

# Regulatory Initiatives, Scandals, and the Impact on the Regulatory Environment

By

Kenneth L. Bryant

MSCJ, CPP, CFE, CRP, CAMS, ACoI

[www.amlcft.com](http://www.amlcft.com)

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The world of financial services is changing rapidly. Over the course of the past several years, there have been a number of regulatory initiatives by standard setting organizations as well as an increase in the review and assessment of jurisdictions by international bodies. As the global post continues to move forward, there should be no surprise that there have been numerous institutions around the world that have met with scandal and enforcement action. In light of the current regulatory environment world wide, it is advisable that the institution undergo a risk assessment and an evaluation of internal controls with a view to ensuring the compliance program meets or exceeds current international standards.

In the past two years, there have been a number of regulatory initiatives that have had the effect of increasing compliance standards worldwide. At an extraordinary Plenary on the Financing of Terrorism held in Washington, D.C. in October 2001, the Financial Action Task Force on Money Laundering (FATF) expanded its mission beyond money laundering to include combating the financing of terrorism (CFT). The FATF began to focus its energy and expertise on the world-wide CFT effort and has actively pursued its activities to counter terrorist financing.<sup>1</sup> In response to the events of September 11<sup>th</sup>, the FATF responded to the United Nations (UN) Security Council Resolution 1373 (New York, 28 September 2001) and UN Security Council Resolution 1390 (New York, 16 January 2002) on Terrorist Financing by issuing their own Eight Special Recommendations on Terrorist Financing for jurisdictions in October 2001.<sup>2</sup> As a follow on, the FATF published their Guidance for Financial Institutions in Detecting Terrorist

Financing in April 2002.<sup>3</sup> In order to assist countries to implement effective measures to the financing of terrorism, the FATF has issued further interpretation and guidance since October 2002 on the Eight Special Recommendations, with respect to informal money (or alternative remittance) transfer systems (SR VI, June 2003), wire transfer requirements (SR VII, February 2003) and non-profit organizations (SR VIII, October 2002).<sup>4</sup>

In addition, the FATF has completed its review of the 40 Recommendations in June 2003. During this review, the FATF updated and specified a list of predicate offenses, expanded the customer due diligence process, enhanced measures for higher risk customers and transactions (including correspondent banking and politically exposed persons or PEPs), extended anti-money laundering (AML) measures to designated non-financial businesses and professions (casinos; real estate agents; dealers of precious metals/stones; accountants; lawyers, notaries and independent legal professions; trust and company service providers), included measures regarding international co-operation, improved transparency requirements through adequate and timely information on the beneficial ownership of legal persons (e.g. companies and trusts), extended many AML requirements to cover terrorist financing, and prohibited shell banks.<sup>5</sup>

Similarly, the Basel Committee on Banking Supervision has promulgated three key documents since late 2001: Customer Due Diligence for Banks, October 2001; Sound Practices for the Management and Supervision of Operational Risk, July 2002; and - The Compliance Function in Banks in October 2003. The Customer Due Diligence paper recommended increased Know Your Customer (KYC) standards in the area of customer acceptance (e.g. PEPs), client identification, on-going monitoring, and risk management.<sup>6</sup> The consultative paper Sound Practices for the Management and Supervision of Operational Risk “outlines a set of principles that provide a framework for the effective management and supervision of operational risk, for use by banks and supervisory authorities when evaluating operational risk management policies and practices.”<sup>7</sup> The Compliance Function in Banks document issues guidance on enhancing the compliance

function in the following areas (11 principles): responsibilities of the board and senior management, status, independence, roles and responsibilities, staff, cross border issues, relationship with internal audit and outsourcing.<sup>8</sup>

