

FEDERAL RESERVE SYSTEM**12 CFR Parts 208, 211, and 225**

[Regulations H, K and Y; Docket No. R-1019]

Membership of State Banking Institutions in the Federal Reserve System; International Banking Operations; Bank Holding Companies and Change in Bank Control

AGENCY: Board of Governors of the Federal Reserve System.

ACTION: Notice of proposed rulemaking.

SUMMARY: The Board of Governors of the Federal Reserve System (Board) is requesting comments on proposed regulations requiring domestic and foreign banking organizations supervised by the Board to develop and maintain "Know Your Customer" programs. As proposed, the regulations would require each banking organization to develop a program designed to determine the identity of its customers; determine its customers' sources of funds; determine, understand and monitor the normal and expected transactions of its customers; and report appropriately any transactions of its customers that are determined to be suspicious, in accordance with the Board's existing suspicious activity reporting regulations. By requiring banking organizations to determine the identity of their customers, as well as to obtain knowledge regarding the legitimate activities of their customers, the proposed regulations will reduce the likelihood that banking organizations will become unwitting participants in illicit activities conducted or attempted by their customers.

The proposed regulations also implement the provisions of 12 U.S.C. 1818(s) by specifically requiring certain bank holding companies and their nonbank subsidiaries, Edge and Agreement corporations, and the U.S. branches and agencies and other offices of foreign banks supervised by the Board to establish and maintain procedures reasonably designed to ensure and monitor compliance with the Currency and Foreign Transaction Reporting Act (31 U.S.C. 5311 *et seq.*) and the accompanying regulations issued thereunder by the United States Department of the Treasury (31 CFR 103.11 *et seq.*) (collectively referred to as the Bank Secrecy Act).

DATES: Comments must be received by March 8, 1999.

ADDRESSES: Comments should refer to Docket No. R-1019, and may be mailed to Jennifer J. Johnson, Secretary, Board

of Governors of the Federal Reserve System, 20th and Constitution Avenue, N.W., Washington, D.C. 20551.

Comments also may be delivered to Room B-2222 of the Eccles Building between 8:45 a.m. and 5:15 p.m. weekdays, or to the guard station in the Eccles Building courtyard on 20th Street, N.W. (between Constitution Avenue and C Street) at any time. Comments received will be available for inspection in Room MP-500 of the Martin Building between 9:00 a.m. and 5:00 p.m. weekdays, except as provided in 12 CFR 261.14 of the Board's Rules Regarding Availability of Information.

FOR FURTHER INFORMATION CONTACT: Richard A. Small, Assistant Director, Division of Banking Supervision and Regulation, (202) 452-5235 or Pamela J. Johnson, Senior Anti-Money Laundering Coordinator, Division of Banking Supervision and Regulation, (202) 728-5829. For users of Telecommunications Devices for the Deaf (TDD) *only* contact Diane Jenkins, (202) 452-3544, Board of Governors of the Federal Reserve System, 20th Street and Constitution Avenue, N.W., Washington, D.C. 20551.

SUPPLEMENTARY INFORMATION:

Background

The integrity of the financial sector depends on the ability of banks and other financial institutions to attract and retain legitimate funds from legitimate customers. Banking organizations are able to attract and retain the business of legitimate customers because of the quality and reliability of the services being rendered and, as important, the sound and highly respected reputation of banking organizations. Illicit activities, such as money laundering, fraud, and other transactions designed to assist criminals in their illegal ventures, pose a serious threat to the integrity of financial institutions. When transactions at financial institutions involving illicit funds are revealed, these transactions invariably damage the reputation of the institution involved. While it is impossible to identify every transaction at a financial institution that is potentially illegal or is being conducted to assist criminals in the movement of illegally derived funds, it is fundamental for safe and sound operations that financial institutions take reasonable measures to identify their customers, understand the legitimate transactions to be conducted by those customers and, consequently, identify those transactions conducted by their customers that are suspicious in nature. By identifying and, when appropriate, reporting such transactions, in accordance with existing suspicious

activity reporting requirements, financial institutions are protecting their integrity and are assisting the efforts of the bank regulatory agencies and law enforcement authorities to thwart illicit activities at financial institutions.

The Board has long advocated that one of the most effective means by which a financial institution can both protect itself from engaging in transactions designed to facilitate illicit activities and ensure compliance with applicable suspicious activity reporting requirements is for the institution to have adequate "Know Your Customer" policies and procedures. While some customers may view "Know Your Customer" procedures as an unnecessary intrusion into their privacy, these procedures are important for complying with the Bank Secrecy Act and suspicious activity reporting requirements. The adoption of the proposed "Know Your Customer" requirements may also assist banks in ascertaining those banking services that will most effectively serve the customers' interests and for managing risks to the bank. Many financial institutions have already adopted policies and procedures that are consistent with the proposed "Know Your Customer" requirements. Additionally, such policies and procedures have enabled banks to better serve their clientele, as well as comply with existing regulatory requirements.

The position of the Board is consistent with that of other countries throughout the world, as evidenced by the pronouncements of several international organizations.¹ Numerous countries have adopted the idea of "Know Your Customer" and mandatory suspicious transaction reporting as the best means of protecting the financial sector from participating in the movement of illicit funds. Such "Know Your Customer" programs seek to stifle the criminal element, which tends to gravitate towards financial institutions that operate within poorly regulated and supervised jurisdictions, in its attempts to conduct transactions involving illegally derived funds.

The requirement to establish a "Know Your Customer" program should assist financial institutions in obtaining

¹ See the Basle Committee on Banking Regulations and Supervisory Practices, "Statement on the Prevention of Criminal Use of the Banking System for the Purpose of Money Laundering" (December 1988), as well as the Committee's, "Core Principles for Effective Banking Supervision" (April 1997); the 1988 United Nations Vienna Convention Against Illicit Traffic in Narcotic Drugs and Psychotropic Substances; the 1990 Council of Europe Convention; and the Financial Action Task Force Forty Recommendations, issued in 1989 and amended in 1996.

information from their customers regarding the identity, the types of transactions to be conducted and the source of funds, among other things. The collection of such information will further assist financial institutions in making a risk-based determination on matters including the extent of identifying information necessary and the amount of monitoring required, by allowing institutions to categorize their customers into different groups based on the types of services being requested and the magnitude and extent of the transactions being conducted. Effective "Know Your Customer" programs will evidence the intent of state member banks, bank holding companies, Edge and Agreement corporations, and the U.S. branches and agencies of foreign banks to take all reasonable measures to thwart the facilitation of potential criminal activity.

