that outlines the standards that the two agencies would consider to enforce their obligations under Section 5 of the FTC Act. This guidance is applicable to the acts and practices of state chartered banks. The guidance includes a discussion of the management of risks relating to unfair or deceptive acts or practices. The agencies believe the risk management techniques can be seen as best practices as well as general guidance.

The OCC issued regulations in January 2004 that specifically included provisions prohibiting national banks from engaging in unfair or deceptive within the meaning of Section 5 of the FTC Act. The agency had previously issued advisory letters addressing abusive or predatory lending practices and later issued guidance that establishes standards for residential mortgage lending practices that specifically refer to the FTC principles.

Further, each of the federal banking agencies, including the OTS, has authority under section 8 of the Federal Deposit Insurance Act (“FDIA”) to bring an enforcement action against an insured depository that it finds is operating in an unsafe and unsound condition. A finding that the institution is offering product and services in an unfair or deceptive manner would be considered an unsafe and unsound action.

Example of FTC Enforcement

The OTS poses a question about whether the enforcement actions brought by the FTC can be used as examples of the elements that might be included in any final rule. Under the FTC Act, the FTC has enforcement authority over non depository lenders and other companies that originate and service mortgages and other loans, including credit card loans. In the enforcement context, the FTC has used a principles based approach to bring cases against companies that it believes or suspects may have engaged in unfair or deceptive acts or practices. In the enforcement actions, the acts and practices are specifically described. Many of the actions have been brought against servicers or consumer finance companies. Of note is that on the FTC website, there is a list of 21 cases brought against subprime lenders since 1998. Not all of them address servicing but a noteworthy example is the Fairbanks settlement.
In the 2003 Fairbanks settlement, the FTC and HUD defined the practices in the servicing area that they believed were unfair and deceptive. The practices highlighted included:

- failing to post consumer’s mortgage payments in a timely and proper manner, and then charging consumers late fees or additional interest for failing to make their payments on time;
- charging consumers for placing casualty insurance on their loans when insurance was already in place;
- assessing and collecting improper or unwarranted fees, such as late fees, delinquency fees, attorney’s fees or other fees and misrepresenting the amounts that consumers owed.

In the Fairbanks settlement, the FTC and HUD also found that the company had violated a number of other consumer protection statutes and as part of the settlement required remedial actions. The settlement provides what might be considered to be best practices for servicers.

In an enforcement action brought by the OTS, the agency used its authority under the HOLA and Section 8 of the FDIA to address similar servicing issues. The OTS entered a Written Supervisory Agreement with Ocwen Federal Bank FSB on April 19, 2004 that identified a number of servicing and consumer complaint issues that the institution was required to address with a systematic compliance plan.

While the FTC’s enforcement actions and settlement documents are a useful roadmap to behaviors of which savings associations should be aware, the agreements are fact specific and include a list of the actions or practices that the Commission has found to be unfair or deceptive in connection with the particular company. Given the fact specific nature of the settlement agreements such examples cannot be seen as the only acts or practices that are found to violate the established principles or the statute. By including the specific practices found in the enforcement documents, the OTS would limit itself in the activities or practices that it might find to be unfair or deceptive.

Questions in ANPR

The agency also solicits input on whether existing guidance should be converted into rules or whether a principles based approach should be used. The agencies, including the OTS, have issued guidance on a number of consumer protection topics, including nontraditional mortgage products, overdraft protection products, and gift card programs. The OTS suggests that it may look to other agencies for examples of how to develop a model. The advance notice refers to the guidelines for residential mortgage lending practices adopted by the OCC. These guidelines mention specific lending practices that the agency finds are predatory or abusive. The advance notice also provides an example of state law models that have been developed and used a more targeted approach.

A targeted approach would list acts or practices regarding specific products. For example in the area of credit cards, residential lending, deposit accounts and gift cards, practices that the OTS finds to be unfair or deceptive would be prohibited.
This ANPR may result in a proposal for savings association or the other agencies may follow the lead of the OTS and/or the agencies may decide to engage in joint rulemaking. Another alternative is that Congress will take action. The ANPR is useful in identifying the issues.
New Changes and Challenges: Non-banks in the Payments System

By: Christopher M. Paridon

As Federal Reserve Board Governor Randall Kroszner highlighted in a speech earlier this year, electronic payments (credit and debit cards combined) have surpassed the use of checks as the preferred means of making non-cash payments. Remote deposit capture is gaining popularity (and acceptance) with banks and their customers, while mobile bill payment and banking options continue to revolutionize the way in which customers conduct transactions. With these and other changes, non-banks have become increasingly prevalent throughout all aspects of the payments system, from front-end functions such as user authentication, to back-end processing, and even in developing new and innovative contributions to the payments system arena.

While their involvement has provided several important new products and methodologies, it has also brought with it increased risks and regulatory concerns. For example, a recent paper by the Federal Reserve Bank of Kansas City shows that in 2006, non-banks accounted for over 50 percent of all ATM transaction volume. Allowing non-banks this amount of access to U.S. payments systems, while not requiring them to be subject to federal regulatory supervision similar to that required of banks, raises the case for a reevaluation of how risks are managed and participants regulated in today’s payments system environment. This is especially true in the areas of data security and prudential supervision.

