DRAFT

UNWARRANTED DEPUTIZATION:

INCREASED DELEGATION OF LAW ENFORCEMENT DUTIES TO FINANCIAL INSTITUTIONS UNDERMINES AMERICAN COMPETITIVENESS

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Executive Summary

- Banks have long worked cooperatively and productively with federal authorities to support essential national interest objectives including countering terrorism and narcotics.

- The financial community is, however, also being conscripted to engage in an ever-broadening array of domestic and extra-territorial policing activities, many of which are the appropriate province of law enforcement and other governmental authorities, not the private sector.

- Instead of basing the American financial community's legal responsibilities on limited, prudent guiding principles, financial institutions are required to comply with a burgeoning assortment of complex, expensive, prescriptive rules. Officials in all branches of government need to realize that increased use of the financial system as a proxy police agency:

    1. Undermines the ability of financial institutions to carry out their most important national security responsibilities, *i.e.*, detecting terrorist and narcotics-related transactions;

    2. Reduces the international competitiveness of American financial institutions; and

    3. Limits the use of the dollar as a reserve currency.

- An "*Interagency Committee on Unfunded Law Enforcement Mandates on the Financial Services Community*" should be designated by the White House Office of Management and Budget to provide analysis and guidance to agencies and Congress on proposed and existing law enforcement mandates.

- The Committee, which could be established without legislation, would review, analyze and comment on proposed and existing regulations, guidance documents, directives, and legislation which impose *de facto* law enforcement mandates on the financial services industry. Comments from stakeholders would be included in the analysis process.

UNWARRANTED DEPUTIZATION:

INCREASED DELEGATION OF LAW ENFORCEMENT DUTIES TO FINANCIAL INSTITUTIONS UNDERMINES AMERICAN COMPETITIVENESS AND NATIONAL SECURITY

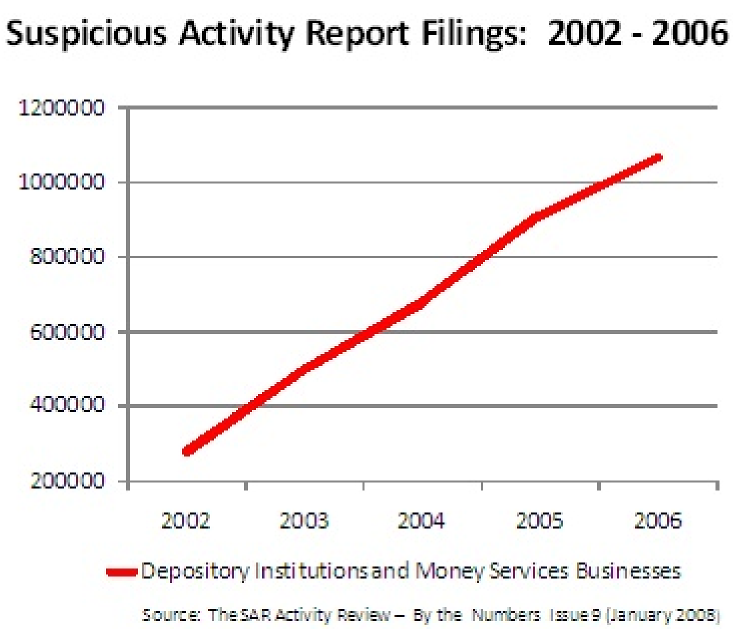
I. Intemperate Use of Financial Institutions as Law Enforcement Agents

The American financial services community engages in vigorous and vital cooperation with law enforcement authorities to support anti-terrorism/counter-narcotics imperatives. The federal government, however, is also increasingly deputizing the private sector to perform a broad array of law enforcement and information gathering activities that are the proper province of federal authorities. Simply stated, *some authorities are and should remain inherently governmental*.

With respect to practicality, it is difficult for financial institutions to have more than one #1 law enforcement priority and all resources are finite. The more policing duties that financial organizations are tasked with, the less attention can be given to any specific law enforcement objective.

Federal officials also need to be cognizant of the fact that expanding the law enforcement duties of U.S. financial services firms imposes costs that place them at an economic disadvantage with their foreign competitors. Moreover, investing these private companies with wide-ranging police and intelligence-gathering authority reduces the desirability of U.S. financial institutions as international business partners. Extensive private sector oversight of global financial transactions on behalf of the U.S. government also makes it less desirable for foreign interests to hold U.S. dollars.

One of the most common mechanisms through which financial institutions exercise law enforcement responsibilities is by filing Suspicious Activity Reports ("SAR") on customer transactions for an expanding number of reasons, as discussed below. As the chart illustrates, SAR filings are soaring.



Illustrative Examples of Expanded Law Enforcement Mandates on the Financial Community

Federal authority is delegated to financial organizations through instrumentalities including:

- Regulations based on legislative mandates; and
- Guidance policies and directives.

A. Enacted Regulations and Policies

Examples of already enacted regulations and policies which include law enforcement and intelligence gathering mandates include:

1. Broad Surveillance for Suspicious Activities. Banks are required by the Bank Secrecy Act ("BSA") to engage in extensive surveillance of their customers' activities without court order or other judicial oversight. Based on these surveillance activities, the institutions report to the Treasury Department on transactions which "the bank knows, suspects, or has reason to suspect...involves funds derived from illegal activities or is intended or conducted in order to hide or disguise funds or assets derived from illegal activities (including, without limitation, the ownership, nature, source, location, or control of such funds or assets) as part of a plan to violate or evade <u>any federal law or regulation</u> or to avoid any transaction reporting requirement under federal law or regulation...."[1]

Banks are also required to develop sufficiently extensive monitoring procedures so that they can report customers to the government if an institution is suspicious that a "transaction has no business or apparent lawful purpose or is not the sort in which the particular customer would normally be expected to engage, and the bank knows of no reasonable explanation for the transaction after examining the available facts, including the background and possible purpose of the transaction."[2]

Thus, banks are broadly empowered and mandated to function as combination of an intelligence gathering agency and government informant with respect to potentially suspected violations of "any federal law or regulation" or any other customer activity that may not be in line with bank expectations for that person.