Effective "Know Your Customer" programs will necessarily require that banking organizations develop "customer profiles" to understand their customers' intended relationships with the institution, and, thereafter, realistically determine when customers conduct transactions that are suspicious or potentially illegal. Banking organizations that already recognize the value of effective "Know Your Customer" programs and have implemented such programs may have found it difficult to convince customers of the need to provide certain information, especially when other financial institutions do not ask for such information. Because such programs will now be required by regulation, financial institutions will not be prejudiced or criticized for needlessly inquiring into the affairs of their customers. Moreover, legitimate customers should be more willing to provide the information requested by the financial institutions because they will be aware that a similar legal responsibility exists for all banking organizations supervised by the federal bank supervisory agencies.

The Board recognizes that a "Know Your Customer" requirement will impose additional burdens on some banking organizations. Mindful of that fact, the Board is striving to impose only those requirements that are necessary to ensure that banking organizations have in place adequate "Know Your Customer" programs. In a supplemental document to be provided at the time these regulations become final, the Board, in coordination with the other federal bank supervisory agencies, will provide detailed guidance on specific steps that banking organizations may consider taking as they implement the

regulations. The guidance is not intended to provide additional interpretive explanations of the regulations, but rather it will provide concrete examples of proven effective means to accomplish the requirements of the regulations, such as identifying customers and monitoring customer transactions. The Board believes that this approach will strike an appropriate balance that responds to requests for additional guidance in this area while preserving the flexibility for each institution to take steps appropriate for its customers.

In order to ensure the effective implementation of "Know Your Customer" programs at each of the domestic and foreign banking organizations supervised by the Board, the proposal also implements the provisions of Section 8(s)(1) of the Federal Deposit Insurance Act, as amended (12 U.S.C. 1818(s)(1)). The "Know Your Customer" programs required by this proposal would be part of the Bank Secrecy Act-related procedures required to be adopted by the domestic and foreign banking organizations supervised by the Board.

Authority to Issue Regulations

The proposed regulations are authorized pursuant to the Board's statutory authority under Section 8(s)(1) of the Federal Deposit Insurance Act, as amended by Section 2596(a)(2) of the Crime Control Act of 1990 (Pub.L. 101-647), which requires, *inter alia*, the Board to issue regulations requiring state member banks, as well as other domestic and foreign banking organizations operating in the United States supervised by the Board, to establish and maintain internal procedures reasonably designed to ensure and monitor compliance with the Bank Secrecy Act. Effective "Know Your Customer" programs serve to facilitate compliance with the Bank Secrecy Act.

The regulations are also being proposed under the Board's general authority to prevent unsafe and unsound practices and to adopt regulations defining safe and sound conduct for banking organizations under its supervision, as well as under the Board's authority to prescribe specific operational and managerial standards for banks, as set forth in 12 U.S.C. 1831p-1(a)(2).

Proposal

The Board proposes to revise 12 CFR Parts 208, 211, and 225 by requiring state member banks, certain bank holding companies and their nonbank subsidiaries, U.S. branches and agencies

and nonbank subsidiaries of foreign banks, and Edge and Agreement corporations (collectively referred to as a "bank" or "banks") to develop and implement a "Know Your Customer" program within their institutions.²

The requirements of the "Know Your Customer" program are set out in general terms, reflecting the Board's view that a "Know Your Customer" program that is appropriate for one institution may not be appropriate for another. Under the proposed regulations, the Board would expect each banking organization to design a program that is appropriate to that organization, given its size and complexity, the nature and extent of its activities, its customer base and the levels of risk associated with its various customers and their transactions. The Board believes that this approach is preferable to a detailed regulation that imposes the same list of specific requirements on every organization regardless of its specific circumstances or situation.

The Office of the Comptroller of the Currency, the Federal Deposit Insurance Corporation, the Office of Thrift Supervision and the National Credit Union Administration are proposing to adopt substantially similar regulations covering national banks, federal branches and agencies of foreign banks, state nonmember banks, insured state chartered branches of foreign banks, savings associations and credit unions, respectively. The Board expects that federal regulators of non-bank financial institutions, such as broker-dealers, will propose similar rules in the future.

The Board proposes to add a new paragraph (d) to section 208.63 of Regulation H of the Board (12 CFR 208.63). New paragraph 208.63(d) describes the requirements for a "Know Your Customer Program" at a state member bank. New sections 211.8(b) and 211.24(f)(2) of the Board's Regulation K and new section 225.4(g) of the Board's Regulation Y make all of section 208.63 of the Board's Regulation H, including the new "Know Your Customer" provisions of section 208.63(d), applicable to Edge and Agreement corporations, the U.S. branches and agencies of foreign banks (except a federal branch or federal agency or a state branch that is insured by the Federal Deposit Insurance Corporation), and certain bank holding

² Generally, the "Know Your Customer" requirements set forth in this proposal will be applicable only to those bank holding companies and their nonbank subsidiaries that engage in business activities or transactions with the public and that are involved with the receipt or disbursement of customer funds.

companies and their nonbank subsidiaries, respectively.

Section-by-Section Analysis

Section 208.63—Procedures for Monitoring Bank Secrecy Act Compliance

Paragraph (d)(1)—Purpose

The proposal makes it clear, by delineating the purposes for which a "Know Your Customer" program should be developed, that it is in each bank's own best interest to establish and implement such a program. The creation of a "Know Your Customer" program is intended to protect the reputation of the bank; facilitate the bank's compliance with all applicable statutes and regulations (including the Bank Secrecy Act and the Board's suspicious activity reporting regulations) and with safe and sound banking practices; and protect the bank from becoming a vehicle for or a victim of illegal activities perpetrated by its customers.

