

Purpose and Scope of the Proposed Act

This memorandum briefly outlines the purpose and potential scope of the proposed **Non Depository Providers of Financial Services Act** ("Proposed Act"). The memorandum also summarizes the major issues that need to be addressed at the outset of the drafting process by the drafting committee ("Drafting Committee"). The Drafting Committee will hold its second meeting on October 24, 1997 in Washington, DC. The Drafting Committee welcomes the input of Commissioners with respect to the scope of the Proposed Act and looks forward to their comments and suggestions.

I. Background: Money Laundering by Non Depository Providers of Financial Services and Money Laundering

Non depository providers of financial services ("NDPs")¹ include a large number of commercial enterprises engaged in the transfer and exchange of monetary instruments and currency. NDPs include money transmitters (e.g., companies issuing money orders), wire transfer agencies, currency exchange houses, and check cashing companies. All of these industries operate outside of the depository institution ("DI") sphere. Consequently, they are subjected to a varying degree of state regulation and oversight. At the federal level, there is no direct regulation of NDPs. As many as 200,000 NDPs may provide financial services within the United States.

NDPs have come under heightened scrutiny in the past two years due to the fact that they have become potential sites for money laundering and illegal activity. Federal and state laws have become stricter with respect to depository institutions ("DIs") and their detection/prevention of money laundering. Money launderers, therefore, have turned to NDPs as a means of transporting illegal money and channeling it into the stream of commerce.

Various studies have confirmed the increasing role of NDPs in money laundering. Both drug traffickers and organized crime units have used NDPs as a means of transmitting currency across borders. As early as 1991, the United States Department of the Treasury ("Treasury") and the Financial Action Task Force identified NDPs as vehicles for money laundering. A 1994 study conducted by the National Association of Attorneys General ("NAAG") confirmed that NDPs (in particular currency exchange houses) were utilized in the Southwestern United States by drug traffickers.

In the fall of 1996, seven east coast money transmitters were indicted for accepting funds that were allegedly drug proceeds in a federal sting operation. The El Dorado Task Force ("Task Force"), formed in 1992, is a joint federal, state and local effort involving the Federal Customer Service, the Internal Revenue Service, the Secret Service, the New York Police Department and the New York State Banking Department. The task force targets industries that facilitate money laundering. In 1996, for example, the Task Force monitored the activities of money transmitters in New York City engaged in fund transfer to Colombia. Based on their investigations, the federal government was able to obtain the first ever guilty plea from a licensed money transmitter, Viga Remittance Corp in July 1996.

The work of the Task Force also enabled the federal government to initiate a geographic targeting order ("GTO") against 22 money transmitters in New York City and their 3,500 licensed agents. Under federal law, the government can require a group of financial institutions within a limited geographic range, to comply with special recordkeeping requirements upon a showing that there is a need for such recordkeeping. The Task Force's previous investigations provided a basis for a GTO directed at transmitters involved in funds transfer to Colombia. In

NDPs have also been referred to as Non-bank financial institutions and Money Services Businesses

August 1996, a GTO was put in place requiring the 22 transmitters to report information about cash transfers to Colombia greater than \$750. According to statements made by Under Secretary of the Treasury, Raymond Kelly, the volume of money transferred to Colombia has dropped by 30% as a result of the GTO. This is more evidence that NDPs such as money transmitters provide a site for money laundering.

Because NDPs operate outside of the watchful eye of bank regulators, they are able to assist money launderers who would be forced to reveal their identities if they transacted with a commercial bank. A currency exchange house, for example, may accept cash from a customer which it will then deposit in its own bank account at a commercial banking institution. The origin or source of the funds is "disguised" because the bank will attribute ownership to the currency exchange business. Similarly, a wire transfer "service" may accept funds from a customer and wire them through its own commercial bank for a small commission. Again, the true source of the funds is thereby masked.

Electronic currency poses a potential new threat. Non banks are becoming issuers of electronic currency. "Digital" cash will also serve as a means to transport illegal money anonymously. Encryption devices may prevent authorities from detecting the owner or source of the money.