Of particular note is that the government's use of phrases such as "apparent lawful purpose" and "the bank knows of no reasonable explanation for the transaction" indicates not only do banks have the duty to learn the purpose of their customers' transactions but

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[1] 12 CFR 21.11(c)(4). [emphasis added]

[2] Ibid., See also, 31 CFR 103.18.

also that the burden is on customers to demonstrate that their transactions (aggregating as little as $5,000) are lawful and proper so as to avoid reporting and investigation. Requiring banks to judge the "apparent" purpose of modest-size transactions provides financial institutions with unwarranted authority and responsibilities and deprives honest customers of financial privacy.

2. **Detecting Wide-Ranging Malfeasance by Public Officials**. Section 315 of the Patriot Act expanded the definition of unlawful activities which are subject to extensive anti-money laundering requirements to include "bribery of a public official, or the misappropriation, theft, or embezzlement of public funds by or for the benefit of a public official."

   By expanding the definition the money laundering, the government substantially increased the power of private sector companies to police all manner of financial activities by political officials. In addition to increasing the law enforcement duties of the private sector, the increased authority, as is the case with all such powers, carries with it the theoretical potential for abuse by rogue employees.

3. **Detecting Possible Corruption by Foreign Politicians**. Regulations established under Section 312 of the Patriot Act "requires the application of enhanced scrutiny to private banking accounts maintained for senior foreign political figures. Enhanced scrutiny must include procedures reasonably designed to detect and report transactions that may involve the proceeds of foreign corruption."

   With respect to correspondent accounts, the regulations require that "U.S. financial institutions covered by the final rule...establish a due diligence program that includes appropriate, specific, risk-based, and, where necessary, enhanced policies, procedures, and controls that are reasonably designed to detect and report known or suspected money laundering activity conducted through or involving any correspondent account established, maintained, administered, or managed in the United States."[3]

   Thus, the U.S. financial industry is required to engage in extensive and expensive surveillance of overseas political officials to police any potential violations by these foreign officials of their own laws.

4. **FDIC's Supervisory Policy on Identity Theft**. The FDIC has established a formal policy for banks which "emphasizes the FDIC's well-defined expectations that institutions under its supervision detect, prevent and mitigate the effects of identity theft...."[4]

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[3] http://www.fincen.gov/312factsheet.html.

[4] http://www.fdic.gov/news/news/financial/2007/fil07032a.html.

This policy is an example of a regulatory agency imposing new unfunded law enforcement mandates on the financial services industry without even going through a formal Administrative Procedure Act ("APA") rulemaking.

5. **Patriot Act Requirement for Collecting Information on Credit Card Account Holders**. The government has enacted regulations which the agencies acknowledge are "likely to alter the manner in which they [banks that offer credit cards] do business by requiring them to gather additional information beyond that which they currently obtain directly from a customer who opens an account at the point of sale or by telephone."[5]

   This law further expands private sector collection and storage of personal data and increases costs to financial institutions and their customers.

6. **Expansive Implementation of the International Emergency Powers Act**. The IEEPA (PL 95-223) grants the government, in event of emergency, broad but necessary powers to "investigate, regulate, or prohibit" virtually all foreign transactions. From a regulatory standpoint, the issue is how such emergency powers are best implemented to combat terrorism and narcotics trafficking.

   While implementation of the anti-money laundering programs for covered financial institutions was supposed to be "risk-based," the financial services community is finding that they "are required to adopt detailed policies and procedures that involve comprehensive auditing of individual transactions, which more often than not pose little to no substantive risk. For example, extensive and expensive monitoring for transactions involving foreign politically exposed persons (PEPs) may be appropriate for one institution, but less appropriate for another engaged in different business activities and offering different products and services to different kinds of consumers."[6]

   Of particular importance, the Financial Services Roundtable explains that if "all institutions are held to the same comprehensive standards, many will be required to needlessly employ resources that could have been employed to monitor and address areas of greater potential or actual risk."[7] Thus, ***over-burdening financial institutions harms their ability to protect national security***.

It should be noted that the above examples of surveillance and reporting requirements are in addition to the other regulatory burdens on financial institutions for goals unrelated to the

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[5] http://treas.gov/press/releases/reports/326finalrulebanks.pdf.

[6] Kovacevich, RM, Dimon, J, James, TA, Renyi, TA, "The Blueprint for Financial Competitiveness," The Financial Services Roundtable, p. 81.

[7] Ibid.

integrity of the financial system, such as the HIPAA requirements on payments processors that are charged with maintaining patient privacy.

B. Pending and Proposed Legislation

In addition to the examples of regulations and policies already in effect which expand the policing powers of financial services providers, there are also laws not yet implemented and/or proposals pending Congressional action which would further expand the privatization of law enforcement.

1. **Financial Payment Systems as Tax Collectors**. Section 511 of the Tax Increase Prevention and Reconciliation Act of 2005 (PL 109-222) called for federal, state and local governments "making any payment to any person providing any property or services..." to "deduct and withhold from such payment a tax in an amount equal to 3 percent of such payment." Congress has delayed, but not repealed, implementation of this section of the law.

   Thus, unless the statutory provision is repealed, when federal employees use their government payment card for routine goods and services, such as office supplies and travel arrangements, the payment system would be required to withhold 3 percent of the payment and remit it to the Internal Revenue Service. In addition to damaging the trust relationship between payment systems and vendors, and harming the cash flow of small businesses and other merchants, the law would expand the law enforcement duties of financial organizations to include tax collection responsibilities, even where no unlawful activity is suspected.

Legislation is pending in Congress which would further increase the use of the financial services community as an arm of the Internal Revenue Service.

2. **Proposed Additional Payment System Tax Collection Duties**. Section 303 of the Accountability in Government Contracting Act of 2007 (S. 680) which has passed the Senate states that the "General Services Administration, in conjunction with the Internal Revenue Service and the Financial Management Service, shall develop procedures to subject purchase card payments to Federal contractors to the Federal Payment Levy program." The Federal Payment Levy Program is a mechanism by which the government can collect "overdue taxes through a continuous levy on certain federal payments disbursed by" the Financial Management Service, a Treasury Department agency that provides centralized payment services for federal agencies.

   The Senate Report accompanying the legislation makes note "of the concerns raised by the banking industry concerning this requirement" but "feels strongly that purchase card payments, which total between $6 billion and $9 billion annually, should not go to individuals or companies that do not meet their federal tax obligations."[8] The Committee does not express any views on the private sector costs that would be imposed by the proposed legislation, the appropriateness of deputizing financial institutions to act as government tax collectors nor on the harm such involuntary privatization of tax collection functions may cause to the business reputation of the card payment systems.