Paragraph (d)(2)—Definitions

Because the text of the proposed regulations is set forth in Regulation H, the term "bank" is defined to mean a state member bank. Regulations K and Y will incorporate by reference the "Know Your Customer" provisions from Regulation H without repeating the entire text of the regulations and make them applicable to bank holding companies and their nonbank subsidiaries, foreign banks operating in the United States that are subject to the Bank Holding Company Act and their nonbank subsidiaries operating in the United States, Edge corporations, Agreement corporations, and branches and agencies of foreign banks in the United States, subject to Regulations K and Y. In most instances, however, banking organizations that do not engage in business transactions with the public will be excluded from the definition of bank, as set forth in paragraph (d)(2). For example, shell bank holding companies that solely own or control the shares of their subsidiary banks or thrifts and nonbank subsidiaries of bank holding companies that operate solely to service the activities of their affiliates and, in so doing, do not interact in any manner with any public customers will not be covered by this proposal. In addition, the proposed regulations will not apply to credit card banks, bankers banks or other banks that operate solely to service the activities of their affiliates.

The proposed regulations define the term "customer" as the person or entity who has an account involving the receipt or disbursement of funds at a bank

and any other person or entity on behalf of whom such an account is maintained. The term encompasses direct and indirect beneficiaries of deposit, loan and other accounts that involve the receipt or disbursement of funds. The term also encompasses a person or entity who owns or is represented by the customer. Under this definition, a "customer" would include an accountholder, a beneficial owner of an account or a borrower and could include the beneficiary of a trust, an investment fund, a pension fund or company whose assets are managed by an asset manager, a controlling shareholder of a closely held corporation or the grantor of a trust established in an off-shore jurisdiction. The term "customer" is not meant to include receipt of services from the bank for which no transaction involving the receipt or disbursement of customer funds occurs, such as a bank's provision of safe deposit boxes.

Paragraph (d)(3)—Establishment of Know Your Customer Program

This section of the proposed regulations requires that each bank supervised by the Board establish a "Know Your Customer" program by April 1, 2000. Additionally, this section of the proposal will require that the "Know Your Customer" program be reduced to writing and approved by the board of directors of the bank, or a committee thereof, and the approval recorded in the official minutes of the board. For the U.S. offices of foreign banks, such approval may be obtained from the highest level management official in the United States.

Paragraph (d)(4)—Contents of Know Your Customer Program

This section of the proposed regulations sets forth the specific requirements for the contents of the "Know Your Customer" program. Banks vary considerably in the way in which they conduct their business on a day-to-day basis. Therefore, the Board believes that to impose regulations that simply require each bank to follow a pre-designed, standardized checklist would not be appropriate. The proposed regulations allow each bank to develop and delineate a system that will comprise the "Know Your Customer" program, consistent with the banking practices of the particular bank that, when followed by the bank, will effectively meet the requirements and goals of the regulations. This will allow each bank to design a "Know Your Customer" program specifically suited to its own situation that appropriately reflects the size and complexity of the

bank, the types of customers it serves and the nature and extent of their activities at the bank.

Additionally, this section recognizes that each bank's "Know Your Customer" program may vary depending on the nature of the specific activity, the type of customers involved, the size of the transactions and other factors that reflect the bank's assessment of the risk presented. This section recognizes that it may be beneficial for banks to classify customers into varying risk-based categories that the banks can use in determining the amount and type of information, documentation and monitoring that is appropriate. While these proposed regulations will provide banking organizations with substantial flexibility in devising an appropriate "Know Your Customer" program, the Board believes that all "Know Your Customer" programs should contain certain critical features, which are set forth herein.

Paragraph (d)(4)(i) of the proposed regulations also requires that the "Know Your Customer" program delineate acceptable documentation requirements and the due diligence procedures the bank will follow in meeting the requirements of the proposed regulations. The delineation of this information in the "Know Your Customer" program will ensure that the same standards are applied throughout the bank and will inform auditors and examiners of the bank's established standards for review of customer information.

Paragraph (d)(4)(ii) of the proposal sets forth the minimum requirements for an acceptable "Know Your Customer" program. The proposed regulations require that, rather than following a "checklist" approach, a bank may develop a "system" designed to meet the basic requirements of the regulations. The system approach allows each bank to design its own program, in accordance with its own business practices, that will best suit the bank. While this places some burden on the bank to develop the specifics of the "Know Your Customer" program, such an approach recognizes that each bank conducts business in accordance with its own policies, procedures, goals and objectives. The "Know Your Customer" program, in order to be the most effective, must be developed and implemented with the bank's regular and ordinary business practices in mind. Potentially, there can be a variety of ways in which a "Know Your Customer" program can be established and operated to best meet the needs of the bank while fulfilling the requirements of the regulations.

Paragraph (d)(4)(ii)(A) of the proposed regulations requires that the "Know Your Customer" program provide a system for determining the identity of customers maintaining accounts at the bank, as defined. It is imperative that a bank establish, to its own satisfaction, that it is dealing with a legitimate person, whether the person is a natural person, corporation or other business entity. The nature and extent of the identification process should be commensurate with the types of transactions anticipated by the customer and the risks associated with such transactions.

The Board does not believe that it is practicable for a financial institution to conduct a large-scale information request from all its existing customers. Rather, the Board contemplates that a financial institution will be able to comply with the proposed regulation with respect to its existing customers by determining their normal and expected transactions using available account data, monitoring their transactions for potentially suspicious activities, and obtaining and documenting additional information from them in order to explain unusual transactions or when otherwise needed. However, for some customers, depending on the severity of the risk associated with such customers and their transactions, it may be necessary to fulfill all of the requirements of these regulations as if these were new customers.

The identity of a prospective customer should be satisfactorily established before a customer relationship with the bank is permanently established. If a prospective customer refuses to provide any of the requested information the customer relationship should not be established. Similarly, if additional or follow-up information is not forthcoming consideration should be given to terminating the relationship.

The best identification documents available for verifying the identity of prospective customers are those which are the most difficult to obtain illicitly and the most difficult to counterfeit. No single form of identification can be guaranteed to be genuine, however, and, therefore, the identification process should be cumulative, obtaining enough information and documentation to assure the bank that it has properly identified the prospective customer.