The Shifting Payments System Landscape

As previously pointed out, the architecture comprising the U.S. payments system has changed dramatically in the past decade. Electronic payments have gained primacy over traditional paper-based payments, thereby demanding new and safer methods of controlling risk and ensuring the safety and soundness of U.S. payments systems. The advent of the Check Clearing for the 21st Century Act (Check 21) has increased the variety of ways, as well as the ease, with which electronic payments are processed. Allowing electronic check conversion, whereby a merchant uses specific information from a paper check to initiate an ACH electronic transaction, changes the payment system utilized for a specific transaction, thereby also impacting the way in which that transaction is regulated. Furthermore, while consumers remain protected under both ACH and check transactions, there are differences in the way each transaction is processed, as well as other nuances, such as reduced float times, customer liability for unauthorized transfers, and the ability of a customer to stop the transaction. Remote deposit capture has also changed the way in which the payments system is utilized,

1 Mr. Paridon is Counsel at the American Bankers Association, Washington, DC. The author may be reached at cparidon@aba.com.
3 RICHARD J. SULLIVAN, RISK MANAGEMENT AND NONBANK PARTICIPATION IN THE U.S. RETAIL PAYMENTS SYSTEM 8 (2Q 2007).
requiring enhanced diligence in regard to the infrastructure through which the transaction is processed.

With the number and relative ease of electronic payments eclipsing the use of checks to make payments, financial institutions and their regulators are faced with an increasing need to provide secure and convenient methods of payments to their customers. Recognizing the trend towards electronic payments, the Federal Reserve System recently amended Appendix A of Regulation CC dealing with processing of checks and funds availability. This change amended the location for processing paper checks to more accurately reflect decreasing volume, eliminating paper check processing at the Nashville, TN, Helena, MT, and San Francisco, CA offices.

**Current Regulation and Supervision of Non-Banks**

Presently, non-banks are subject to supervision under the terms of the Bank Service Company Act of 1963 (BSCA). Under this law, financial institutions are required to notify their primary federal regulator in writing of any relationships or contracts they enter into with third parties for provision of certain services to the financial institution. These services include check and deposit sorting and posting, as well as other “similar functions performed for a depository institution.” Bank service companies are subject to examination and regulation to the same extent as their principal investor, which would be the financial institution. Additionally, whenever a federally regulated depository institution, or its functionally regulated subsidiary or affiliate, “causes to be performed for itself . . . any [permissible bank service company] services,” this performance will be subject to regulation and examination “to the same extent as if such services were being performed by the bank itself . . . .” Therefore, any company that provides services to a bank, such as check and deposit sorting and posting, preparation and mailing of checks, statements, or similar items, will be subject to regulation and examination by the bank’s federal regulator.

In spite of these measures, many non-bank payments system providers avoid full federal regulatory supervision due to the fact that the terms of the BSCA specify that there must be an outsourcing relationship present before the BSCA applies. Thus, companies who originate payments and subsequently send the information to the banks for processing avoid federal regulation under the BSCA.

To demonstrate, as a state-licensed money transmitter in 31 states, as well as the District of Columbia and Puerto Rico, PayPal remains subject to regulations from FinCEN, but is

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4 See Availability of Funds and Collection of Checks, 72 Fed. Reg. 27951 (May 18, 2007).
9 Id.
10 For a list of permissible bank service company activities, see 12 U.S.C. § 1863.
not subject to federal regulation as a depository institution.\textsuperscript{11} PayPal does, however, state that it complies with the Electronic Funds Transfer Act, as enforced under the Federal Reserve’s Regulation E. Other companies with similar models and services such as Obopay and Yodlee are likely to follow similar regulatory patterns. Likewise, non-banks or merchants that offer electronic check conversion, are also not subject to federal regulation as depository institutions. They are required under the terms of Regulation E to provide consumers with notice that their checks may be converted to electronic payments, and must obtain consumer consent before initiating such transactions.\textsuperscript{12} The Federal Trade Commission has enforcement authority over non-banks for purposes of this provision.

Regulators need to be provided appropriate and effective enforcement tools to ensure that not only do non-banks in the payments system comply with required regulatory provisions, but also that they engage in appropriately safe and secure risk management. Given that the BSCA is over 40 years old, revisiting this legislation should be given serious consideration with an eye towards establishing uniform supervision for uniform activities. Additional regulatory provisions may be called for as well; if non-banks are engaging in the same or greater involvement in the payments system as depository institutions, the industry should be provided a level playing field with all parties subject to equivalent regulatory and supervisory standards.

**Non-Banks and Unlawful Internet Gambling Regulation**

To the extent that they are part of the payments system, non-banks will be affected by the newly proposed prohibition on funding of unlawful Internet gambling (Prohibition)\textsuperscript{13} as well. For instance, PayPal, as a state-licensed money transmitting business, would be subject to the terms of the Prohibition, and would have to “establish policies and procedures reasonably designed to identify and block or otherwise prevent transactions in connection with unlawful Internet gambling.”\textsuperscript{14} While the proposed regulation’s suggested policies and procedures for money transmitting businesses are similar to those for depository institutions and appear to be robust, including due diligence, customer agreements, and monitoring of payment patterns and web sites, how these requirements will be followed remains to be seen. Additionally, enforcement of the Prohibition for money transmitting businesses falls on the Federal Trade Commission, which may adopt a different methodology or level of enforcement and regulation than that reached by the Federal Reserve Board and other federal financial regulators who will enforce the regulation for insured depository institutions.

