AML STATE OF THE ART: 2008

(Presented at IPMI New York Chapter, September 24, 2008)

GENERAL TRENDS:

We are at a watershed in which financial regulation is going to mushroom. Companies involved in precious metals haven't felt this too much, but it's inevitable that we'll be affected. This talk is about where we stand with the anti-money laundering regulations, and some trends I see looking ahead.

Accelerating regulation:

Financial regulatory laws get passed in the wake of a crisis. The USA PATRIOT Act was passed in October, 2001, a month and ten days after 9/11. We knew at the time that the law intruded into our civil rights. By 2003, when the Anti-money laundering rules were introduced to the precious metals industry, there was already movement to reduce some of the new powers of search.

The system lets us "push-back" and moderate the excesses with self-correcting mechanisms. In this case, it has been through legislative amendments and actions brought through the courts. And they work. But what I've seen in the AML regulatory and enforcement process during the last two years undermines our ability to push back.

General vs. Specific Regulations:

The first problem that comes to mind is general regulations—as opposed to specific—financial regulations. Today, we have an extreme example— it's what's called "risk based" regulation. "Risk-based" is this year's regulatory mantra. The idea is that you, the company's management, know your business much better than the Government regulators. It follows that you are best-qualified to determine how comprehensive your AML program should be and the extent of due diligence your company should undertake.

On the surface, the logic is compelling. As a practical matter, it gives the regulatory and enforcement bodies huge leverage. If you have a laundering problem, the question will be whether you were sufficiently thoughtful and diligent in assessing your risk and in implementing your AML program—or if you could have avoided the problem with more comprehensive programs or diligence.

Because you cannot be sure of the answer, and because you can't afford to take the chance of being wrong, general regulations leave you no choice but to over-comply.

Specific financial regulations, such as the Internal Revenue Code, favor the regulated. That's because the lines are clear and the onus is on the Government to define them in detail. You, the regulated company, know exactly what you have to do to be in compliance. There's no need to over-comply to give yourself a margin of safety. So, specific regulations favor the consumer; General regulations favor the enforcers. And risk-based programs are extreme examples of general regulation. It's a reflection that the regulators are on the ascendency.

Banks versus Metals:
The AML regulations for precious metals were formulated with banks and large, regulated financial institutions as a backdrop. But there are a lot of practical differences between us and those large institutions. For better or worse, one that we are going to find more and more important is that the precious metals industry has no overarching supervisory body.

The Government deals with banks, insurance companies and securities brokers through experienced supervisory bodies, like bank examiners and the SEC. We have no financial supervisor that understands our business. IRS is the default investigatory agency for industries such as ours which are covered by the Act but for which there is no regulatory body. From the standpoint of money and manpower, it probably means we will have lighter regulation. From the standpoint of having knowledgeable people to deal with, we could have some real problems. The risk to us is uneven, inconsistent enforcement.

INDUSTRY OBSERVATIONs
I'm going to shift from these broad question to some observations as to how the AML rules affect our industry and how we are responding.

Controls:
The nature of our business requires strong metal and financial controls. . It's part of survival given the values and turnover and leverage involved. And for the most part, the day-to-day controls we apply address the money laundering risks.

Likewise, because of the credit relationships in our industry, we have to know our customers well. We have a hundred, two-hundred, maybe seven-hundred customers. (Manufacturers have more, but their risks tend to be less). The small number of our customers and the fact that they barely change from year to year means we know every one of them. I haven't come across anyone in the industry without adequate customer records.

But what I see in company after company is that our customer controls focus on credit, not criminality. And the two are very different. In a setting of thriving organized crime, odds-on the criminals are creditworthy. The risks of doing business with a criminal are hard to detect or avoid. But the very least we should do is check our customers and suppliers against not just the OFAC list but a few lists of known and suspected money launderers, just as other regulated financial institutions do.

Office of Foreign Assets Control/Specially Designated Nationals and Blocked persons
The OFAC list is a list of people and companies embargoed by the U.S. Government. It's illegal for us to do business with anyone on the list. There's no requirement to check the list, but if you do business with someone on it, you are subject to criminal prosecution. So it's a list we should all check for a variety of reasons.

Until about a year ago, OFAC would update the list monthly. Now, we get updates every other day, and there have been 9,000 names added since 2006. That's a problem because the checks we do against our customers can become outdated overnight.