As an example, an integral part of the identification process should be the prospective customer's address or place of business and telephone number. Verification of this information for some customers could include physical observation of the location at the

address provided and return telephone calls, or "call backs," to determine the authenticity of the telephone number provided. Extra consideration may be required when it is determined that a prospective customer is situated outside of the area normally served by the bank.

The identification process for natural persons wishing to establish a customer relationship should, when appropriate and practicable, include the review of appropriate identification documentation. In these instances, acceptable forms of documentation should include within the document a photograph and description of the individual, along with the signature of the individual. The documentation should also be easily recognizable identification issued by a government entity. While not an exhaustive list, some examples of acceptable identification documentation could include: driver's license with photograph issued by the State in which the bank is located;³ State identity card with photograph issued by the State in which the bank is located; and United States passport or alien registration card. Other forms of identification, while not sufficient to be used without corroboration, are satisfactory as forms of secondary identification that could be used in conjunction with the types of identification documentation described above to assist in identifying or verifying the identity of the prospective customer. Some examples, again while not an exhaustive list, could include: employer identification card; student identification card; out-of-State driver's license; credit card; and current utility bills from place of residence. At a minimum, the accepted forms of identification should be recorded and, if no legal impediment exists, duplicated and maintained in the customer's "file" at the bank.

Similarly, for prospective corporate or business customers, the customer identification process should include the review of appropriate documentation that allows for a means to verify that the corporation or other business entity does exist and does engage in the business, as stated. In establishing the identity of a corporate or business customer, the prospective customer should provide evidence of legal status, such as an incorporation document, a partnership agreement, association documents, or a business license. In some instances, it may also be necessary to obtain information on

the controlling owners of the business or legal entities. Additionally, the prospective customer should provide a financial statement of the business, a description of the business to include such information as whether the business is in the wholesale or retail markets, and a description of the business's primary area of trade. It also may be appropriate to obtain information related to customers and suppliers of the prospective customer for purposes of verifying information presented by the prospective customer. At a minimum, all documentation reviewed, as well as verifications of the information contained therein, should be recorded and maintained within the customer's "file" at the bank.

Any practice of a bank that allows for the establishment of a customer relationship without face to face contact with bank personnel, such as banking by mail or Internet banking, poses difficulties in the identification of the prospective customer by use of the traditionally accepted practice of obtaining identification documentation to include photographic identification. Even though photographic identification in such circumstances will be impractical, other accepted means of identifying a customer are still viable. In such circumstances, special care should be given to verification of address and telephone number, as well as the use of commercially available data to compare such items as name with date of birth and social security number.

Introductions or referrals of prospective customers by established customers of the bank, while extremely valuable in providing background information about the prospective customer, cannot take the place of identification requirements that should be set forth in the bank's "Know Your Customer" program. Details regarding the introduction or referral should be documented so that the information obtained can be effectively used to assist in the verification of the prospective customer.

The proposed regulations allow each bank to determine what documentation will be appropriate and acceptable in light of circumstances regarding that particular bank. If the identification process will allow for the possibility of exceptions to the established practice, for, as an example, accounts being established for senior citizens or minors, the possible exceptions should be delineated within the "Know Your Customer" program.

Heightened interest in the marketing of private banking activities by banks, as well as the heightened interest by banking customers, in the benefits

³ For customers that are located in a multi-state regional area, such as the Washington, D.C. metropolitan region, which encompasses parts of Maryland and Virginia, identification documents from a neighboring state would be acceptable.

derived from using private banking services has lead to a demonstrable increase in the number of private banking clients.⁴ As the market for private banking grows, so does the level of competition among institutions that provide private banking services. Accordingly, there is increased pressure to obtain new customers, increase the assets under management, and contribute a greater percentage to the net income of the bank.⁵ Emphasizing customer growth, without adopting appropriate procedures to understand a customer's personal and business background, source of funds and intended use of the private banking services, may well certainly lead to increased reputational and legal risks.

Typically, private banking customers make use of such account vehicles as personal investment companies (PICs), trusts, personal mutual investment funds, or are clients of financial advisors. The establishment of such accounts serves the stated purposes of protecting the legitimate confidentiality and financial privacy of the customers that use such accounts. However, banks need to identify properly the beneficial owners of such accounts, through an effective "Know Your Customer" program. Therefore, "Know Your Customer" procedures for identifying the beneficial owners of such accounts should be no different than the procedures for identifying other customers of the bank. Any needed confidentiality required by customers of a bank's private bank can be addressed by the development of special protections to limit access to information that would generally reveal the beneficial owners of these accounts.⁶

Equally important is the identification of beneficial owners of assets bought, sold or managed through a relationship with a bank. Such transactions often occur at the behest of intermediaries, such as asset managers, who may or may not be registered investment

advisors, who deal with banks on behalf of one or more of their clients. For purposes of the proposed regulations, the "customer" of the bank in these types of situations would include the beneficiaries of the transactions and not just the intermediaries. The extent of the information regarding the customer that may be necessary to fulfill the bank's "Know Your Customer" obligations should depend on a risk-based assessment of the customer and the transactions that will occur, such as the type, duration and size of the transactions, and should be addressed within the bank's "Know Your Customer" program.

Ultimately, the amount of information necessary to identify adequately the beneficial owner of an account should be the result of a risk assessment of the customer and the intended transactions of the customer. The bank's "Know Your Customer" program should provide the flexibility to group or categorize customers in a manner that allows the bank to better determine the amount of information necessary for such groups or categories. In some instances, however, it may not be necessary to determine the identity of the beneficiaries of the bank's customers, because the identity of these customers has already been satisfactorily established. For example, if the bank's customer is a widely-held mutual fund or asset management fund, a bank does not have to "know" all of the customer's shareholders and certainly does not have to monitor the shareholders' individual transactions that may occur through the bank. Similarly, in the event that a bank's customer is a financial institution supervised by the Board or another federal or state financial institutions supervisory agency and the bank is acting as an intermediary for the financial institution that is the bank's customer in such activities as check clearing or funds transfer processing, the bank is under no obligation to "know" the customers of the financial institution or monitor the transactions of the financial institution's customers. On the other hand, if the bank's customer is a mutual fund established in an off-shore jurisdiction that has a limited number of shareholders, the bank will be required to "know" the customers of the mutual fund.