Federal and state regulators and law enforcement authorities have traditionally relied on currency transaction reports ("CTRs") as a means of detecting money laundering in financial institutions (including DIs and NDPs), predominantly banks. Pursuant to the federal Bank Secrecy Act ("BSA"), financial institutions are required to report currency transactions equal to or greater than \$10,000 to Treasury. For example, if a bank customer deposits \$10,000 into his or her bank account, the bank is obligated to file a CTR. The CTR indicates the name of the depositor as well as the nature of the transaction.

NDPs are technically obligated to file CTRs. The lack of federal and state oversight and regulation of NDPs, however, makes it difficult to enforce this requirement. Some NDPs may be unaware, furthermore, that they possess such an affirmative obligation.

DIs are also required to file suspicious activity reports ("SARs") for financial transactions that suggest money laundering or other illegal/fraudulent activity. By contrast, NDPs are not obligated to complete SARs. At present, Treasury does not have an SAR designed for NDPs. Customers, may therefore, structure transactions with NDPs that would be normally be identified as a suspicious activity if conducted through a bank. For example, a customer who wires a large number of money transfers to a foreign country might remain undetected with an NDP but be reported to Treasury by a DI.

Banking regulatory agencies such as the Federal Reserve have also required DIs to "know their customers" in order to determine whether money that they are receiving or transmitting is derived from illegal activity. Compliance programs require banks to ascertain the true identity of customers as well as the potential origin of the funds being deposited. Because NDPs are subjected to less or no regulatory oversight (as compared with banks) they do not have the same level of compliance programs.

Treasury and FinCEN are currently considering three proposed rules that would address the absence of NDP oversight on the federal level. The first rule would create a registration scheme for NDPs. The other two rules would extend the SAR transaction reporting requirements to certain categories of NDPs. Treasury has just initiated the notice of proposed rulemaking with respect to these rules and will solicit the views of industry groups, government agencies and the general public.

B. Current Legislative Responses

In 1994, Congress enacted the Money Laundering Suppression Act ("MLSA") (P.L. 103-225). The MLSA recommended that the States enact uniform laws to regulate NDPs. Treasury was simultaneously required to develop a federal NDP registration scheme. Section 407 of the MLSA urges states to enact uniform laws **"to license and regulate"** NDPs including businesses which "provide check cashing, currency exchange, or money transmitting or remittance services, or issue or redeem money orders, travelers checks and other similar instruments"

Congress specifically requested that the states should develop a uniform act under the auspices of the National Conference of Commissioners on Uniform State Laws ("Conference") or the American Law Institute. Congress recommended that a proposed uniform act would include:

- (1) licensing requirements for NDPs;
- (2) licensing standards for NDPs that focus on:
 - (a) the business records and capital adequacy of the NDP;
 - (b) the competence and experience of the directors and officers of the NDP;
- (3) reporting requirements concerning disclosure of fees for services offered to consumers;
- (4) procedures to ensure compliance with federal currency transaction reporting requirements; and
- (5) criminal penalties for the operation of an NDP business without a license.

Section 407 also calls for the states to enact criminal or civil penalties for (1) operating a money transmitting business without a license and (2) failing to comply with the currency reporting requirements of the BSA.

Section 408 of the MLSA imposes a federal reporting requirement on NDPs (including casinos) to register with Treasury. An NDP must disclose the name and location of its operations as well as the names of the persons who control the business. Treasury's Financial Crimes Enforcement Network ("FinCEN") is supposed to oversee the registration program.

Current state regulation of NDPs is extremely varied. At present, 30 states have criminal money laundering statutes. Only 8 of these statutes make it illegal for financial institutions to fail to comply with the BSA. The BSA defines the term "financial institutions" to include both DIs and NDPs. Money transmitters (check and money order sellers) are regulated in approximately 44 states, check cashers in 18 states, and wire transfer agencies in about 21 states. Currency exchange businesses are the least regulated with only 6 states having applicable legislation. Bonding, licensing and reporting requirements vary greatly among jurisdictions and between industries. Electronic currency has only recently emerged as a potential subject for federal and state regulation. 23 states in total have licensing requirements for NDPs.

Approximately, 15 states require financial institutions to report suspicious transactions that might involve money laundering to state authorities. Most of the state reporting legislation does not specifically address NDPs (but may apply to NDPs by implication). Of these, 5 states (Colorado, Connecticut, Idaho, Indiana and Oklahoma) require financial institutions to file federal SARs concurrently with state authorities. Arizona has its own suspicious activity form for financial institutions. Suspected money laundering activities are reported to Arizona's Attorney

General on a one page form.