Banks have software that checks all their customers against the OFAC and other lists automatically on a regular basis. Up to now, the search engine we have provided you checks 9 different lists simultaneously, but lets you look up only one name at a time. It only takes a minute, but it isn't practical to do a few hundred searches on a regular basis.

So we are upgrading our software for you to enter your whole list of customers into our search engine. And that should be available shortly.

SARs:
Another major difference from other financial institutions is: we don't have to file Suspicious Activity Reports. We are "encouraged" to, and the rules say the Government is contemplating mandatory filing, but that hasn't happened.
Filing SARs would totally change the relatively mild impact of AML regulations on our companies. It would mean hours of extra work and a lot more regulatory oversight. I see two things that could precipitate mandatory filing:

- First, if the Government feels it is being toyed with. In May, I was told there have been zero SARs filed by precious metals companies.
  Here's the problem: the Sigue deferred prosecution agreement underscores the wisdom of not filing if you don't have to. Sigue filed SAR's on activity it detected among its agents. But the Justice Department and FinCEN determined that submitting a SAR isn't enough; you have to be pro-active in investigating the problem and curing it. Just how proactive is up to Justice, FinCEN and the enforcement agencies. But whether or not it's sensible to file, given our reporting efforts to date, I'd say we are vulnerable to having SAR's become mandatory.
- Another reason would be if one of us has a major money-laundering incident. If a money laundering violation is egregious enough, FinCEN might make SARs mandatory.
  - Even if you do not file SARs, I and others have urged you to document suspicious activity. Just write it up and file it. In a criminal investigation, it could be the one thing standing between you and a claim of willful blindness. But I have seen only one company among my clients that systematically documents suspicious activity.
  - Suspicious activity doesn't have to be a major episode—it could be anything that strikes you as a bit off-track from normal business. If you have 500 customers and an active business, it would be really unusual not to have a single episode in a year that rouses your suspicions. But that's what I'm being told in my reviews.

Training:
One of the four pillars of the AML Rule is to train our staff, but the regulation doesn't specify how often. Frequency is "risk-based." Banks, securities brokers and insurance companies

generally require training every six months and some every quarter

In the programs I've helped set up for you, the interval is generally annual. But what I'm finding is that some of you stretch the training interval to well over a year. From a substantive and from a regulatory standpoint, I think that's really unwise.

Substantively, for training to be effective it has to be reinforced and repeated. I can tell you that it's immediately after staff training that I get calls from AML Compliance Officers asking me about suspicious activity questions from employees. People do pay attention. And from a regulatory standpoint, there's nothing easier for an enforcement officer than to check on the frequency and quality of your training.

The Sigue deferred prosecution agreement underscored that making educational materials available to employees is not enough; you are responsible to assure that employees actually take the course and understand the content. So handing out a CD or brochure is not going to do the job. It also makes clear that not only your employees but your agents and representative should receive training.

We've made sure our courses cover all the ground that FinCEN suggests. The courses are interactive, which means there are review questions throughout and a quiz at the end to be sure employees absorb the material. The company automatically gets written notification and the score when the employee completes the course. And the courses take only about half an hour.

Pending:
There are two precious metals questions pending before FinCEN:

1. The first is whether silver is to be classified as a precious metal. Three years ago, in December 2005, I got FinCEN to put a hold on covering silver until it comes up with a ruling, but it applies just to companies that do only silver and no other precious metals. As of last week, FinCEN said there is no change.
2. I also petitioned FinCEN a year ago to change the standards for being designated a dealer in precious metals. FinCEN inserted a clause in its Interim Final Rule that sets two standards for coverage as a dealer in precious metals.
   First, if you deal in metal containing over 50% precious metals. But also, if you sell a finished product in which more than 50% of the value is attributable to precious metals. The second part affects any number of manufacturers—starting with 10 karat jewelry and extending to gold-clad sheet, spark plugs, plating solutions, catalytic compounds—the list goes on and on. The clause conflicts with the 50% by weight standard and there's no question that it's an error. But it's still out there.

One last thought on enforcement of the regulations. To do spot checks and enforce the Rules, IRS has to have a book to go by. This is what they call an examination manual. The final draft was to be completed this month, but it has been delayed. Once the examination manual is complete, you can expect spot checks to begin.