\textsuperscript{11} In February 2007, eBay is reported to have approached officials in Washington about obtaining an ILC charter for PayPal.\textsuperscript{11} If eBay successfully obtains an ILC charter for PayPal, then PayPal would be subject to FDIC regulation as a state-licensed depository institution once it applied for and received FDIC deposit insurance.

\textsuperscript{12} 12 C.F.R. § 205.3(b)(2)(i).

\textsuperscript{13} Prohibition on Funding of Unlawful Internet Gambling, 72 Fed. Reg. 56680 (Oct. 4, 2007).

\textsuperscript{14} Id.
Non-Bank Partnerships

One popular method for non-banks to gain access to the payments system is for retailers to partner with a financial institution to offer services. Wal-Mart, perhaps the nation’s largest retailer, has partnered with GE Money to offer check-cashing services and reloadable debit cards. This partnership seems aimed at offering services to the unbanked, but will also likely result in Wal-Mart’s capturing of a significant portion of this market. The FDIC’s Committee on Economic Inclusion (ComE-IN) recently held a meeting on money services businesses and their access to the banking and payments system, possibly indicating regulator concern over the extent to which individuals are using non-federally regulated business to access the payments system and conduct financial transactions. Likewise, Virgin Money’s acquisition of CircleLending and entry into the expanding person-to-person (P2P) lending market signals their interest in entering banking. This conclusion is bolstered by Virgin’s statement that they want to be a “disruptive force” in the mortgage market.15

Non-banks are also expanding into the mobile payments market. PayPal and Obopay currently offer their products through mobile phones, and have partnered with wireless carriers to provide their customers with bill payment services. While banks have also begun to engage themselves in this developing area, their efforts will benefit from working with federal banking regulators, but non-banks offering the same services will not have the same regulation and supervision. This dichotomy is especially salient given that this nascent technology continues to evolve, with important questions still largely undecided such as carrier access, system integrity, user verification, and even through what platform to deliver these services, such as downloadable applications, text messaging, or wireless application protocol (WAP).

Conclusion

The proliferation of non-banks in the payments system seems irreversible and is here to stay. Non-banks have gained a substantial market share in ATMs, peer-to-peer lending, and the online payments system. It is undeniable that they have been agents of innovation within the payments system, pushing the boundaries of current technologies and methodologies. While this has resulted in advances in how payments are conducted, it also poses the possibility that innovation will outstrip the ability of the payments system and regulators to adequately supervise and protect these same transactions. The specter of fraud or identity theft remains a serious question, especially for the online non-bank payment providers.16

The question of whether or not the existing supervisory and regulatory composition for non-banks in the payments system is adequate should receive new and careful attention, with an eye towards reinforcing, or replacing if necessary, this structure.

State-Chartered Banks in the Post-Watters Environment

By: Travis P. Nelson

In Watters v. Wachovia, the U.S. Supreme Court brought some measure of certainty to preemption issues relative to national bank operating subsidiaries, but has invited new and revived debate as to the application of federal preemption principles to the activities of state-chartered banks. This article will consider how Watters and other recent court decisions might resolve some issues, and raise new ones.

The Watters Revolution

On April 17, 2007, the U.S. Supreme Court issued its much-anticipated decision in Watters, holding that operating subsidiaries of national banks are entitled to the same preemption as their parent associations. The Watters decision will be studied as much for what it did not say in its analysis as for what it did in its ultimate outcome. A “home run” from the Office of the Comptroller of the Currency’s (OCC) perspective would have entailed the Court declaring that the OCC regulation at issue – “Unless otherwise provided by Federal Law or OCC regulation, State laws apply to national bank operating subsidiaries to the same extent that those laws apply to the parent national bank” – is valid as preempting state regulation of operating subsidiaries of national banks. The OCC did not get its wish, as the Court described that issue as “an academic question” that need not be addressed. According to the Court, the rule does not provide a new substantive provision, but rather “clarifies and confirms what the National Bank Act already conveys: a national bank has the power to engage in real estate lending through an operating subsidiary, subject to the same terms and conditions that govern the national bank itself; that power cannot be significantly impaired or impeded by state law.” Beyond the core holding of the Court, some practitioners view Watters as ending the practice of “per se” preemption regulations, absent clear Congressional directive, as exceeding agency authority. Unfortunately, however, as the Watters majority declined to address the validity of the OCC preemption regulation at issue in the case, referring to such a discussion as “an academic question,” a definitive answer on this practice will have to wait for another day.

Preemption and the State Charter

In considering how Watters might affect state-chartered banks, it is important to consider and compare parallel or similar preemptive abilities of national banks. Though to a much lesser extent, state-chartered banks enjoy the benefits of preemption like their national bank cousins.
This preemption lies in the ability to export interest rates, as provided in § 27(a) of the Federal Deposit Insurance Act ("FDIA"):

In order to prevent discrimination against State-chartered insured depository institutions . . . with respect to interest rates . . . such State bank[s] . . . may, notwithstanding any State constitution or statute which is hereby preempted for the purposes of this section, take, receive, reserve, and charge on any loan or discount made, or upon any note, bill of exchange, or other evidence of debt, interest . . . at the rate allowed by the laws of the State . . . where the bank is located . . . .4

This language in the FDIA governing the exportation authority of state-chartered banks is strikingly similar to the comparable provision for national banks contained in the National Bank Act ("NBA"): “Any association may take, receive, reserve, and charge on any loan or discount made, or upon any notes, bills of exchange, or other evidences of debt, interest at the rate allowed by the laws of the State, Territory, or District where the bank is located . . . .”5

