Office of Advocacy

**TESTIMONY**

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**before the**

**SUBCOMMITTEE ON COMMERCIAL AND ADMINISTRATIVE LAW**

**COMMITTEE ON THE JUDICIARY**

**U.S. HOUSE OF REPRESENTATIVES**

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**on**

**Proposed "Know Your Customer" Rule**

**Issued by the Federal Reserve System, the Federal Deposit Insurance Corporation and the Office of the Comptroller of the Currency and the Office of Thrift Supervision of the Department of Treasury.**

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Good Morning, Mr. Chairman and members of the Subcommittee. Thank you for inviting me to testify today before the Subcommittee on the recent regulatory proposal issued by the federal banking regulators to implement a "Know Your Customer" program for all banks.

My name is Jere W. Glover and I am Chief Counsel for the Office of Advocacy at the U.S. Small Business Administration. Congress established the Office of Advocacy in 1976, and its statutory mission is to represent the views of small

business before federal agencies and Congress.(1) As Chief Counsel for Advocacy I am also charged with monitoring federal agencies' compliance with the Regulatory Flexibility Act (RFA)(2) as amended by the Small Business Regulatory Enforcement Fairness Act of 1996 (SBREFA).(3)

In addition, I am charged by Congress to monitor and report on the availability of capital and credit for small businesses. To fulfill this mandate, the Office of Advocacy has undertaken a series of studies analyzing bank lending to small businesses. The studies are titled, "Small Business Lending in the United States," "The Bank Holding Company Study," and the "Micro-Business-Friendly Banks in the United States" study. This year we have added the study, "Small Farm Lending in the United States."(4) In addition, we have funded with the Federal Reserve Board two surveys entitled, "The National Survey of Small Business Finances."

The Office of Advocacy also held a major conference to discuss the impact of bank mergers and consolidation on small businesses and small banks. Our intent was to raise the visibility of the potential harm that could be caused by mergers and consolidations. No clear answers emerged, but we are continuing to monitor the issue.

Before discussing the proposal of the federal banking regulators, I would like to give a brief outline of the provisions of the Regulatory Flexibility Act and the SBREFA amendments.

## The Regulatory Flexibility Act

The Regulatory Flexibility Act was created by Congress in response to one of the recommendations of the 1980 White House Conference on Small Business. The primary purpose of the Act is to establish, as a principle of regulatory issuance, that federal agencies endeavor, consistent with the objectives of the rule and of applicable statutes, to fit regulatory and informational requirements to the scale of entities subject to the regulation. In essence, the Act requires agencies to take a closer look at proposed regulatory actions and their potential impacts upon small entities and to elicit comments from the small business community.

The Act requires agencies to determine whether a proposed regulatory action will have a "significant economic impact upon a substantial number of small entities." (5)If so, then the agency must perform an Initial Regulatory Flexibility Analysis. (6) If the agency does not believe there will be a "significant economic impact upon a substantial number of small entities," then the head of the agency may certify to that effect. For final regulatory actions, agencies must incorporate small entities' comments into a Final Regulatory Flexibility Analysis (7)or verify their original certification.

In 1996, significant amendments were added to the Regulatory Flexibility Act by SBREFA. Changes include the requirement that a factual justification accompany a certification statement, a greater emphasis to be placed on outreach efforts to small entities, Small Business Advocacy Review Panels be established for some EPA and OSHA proposed regulatory actions, and the most significant change -- judicial review of major sections of the Act. Small entities may now bring actions against federal regulatory agencies seeking judicial review of the agencies' Regulatory Flexibility Act proceedings.

Outside of the Regulatory Flexibility Act, SBREFA established new regulatory requirements for federal regulatory agencies that include the adoption of compliance policies with mitigation provisions, the compilation of small entity compliance guides for regulations where a Final Regulatory Flexibility Analysis has been conducted, the establishment of Regional Small Business Regulatory Fairness Boards and the establishment of a Small Business and Agriculture Regulatory Enforcement Ombudsman.