C. Model Act from Money Transmitters Regulators Association

The Money Transmitters Regulators Association² ("MTRA") has developed a model act ("MTRA Act") that deals with the licensing and regulation of money transmitters.³ The MTRA has described its model act as a "safety and soundness" law. The MTRA Act provides a useful frame of reference but does not have a broad enough scope so as to preclude the Conference's efforts with respect to NDPs. The act specifically excludes check cashers and currency exchange operations from its scope. Moreover, the MTRA Act does not deal with reporting requirements or enforcement mechanisms aimed at money laundering prevention. The act, for example, does not provide penalties for an NDP's failure to comply with federal currency reporting requirements.

The MTRA Act may, however, serve as a useful starting point for the Drafting Committee's discussions. If the Drafting Committee decides to deal with licensing and regulation of NDPs generally, the MTRA Act may provide a beginning model for expanded uniform legislation that would include check cashers and currency transmitters as well as money transmitters. Additionally, the drafting committee needs to decide whether currency/suspicious activity reporting requirements should be the subject of a separate act or should be included in conjunction with licensing provisions.

The Committee Chair has been in contact with Ezra C. Levine, an attorney who represents the Non-Bank Funds Transmitters Group. Mr. Levine has expressed his group's interest in the Conference's proposed project. The Drafting Committee welcomes their participation through an observer to the drafting process, as well as the participation of other interest groups.

D. Conference Activities to Date

On January 7, 1995, the Conference Committee on Scope and Program ("S&P") approved the creation of a study committee ("Study Committee") to assess the need for a uniform act on NDPs. Judge Willoughby was appointed the Chairperson of the Study Committee. The Study Committee solicited the views of regulators, state prosecutors, and NDP industry associations as part of its review. The majority of those who responded recommended that the Conference undertake such a project. On July 16, 1996, the Executive Committee of the Conference approved a drafting committee for a proposed uniform act related to "nonbank and non-broker dealer providers of financial services."

In October 1996, Conference President Bion Gregory appointed the drafting committee as follows:

Tom Bolt (Virgin Islands) Committee Chair

Rush C. Deacon (Arkansas)

David A. Gibson (Vermont)

The MTRA describes itself as a regulatory organization comprised of members from various state banking departments. The MTRA invites industry involvement but considers itself a regulatory organization governed by regulators rather than industry participants.

To date, 5 jurisdictions have adopted the MTRA Act in some form.

Michael Houghton (Delaware)

Scott Scherer (Nevada)

Sandra S. Stern (New York)

Ken H. Takayama (Hawaii)

The Committee Chair has obtained the records of the Study Committee. At the suggestion of Conference Executive Director Fred H. Miller, the Chair has also initiated discussion with the Federal Reserve Bank of New York ("FRBNY") and Treasury concerning project funding.

The Committee Chair has also attended the American Bar Association/American Bankers' Association Money Laundering Enforcement Seminar in Washington, DC in October 1996. He initiated contact with regulators and NDP interest groups. Following the seminar, the Chair met with senior level members of FinCEN -- William Beatty (Associate Director), Steven Kroll (General Counsel), and Peter Djinis (Assistant Director for Regulation). FinCEN has contracted with Coopers & Lybrand for a study assessing the number of NDPs in existence and the volume of their trade. Subsequent to the FinCEN meeting, the Committee Chair and FinCEN Associate Director Beatty met with James E. Johnson, an Assistant Secretary at Treasury. FinCEN and Treasury are strongly committed to the Conference's project and have promised to allocate funds accordingly. The Committee Chair has been in active consultation with members of both the House and Senate Banking committees concerning the status of the Proposed Act.

The FRBNY and the Board of Governors of the Federal Reserve ("Board") also strongly endorse the Proposed Act. The Committee Chair has met with Thomas Baxter, General Counsel of the FRBNY, and Rick Small, Special Counsel and money laundering expert from the Board. The FRBNY has agreed to secure project funding from private foundations and has met with Treasury to express its support for the Proposed Act.