This similarity in the language of the FDIA and the NBA is not coincidental. “The historical record clearly requires a court to read the parallel provision of [the Depository Institutions Deregulation and Monetary Control Act of 1980 – “DIDMCA”] and [the NBA] in pari materia. It is, after all, a general rule that when Congress borrows language from one statute and incorporates it into a second statute, the language of the two acts should be interpreted in the same way.”6 The two federal appellate courts that have addressed this issue with regard to state-chartered banks have also held that § 27 completely preempts state law claims challenging the rates of interest charged by state-chartered, federally insured banks, relying on the principle of pari materia to find that Congress intended § 27 to completely displace contrary state laws in the area of interest rates.7 The Fourth Circuit in Vaden relied on the legislative history of § 27, which “tells us that Congress intended ‘to allow competitive equity among financial institutions, and reaffirm the principle that institutions offering similar products should be subject to similar rules,’” and that “[t]he FDIA was enacted in part ‘to provide parity, or competitive equality, between national banks and State chartered depository institutions.’”8

6 Greenwood Trust Co. v. Massachusetts, 971 F.2d 818, 827 (1st Cir. 1992) (holding that § 27 preempted enforcement of state law that prohibited the imposition of late fees on credit cards issued by subsidiary of a state-chartered, federally insured bank). This is consistent with the interpretation of the FDIC. FDIC General Counsel’s Opinion No. 10: Interest Charges under § 27 of the FDIC, 63 Fed. Reg. 19,258, 19,259 (Apr. 17, 1998).
The Ginsburg Approach

In two sentences, and without prodding from briefing counsel, Justice Ginsburg provides what practitioners widely regard as the crucial lesson to be learned from \textit{Watters}: “We have never held that the preemptive reach of the [National Bank Act] extends only to a national bank itself. Rather, in analyzing whether state law hampers the federally permitted activities of a national bank, we have focused on the exercise of a national bank’s powers, not on its corporate structure.”\textsuperscript{9}

Justice Ginsburg’s analytical approach may ultimately become the benchmark for analyzing the preemptive powers of financial institutions. The next round of financial institution preemption raises a question that \textit{Watters} does not quite reach but for which an answer can be inferred: If preemption protects operating subsidiaries of national banks from state law interference, does it not also protect agents of national banks? This issue, like the issue in \textit{Watters}, has undeniable implications for state-chartered banks.

In \textit{SPGGC v. Ayotte}, the First Circuit addressed the question of whether states have the power to regulate the activities of national banks and federal savings associations that choose to carry out their activities through third-party agents.\textsuperscript{10} Perhaps remembering the lesson from \textit{Watters} as to reliance on preemption regulations, the \textit{Ayotte} court looked to the NBA’s language permitting national banks to use “dually authorized officers or agents” in the exercise of their incidental powers. Further, in rejecting the state’s argument that the OCC preemption regulation is irrelevant as it covers banks and not third-parties, the \textit{Ayotte} court followed the guidance of Justice Ginsburg, stating: “this analysis is too formalistic: the question here is not whom the New Hampshire statute regulates, but rather, against what activity it regulates.”\textsuperscript{11} In applying both the NBA and the Home Owners Loan Act (“HOLA” – governing federal savings associations), the \textit{Ayotte} court held that national banks and federal savings associations may exercise their preemptive powers through agents free of state law restrictions. In other words, at least in the First Circuit, if a state law restriction would be preempted as applied to a national bank or federal savings association, then that law would be preempted as applied to agents of those institutions insofar as such agents are performing activities on behalf of their federally-chartered principals.\textsuperscript{12}

\begin{itemize}
  \item \textsuperscript{9} \textit{Watters} at 13 (emphasis in original)
  \item \textsuperscript{10} \textit{SPGGC v. Ayotte}, 488 F.3d 525 (1st Cir. 2007).
  \item \textsuperscript{11} Id. (emphasis in original).
  \item \textsuperscript{12} The \textit{Ayotte} court cited with approval a lower court decision that reached a similar result as to exclusive agents of federal savings associations. \textit{State Farm Bank, F.S.B. v. Burke}, 445 F. Supp. 2d 207 (D. Conn. 2006). While \textit{Ayotte} considered whether substantive state law provisions apply to agents, the \textit{Burke} court addressed the question of whether exclusive agents were subject to licensure generally, without reaching the application of technical restrictions on licensees.
\end{itemize}
A federal district court in Ohio, in *State Farm Bank, F.S.B. v. Reardon*, reached a result contrary to *Ayotte* and *Burke*, holding that exclusive agents of a federal savings association are subject to state mortgage broker laws notwithstanding the assertion of preemption by the OTS. In response to the attempts by John Reardon, Superintendent of the Ohio Division of Financial Institutions, to enforce state law against the exclusive agents of State Farm, the company argued that application of Ohio law to exclusive agents of a federal savings association is preempted by the Home Owners Loan Act (HOLA) and implementing regulations promulgated by the OTS. These regulations were evidenced by an OTS Chief Counsel opinion letter addressing the precise State Farm activities at issue. The court rejected State Farm’s argument that the Ohio law is preempted. Under the facts and circumstances before the court, the court did acknowledge that the OTS might very well have preemptive authority in this matter, but even if it did, the exercise of such authority had not yet been properly established by the agency. The court rejected the validity of the OTS Chief Counsel opinion letter, holding that the letter attempted to change the law and the agency’s existing policy but was not the product of notice-and-comment rulemaking under the Administrative Procedures Act, and therefore was not entitled to deference.\(^\text{13}\) The court determined that the underlying statute and regulations provide no support for the proposition that non-employee third party exclusive agents are exempt from state regulations.