3. **Payment Card IRS Reporting Proposal**. The President's FY 2008 Budget included a provision that would require "banks to report to the IRS annually on aggregate credit and debit card reimbursement payments made to businesses."[9] The Electronic Transaction Association testified before Congress that the proposal, which had also been made the previous year, "would: (1) provide potentially misleading information to the IRS; (2) create a costly new reporting requirement that would increase consumer prices; and (3) drive small businesses away from accepting payment cards."[10]

Another analysis of the proposal noted that the reporting is not as simple as it may seem for a number of reasons including that smaller banks sometimes work with "a larger bank that actually performs the merchant bank card services. In each of those cases, it is not exactly clear who should do the sending or what information should be sent" and that "payment card receipts may or may not include adjustments for disputed purchases known as charge-backs." Furthermore, the "costs of programming and reporting are large and will result in higher fees."[11]

A key concern regarding the proposal is that the data reported would not be effective at helping the IRS uncover tax cheats since "payment card companies would only report credit transactions, and businesses would report income from both credit and cash transactions (combined, not separately) on their tax returns, the IRS will not be in a position to reconcile this information efficiently and accurately."[12] Thus, banks, merchants and consumers may be forced to spend significant sums of money to generate data lacking practical utility.

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[8] Report of the Committee on Homeland Security and Governmental Affairs to accompany S. 680, Report No. 110-201, October 22, 2007.

[9] Carla Balakgie, Executive Director, Electronic Transactions Association, Testimony before the House Committee on Ways & Means, Subcommittee on Oversight, April 3, 2007.

[10] Ibid.

[11] Martin A. Sulivan, "Treasury Expects Billions From Credit Card Reporting Proposal," *Tax Notes*, June 4, 2007, found at http://www.taxanalysts.com/www/features.nsf/Articles/7CD60C28151D8003852572F800542887?OpenDocument.

[12] Ibid.

4. **Payment Card Systems as a Customs Service and DEA Proxy**. An op-ed article in the *Washington Post* by a former Assistant Secretary of State and a former Deputy Attorney General proposed that payment card companies be required to buy illegal drugs from websites which purport to offer prescription narcotics. Presumably the financial organizations would also need to have each sample received tested to determine whether it actually contained a controlled substance. In event that the bank determined that a website was illegally selling drugs, the proposal calls for them to "notify U.S. law enforcement authorities, who in turn would be obligated to notify Internet service providers, search engines and package delivery companies."[13] Whether ISPs and search engines would be obligated to block access to websites violating the law is not discussed.

   Under the proposal, card companies would be required to purchase illegal substances from tens of thousands of suspected vendors. Depending on the specific wording on a website's order form, banks may need to misrepresent their identity, an undercover stratagem appropriate for law enforcement agencies but not financial institutions. Moreover, given the ease with which illegal online drug dealers can change identity, and the time lag in verifying that a given website is engaged in criminal activity and taking associated action, the proposal is unlikely to make a dent in the sale of controlled substances over the internet. While there is no indication that the recommendation will be enacted, it does serve as an example of how well-intentioned law enforcement proposals seek to enlist the financial services community in tasks that are appropriate only for duly authorized governmental authorities.

II. Reducing the International Competitiveness of American Financial Institutions

American financial services organizations compete in the international marketplace with European, Asian and other major foreign financial institutions. Successful competition by American businesses requires that they be competitive in terms of costs, services provided, and banking environment.

Maintaining competitiveness in the international marketplace demands that American financial services providers not only offer quality, sophisticated products to meet evolving market demands, but also that they offer services that are price and privacy competitive with financial institutions based in other major industrial countries.

A. Higher Costs Associated with Surveillance and Reporting Activities Place American Financial Services Companies at a Global Competitive Disadvantage

The direct costs of American banks complying with the expanding array of surveillance and reporting requirements is rising rapidly both in absolute terms and relative to costs for banks in

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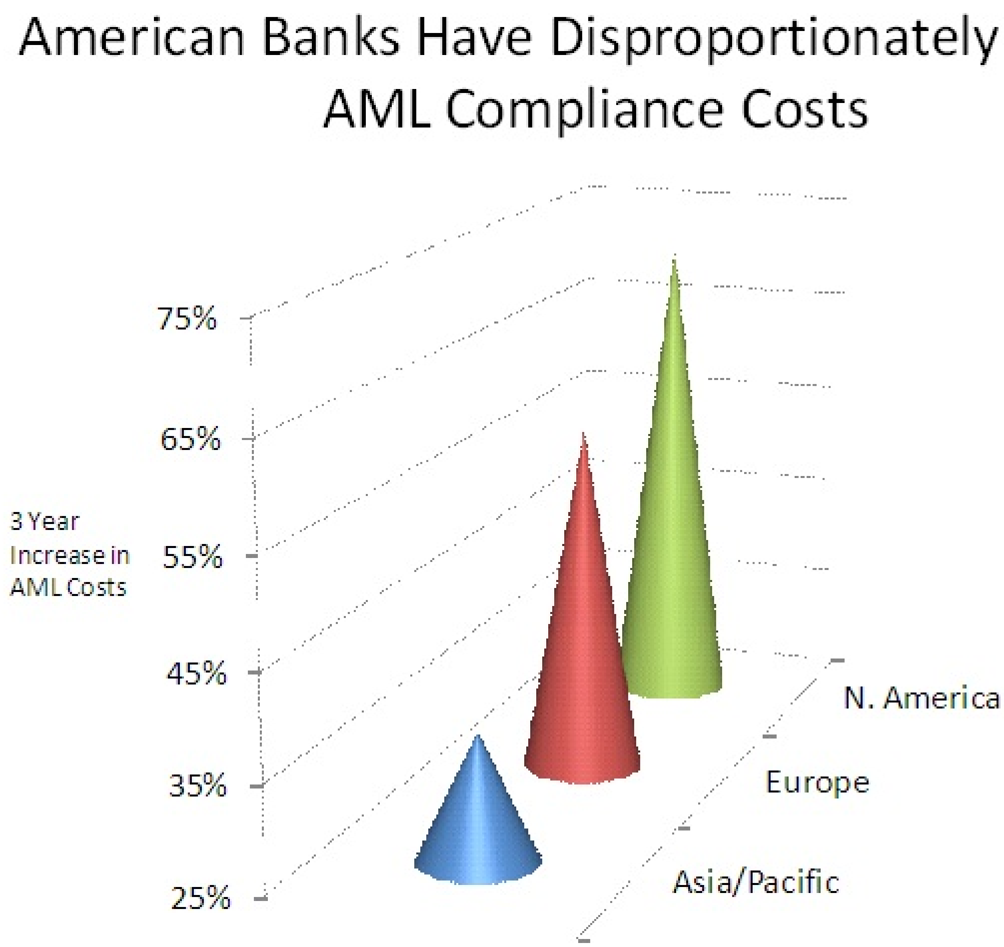
[13] Mathea Falco and Philip Heymann, "Fighting the Online Drug Corner," *The Washington Post*, March 15, 2008; A13.