NAAG has also expressed support for the project. In particular, NAAG has offered to provide an observer to work with the Drafting Committee. If the Proposed Act is drafted, NAAG will facilitate the introduction and adoption of such legislation in the fifty states through the respective state attorneys general.

Executive Director Miller appointed Professor Anita Ramasastry, a law professor at the University of Washington, as reporter to the Drafting Committee. Professor Ramasastry is a former Federal Reserve attorney who teaches in the fields of banking and commercial law. The Committee Chair and the Reporter have been in frequent contact and have begun to (1) gather relevant information, data and state/model legislation concerning NDPs and (2) identify issues and topics that might be included in the Proposed Act.

On January 1997, the Executive Committee of the Conference approved of the Drafting Committee's work with respect to the Proposed Act. The Executive Committee, however, approved the commencement of the project conditional upon the Conference's ability to obtain funding for the Proposed Act.

The Drafting Committee submitted a proposed list of observers and advisors to the President of the Conference, Bion Gregory. The list of observers and advisors was formally approved and includes representatives from the federal government, state regulatory bodies, and industry associations.

On June 1997, representatives of the FRBNY, Ernest Patrikis, First Vice President

of and Thomas C. Baxter met with Under Secretary Kelly at Treasury. Kelly agreed to provide financial support for the Drafting Committee's efforts. Subsequently, the Conference has received an initial commitment from Treasury of \$100,000 to support the initial stages of the project. Based on Treasury's funding of the project, the Executive Committee authorized the Drafting Committee to commence work on the Proposed Act.

The Committee Chair has conferred with the Drafting Committee. He scheduled an initial meeting of the Drafting Committee to coincide with the Conference's annual meeting. He has tentatively planned the second meeting which will include observers and advisors for October 1997. He hopes to circulate an initial draft of the Proposed Act at this meeting.

II. Proposed Act

A. Reasons for Proposed Act

There are many benefits to be gained from the Proposed Act. Uniform legislation would simplify NDP compliance efforts with respect to money laundering prevention for NDPs who transact business in multiple jurisdictions. The diverse nature of state legislation currently makes compliance difficult for many NDPs. The Proposed Act would also facilitate and enhance enforcement of existing money laundering and BSA provisions. At present, even those states with enforcement mechanisms for non-compliance (e.g., for an NDP's failure to comply with federal currency reporting requirements), have not been actively enforcing these statutes.

The Proposed Act will potentially provide a comprehensive framework for dealing with money laundering issues unique to NDPs as distinguished from DIs. The Proposed Act would potentially provide a uniform licensing/regulatory scheme for various NDPs including check cashers, currency exchange business, and money transmitters.

Electronic currency may also become an increasingly popular vehicle for money laundering. The Drafting Committee will need to consider whether electronic currency providers should be treated as NDPs. To the extent that various NDP industries may be incompatible for unitary treatment, the scope of our endeavor will be narrowed or adjusted to respond to such concerns.

The Drafting Committee intends to consult with a broad range of organizations and individuals prior to defining the ultimate scope of its endeavor. Some of the organizations that the Drafting Committee has invited to participate include: MTRA, NAAG, FinCEN, FRBNY, the National Association of Check Cashers, the American Bar Association, the National Association of District Attorneys, the House and Senate Banking Committees, and the Conference of State Bank Supervisors.

B. Potential Issues to be Addressed in Proposed Act

We have identified several of the major topics that may be addressed within the framework of the Proposed Act. The Drafting Committee will need to decide, at the outset, whether these topics and issues will be addressed within the Proposed Act. The scope of our endeavor will be further clarified during the Drafting Committee's initial meeting in Sacramento

1. Name for Proposed Act

NDPs have also been referred to as non-bank financial institutions and also as money service businesses. Initially, the Drafting Committee will need to decide whether the Proposed Act should use the term NDP when referring to the various types of institutions to be covered by the act.

The Drafting Committee will also need to consider definitional alternatives.

We also need to consider what types of institutions fall within the definition of NDP (or whatever term we ultimately select). As stated previously, some of the institutions routinely grouped under the term NDP include money transmitters, foreign exchange businesses, and check cashing agencies. We need to consider whether the Proposed Act should treat these entities in a similar fashion.