Most practitioners might have thought that under the above-quoted language from *Ayotte* and *Watters* that the Ohio court, even if it viewed the OTS State Farm Opinion Letter as flatly over-reaching, would have undertook an analysis like the *Ayotte* court and found a statutory basis for preemption. Instead, however, the Ohio court viewed the *Watters* holding as applying only to banks and their operating subsidiaries, and that absent a controlling regulation, there was no legal basis for preempting application of state law to agents. There are definite problems with this decision, for example, that it acknowledges the possibility that the OTS could promulgate a preemption regulation, while such practice is at least called into question by *Watters*, and that it declines to address application of *Ayotte*.

More recently, the Second Circuit issued its decision in *SPGGC v. Blumenthal*.\(^\text{14}\) Similar to the First Circuit in *Ayotte*, this case examined the question of whether an agent of a national bank is entitled to preemption from state law in activities it performs for its national bank principal. At issue in *Blumenthal* were two provisions of the Connecticut law prohibiting gift cards that impose (1) inactivity or dormancy fees, and (2) an expiration date. Unlike the First Circuit, this court found that *Watters* should be limited to operating subsidiaries: “*[W]e believe that it would be a mistake to read *Watters* so broadly as to obscure the unique role assigned to operating subsidiaries in the context of national banking regulation.*” Notably, however, even though the Second Circuit took a narrower view of *Watters* than the First Circuit, it did acknowledge that under the right circumstances an agent could be covered by the preemption afforded a national bank. The court distinguished its holding from that in *Ayotte* on the facts, focusing on the degree of agency and the extent to which the fees were determined by the

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\(^\text{13}\) This is contrasted with *Watters*, which viewed the OCC regulation as a mere confirmation of existing statutory law.

national bank versus the non-bank third party. In the end, Blumenthal did not reject Ayotte and would probably have upheld Burke, which involved agents with very little discretionary authority independent of their federally-chartered principals.

State-Chartered Banks After Watters

As noted above, Watters has called into question the practice of agencies promulgating preemption regulations. This possible effect of Watters may extinguish the currently stalled FDIC preemption rulemaking. In 2005, the FDIC issued a notice of proposed rulemaking addressing, among other things, the preemption of state law as applied to state-chartered banks. Specifically, the FDIC’s proposed rule would provide parity of preemption for state-chartered banks with national banks, declaring that the law of a host state will not apply to the activities of a branch of an out-of-state state-chartered bank if such host state law would not apply to the activities of a branch of an out-of-state national bank. Further, the FDIC proposed that an out-of-state state-chartered bank may engage in any activity in a host state that is permissible for either an out-of-state national bank, or a bank chartered by the host state. Whether the FDIC has the legal authority to promulgate such a per se preemption regulation is debatable, however regardless of its legality, given the uncertainty on the practice raised by Watters, practitioners should look beyond the regulation for a statutory basis for such preemption.

An appropriate area to focus the comparison of national bank and state-chartered bank preemptive abilities is on interest rate exportation. Those who would attempt to restrict the scope and application of Watters, in addition to reading it as limited to operating subsidiaries as the Blumenthal court did, might also attempt to limit its holding to national banks, or at least national bank powers. Proponents of this view would argue that the legislative history and case law supporting parity between national banks and state-chartered banks focuses on the parity of § 85 of the NBA and § 27 of the FDIA, however the recent case law addressing national banks’ use of operating subsidiaries or agents have based the preemptive benefits of operating subsidiaries and agents not on national banks’ exportation authority under § 85, but rather on the powers of national banks as listed in § 24. Arguably, under this approach, the ability of a national bank to export interest rates through operating subsidiaries and agents only exists through the national bank powers contained in § 24. Some might argue that this view is supported by Justice Ginsburg’s emphasis on the word “powers” in her approach to preemption analysis: “[I]n analyzing whether state law hampers the federally permitted activities of a national bank, we have focused on the exercise of a national bank’s powers, not on its corporate

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16 Id. at 60031.

17 Id.

structure." Under this view, because Congress did not federalize the powers of state-chartered banks, they do not enjoy the same powers as national banks, only the exportation ability.

This view would be incorrect because in drafting §27, Congress expected that the doctrine of pari materia would enable state-chartered banks to fully and completely step-into-the-shoes of national banks in every aspect of their exportation powers. Section 27 was enacted as part of the DIDMCA,\(^\text{20}\) in which as discussed above, “Congress made a conscious choice to pattern section 1831d after section 85 to achieve competitive equality in the area of interest charges between state and national banks.”\(^\text{21}\) This notion that the word “powers” should control and demand a reference to § 24 at the exclusion of § 85, is overly literal, and ignores Justice Ginsburg’s likely use of the word “powers” synonymously with “activities” that she uses in the preceding clause. The First Circuit obviously recognized this when it focused on the “activity” that is targeted. The point behind both \textit{Watters} and \textit{Ayotte} is that the preemption analysis must focus not on the identity of the party engaging in the conduct, but rather on whether the conduct itself is entitled to preemption.