Having earlier recognized the FATF Forty and the Eight Special Recommendations on Terrorist Financing (FATF 40+8) as the international standards for combating money laundering and terrorist financing, the International Monetary Fund (IMF) and World Bank formally added them to the list of standards for which Reports on the Observance of Standards and Codes (ROSCs) are prepared. ROSCs previously included assessment criteria based on standards set by the Basel Committee (e.g. Core Principles for Effective Banking Supervision, September 1997),<sup>9</sup> the International Association of Insurance Supervisors (IAIS) (e.g. Anti-Money Laundering Guidance Notes for Insurance Supervisors and Insurance Entities, January 2002),<sup>10</sup> the International Organization of Securities Commissions (IOSCO) (e.g. The Objectives and Principles of Security Regulation, February 2002),<sup>11</sup> and the Egmont Group (e.g. Statement of Purpose, June 2001).<sup>12</sup> In October 2002, the IMF, the World Bank and the FATF agreed on a common methodology to assess compliance with the FATF Recommendations.<sup>13</sup> This methodology has now been used both for FATF mutual evaluations and IMF/World Bank assessments. This has placed considerable pressure on jurisdictions and their respective regulators, such as Cayman, particularly in the context of the Offshore Financial Center (OFC) Assessment program of the IMF/World Bank and to which the Cayman Islands recently under went in September 2003.

Moreover, the amount of regulatory and law enforcement information sharing has increased immeasurably worldwide in the past several years. The Basle Committee on Banking Supervision and the Offshore Group of Banking Supervisors (OGBS) published The Supervision of Cross-Border Banking in October 1996. In effect, this paper called for and suggested measures “to improve the access of home supervisors to information necessary for effective consolidated supervision.”<sup>14</sup> Similarly, the G-7 Finance Ministers

published a report entitled Financial Stability – Supervision of Global Financial Institutions in May 1998 which called for increased cooperation on ten key principles on information sharing among regulatory supervisors.<sup>15</sup> In addition, the Egmont Group was created in June 1997 and the number of financial intelligence units (law enforcement information sharing) worldwide has grown to 84 in July 2003.<sup>16</sup>

The increasing regulatory standards for AML/CFT and the international review methodologies to ensure their implementation have combined with more effective supervisory surveillance yielded as a result of increased information sharing and global cooperation among regulatory supervisors and law enforcement. It comes as no surprise that the number of compliance violations detected is on the rise worldwide as are the hefty fines and penalties as a result of enforcement actions. The following is a list of just some of the recent enforcement actions worldwide in the last few years by date, institution, violation and amount:

06/2002	Valley National Bank of New York	Failure to file SARs	USD \$15.8 million forfeiture
12/2002	Broadway National Bank, of New York	Failure to file SARs Failure to maintain an AML program	USD \$4 million fine
12/2002	Royal Bank of Scotland Plc	Money laundering control failings	GBP £750,000 fine
12/2002	Western Union	Inadequate Compliance Program Failure to file SARs and Currency Transaction Reports (CTRs)	USD \$8 million fine
01/2003	Banco Popular de Puerto Rico	Failure to file Suspicious Activity Reports (SARs)	USD \$21.6 million forfeiture
03/2003	Western Union	Failure to file CTR's	USD \$3 million fine
04/2003	Paypal	Transmitting criminal proceeds	Pending

		from on line gambling	
05/2003	Mirage Casino	Failure to file CTR's	USD \$5 million fine
08/2003	Western Union	Inadequate money laundering control procedures Failure to file CTR's	USD \$5 million fine
10/2003	Delta National Bank & Trust Company	Failure to file SARs	USD \$950,000 forfeiture
12/2003	Abbey National Bank	Inadequate money laundering controls Failure to properly identify clients	GBP £2.3 million fine
01/2004	Bank of Scotland	Failure to keep proper customer identification	GBP £1.25 million fine
03/2004	Hudson United Bank	Inadequate AML compliance program	USD \$5 million fine
04/2004	Raiffeisen Zentralbank Österreich	Inadequate money laundering controls	GBP £170,000 fine
05/2004	Riggs Bank	Failure to file SARs	USD \$25 million civil penalty