other regions. According to a recent survey by KPMG International, North American banks estimate that their Anti-Money Laundering ("AML") costs have increased by 71% over the last three years. By comparison, banks in Europe estimated their AML-compliance costs increased by 58% while Asia/Pacific-based banks experienced an estimated 37% cost increase.[14]



Source: KPMG International --Global Anti–Money Laundering Survey 2007

The higher AML compliance costs for American banks does not mean that the European and Asian financial institutions are less committed to fighting money laundering than their U.S. counterparts. Instead, the lower regulatory costs are, at least in part, the result of more efficient regulatory regimes. For example, the KMPG International report notes that in the U.K., the "***Financial Services Authority (FSA) has replaced fifty-seven pages of detailed AML rules with two pages of principles***, backed up by industry guidance. Both the new material...and the

[14] KMPG International, Global Anti–Money Laundering Survey 2007, p. 14.

industry guidance...place particular emphasis on the responsibility and accountability of senior management for AML systems and controls."[15]

A senior official in the British Financial Service Authority's Financial Crime Sector explained their shift to principles-based regulation by noting that the "changes in our Handbook do not mean we are going soft on money laundering, they are part of delivering a more proportionate and effective regime to counter money laundering. We believe that firms will increasingly be able to target their resources where they will make the most difference in fighting crime."[16]

One of the key differences in regulatory approaches to AML responsibilities between U.S. and European regulators is the American use of prescriptive rules-based requirements rather than principles-based regulation. As KPMG International explains, "In the case of the U.S., it is apparent that all internationally active banks have a global component to their policies and procedures, reflecting the need to implement the extra-territorial components of domestic legislation on a global basis, principally the Office of Foreign Assets Control (OFAC) requirements and the requirements of the U.S.A. PATRIOT Act 2001 with respect to, for example, correspondent banking and international private banking relationships." In Europe, where banks also use a global approach to AML policies, "the high-level, principles-based nature of AML requirements...makes it easier to design policies and procedures that are flexible enough to be implemented outside the home country."[17]

The expanding array of law enforcement duties combined with a prescriptive rules-based approach to regulation results in American banks being placed at a competitive disadvantage to their leading international rivals. As the Bloomberg-Schumer report on American financial services competitiveness explained, "[p]revention of financial crime should be implemented via regulation assisting financial institutions in efficiently combating money laundering and terrorism finance, and by <u>ensuring that the substantial resources devoted by the private sector to this priority are used effectively</u>."[18]

Any analysis of the differential regulatory burden on American financial institutions stemming from their additional law enforcement duties also needs to consider the associated opportunity costs. The actual costs of deputizing financial institutions to an unwarranted degree includes not just the dollars spent but also how an institution's resources (financial and management) could have been productively used to develop new products, expand into new markets, and otherwise strengthen their position in the intensely competitive international financial services marketplace.

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[15] Ibid., pp. 12-13. [Emphasis added.]

[16] Financial Services Authority Press Release, FSA/PN/008/2006, 27 January 2006.

[17] Ibid., p. 20.

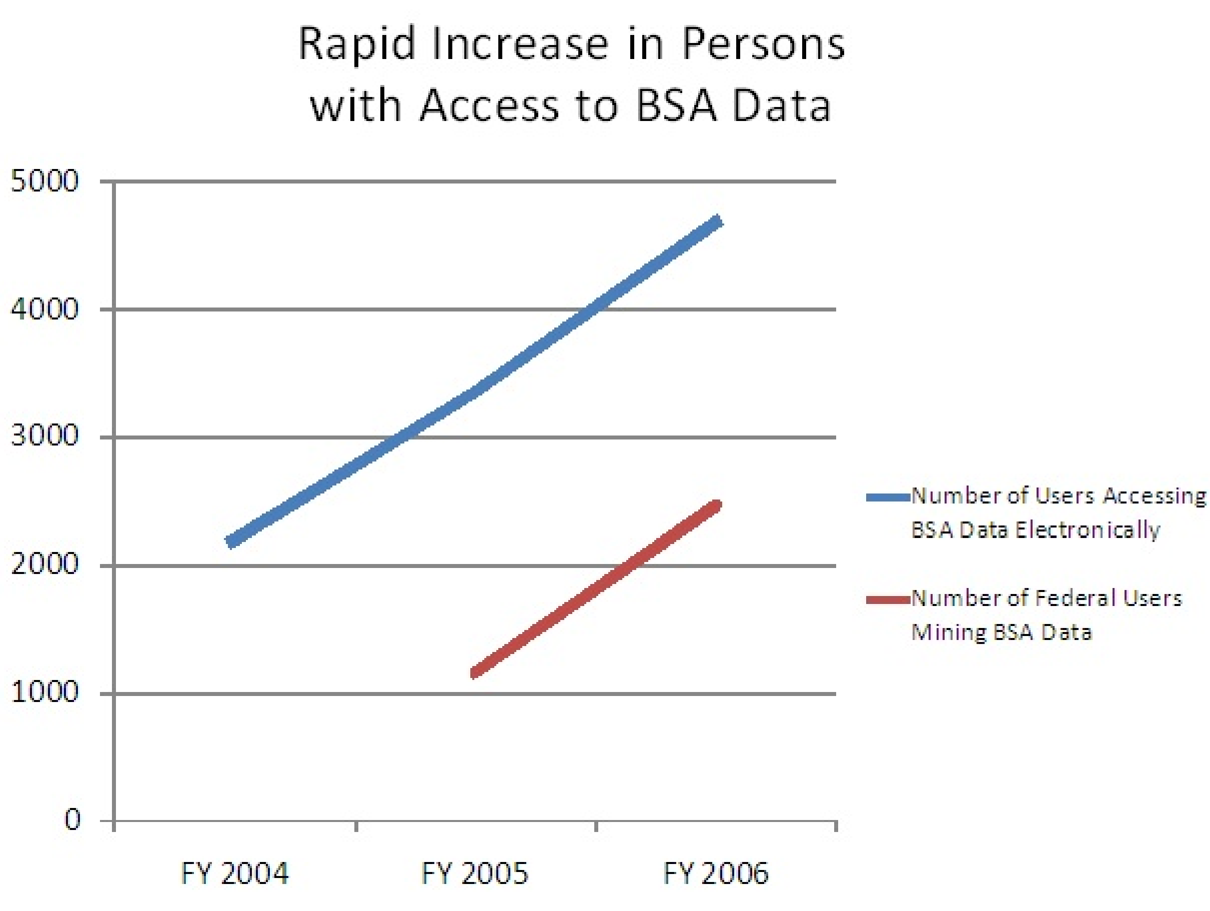
[18] Bloomberg, MR and Schumer, CE, "Sustaining New York's and the US' Global Financial Services Leadership," p. 92. [Emphasis added]