The question then becomes: What is the extent of the “competitive equality” that Sen. Proxmire and his brethren intended DIDMCA to bring about? It seems counterintuitive to give state-chartered banks full “competitive equality” with their national bank counterparts in the area of interest rate exportation, and yet hamper such parity by withholding the parity of powers needed to achieve such equality. To illustrate, § 85 gives national banks the power to “take, receive, reserve, and charge” interest (as does § 27 for state-chartered banks), but nowhere in § 85 does the statute prescribe the means through which such interest may be taken, received, reserved or charged. The vehicles through which to engage in these activities, for example, through contracting for the interest,\(^\text{22}\) or to sue for interest payments due,\(^\text{23}\) or to collect interest through agents, all implementing powers under § 24,\(^\text{24}\) all must be implied in § 85. Arguably then, in drafting § 27, Congress was doing so with a view not only toward § 85, but to § 24 as well insofar as Congress sought to provide parity for state-chartered banks in the power to implement interest rate exportation, or in the alternative, with a view toward typical state-chartered bank powers that tend to mirror that of national banks.\(^\text{25}\) For a state to assert that while it cannot regulate an out-of-state state-chartered bank’s ability to set interest rates in accordance

\(^{19}\) \textit{Watters} at 13 (emphasis in original).
\(^{21}\) Notice of FDIC General Counsel’s Opinion No. 11, 63 Fed. Reg. 27282, 27283 (May 18, 1998).
\(^{24}\) 12 U.S.C. § 24(Seventh).
\(^{25}\) For example, the Commonwealth of Pennsylvania allows its state-chartered banks to appoint agents, and to use such to engage in permissible banking activities, including activities permissible for national banks. 7 P.S. § 201.
with its home state law, or export such rates, but that it can regulate the corporate mechanisms of such exportation, would be to eviscerate the very parity that Congress sought. This cannot be the result that Congress intended.

Conclusion

The debate is surely far from over, and practitioners from Wall Street to Main Street are seeing a rise in state regulators and attorneys general, dismayed at their loss in *Watters*, attempting to circumvent preemption issues by bringing enforcement actions against those third parties with whom banks would attempt to partner. While both federally-chartered and state-chartered institutions are susceptible to litigation arising out of such state actions, state-chartered institutions currently are at a disadvantage as they have not enjoyed the recent string of appellate court victories as their federal cousins.
MONEY LAUNDERING AND CRIMINAL PROSECUTIONS OF BANKS:  
A FOCUS OF BANK ENFORCEMENT ACTIVITY IN RECENT YEARS  
By Thomas P. Vartanian and Dominic A. Labitzky*  

Bank Secrecy Act and Anti-Money Laundering (BSA/AML) related enforcement actions have grown to become a significant focus of the federal bank regulators’ enforcement activity over the course of the last few years. With the enactment of the USA PATRIOT Act,1 the role of banks in combating terrorist financing has only sharpened this focus. In 2004, the bank regulators undertook 437 enforcement actions, 66 of which were BSA/AML related. The following year, bank enforcement actions totaled 410 of which 53 were BSA/AML related actions. The trend of BSA/AML related enforcement actions constituting approximately 15 percent of total bank enforcement actions continued last year when bank regulators undertook 56 BSA/AML enforcement actions out of a total of 369 enforcement actions. As a result of the focus on BSA/AML compliance, BSA/AML related enforcement actions have also led to record civil money penalties (CMPs) ranging from $10 million to $100 million. However, civil enforcement actions are not the only penalties banks may face for BSA/AML violations.

The BSA also provides for criminal sanctions2 and the Department of Justice (DOJ) has been increasingly active in pursuing criminal enforcement actions involving banks over the past few years. Continued focus on BSA/AML compliance is virtually assured as the integral role banks play in identifying money laundering and terrorist financing is not likely to change. Although every case is different, banks may learn to improve upon their compliance programs and minimize their vulnerability to civil and criminal penalties by avoiding the pitfalls that have led to past enforcement actions.

BSA/AML ENFORCEMENT

Banks are required to maintain a BSA/AML compliance program comprised of: (i) a system of internal controls to ensure ongoing compliance; (ii) daily coordination and monitoring of compliance by a designated person (e.g., a BSA/AML officer); (iii) adequate training for compliance and other appropriate personnel; and (iv) independent testing of the compliance function by internal auditors or an outside party.3 BSA/AML enforcement actions differ

* Mr. Vartanian is a partner and Mr. Labitzky is an associate in the Washington, D.C., office of Fried, Frank, Harris, Shriver & Jacobson LLP. The authors regularly represent clients with regard to bank enforcement matters, including entities and issues that may be discussed in this article. The authors summarize bank enforcement cases and trends every six months.

1 President George W. Bush signed the USA PATRIOT Act (Act) into law on October 26, 2001. The Act established new rules and responsibilities affecting banks including, among others, establishing standards for customer identification at account opening (including requiring checks against government-provided lists of known or suspected terrorists) and requiring bank regulators to evaluate an institution’s anti-money laundering record when considering bank mergers, acquisitions, and other applications for business combinations.


depending in part on the existence and efficacy of a bank’s BSA/AML compliance program. A deficiency in only one area of the compliance program may lead to a less significant enforcement action, a memorandum of understanding or a cease and desist order, for example, than the complete absence of BSA/AML compliance program.