Paragraph (d)(4)(ii)(B) of the proposed regulations requires that the "Know Your Customer" program provide a system for determining the source of funds of customers. An effective "Know Your Customer" program requires that a bank understand the nature and source of the funds being placed in the bank by

the customer including the types of instruments used and from where the funds or assets were derived or generated. Under standards that currently exist in criminal law, failure to obtain knowledge that is readily available, such as the source of funds of a particular customer, because of a desire to avoid the perceived embarrassment of having to obtain such information, can lead to the prosecution for a money laundering violation when it is later determined that the funds in question were derived from illicit activity.⁷ Adoption of, and adherence to, a "Know Your Customer" program can substantially minimize the risks to a bank.

For purposes of determining and documenting the source of funds, the amount of information necessary can depend on the type of customer in question. As an example, for a majority of retail banking customers that maintain transaction accounts, where practically the only source of funds comes from payroll deposits, it is a relatively simple task to identify and document the source of funds as payroll deposits. On the other hand, a more detailed analysis, with a more extensive documentation process, would necessarily be required for high net worth customers with multiple deposits from a variety of sources. For these reasons, among others, it may be beneficial for banks to classify customers into varying categories, based on such factors as the types of accounts maintained and the types of transactions conducted and the potential risk of illicit activities associated with such accounts and transactions. Banks could then develop procedures, as part of the "Know Your Customer" programs, to obtain necessary information and documentation based on the risk assessment for the various categories or classes established by a bank.

Paragraph (d)(4)(ii)(C) of the proposed regulations requires that the "Know Your Customer" program provide a system for determining customers' normal and expected transactions involving the bank. The primary objective of such a process is to enable the bank to predict with relative certainty the types of transactions in which a customer is likely to be engaged. Without an understanding of the normal and expected transactions of the customers of the bank is virtually impossible to determine if any particular transaction conducted by a customer is suspicious.

Understanding a customer's normal and expected transactions is not a task

⁴ For an in-depth discussion of private banking and sound practices associated with the administration of private banking activities, see the July 1997 Guidance on Sound Risk Management Practices Governing Private Banking Activities, prepared by the Federal Reserve Bank of New York and issued by the Board (hereinafter referred to as the "Sound Practices Paper"). The Sound Practices Paper was distributed, or made available, to banking organizations supervised by the Board by the Federal Reserve Banks pursuant to the Board's Division of Banking Supervision and Regulation SR Letter 97-19 (SUP). Copies of the Sound Practices Paper and SR Letter are available on the Board's public Internet web site (www.federalreserve.gov).

⁵ See Sound Practices Paper at page 2.

⁶ For a more specific discussion of suggested "Know Your Customer" procedures appropriate for private banking operations see generally Sound Practices Paper.

⁷ See 18 U.S.C. 1956 and 1957.

that can be accomplished entirely at the inception of the account relationship. While it should be a simple task to obtain and record information as to a customer's expectations at the time of account opening, only after reviewing the customer's activity for a given period of time can a determination as to the customer's normal transactions be made. For this reason, effective "Know Your Customer" procedures for determining the normal and expected transactions for a bank's customers should envision an amount of time adequate to make these assessments.

The "Know Your Customer" procedures for determining normal and expected transactions should also take into consideration the type of account that is being established. As an example, a demand deposit account associated with a payroll deposit will not require an inordinate effort to determine that the customer will, most likely, use the account for ordinary living expenses and the deposit of the customer's salary. Conversely, a business account or an account maintained by a private banking customer may require a more in-depth analysis of the customer's intended use of the account coupled with a heightened ongoing review of account activity to determine if, in fact, the customer has acted in accordance with the expectations developed at the inception of the account relationship.

Paragraph (d)(4)(ii)(D) of the proposed regulations requires that the "Know Your Customer" program provide a system for monitoring, on an ongoing basis, the transactions conducted by customers to determine if their transactions are consistent with the normal and expected transactions for particular customers or for customers in the same or similar categories or classes. The proposed regulations do not require that every transaction of every customer be reviewed on a daily basis. However, banks must develop and implement effective monitoring systems, commensurate with the risks presented by the types of accounts maintained at the bank and the types of transactions conducted through those accounts.

The Board is not suggesting that banks must expend considerable resources to purchase sophisticated computer hardware or software as a means of complying with the proposed regulations. The effectiveness of the monitoring system of a bank's "Know Your Customer" program will be based on that particular bank's ability to monitor transactions consistent with the volume and types of transactions conducted at the bank.

There are numerous means by which a system can be developed to carry out

the ongoing monitoring of the transactions being conducted by the customers of the bank. Therefore, it would be appropriate for a bank to design a monitoring system that would correspond to the risk associated with the types of accounts maintained and the types of transactions conducted through those accounts.

The design of such a monitoring system, for example, could involve the classification of accounts into various categories based on such factors as the type of account, the types of transactions conducted in the various types of accounts, the size of the account, the number and size of transactions conducted through the account, and the risk of illicit activity associated with the type of account and the transactions conducted through the account. For certain classes or categories of accounts, which may be the majority of accounts at some banks, it may be sufficient for an effective monitoring system to establish parameters for which the transactions within these accounts will normally occur. Rather than monitoring each transaction, an effective monitoring system could entail monitoring only for those transactions that exceed the established parameters for that particular class or category of accounts. Under the proposed regulations, a bank's determination as to how to monitor its various accounts based on the risks associated with those accounts will be given great deference by the Board.

In many instances, monitoring is already occurring. As an example, monitoring of transactions already occurs as a means of complying with existing suspicious activity reporting regulations. Similarly, monitoring occurs for such things as large cash transactions, check kiting and attempted withdrawals from accounts with insufficient funds or from closed accounts.

For other categories or classes of accounts, it may be necessary to monitor most, if not all, transactions conducted. One such example are transactions conducted by private banking customers. As a general proposition, transactions of private banking customers usually involve large sums of money. For this reason alone, it is important that a bank understands the nature of these transactions and reviews these transactions to ensure that the transactions are consistent with the normal and expected transactions for that particular customer or for customers in the same or similar categories or classes. It is the Board's experience that relationship managers are very aware of transactions

conducted by a private banking customer and, in most instances, assist the private banking customer in conducting the transactions. Therefore, there should be little, if any, hardship associated with reviewing transactions to ensure that they are consistent with the normal and expected transactions for that particular customer.