B. Excessive Law Enforcement Duties Degrade the Desirability American Financial Institutions as Business Partners

All responsible financial institutions, irrespective of nationality, will report transactions suspected of being associated with narcotics trafficking, terrorism and other serious crimes to appropriate authorities. The KPMG International study found that there were substantial increases in AML investments by banks in every region of the world over the last three years. The level of federally-mandated surveillance and reporting by U.S. financial institutions, however, has reached such an extreme degree that even personal peccadillos have become the subject of criminal investigation.

Given the pervasive surveillance environment created by the expanding array of policing responsibilities placed on U.S. financial organizations, it is not surprising that even the most law-abiding persons and institutions may prefer to use a non-American bank whenever possible.

Concern over reporting to the federal government by financial institutions is exacerbated by the rapid rise in the number of people who: 1) have access to Bank Secrecy Act data; and 2) are conducting data mining exercises on the data downloaded to their agencies.



Source: Financial Crimes Enforcement Network, "Annual Report Fiscal Year 2006," p. 49.

Sharing of information by federal officials is an essential component of all law enforcement efforts. The steep increase in the reporting of "suspicious" transactions combined with rapid rise in the number of people are accessing and using that data, however, create an environment in which many law abiding persons and organizations may not view their privacy as being appropriately protected. The result is that U.S. institutions are placed at a further competitive disadvantage in the international marketplace.

III. Undermining Anti-Terrorist Capabilities

American financial institutions play an invaluable role in protecting national security by tracking and reporting on transactions potentially connected with terrorist/narcotics activities. Diverting the attention and finite resources of banks to also monitor far less significant activities undermines the ability of banks to focus on detecting national security threats.

The Financial Crime Section Leader of the U.K.'s Financial Services Authority explained the value of using a principles-based risk assessment approach to combating money laundering and terrorist financing at an international financial crime conference:

> *For all of us involved in the fight against money laundering and terrorist financing, resources are limited. It is therefore essential that we use resources effectively and efficiently. By **ensuring that resources are focused on real money laundering risk**, the risk based approach can help us to maximise our return investment in fighting money laundering and ensure that we get the best possible bang for our buck.*
>
> ***
>
> *The so called 'tick box approach' to AML, where firms look to manage regulatory risk associated with financial crime is inherently wasteful. **If a firm invests in systems that are focussed not on reducing the financial crime risks, but simply to avoid regulatory sanction, this is no good for anyone**. It imposes financial costs the firm, irritates large number of honest customers and doesn't maximise harm reduction for society as a whole.*[19]

The U.S. federal government has already, at last nominally, recognized the importance of financial institutions prioritizing use of resources in their monitoring activities. For example, the multi-agency Federal Financial Institutions Examination Council, with respect to private banking, has stated that bank "[m]anagement should establish a risk profile for each customer to be used in prioritizing oversight resources and for ongoing monitoring of relationship activities."[20]

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[19] Speech by Philip Robinson, Financial Crime Sector Leader, FSA, Asia-Pacific Financial Crime Conference & Exhibition 2006, Singapore July 27 2006. [Emphasis added]

[20] Federal Financial Institutions Examination Council, "Bank Secrecy Act / Anti-Money Laundering Examination Manual," p. 245.

Similarly, with respect to non-bank financial institutions, the Council directs that "management should weigh and evaluate each risk assessment factor to arrive at a risk determination for each customer and to prioritize oversight resources."[21]

The Asian Development Bank ("ADB") in discussing their role in fighting money laundering and combating the financing of terrorism ("CFT"), noted that "ADB should locate and implement its AML/CFT activities within the broader context of its existing goals, policies, and strategies for assisting DMCs such as poverty reduction, strengthening financial systems, and promoting good governance and anticorruption. This will ensure that ADB's work on AML/CFT does not compete with or override existing operational priorities or divert scarce financial and human resources."[22] Thus, the ADB is recognizing that unless AML/anti-terrorism objectives are properly integrated into other activities, scarce financial and human resources will be wasted.

The federal government has recognized the importance of prioritization to ensure the efficient use of their own limited AML/terrorist-financing resources. For example, the State Department's Terrorist Finance Working Group ("TFWG") explained that "Inundated with requests for assistance from our foreign allies, the TFWG developed the following process to prioritize the use of our limited financial and human resources to build comprehensive anti-money laundering and counterterrorist finance (AML/CTF) regimes...."[23]

As was already noted, the Financial Services Roundtable has warned that poorly designed regulatory regimes will force institutions to "needlessly employ resources that could have been employed to monitor and address areas of greater potential or actual risk."

In short, maximizing the ability of financial institutions to detect and report transactions associated with terrorism and narcotics requires that their limited financial and human resources not be diverted to lower priority issues. **The federal government's current "kitchen sink" approach of enacting legislation, regulations and other detailed policies to address virtually every imaginable sort of potential financial wrongdoing is counterproductive**, undermining the ability of financial institutions to effectively address the nation's highest priorities.