In addition to the four core requirements described above, comprehensive customer due diligence programs and account opening procedures are further critical components of an effective BSA/AML program. Effective customer due diligence programs play a critical role in helping banks evaluate transactions and determine whether filing a suspicious activity report (SAR) is appropriate.

Finally, banks need to design and structure their BSA/AML programs to adequately address the risk posed by the products and services being offered to the bank’s customers, as well as the geographic locations in which the bank does business. As noted above, the nature of the enforcement action and its impact will differ according to the type and severity of the issues raised.

For example, in the 2004 case against Riggs Bank, N.A., the Office of the Comptroller of the Currency (OCC) in conjunction with the Financial Crimes Enforcement Network (FinCEN) assessed a $25 million CMP for failing to implement an effective BSA/AML program and, as a result, failing to detect and investigate numerous suspicious transactions.\(^4\) According to the OCC’s consent order, Riggs’ BSA/AML program failed to comply with all four core requirements.\(^5\) Riggs’ internal controls system failed to adequately identify and address the risks attending various customer relationships as well certain high-risk products and services. Riggs lacked effective monitoring and compliance oversight by its BSA/AML office and failed to ensure adequate training of compliance personnel. With respect to independent testing of its BSA/AML compliance program, the OCC and FinCEN found that Riggs’ audits did not adequately test the compliance function and suffered from flawed testing and sampling.

This case and the corresponding large CMP illustrate a severe BSA/AML enforcement action. The bank’s total failure to implement a BSA/AML program commensurate with the risks attending its customers, products and services was only magnified by the fact that the bank’s BSA/AML deficiencies led the bank to fail to properly detect and investigate numerous suspicious transactions and file the requisite SARs. BSA/AML program deficiencies coupled with evidence of money laundering or other suspicious activity are significantly more likely to lead to severe enforcement actions and significant CMPs than compliance deficiencies alone.


In addition to the case against Riggs, the 2004 enforcement action by the Federal Reserve Board (FRB) and FinCEN against AmSouth Bank, of Birmingham, Alabama, further exhibits how compliance deficiencies, together with evidence of actual laundering or other illegal activity, can lead to severe sanctions. The action against AmSouth involved a $10 million CMP and cited material deficiencies in three of the four main components of AmSouth’s BSA/AML compliance program – internal controls, training, and independent testing. AmSouth failed to tailor its policies, procedures, and controls to the levels of risk presented by certain of its customers and a number of its products. For example, the bank failed to adequately identify and monitor certain customer accounts with cash-intensive activity to determine whether or not such activity warranted further inquiry or the filing of SAR. These deficiencies in AmSouth’s compliance program further resulted in the failure to identify, analyze, and report suspicious activity occurring at the bank.

Bank regulators have also focused on foreign banks doing business in the United States in addition to U.S. banks doing business abroad. In 2005, the OCC and FinCEN assessed a $24 million CMP against the New York branch of Arab Bank PLC, Amman, Jordan. The OCC alleged that Arab Bank engaged in substantial funds transfer operations that included a large number of transactions for parties that did not have accounts at the bank but whose transactions were originated by or received by other Arab Bank offices or branches, its affiliates, or by third-party correspondent banks. In connection with these transfers, the bank failed to adequately implement a program to monitor for suspicious activity, failed to adequately obtain information on funds transfers sufficient to determine whether it was required to file SARs, and failed to adequately audit or manage the implementation of a program to monitor money transfers for suspicious activity. In light of the high-risk characteristics, geographic locations of the parties, the BSA/AML deficiencies were deemed especially serious.

The Arab Bank case provides a good example of the type of activity regulators consider high-risk and therefore deem to require additional safeguards. Wire transfers, international correspondent banking, and private banking relationships are all examples of high-risk products or services. When banks provide such services to high-risk customers, money services businesses, such as check cashing services and currency dealer, or cash intensive businesses, or provide such high-risk products or services to customers in high-risk geographic locations,

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countries identified by the Office of Foreign Assets Control, regulators will expect enhanced due diligence procedures, as well as other policies and procedures designed to take into account any additional risks.

The April 2006 joint FinCEN and Office of Thrift Supervision (OTS) enforcement action\textsuperscript{10} against BankAtlantic, of Fort Lauderdale, for the alleged failure to report millions of dollars of suspicious transactions provides another good example of a failure to adequately address the risks attending high-risk customers and geographic regions.\textsuperscript{11} The allegations included BankAtlantic’s failure to implement an adequate BSA/AML program and internal controls designed to detect and report money laundering and other suspicious activity. According to FinCEN, BankAtlantic’s primary market of South Florida is designated as a High Intensity Money Laundering and Related Financial Crime Area as well as a High Intensity Drug Trafficking Area. BankAtlantic’s customers included high net worth individuals, many of whom were non-resident aliens, as well as offshore corporations, consulates and politically exposed persons.\textsuperscript{12} The banks business focused heavily on wire transfers and facilitated over 100,000 funds transfer per year. Despite the high levels of risk posed by the combination of the bank’s funds transfer business, geographic location and high-risk customer base, Bank Atlantic conducted business without the appropriate systems or controls in place to identify suspicious activity.

According to the agencies, the systemic defects in BankAtlantic’s BSA/AML program resulted in the failure to timely file numerous SARs. This enforcement action allegedly involved tens of millions of dollars in unreported suspicious financial transactions, including more than $10 million in suspected drug proceeds.