Many banks already engage in sufficient account monitoring activities. These practices should be formalized in a sound "Know Your Customer" program, which will ensure that banks have identified and implemented procedures that adequately monitor a broad range of account activity while providing flexibility in defining the requisite monitoring activity in light of the risks associated with particular customers and the transactions being conducted.

Paragraphs (d)(4)(ii)(E) of the proposed regulations require that the "Know Your Customer" program provide a system for determining if a transaction is suspicious and making a report, when necessary, in accordance with the Board's suspicious activity reporting regulations. In identifying reportable transactions, a bank should not conclude that every transaction that falls outside what is expected for a given customer, or for categories or classes of customers, should be reported. Rather, a bank should focus on patterns of inconsistent transactions and isolated transactions that present risk factors that warrant further review.

Paragraph (d)(5)—Compliance With Know Your Customer Program

Paragraph (d)(5) of the proposed regulations sets forth the requirements a bank must follow to ensure that it is in compliance with its "Know Your Customer" program. The requirements include that a bank provide for and document a system of internal controls to ensure ongoing compliance, as well as provide for and document independent testing for compliance with the "Know Your Customer" program. Additionally, the bank must designate an individual responsible for coordinating and monitoring day-to-day compliance and provide for and document training to all appropriate personnel of the content and requirements of the "Know Your Customer" program.

Paragraph (d)(6)—Availability of Documentation

Paragraph (d)(6) of the proposed regulations requires, for all accounts opened or maintained in the United States, that all information and documentation necessary to comply

with the regulations be made available for examination and inspection, at a location specified by a Board or Reserve Bank representative, within 48 hours of a request for the provision of such information and documentation. In instances where the information and documentation is at a location other than where the customer's account is maintained or the financial services are rendered, the bank must include, as part of its "Know Your Customer" program, specific procedures designed to ensure that the information and documentation is reviewed on an ongoing basis by appropriate bank personnel.

Issues may arise, on occasion, concerning whether foreign laws permit a bank to disclose certain customer information to bank supervisory agencies, such as the Board. The Board believes that nondisclosure provisions that may exist in foreign, if they exist, should not, in any event, present a bar to the disclosure of such information and documentation. In instances where foreign laws have been raised as creating a prohibition to the disclosure of information that is required by the proposed regulations, the Board's experience is that the information already exists within the banking organization in the United States because the information is used by the relationship manager, who resides in the United States, as well as other components of the bank, to provide banking services to the customer. Moreover, in other instances where banks have raised foreign law disclosure issues, the banks, at the Board's suggestion, have obtained from their customers waivers to any perceived prohibition to disclosure of the information and documentation. Therefore, in the opinion of the Board, there is no prohibition or insurmountable bar to the disclosure of the required information and documentation.

Comments Sought

In addition to other comments that commenters may feel are appropriate, the Board is seeking comments specific to the following:

1. Whether the proposed definition of "customer" is sufficient to include all persons who benefit from the transactions conducted at the bank, such as persons who establish off-shore shell companies or entities or otherwise conduct their business through intermediaries.

2. Whether the proposed definition of "customer" is too broad and will unnecessarily include persons that pose a minimal "Know Your Customer" risk.

3. Whether a bank's "Know Your Customer" program should apply to a bank's counterparty relationships with respect to transactions in wholesale financial markets (e.g., sales or purchases involving foreign exchange or securities) and correspondent banking relationships or if, in such markets, a different standard than that applicable to retail relationships would be more appropriate and, if such a distinction is appropriate, how the definition of "customer" can be distinguished between transactional counterparty customers, correspondents and retail customers.

4. Whether the proposed regulations will create a competitive disadvantage with respect to other financial sector entities offering similar services that may not be subject to the proposed regulations (citing, where possible, specific examples).

5. Whether the proposed regulations will create a competitive disadvantage with respect to other financial entities offering similar services that may not be subject to similar regulations.

6. Whether the actual or perceived invasion of personal privacy interests is outweighed by the additional compliance benefits anticipated by this proposal.

7. Whether there would be a minimum account size threshold below which the "Know Your Customer" requirements would be waived.

Regulatory Flexibility Act

Pursuant to section 605(b) of the Regulatory Flexibility Act (RFA) (5 U.S.C. 605(b)), the initial regulatory flexibility analysis otherwise required under section 603 of the RFA (5 U.S.C. 603) is not required if the head of the agency certifies that the rule will not have a significant economic impact on a substantial number of small entities and the agency publishes such certification and a succinct statement explaining the reasons for such certification in the **Federal Register** along with its general notice of proposed rulemaking.

The Board hereby certifies that the proposal will not have a significant economic impact on a substantial number of small entities. The proposal should result in a net benefit to banks regardless of size because it establishes uniform rules relating to the identification of customers for all banking organizations supervised by the Board. Most banking organizations, from small to large, already have policies and procedures aimed at collecting, retaining and reviewing the types of information required by this proposal,

and there should, thus, be little economic impact from this proposal.

Paperwork Reduction Act

In accordance with the Paperwork Reduction Act of 1995 (44 U.S.C. 3506; 5 CFR 1320 Appendix A.1), the Board reviewed the proposed rule under the authority delegated to the Board by the Office of Management and Budget.

The collection of information requirements in this proposed regulation are found in 12 CFR 208, 211, and 225. This information is required to evidence compliance with section 8(s) of the Federal Deposit Insurance Act. The recordkeepers are for-profit financial institutions, including small businesses. Records must be retained for five years for inspection under the institution's established standards for review of customer information and pursuant to the Bank Secrecy Act.

The OMB control number for the information collection contained in the proposed rule is 7100-0212. The Board may not conduct or sponsor, and an organization is not required to respond to, this information collection unless it displays a currently valid OMB control number.