Since SBREFA, small entities are increasingly seeking judicial review of agencies' regulatory actions. To date, we are aware of four cases that have been reviewed at the appellate level, five cases that have been decided on the district court level and at least four or more cases that are still pending. Attached is a list of cases where Regulatory Flexibility Act issues have been raised by small entities.(8)

To assist federal regulatory agencies and small business entities, we have conducted numerous outreach seminars and programs. In addition, last year we published a guide for federal regulatory agencies entitled, "The Regulatory Flexibility Act: An Implementation Guide for Federal Agencies."(9) Please note that we received substantial input from federal regulatory agencies on the content of the booklet. The booklet was prepared as guidance and not as a legal interpretation of the Regulatory Flexibility Act. The courts are the final interpreters of the Act.

In addition, we work with agencies that request our assistance with the Regulatory Flexibility Act and answer their questions about the rulemaking process.(10) Attached is a list of some of the issues with which we have been involved in Fiscal Year 1998 and that have resulted in significant changes and savings for small entities.(11)

Based upon our experience with the Regulatory Flexibility Act and the Small Business Advocacy Review Panels, we continue to emphasize the need for clarity in rule language, a quantitative analysis in an agency's certification justification and sufficient input from small entities. Regarding uncertain regulatory impacts on small entities, Advocacy has advised that "… it is recommended that the agency err on the side of caution and perform an IRFA with the available data and

information, and solicit comments from small entities regarding impact. Then, if appropriate, the agency can certify the final rule."(12)

Inadequate certifications, including initial certifications, are judicially reviewable but only after a rule has become final. SBREFA has been in effect only three years. In the life of regulatory development, that is a short time. With the rise of appeals of final agency actions, we fully expect that agency certifications will be one of the areas contested by small entities.

**Proposed "Know Your Customer" Rule (PDF File)**

Now let me address the proposed "Know Your Customer" Rule.

Late last year in a further effort to stem money laundering and illegal financial transactions through our banking system, the federal banking regulators issued a joint regulatory proposal known as the "Know Your Customer" rule. (13)

Small businesses and community banks are very much in support of deterring money laundering and other illegal financial transactions. As highlighted in each of the preambles of the proposed "Know Your Customer" regulation, these types of activities destroy customer confidence and the integrity of the banking system. No bank wants to develop a reputation as a bank that fosters criminal activity.

As drafted, the proposal would require all banking organizations to implement a "Know Your Customer" program that consists of monitoring customers, their transactions and the transactions of third parties (intermediaries) done in the normal course of business for illegal and suspicious activities. Banks would be required to identify the real identities of their customers (even if transactions are conducted by third parties) and develop customer profiles, determine the source of the customer's or third party's funds, monitor account transactions, develop a system to determine normal and expected transactions and establish a system to know when to report activity that is not normal or ordinary for the customer or the transaction.

Recognizing that banks are already obligated under existing regulations of the Bank Secrecy Act(14) and the Currency and Foreign Transaction Reporting Act (15) to file transaction reports and to generally monitor suspicious activities, the federal banking regulators decided to propose a very "flexible" regulation. It was reasoned that each bank already has some form of in-bank oversight for criminal activity and therefore could design their own "Know Your Customer" program.

While it is true that banks are already doing some of this, what they have been doing is neither as comprehensive nor as expansive as may be required by the proposed regulation. Further, the proposed regulation does not detail how the current regulatory scheme was deficient or how banks could improve their oversight within the current system. In addition, a key element lacking in the

proposal was a description of how the banking regulators would enforce the new programs. The enforcement criteria used to judge the proposal did not include any concrete examples as to what constitutes a sufficient "Know Your Customer" program, what is considered a satisfactory customer profile and what constitutes sufficient maintenance of the program. The proposal did indicate that guidelines would be issued with the publication of the final regulation. However, guidance after a rule has become final deprives small entities of commenting on key components of the proposal.