Similarly, in this year’s joint OCC and FinCEN enforcement action against Union Bank of San Francisco, California, the regulators cited Union Bank’s failure to adequately manage the risk associated with a number of its accounts maintained by Mexican casas de cambio, or exchange offices, customers the bank knew presented a heightened risk of money laundering.\textsuperscript{13} While the


\textsuperscript{11} DOJ and the bank entered into a deferred prosecution agreement the terms of which included, among others, forfeiting $10 million, accepting and acknowledging responsibility for the DOJ alleged conduct, and cooperating with certain requests for documents and other information. DOJ agreed to defer prosecution of the bank for 12 months, and further agreed to dismiss the charges with prejudice pending full compliance with the agreement by the bank. See Deferred Prosecution Agreement, U.S. v. BankAtlantic (Apr. 2006), available at http://www.usdoj.gov/usao/fls/PressReleases/Attachments/060426-02BankAtlanticDPA.pdf.


Union Bank action involved a deficiency in only one of the four core BSA/AML program elements, i.e., failing to implement an adequate BSA/AML compliance program designed to identify and report transactions indicative of money laundering or other illegal activity, Union Bank also failed to comply with a 2005 OCC memorandum of understanding that required the bank to improve its process for identifying and reporting suspicious transactions.\textsuperscript{14} The regulators assessed Union Bank a $10 million CMP.

Bank regulators are not likely to shift their enforcement focus away from money laundering anytime soon. In evaluating their BSA/AML programs, institutions should focus on (i) the risks that their business profile and customers create and understand how to design and implement a compliance program to adequately address those risk; (ii) have strong customer identification programs in place and thoroughly documented account opening procedures; and (iii) encourage a culture and leadership dynamic that focuses on successful money laundering compliance.

**CRIMINALIZATION OF BANKING**

Over the course of the last two decades, a number of laws, including FIRREA, FDICIA, The Crime Control Act, The USA PATRIOT Act, Sarbanes-Oxley, etc., have expanded on areas of criminal exposure for banks and bankers. Criminal authorities have, according to the evidence in the last decade, significantly increased their presence, investigations and prosecutions in the banking industry. In that regard, prosecutors have been pursuing criminal actions against a greater number of banks and have been entering into an increasing number of deferred-prosecution agreements (DPAs) with banks and other financial institutions. The greater number of DPAs likely supports an effort of seeking to impose a sense of criminal sanction but avoiding the stigma of indictment that could destroy a company. Under a DPA, a company avoids prosecution by agreeing to particular terms. DOJ will generally defer indictment for a period ranging from 18 months to several years. Commonly, the terms of DPAs include publicly acknowledging responsibility, paying a fine, agreeing to implement reform initiatives (usually monitored by an independent third party), as well as agreeing to cooperate with any ongoing investigation. After demonstrating compliance with the agreement and successful reform, DOJ will generally dismiss its charges when the term of the agreement expires. Violating the terms of an agreement will likely trigger prosecution.

While the BSA has included criminal sanction for more than thirty years, criminal penalties for banks, e.g., for the failure to file SARs, were virtually non-existent until a number of years ago. In 2002, the first criminal case against a bank for the failure to file SARs involved Broadway National Bank of New York.\textsuperscript{15} The Broadway case involved over $120 million in bulk cash and


structured deposits\textsuperscript{16} made at the bank over a period of two years. Broadway pleaded guilty to three criminal counts: failing to file SARs, failing to establish or maintain an adequate BSA program, and assisting customers in structuring deposits to evade reporting requirements. In conjunction with the guilty plea, the bank also paid a $4 million criminal fine.

Since the Broadway case, criminal authorities have sought criminal sanctions in an increasing number of cases against banks. For example, all but one of the cases discussed in the preceding section included a related action by DOJ. In the Riggs case, for example, the bank pleaded guilty to failing to timely file accurate SARs.\textsuperscript{17} Riggs also paid a $16 million criminal fine in addition to the $25 million CMP assessed by the OCC and FinCEN. The AmSouth case involved a DPA in connection with the bank’s guilty plea for one count of failing to file SARs in a timely, complete and accurate manner.\textsuperscript{18} That case also involved a DPA and a $40 million civil forfeiture. The more recent cases, BankAtlantic\textsuperscript{19} and Union Bank,\textsuperscript{20} have also involved criminal sanctions.

While criminal penalties for banks have hardly become the norm, a greater number of enforcement actions include criminal sanctions. What seems clear from past example of criminal sanctions against banks in the money laundering context is that DOJ seeks to prosecute banks involved in money laundering that have systemic deficiencies in their BSA/AML compliance programs. Thus, in addition to facing significant CMPs imposed by bank regulators, banks with severe and far-reaching BSA/AML compliance deficiencies can also expect to have to deal with DOJ. Not to mention the stigma attached to corporate criminal indictments, criminal prosecution adds an additional significant layer of complexity and cost to enforcement actions. Banks that focus on the core elements of BSA/AML compliance, implement strong customer due diligence programs and understand how to tailor their compliance programs according to different levels of risk posed by their customers, products and services offered, and geographic regions served may be able to avoid the most severe enforcement actions in cases where compliance deficiencies do come to light.

\textsuperscript{16} Structuring deposits refers to the process of breaking a large sum of money intended for deposit into numerous smaller deposits in order to avoid triggering BSA-required reporting for cash transaction involving sums of over $10,000.