Recordkeepers for this information collection include all state member banks, U.S. branches and agencies of foreign banks, Edge and agreement corporations supervised by the Board, and certain bank holding companies and nonbank subsidiaries of bank holding companies.⁸ The Federal Reserve estimates there will be 3,500 recordkeepers in the first year; in subsequent years, the recordkeepers will consist of newly-chartered institutions subject to the rule. The majority of the paperwork burden associated with the proposed rule is the one-time cost of developing a plan and implementing written policies and procedures. In the normal course of business, most institutions likely already have sufficient information about their customers in their files and would only need to organize and review such information. Because each institution would design its own program in accordance with its own business practices, the Federal Reserve estimates that the burden of the proposed rule would vary considerably and may range from ten to thirty hours.

The proposed rule is not expected to significantly increase the ongoing annual burden for the recordkeepers because most of the ongoing burden is incurred and accounted for under other existing information collections.

⁸The proposed rule will not apply to shell bank holding companies.

Ongoing costs include gathering the required information about customers (to the extent that the bank does not already possess such information), monitoring customer transactions, and reporting unusual or suspicious transactions. Institutions likely perform most, if not all, of these tasks currently as part of their fraud prevention procedures, as part of their monitoring of transactions for reporting on the Department of the Treasury's Currency Transaction Reports (OMB No. 1545-0183), and as part of their procedures to detect violations or suspicious activity reported on the Suspicious Activity Report. Because the records would be maintained at the subject organizations and are not provided to the Board, no issue of confidentiality under the Freedom of Information Act arises.

Comments are invited on: (a) whether the proposed collection of information is necessary for the proper performance of the Federal Reserve's functions, including whether the information has practical utility; (b) the accuracy of the Board's estimate of the burden of the proposed information collection, including the cost of compliance; (c) ways to enhance the quality, utility, and clarity of the information to be collected; and (d) ways to minimize the burden of information collection on respondents, including through the use of automated collection techniques or other forms of information technology. Comments on the collection of information should be sent to Mary M. McLaughlin, Chief, Financial Reports Section, Division of Research and Statistics, Mail Stop 97, Board of Governors of the Federal Reserve System, Washington, DC 20551, with copies of such comments to be sent to the Office of Management and Budget, Paperwork Reduction Project (7100-0212), Washington, DC 20503.

List of Subjects

12 CFR Part 208

Accounting, Agriculture, Banks, banking, Confidential business information, Crime, Currency, Federal Reserve System, Flood insurance, Mortgages, Reporting and recordkeeping requirements, Securities.

12 CFR Part 211

Exports, Federal Reserve System, Foreign banking, Holding companies, Investments, Reporting and recordkeeping requirements.

12 CFR Part 225

Administrative practice and procedure, Banks, banking, Federal Reserve System, Holding companies,

Reporting and recordkeeping requirements, Securities.

For the reasons set forth in the preamble, parts 208, 211, and 225 of chapter II of title 12 of the Code of Federal Regulations are proposed to be amended as set forth below:

PART 208—MEMBERSHIP OF STATE BANKING INSTITUTIONS IN THE FEDERAL RESERVE SYSTEM (REGULATION H)

1. The authority citation for 12 CFR Part 208 continues to read as follows:

Authority: 12 U.S.C. 24, 36, 92a, 93a, 248(a), 248(c), 321-338a, 371d, 461, 481-486, 601, 611, 1814, 1816, 1818, 1823(j), 1828(o), 1831o, 1831p-1, 3105, 3310, 3331-3351, and 3906-3909; 15 U.S.C. 78b, 781(b), 781(g), 781(i), 78o-4(c)(5), 78o-5, 78q, 78q-1, and 78w; 31 U.S.C. 5318; 42 U.S.C. 4012a, 4104a, 4104b, 4106, and 4128.

2. Section 208.63 is amended by adding a new paragraph (d) to read as follows:

§ 208.63 Procedures for monitoring Bank Secrecy Act Compliance.

* * * * *

(d) *Know your customer program*—(1) *Purpose.* This paragraph (d) requires that member banks establish and regularly maintain procedures reasonably designed to determine the identity of their customers, as well as their customers' normal and expected transactions and sources of funds involving the bank. These procedures (referred to as the "Know Your Customer" program) are intended to: protect the reputation of the bank; facilitate the bank's compliance with all applicable statutes and regulations (including the Bank Secrecy Act and the suspicious activity reporting requirements of 12 CFR 208.20) and with safe and sound banking practices; and protect the bank from becoming a vehicle for or a victim of illegal activities perpetrated by its customers. In general, the "Know Your Customer" rules apply to all state member banks, however, the rules do not apply to credit card banks, bankers' banks, or banks that operate solely to service the activities of their affiliates.

(2) *Definitions.* For the purposes of this paragraph (d):

(i) *Bank* means a state member bank.

(ii) *Customer* means:

(A) Any person or entity who has an account involving the receipt or disbursement of funds with a bank; and

(B) Any person or entity on behalf of whom such an account is maintained.

(3) *Establishment of Know Your Customer program.* By April 1, 2000, each bank shall develop and provide for

the continued administration of a Know Your Customer program. The Know Your Customer program shall be reduced to writing and approved by the board of directors (or a committee thereof) with the approval recorded in the official minutes of the board.

(4) *Contents of Know Your Customer program.* The Know Your Customer program may vary in complexity and scope depending on different categories or classes of customers established by the bank and the potential risk of illicit activities associated with those customers' accounts and transactions. Components of the program should include the following:

(i) Appropriate documentation requirements and due diligence procedures established by the bank to comply with this paragraph (d); and

(ii) A system for:

(A) Determining the identity of the bank's new customers and if the bank has reasonable cause to believe that it lacks adequate information to know the identity of existing customers, determining the identity of those existing customers;

(B) Determining the customer's sources of funds for transactions involving the bank;

(C) Determining the particular customer's normal and expected transactions involving the bank;

(D) Monitoring customer transactions and identifying transactions that are inconsistent with normal and expected transactions for that particular customer or for customers in the same or similar categories or classes, as established by the bank; and

(E) Determining if a transaction is suspicious, in accordance with the Board's suspicious activity reporting regulations and reporting accordingly.