Although there have been no published reports of fines and penalties levied on Cayman Financial Services Providers (FSPs) by the Cayman Islands Monetary Authority (CIMA), there have been two recent court cases: Eurobank and Cash 4 Titles (C4T). In 2001, the Eurobank case resulted in the arrest of four defendants including the Chairman of the Board, Managing Director, Company Secretary and a Senior Trust Officer of the bank. The indictment consisted of several counts of assisting another to retain or control the benefits of criminal conduct with respect to various individuals and entities. In essence, Eurobank lacked proper procedures for accepting clients and funds during the 1996-1999 time frame and that the four defendants were critical personnel in the management of the bank. Eurobank was subsequently wound up and forfeited USD \$23 million to the U.S.

Government. The Eurobank case was eventually dismissed in December 2002 due to investigative and prosecutorial misconduct by the Cayman Islands Government.

(C4T) Management Inc. was an Atlanta based business and was the holding company for over 20 corporations which owned and operated Cash 4 Titles stores in the US. C4T had about 115 retail outlets in 11 states that lent money to people with bad credit at exorbitant interest rates and collateralized or secured the loans with the titles of vehicles and pay checks. Essentially, C4T was a “Ponzi” or pyramid scheme. In December 1999, three officers of the ABC Bank (Cayman) are fired following suspensions a month earlier after an internal investigation into the bank's handling of accounts controlled by the key principal (KP) of C4T. All three were involved in administering accounts controlled by the KP and other parties connected with the C4T Ponzi scheme. The ABC Bank subsequently found that the three officers had breached internal operating procedures. In February 2000, the ABC Bank is named a defendant in a class action civil lawsuit filed in the US District Court for the Southern District of Florida. In September 2000, the U.S. Securities and Exchange Commission (SEC) added 16 defendants, including 2 Cayman subsidiaries of the bank (bringing the total to 42) to a lawsuit filed in the US District Court for the Northern District of Illinois. The class action lawsuits alleged that the C4T funds going into the scheme were generally directed through offshore structures in the Cayman Islands and the Bahamas, with the ABC Bank acting as the main banker. Apart from providing banking services to C4T, senior officers of the ABC Bank allegedly played an active part in promoting the scheme (aggressively “hyping” it), facilitated its continued existence (as C4T conspirators emphasized the Bank's conservative and exemplary reputation), invested in it themselves and jointly owned property with C4T principals. It had also been claimed that the bank allowed the scheme to go on for almost two years after receiving a report from outside counsel indicating that its involvement with Cash 4 Titles amounted to money laundering. The complaint against the ABC Bank was filed under the U.S. Racketeering Influenced and Corrupt Organizations (RICO) Act, which allows courts to award treble damages or up to \$900 million in this instance if the

case was proven. In October 2001, the ABC Bank settled the case and agreed to pay \$67.5 million in damages.<sup>17</sup> Several other lawsuits and the criminal case are still pending.<sup>18</sup>

The lessons learned from both the international and Cayman Islands cases are good examples of the types of risk a financial institution can encounter for failing to comply with international standards and best practices. The Basel Committee on Banking Supervision in its Customer Due Diligence paper identifies four major types of risk:

Reputational – the potential that adverse publicity regarding a bank’s business practices and associations, whether accurate or not, will cause a loss of confidence in the integrity of the institution;

Operational – the risk of direct or indirect loss resulting from inadequate or failed internal processes, people and systems or from external events;

Legal – the possibility that lawsuits, adverse judgments or contracts that turn out to be unenforceable can disrupt or adversely affect the operations or conditions of the bank (such as fines, criminal liabilities and special penalties imposed by supervisors and legal costs);

Concentration – As to the assets side of the balance sheet, banks can not set prudential limits to restrict their exposures to single borrowers or groups of related borrowers without knowing precisely who the customers are and their relationship with other customers. On the liabilities side, concentration risk is closely associated with funding risk, particularly the risk of early and sudden withdrawal of funds by large depositors, with potentially damaging consequences for the bank’s liquidity.<sup>19</sup>

The exposure of these types of risk to this institution have increased with the advent of international initiatives which have increased the number of predicate offenses, expanded KYC and due diligence, called for transparency in beneficial ownership, extended measures for non-financial businesses and professions, restricted correspondent banking, prohibited shell banks, highlighted PEP risk, and alerted the world to terrorist financing.