A "flexible" regulation combined with the lack of precise oversight and enforcement controls can lead to uncertain and costly compliance for small entities and arguably ineffective oversight of a problem that itself has not been explicitly defined. We believe that the requirements of the Regulatory Flexibility Act, if they had been fully complied with, would have elicited comments from the small banking community and helped the regulators draft a more appropriate regulatory response – or no regulatory response, if regulations could not effectively address the issue.

Regulatory Flexibility Act Compliance and the Proposed

"Know Your Customer" Rule

Let me state from the outset that the agencies did not comply with the Regulatory Flexibility Act. First, it is clear that this rule will have an impact upon small entities thus certifications were inappropriate. Second, while two of the regulators did undertake Initial Regulatory Flexibility Analyses, the analyses were woefully inadequate to elicit valuable input from the affected small entities.

The Federal Reserve System and the Office of the Comptroller of the Currency certified that the proposed "Know Your Customer" regulation would not have a significant economic impact upon a substantial number of small entities. The Federal Deposit Insurance Corporation (FDIC) and the Office of Thrift Supervision (OTS), while stating that they were unable to determine the impact upon small entities, published an Initial Regulatory Flexibility Analysis.

In this proposal it was more appropriate and legally correct to conduct an Initial Regulatory Flexibility Analysis rather than just issue a straight certification.

Under the first test of the Regulatory Flexibility Act, as to whether there is a "significant economic impact upon a substantial number of small entities," the banking regulators had already determined that the proposal would affect all banks, including community banks. Since the nature of the proposals included many undetermined items that could be very broadly interpreted by small community banks, we believe an Initial Regulatory Flexibility Analysis could have been used to determine the exact scope of the economic impact. This could

be have been done through a series of detailed questions and regulatory alternatives to elicit responses from the small banking community.

Although the FDIC and OTS did the right thing in publishing Initial Regulatory Flexibility Analyses they did not go far enough. The following detailed questions could have been included in the proposal: what are the anticipated overall costs to small community banks, what is the cost of training (to what extent are specialized expertise and professional skills necessary), what are the potential costs of hiring outside assistance (consultants, attorneys and accountants), what are the anticipated costs of the software changes necessary for monitoring and recordkeeping, and how much of the cost will need to be passed on to customers. More importantly, questions needed to be asked about the scope of the problem and the anticipated impact of the proposed regulation in solving the problem. Finally, an Initial Regulatory Flexibility Analysis should have contained regulatory alternatives or request suggested alternatives from the small banking community. In both analyses, alternatives were peremptorily dismissed as inappropriate and unworkable.

The notice did question whether the proposal would cause a competitive disadvantage for banks competing against non-bank financial institutions and whether there would be an actual or perceived backlash due to customers' privacy concerns. But the more important questions, listed above, were omitted.

The Office of Advocacy has consulted with some representatives of the small banking community. They indicated that the proposal would cost substantially more and take more time to implement than cited. Many believe that new computer software programs would have to be purchased and customized to do the more intrinsic monitoring of customers and transactions and general maintenance of the system than anticipated under the proposed regulation. In addition, many also believe that they will have to hire and expertly train at least one person in each bank or banking system to oversee the implementation and maintenance of the proposed program.

Others see a comparison to the original regulations of the Community Reinvestment Act issued in the 1970's, before the passage of the Regulatory Flexibility Act. At the time, the regulation was intended to be flexible, with each bank being able to tailor the implementation to their own lending programs. Within a decade it became apparent that the regulation was a compliance nightmare. The new regulatory structure revised later has a small community bank exemption but the re-drafting of the Community Reinvestment Act regulations came only after a series of national public meetings, thousands of comment letters and many revisions. The lack of precision in the "Know Your Customer" proposal might have similar results, intermediate unproductive costs and no regulatory impact to the underlying problem.