Additionally, we should evaluate whether new types of businesses such as electronic currency providers and the manufacturers of stored value cards, should also be encompassed within the definition of NDP. It is crucial to come up with a feasible and comprehensible definition of NDP (or its definitional equivalent).

At present, the name of the Proposed Act is the Regulation of Non-Depository Providers of Financial Services. The Drafting Committee should also evaluate the title of the Proposed Act to determine whether it captures the scope and nature of the subject matter being regulated.

2. Licensing and Regulation of NDPs

Congress, in the MLSA, encouraged states to adopt uniform legislation governing the licensing and regulation of NDPs. At the outset, the Drafting Committee, after consultation with advisors and observers, should make a preliminary decision about the scope of the Proposed Act. Licensing could be a crucial element in money laundering prevention. Proper licensing mechanisms will help states detect illegitimate NDP operations and prevent them from conducting business. Additionally, licensing is one method by which states could monitor the operations of these businesses. Licensing might better ensure compliance with existing laws (such as the federal currency reporting requirements).

The Drafting Committee recognizes the need to consider the potential scope of licensing under the Proposed Act. Within scope we need to more closely consider the extent to which licensing as opposed to other alternatives is the best method for dealing with NDPs. First, we need to consider whether it is possible to treat different kinds of NDPs in a similar manner. We also need to analyze the existing MTRA Act and the extent to which this act, if more widely enacted, obviates the need for further legislation in this area. As discussed above, we could also decide to work with the MTRA to augment its act. The Proposed Act might then focus solely on NDPs other than money transmitters, such as check cashers and currency exchange houses.

We also are aware of the potential implementation problems that may be created by licensing requirements. State Banking Departments have frequently been the administrative body vested with NDP oversight. To the extent that we create a uniform licensing scheme, these bodies will have increased responsibility with respect to NDP supervision. This responsibility will potentially create increased fiscal and administrative burdens for the various states.

Regulation of NDPs can be achieved in a variety of manners. The Drafting Committee, therefore, will consider alternative means of gathering information concerning NDPs. We will consider whether broad regulatory legislation is necessary (that would include ongoing supervision of NDPs) or whether a registration/mandatory disclosure system is preferable. The Proposed Act, for example, could build on the newly enacted federal registration regulations for NDPs. If we required NDPs simply to register and file information with the states, we could simultaneously enact penalty provisions for the filing of false or inaccurate information.

3. Reporting Requirements

Approximately eight states require that financial institutions comply with federal reporting requirements under the BSA. To the extent that NDPs have currency reporting requirements, states have not actively monitored NDP compliance. One of the key issues that the Proposed Act will attempt to address is NDP compliance with federal currency reporting requirements. The Proposed Act may simultaneously impose civil or criminal penalties for non compliance with federal law (see section 3 below).

Additionally, the Drafting Committee will consider the need for NDPs to file SARs. At present, Treasury has not created a SAR for NDPs. The Drafting Committee, therefore, needs to assess whether state reporting requirements and forms are necessary in the absence of a federal SAR.

Furthermore, we will need to review the proposed federal rules concerning SARs designed for NDPs in order to determine how state regulation might complement federal legislation of this nature.

The Drafting Committee will be in a good position to assess the unique characteristics of NDP financial transactions. Based on this assessment, we may be able to identify suspicious patterns of NDP customer conduct that should be reported to state authorities.

4. Enforcement Mechanisms

We will also need to consider the potential enforcement mechanisms that will ensure NDP compliance with obligations placed upon them by virtue of the Proposed Act.

The Proposed Act may potentially require NDPs to do the following:

- (1) obtain a license;
- (2) retain records;
- (3) file information with the state banking authorities; or
- (4) comply with federal or state reporting requirements related to money laundering detection.

To the extent that any of these activities are mandated, the Proposed Act will need to consider civil or criminal penalties for failure to comply with these provisions. If the states have enforcement powers with respect to NDPs, we will need to consider notice and hearing provisions as well.

We have mentioned both civil and criminal penalties. Congress suggested the notion of criminal penalties in the MLSA perhaps because money laundering itself is a criminal offense. We are mindful, however, that civil penalties may be preferable because we are contemplating a commercial law that may primarily be enforced by an administrative agency rather than by law enforcement authorities.