IV. Reducing the Role of the Dollar as a Reserve Currency

The dollar remains the world's primary reserve currency. Other currencies are, however, gaining in global prominence.

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[21] Ibid., p. 273.

[22] Asian Development Bank, Operations Manual Section 56, "Enhancing the Asian Development Bank's Role in Combating Money Laundering and the Financing of Terrorism," April 1, 2003.

[23] Realuyo, C, "Building a Counterrorist Finance Regime," eJournalUSA, September 2004.

A. The U.S. Benefits From Dollar As The Leading Global Currency

The U.S. economy derives many advantages from the dollar being the world's leading reserve currency. With respect to trade, two examples of the benefits of having our native currency as the world's most accepted store of value are:

- Oil, America's most strategically crucial import, is priced in dollars; and

- Commercial aircraft, one of the United States' most important manufactured exports, are internationally priced in dollars.

If these strategic goods were to be globally priced in another currency, such as Euros or a basket of currencies, there would be *substantial* negative consequences for the U.S. economy. With respect to oil, not only would the American economy be subject to the commodity's price changes, but also to currency fluctuations. Thus, decreases in U.S. interest rates, a major factor in determining exchange rates, would lead to near-automatic increases in the price Americans pay for petroleum. Such price increases would be in addition to any increases in the international price of oil. Thus, as U.S. interest rates are lowered for domestic policy reasons, such as in response to the housing market, oil prices would further increase.

If oil were not priced in dollars, virtually all energy-using American industries would need to engage in currency hedging activities to reduce their risk exposure. The cost of these transactions would place yet another burden on American businesses and reduce their competitiveness.

An illustrative example of the business harm from having a primary good priced in another currency is provided by Airbus. As a recent article in *The Times* (London) explained, "Aircraft are priced in dollars but Airbus's costs are nearly all in euros, which makes the company highly sensitive to exchange-rate movements." The paper noted that "Airbus has been among the companies hardest hit by the declining value of the dollar and it may be forced to move work out of the eurozone to limit future damage."[24]

Thus, export of American jobs is only one of the economic harms that would result from strategic goods being priced in another currency.

It is important to note that the U.S. government also benefits from being able to sell all of its debt in dollars. The consequences that would result if the U.S. government needed to denominate its debt in another currency are far beyond the scope of this paper.

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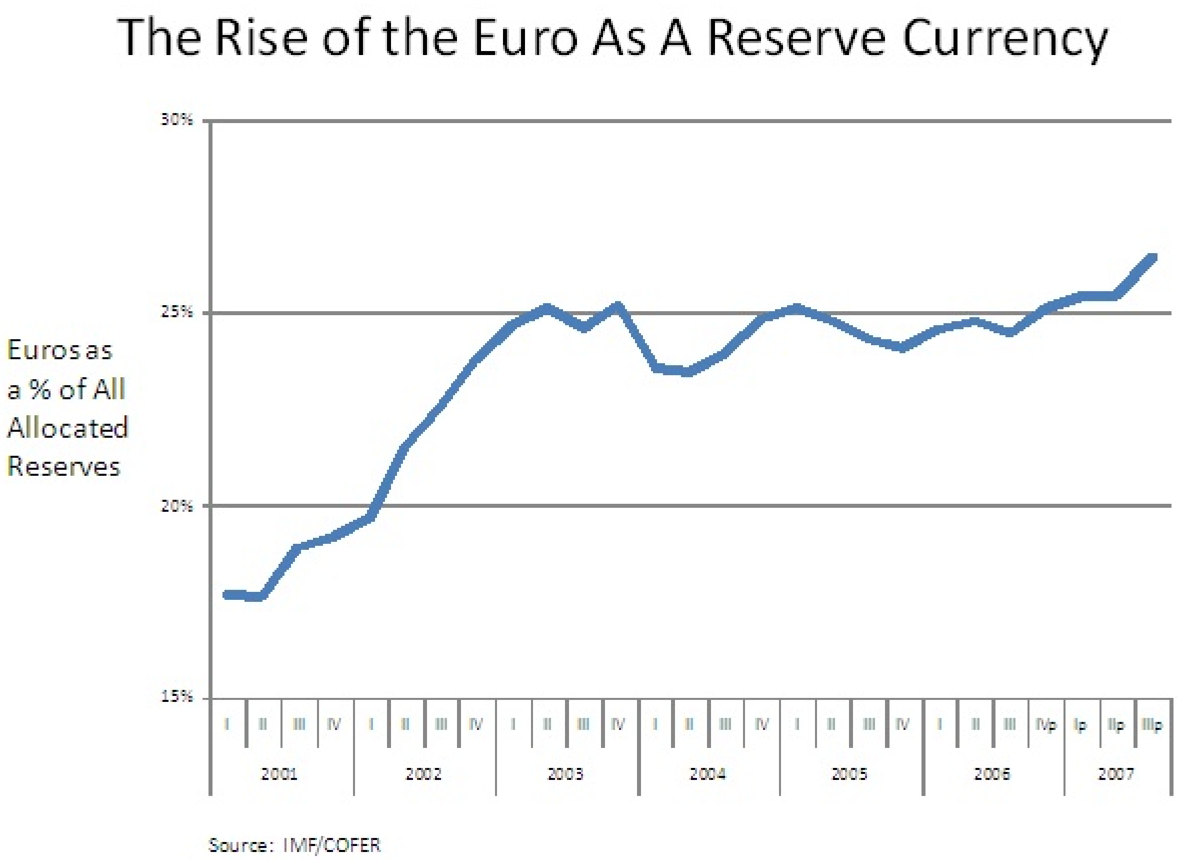
[24] Robertson, D., "Airbus reports record loss as falling dollar costs it €1bn," *The Times*, March 12, 2008. http://business.timesonline.co.uk/tol/business/industry_sectors/engineering/article3533582.ece.

A. Use of the Dollar as a Reserve Currency is Declining

The Rise of the Euro

Use of the U.S. dollar as a reserve currency has declined slowly but steadily since the 2nd half of 2001 according to the IMF's Currency Composition of Official Foreign Exchange Reserves (COFER) database. The reasons for dollar's decline as a reserve currency are complex, multi-variate and cannot and should not be attributed to any single policy or event. Meanwhile, the growth in the Euro's use as a reserve currency has coincided with the increase in federally-mandated financial surveillance and reporting activities.