Based on our experience with the Regulatory Flexibility Act and the Small Business Regulatory Review Panels, we believe that an Initial Regulatory Flexibility Analysis should have been conducted for this proposal with significant input from affected small entities. While we applaud the FDIC and OTS for taking the initiative to prepare an Initial Regulatory Flexibility Analysis, they clearly needed to do a more thorough job. We believe that other regulatory outreach activities should have been undertaken by the banking regulators, including advanced notices of proposed rulemaking, industry roundtables, and public meetings.

While I am not recommending at this time that the Small Business Advocacy Review Panel provisions of SBREFA be extended beyond EPA and OSHA to all federal agencies, I do believe that a panel-like process would be extremely beneficial in this instance. It is fair to say that we are continually impressed by the value added to the process by small entities and how more effective regulatory proposals can be devised in response to small entities' input.

Conclusion

The Regulatory Flexibility Act was passed by Congress in 1980 to ensure that small entities' voices are heard in the federal rulemaking process. The Act requires agencies to take a closer look at proposed regulatory actions and their potential impacts upon small entities and to elicit comments from the small business community. In 1996, Congress amended the Act through the Small Business Regulatory Enforcement Fairness Act thereby placing greater responsibilities on agencies to consider the impact of proposed regulations on small entities. In addition, it gave the right to small entities to challenge improper federal agencies' actions.

With respect to the proposed "Know Your Customer" rule issued by the federal banking regulators, we believe that the Initial Regulatory Flexibility Analyses should have been performed. We believe that the Federal Reserve Board and the Office of the Comptroller of the Currency improperly certified that the proposal would not have a "significant economic impact upon a substantial number of small entities." While we applaud the FDIC and OTS for preparing an Initial Regulatory Flexibility Analyses, we believe that the analyses should have been more thoroughly constructed so as to elicit appropriate input from small banks and small banking organizations.

The Office of Advocacy and small entities are watching. Given the visibility of judicial review under the Regulatory Flexibility Act, it can be expected that improper agency actions will be challenged. Especially vulnerable are agencies that issue improper certifications. In light of this, federal regulatory agencies need to take the Regulatory Flexibility Act seriously.

ENDNOTES

1. The Office of Advocacy, established by Public Law 94-305, is an independent office charged with representing the views and interests of small businesses before the Federal government. By law, the Chief Counsel is appointed by the President from the private sector and confirmed by the Senate. The Chief Counsel's comments and views are his own and do not necessarily reflect the views of the Administration or the U.S. Small Business Administration.

2. 5 U.S.C. §601 et seq.

3. Public Law 104-121, 110 Stat. 857 (codified at 5 U.S.C. §601 et seq.).

4. The studies are available on SBA's Internet website at http://archive.sba.gov/ADVO/research.

5. 5 U.S.C. §605(b).

6. 5 U.S.C. §603.

7. 5 U.S.C. §604.

8. Appendix A.

9. "The Regulatory Flexibility Act: An Implementation Guide for Federal Agencies," U.S. Small Business Administration, Office of Advocacy, 1998.

10. In 1998, the Office of Advocacy received inquiries from the Office of Thrift Supervision on proposed two regulatory actions prior to their publication in the Federal Register.

11. See Appendix B.

12. The Regulatory Flexibility Act: An Implementation Guide for Federal Agencies," U.S. Small Business Administration, Office of Advocacy, 1998, at page 22.

13. Regulations H, K, Y: State Banking Institutions Federal Reserve System Membership, International Banking Operations, and Bank Holding Companies and Bank Control Change; "Know Your Customer" Requirements; Minimum Security Devices and Procedures and Bank Secrecy Act Compliance; and the Development and Maintenance of "Know Your Customer" Programs to Deter and Detect Financial Crimes; Proposed Rules, 63 Federal Register 67516 et seq (PDF File).

See Viewing Utilities if necessary.

14. 12 U.S.C. 1951 et seq.

15. 31 U.S.C. 5311 et seq.

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