In order to assess whether this institution is meeting prevailing international regulatory standards and best practices as well as the expectations of the local regulator, and thus avoiding significant reputational, legal, operational and concentration risk, it is advisable that a risk assessment be undertaken to re-evaluate the institution's risk management and internal control process in light of recent international initiatives. Initially, this should be conducted by internal audit and cover at a minimum the following areas: management oversight and the control culture, risk recognition and assessment, control activities and segregation of duties, information and communication, monitoring activities and correcting deficiencies.<sup>20, 21</sup> As a precautionary measure and as an additional check and balance, a secondary audit should also be conducted by an outside independent external auditor with a specific view to provide important feedback on the effectiveness of the risk management and internal control system<sup>22</sup> and "to confirm that [the institution is] in compliance with supervisory practice."<sup>23</sup>

In conclusion, recent international initiatives have continually increased regulatory standards and best practices and international bodies have stepped up their efforts with a comprehensive methodology to ensure compliance by various jurisdictions and their respective regulators around the world. At the same time, information sharing amongst regulators and law enforcement is at the highest level it has ever been. These two factors have provided for more effective regulatory supervision and have resulted in a higher detection rate for non-compliance. In tandem, there have been numerous criminal and civil cases brought and regulators have exacted multi-million dollar fines and penalties. As the regulatory environment becomes increasingly more difficult world wide, Cayman is not likely to escape it as recent history has shown. As the breadth and scope of regulatory enforcement increases, so does the potential for significant reputational, legal, operational and concentration risk to this institution. A risk assessment should be undertaken by internal and external audit to re-evaluate the institution's risk management and internal control process. Once any risk exposures and deficiencies are addressed and corrected, the institution will not only be in a better position from a corporate governance

standpoint but may also avoid any regulatory sanction and/or mitigate any potential fine or penalty.

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<sup>1</sup> FATF Website: [http://www1.oecd.org/fatf/TerFinance\\_en.htm#Documents](http://www1.oecd.org/fatf/TerFinance_en.htm#Documents)

<sup>2</sup> ICA Course Book Appendix 10: FATF - Special Recommendations on Terrorist Financing, October 2001

<sup>3</sup> FATF - Guidance for Financial Institutions in Detecting Terrorist Financing, April 2002  
[http://www1.oecd.org/fatf/pdf/GuidFITF01\\_en.pdf](http://www1.oecd.org/fatf/pdf/GuidFITF01_en.pdf)

<sup>4</sup> FATF Website: [http://www1.oecd.org/fatf/TerFinance\\_en.htm](http://www1.oecd.org/fatf/TerFinance_en.htm)

<sup>5</sup> ICA Course Book Appendix 11: FATF – 40 Recommendations

<sup>6</sup> ICA Course Book Appendix 9: Basel Committee on Banking Supervision – Customer Due Diligence for Banks, October 2001

<sup>7</sup> ICA Course Book Appendix 4: Basel Committee on Banking Supervision - Sound Practices for the Management and Supervision of Operational Risk, July 2002

<sup>8</sup> ICA Course Book Appendix 22: Basel Committee on Banking Supervision - The Compliance Function in Banks

<sup>9</sup> ICA Course Book Appendix 2: Basel Committee on Banking Supervision - Core Principles for Effective Banking Supervision

<sup>10</sup> International Association of Insurance Supervisors (IAIS) - Anti-Money Laundering Guidance Notes for Insurance Supervisors and Insurance Entities, January 2002 <http://www.iaisweb.org/02money.pdf>