The Startling Rise of the Pound Sterling

From the standpoint of understanding how regulatory regimes potentially impact the selection of reserve currencies, the sharp rise in the use of the pound sterling is of particular interest. Since 2002, the quantity of pounds sterling held as a reserve currency has more than quadrupled and its share of all reserve currencies has gone up by 70%.

Of particular note, ***use of the pound sterling as a reserve currency has grown sharply while the U.K. has reformed its AML policies by moving to a regulatory regime based on guiding principles rather than use of detailed, prescriptive rules-based regulations***.

The U.K. financial regulator, the FSA, moved to a principles-based regulatory approach in August 2006 with the replacement of their "Money Laundering Handbook with high-level provisions on senior management systems and controls."[25] The U.K. government's decision to move to principles-based regulation was no surprise and the decisionmaking process was publicly discussed for some years. For example, in July 2005, the FSA published a detailed document on money laundering explaining that,

> *Our Handbook of Rules and Guidance...presents the standards we expect of regulated firms.... it should reflect our vision and values. These include* ***an approach to rule-making based as far as possible on high-level principles, rather than detailed prescription****; a focus on senior management responsibility; and acting in a proportionate and risk-based way. We intervene less where we believe market forces work better....*[26]

In discussing how the new risk-based AML policies were developed, the FSA explained,

> *We consulted in 2003/04 (Discussion Paper (DP) 22: Reducing money laundering risk) on the practical issues surrounding 'know your customer' requirements and AML monitoring. We set out our tentative conclusions on the way forward in April 2004, when we said that our general approach was a strong preference for the industry itself to provide the necessary standards in these matters.*
>
> *The...consultation draft...reinforces our proposed policy of confining our Handbook to high-level regulatory obligations and expectations, moving away from providing detailed rules and guidance.*[27]

Since the 2006 replacement of the FSA's Money Laundering Handbook with principles-based regulation, the FSA has continued to further implement principles-based regulation internationally. As the FSA's Chief Executive noted in December 2006, "we will be seeking through 2007 to marry our obligations to implement key EU measures with our domestic commitment to move towards more principles-based regulation."[28]

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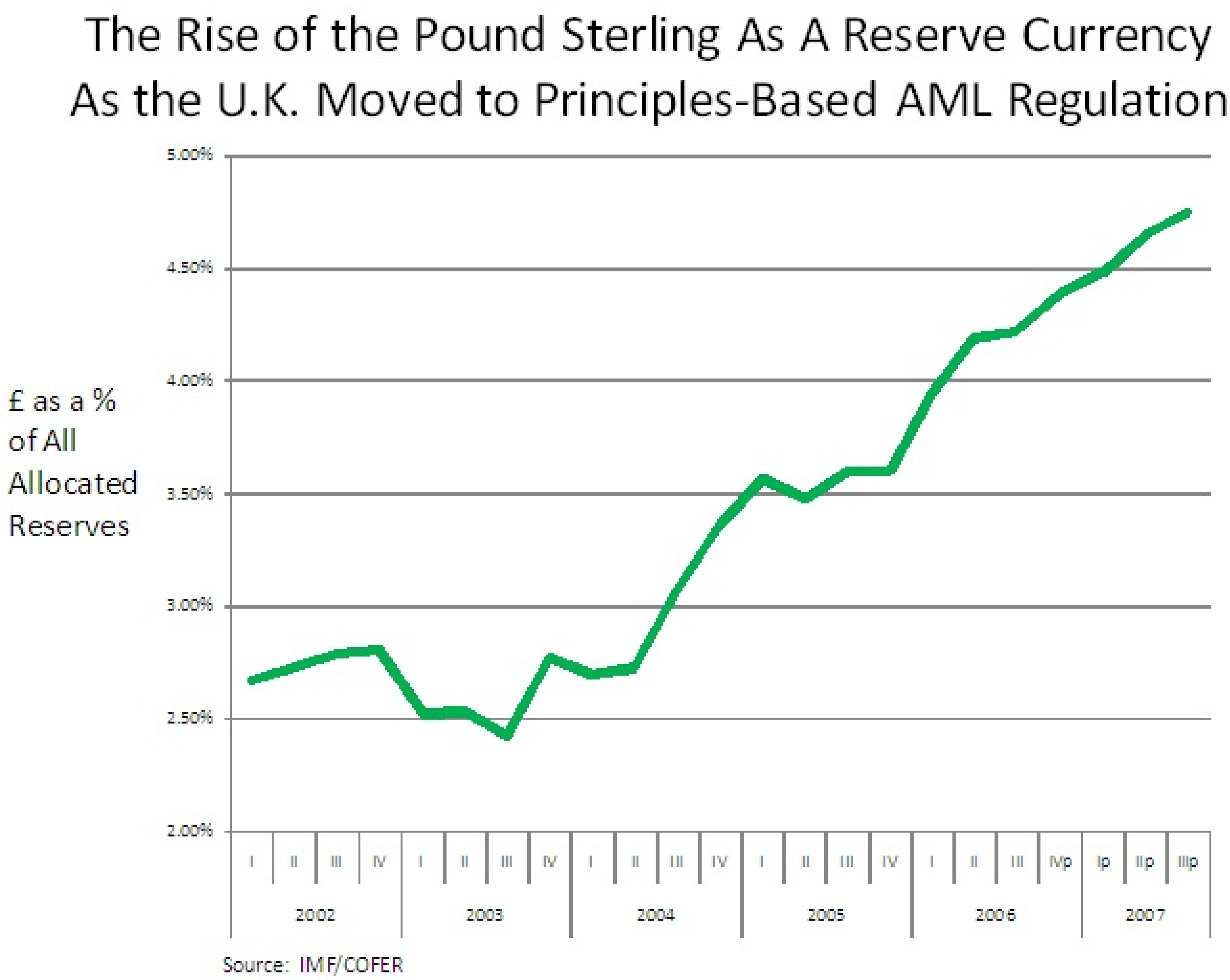
[25] Financial Services Authority, "International Regulatory Outlook, December 2006," p. 30.

[26] Financial Services Authority, "Reviewing the FSA Handbook: Money Laundering, Approved Persons, Training and Competence, and Conduct of Business," July 2005, p. 3.