(5) *Compliance with Know Your Customer program.* The bank shall comply with its Know Your Customer program. To ensure compliance, the bank shall:

(i) Provide for and document a system of internal controls;

(ii) Provide for and document independent testing for compliance to be conducted by bank personnel or by an outside party on a regular basis;

(iii) Designate an individual or individuals responsible for coordinating and monitoring day-to-day compliance; and

(iv) Provide for and document training to all appropriate personnel, on at least an annual basis, of the content and required procedures of the Know Your Customer program.

(6) *Availability of documentation.* For all accounts opened or maintained in the United States, each bank must

ensure that all information and documentation sufficient to comply with the requirements of this paragraph (d) are available for examination and inspection, at a location specified by a Board or Reserve Bank representative, within 48 hours of a Board or Reserve Bank representative's request for such information and documentation. In instances where the information and documentation is maintained at a location other than where the customer's account is maintained or the financial services are rendered, the bank must include, as part of its Know Your Customer program, specific procedures designed to ensure that the information and documentation is reviewed on an ongoing basis by appropriate bank personnel in order to comply with this paragraph (d).

PART 211—INTERNATIONAL BANKING OPERATIONS (REGULATION K)

1. The authority citation for 12 CFR part 211 continues to read as follows:

Authority: 12 U.S.C. 221 *et seq.*, 1818, 1835a, 1841 *et seq.*, 3101 *et seq.*, 3901 *et seq.*

2. A new § 211.9 would be added to read as follows:

§ 211.9 Procedures for monitoring Bank Secrecy Act compliance.

(a) Each Edge corporation or any branch or subsidiary thereof, Agreement corporation or branch or subsidiary thereof, shall, by April 1, 2000, in accordance with the provisions of § 208.63 of the Board's Regulation H, 12 CFR 208.63, develop and provide for the continued administration of:

(1) A program reasonably designed to ensure and monitor compliance with the provisions of subchapter II of chapter 53 of title 31, United States Code, the Bank Secrecy Act, and the implementing regulations promulgated thereunder by the Department of the Treasury at 31 CFR part 103; and

(2) A "Know Your Customer" program reasonably designed to identify customers of the Edge or Agreement corporation or subsidiary thereof, including customers' normal and expected transactions at or through the institution.

3. Section 211.24 is amended as follows:

a. Paragraph (f) is redesignated as paragraph (f)(1); and

b. A new paragraph (f)(2) is added.

The addition would read as follows:

§ 211.24 Approval of officers of foreign banks; procedures for applications; standards for approval; representative-office activities and standards for approval; preservation of existing authority; reports of crimes and suspected crimes; government securities sales practices.

* * * * *

(f) *Reports of crimes and suspected crimes.*—(1) * * *

(2) *Procedures for monitoring Bank Secrecy Act compliance.* Each branch and agency of a foreign bank (except a federal branch or a federal agency or a state branch that is insured by the Federal Deposit Insurance Corporation) in the United States shall, by April 1, 2000, in accordance with the provisions of § 208.63 of the Board's Regulation H, 12 CFR 208.63, develop and provide for the continued administration of:

(i) A program reasonably designed to ensure and monitor compliance with the provisions of subchapter II of chapter 53 of title 31, United States Code, the Bank Secrecy Act, and the implementing regulations promulgated thereunder by the Department of the Treasury at 31 CFR part 103; and

(ii) A "Know Your Customer" program reasonably designed to identify customers of the branch or agency, including customers' normal and expected transactions at or through the institution.

PART 225—BANK HOLDING COMPANIES AND CHANGE IN BANK CONTROL (REGULATION Y)

1. The authority citation for 12 CFR part 225 continues to read as follows:

Authority: 12 U.S.C. 1817(j)(13), 1818, 1828(o), 1831i, 1831p–1, 1843(c)(8), 1844(b), 1972(l), 3106, 3108, 3310, 3331–3351, 3907, and 3909.

2. Section 225.4 is amended by adding a new paragraph (g) to read as follows:

§ 225.4 Corporate practices.

* * * * *

(g) *Procedures for Monitoring Bank Secrecy Act Compliance.*—(1) By April 1, 2000, each company described in paragraph (g)(2) of this section, shall, in accordance with the provisions of § 208.63 of the Board's Regulation H, 12 CFR 208.63, develop and provide for the continued administration of:

(i) A program reasonably designed to ensure and monitor compliance with the provisions of subchapter II of chapter 53 of title 31, United States Code, the Bank Secrecy Act, and the implementing regulations promulgated thereunder by the Department of the Treasury at 31 CFR part 103; and

(ii) A "Know Your Customer" program reasonably designed to identify

customers of the company, subsidiary, or foreign bank including customers' normal and expected transactions at or through the institution.

(2) Paragraph (g)(1) of this section shall apply to each company that:

(i)(A) Is a bank holding company or a nonbank subsidiary thereof; or

(B) Is a nonbank company operating in the United States that is a subsidiary of a foreign bank that is a bank holding company or that is subject to the BHC Act by virtue of section 8(a) of the International Banking Act (12 U.S.C. 3106(a)); and

(ii) Holds accounts involving the receipt or disbursement of funds for persons other than affiliates.

By order of the Board of Governors of the Federal Reserve System, December 1, 1998.

Jennifer J. Johnson,

Secretary of the Board.

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DEPARTMENT OF THE TREASURY

Office of the Comptroller of the Currency

12 CFR Part 21

[Docket No. 98–15]

RIN 1557–AB66

"Know Your Customer" Requirements

AGENCY: Office of the Comptroller of the Currency, Treasury (OCC).

ACTION: Notice of proposed rulemaking.

SUMMARY: The OCC is proposing to issue a regulation requiring national banks to develop and maintain "Know Your Customer" programs. As proposed, the regulation would require each bank to develop a program designed to determine the identity of its customers; determine its customers' sources of funds; determine the normal and expected transactions of its customers; monitor account activity for transactions that are inconsistent with those normal and expected transactions; and report any transactions of its customers that are determined to be suspicious, in accordance with the OCC's existing suspicious activity reporting regulation. By requiring banks to determine the identity of their customers, as well as to obtain knowledge regarding the legitimate activities of their customers, the proposed regulation will reduce the likelihood that banks will become unwitting participants in illicit activities conducted or attempted by their customers.