<sup>11</sup> ICA Course Book Appendix 8: The International Organization of Securities Commissions (IOSCO) - The Objectives and Principles of Security Regulation, February 2002

<sup>12</sup> The Egmont Group – Statement of Purpose, June 2001  
[http://www1.oecd.org/fatf/pdf/EGstat-200106\\_en.pdf](http://www1.oecd.org/fatf/pdf/EGstat-200106_en.pdf)

<sup>13</sup> ICA Course Book Appendix 7: International Monetary Fund and World Bank – AML/CFT Review Methodology and Assessment Process, June 2002

<sup>14</sup> Basle Committee on Banking Supervision and the Offshore Group of Banking Supervisors (OGBS) - The Supervision of Cross-Border Banking, October 1996 <http://www.bis.org/publ/bcbs27.pdf>

<sup>15</sup> ICA Course Book Appendix 16: G-7 Finance Ministers - Financial Stability – Supervision of Global Financial Institutions, May 1998

<sup>16</sup> The Egmont Group – List of Operational Units (Meeting the Egmont Definition), July 2003  
[http://www1.oecd.org/fatf/pdf/EGFIUlist2003\\_en.PDF](http://www1.oecd.org/fatf/pdf/EGFIUlist2003_en.PDF)

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<sup>17</sup> In July 2001, an application for preliminary approval of a settlement agreement with victims of C4T was filed with the US District Court for the Southern District of Florida. In October 2001, the court gave final approval to the settlement of the Illinois and Florida C4T litigation and made a provision to recognize opt outs. At that time, the receiver indicated that 2,200 people had made claims totaling \$165 million. The settlement agreement provides for a payment of up to 50 per cent of actual out of pocket losses to investors in C4T. The total payment by the ABC Bank, including all court approved fees and expenses, was not to exceed \$67.5 million. Not included in the settlement agreement is the third lawsuit that was filed in Alabama in April 2001, those who have filed a separate lawsuit against the bank at the Grand Court of the Cayman Islands, and the defendants currently fighting criminal charges in the Cayman Islands (both Cayman Islands cases are still pending, see foot note 12 below).

<sup>18</sup> In October 1999, a lawsuit was filed in the Cayman Islands, the plaintiffs (6 persons/1 entity) were seeking \$22 million against the ABC Bank and two C4T related entities. In April 2001, another civil lawsuit was filed on behalf of more than 170 plaintiffs from various parts of the United States at the Circuit Court of Shelby County, Alabama. The plaintiffs have alleged fraud, breach of fiduciary duty, negligence and violation of the securities acts of 17 U.S. states. In February 2002, a new lawsuit has been filed against the ABC Bank by victims of the C4T scheme who have opted out of the \$67.5 million settlement agreement with the bank. More than 40 plaintiffs filed an action under the Racketeering Influenced and Corrupt Organizations Act at the U.S. District Court for the Southern District of Florida. The “Marketer Plaintiffs” were collectively seeking \$43.4 million, plus compensatory damages of treble that amount, punitive damages and legal fees.

<sup>19</sup> ICA Course Book Appendix 9: Basel Committee on Banking Supervision – Customer Due Diligence for Banks, October 2001, pp. 306-307

<sup>20</sup> ICA Course Book Appendix 3: Basel Committee on Banking Supervision – Framework for Internal Control Systems in Banking Organizations, September 1998

<sup>21</sup> ICA Course Book Appendix 13: Internal Control Working Party of the Institute of Chartered Accountants in England & Wales – Internal Control Guidance for Directors on the Combined Code, Assessing the Effectiveness of the Company’s Risk and Control Process Annex

<sup>22</sup> ICA Course Book Appendix 3: Basel Committee on Banking Supervision – Framework for Internal Control Systems in Banking Organizations, September 1998, p. 76

<sup>23</sup> ICA Course Book Appendix 9: Basel Committee on Banking Supervision – Customer Due Diligence for Banks, October 2001, p. 322