[27] Ibid., p. 15.

[28] Financial Services Authority, "International Regulatory Outlook, December 2006," p. 5.



A minimalist conclusion is that moving to a principles-based AML regulatory regime, instead of deputizing financial institutions to police virtually every national policy, is non-injurious to the health of the country's financial system.

V. Recommendation: OMB Appointment of an Interagency Committee on Unfunded Financial Services Law Enforcement Mandates

OMB's Existing Authority to Appoint the Interagency Committee

- The White House Office of Management and Budget ("OMB") should appoint an inter-agency committee to review proposed and existing policies which deputize the financial services industry. OMB already has the authority to take such action under Executive Order 12866, Regulatory Planning and Review; ***no new statutory authority is required***. Specifically, the Executive Order directs the government to undertake "a program to reform and make more efficient the regulatory process."[29]

- The purpose of an Interagency Committee on Unfunded Financial Services Law Enforcement Mandates is directly covered by the objectives of the Executive Order which include:
  - Enhance planning and coordination with respect to both new and existing regulations;
  - Restore the integrity and legitimacy of regulatory review and oversight; and to
  - Make the process more accessible and open to the public.
- The Order also directs agencies to "identify and assess alternative forms of regulation and shall, to the extent feasible, specify performance objectives, rather than specifying the behavior or manner of compliance that regulated entities must adopt."
- The Order places OMB in charge of regulatory coordination and review and explains that within "the Office of Information and Regulatory Affairs (OIRA) is the repository of expertise concerning regulatory issues, including methodologies and procedures that affect more than one agency, this Executive order, and the President's regulatory policies."
- Moreover, the Executive Order directs OMB to "provide guidance to agencies and assist the President, the Vice President, and other regulatory policy advisors to the President in regulatory planning and shall be the entity that reviews individual regulations, as provided by this Executive order."

Committee Composition

- The interagency committee would be composed of the primary federal banking agencies including the Federal Reserve System, Office of the Comptroller of the Currency, Federal Deposit Insurance Corporation, and the Office of Thrift Supervision. The committee's functions could be undertaken by either a new or existing interagency committee.

Committee Operation: Proposed Regulations, Policies and Legislation

- Operation of the financial services law enforcement mandates committee would be patterned after Executive Order 13272, "Proper Consideration of Small Entities in Agency Rulemaking." EO 13272 requires agencies to "issue written procedures and policies, consistent with the [Regulatory Flexibility] Act, to ensure that the potential impacts of agencies' draft rules on small

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[29] Executive Order 12866, as amended.

businesses, small governmental jurisdictions, and small organizations are properly considered during the rulemaking process."

- The Order also requires agencies to notify the Office of Advocacy within the U.S. Small Business Administration "of any draft rules that may have a significant economic impact on a substantial number of small entities under the Act. Such notifications shall be made (i) when the agency submits a draft rule to OIRA under Executive Order 12866 if that order requires such submission, or (ii) if no submission to OIRA is so required, at a reasonable time prior to publication of the rule by the agency."

  – Thus, using the EO 13272 model, agencies would be required to provide the interagency committee with draft rules and policies at the time they are provided for EO 12866 review or a similar time prior to finalization.

- Since some of the law enforcement mandates on the financial services industry occur outside the normal regulatory process, the agencies would be directed by OMB to also submit proposed or planned guidance polies and inter- or intra-agency directives which would place law enforcement and/or information collection mandates on private sector financial organizations.

- The interagency committee would also review and analyze proposed legislation. With respect to their authority regarding legislation, it should be noted that: 1) OMB already regularly analyzes and comments on proposed legislation; and 2) analysis of legislative mandates is explicitly required by the Executive Order 12866.

- To ensure that all relevant proposed policy issues are brought before the interagency committee for review, representatives of the financial industry would be allowed to provide to the committee any proposed/planned policies that agencies neglected to forward.

- Proposed/planned regulations and policies would be analyzed to determine:

  – ***Competitive Impact***. The effect of the planned policy on:

    1. The international competitiveness of U.S. financial organizations;

    2. The ability of financial organizations to carry out their other law enforcement mandates; and

    3. The cumulative burden of law enforcement mandates on financial organizations.

  – ***Feasibility***. An analysis of whether the planned regulation or policy would be reasonably likely to achieve its policy goals given the resource constraints of the financial community.

– ***Coordination and Prioritization***. An analysis of the proposed regulation's:

1. Potential conflict with other existing and/or planned domestic regulations <u>and</u> with foreign regulations with which many U.S. explicit organizations are required to comply; and

2. Priority rank relative to other law enforcement mandates.

- As part of its analysis process, the committee should solicit the views of the financial community.

Committee Operation: Existing Regulations, Policies and Legislation

- Executive Order 12866 calls for review of existing regulatory and legislative mandates. Specifically, each agency is ordered to "submit to OIRA a program...under which the agency will periodically review its existing significant regulations to determine whether any such regulations should be modified or eliminated so as to make the agency's regulatory program more effective in achieving the regulatory objectives, less burdensome.... <u>The agency shall also identify any legislative mandates that require the agency to promulgate or continue to impose regulations that the agency believes are unnecessary or outdated by reason of changed circumstances</u>."

- A model for review of existing regulations is also provided by Section 610 of the Regulatory Flexibility Act, as amended. This law requires agencies to "publish in the *Federal Register* a plan for the periodic review of the rules issued by the agency which have or will have a significant economic impact upon a substantial number of small entities." The "purpose of the review shall be to determine whether such rules should be continued without change, or should be amended or rescinded, consistent with the stated objectives of applicable statutes, to minimize any significant economic impact...." In reviewing existing rules, agencies are required to solicit public comments and to consider "the complexity of the rule" and the "nature of complaints or comments received concerning the rule from the public."

- Section 610 calls for "the review of all such agency rules existing...within ten years of that date and for the review of such rules adopted after the effective date of this chapter within ten years of the publication of such rules as the final rule." Using the Regulatory Flexibility Act as a model, the interagency committee would review existing rules and policies based on the ten year review schedule agencies have already established.

Implementation

- The recommendations of an Interagency Committee on Unfunded Financial Services Law Enforcement Mandates would be provided to OMB, agencies, Congress, and private sector stakeholders.