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Expert Analysis

When Bank Compliance Fails: Enforcing Accountability

By **Mark P. Zimmett**

Why do the world's great banks continue to finance countries that our government regards as "hostile targets,"[1] and what more can be done to stop it?

Our state and federal authorities have been fighting persistent U.S. sanctions violations committed or apparently facilitated by banks and others assisting sanctioned parties such as Iran and Syria to circumvent our foreign assets control regulations. Those sanctioned cannot entirely avoid trading in U.S. dollars. But dollar transactions, which are cleared in the United States, are prohibited to them. So they enlist their bankers to try to help them evade the prohibitions.

When our authorities discover the apparent violations, they frequently fine the banks or exact settlements, force them to fire culpable employees and even file criminal prosecutions against them; but the violations continue.

Blatant Violations

More than $14 billion in fines and penalties have been paid to federal and New York State authorities in the past five years for violating or facilitating apparent violations of the U.S. Treasury's Office of Foreign Assets Control (OFAC) regulations. The regulations enforce economic sanctions programs that block or freeze the assets of, and impose trade restrictions against, targeted foreign countries, regimes and individuals (Specially Designated Nationals and Blocked Persons), such as terrorists, international narcotics traffickers, those engaged in activities related to the proliferation of weapons of mass destruction, and other threats to the national security, foreign policy or economy of the United States.[2]

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U.S. jurisdiction to enforce the regulations extends to the sanctioned targets' interests in property coming into the United States as, for example, their interests in U.S. dollar transactions clearing through banks in the U.S. Banks paying fines, penalties or settlements include those of our staunchest Western allies, BNP Paribas, Barclays, Commerzbank, Crédit Agricole, Deutsche Bank, HSBC, ING Bank, Royal Bank of Scotland, Standard Chartered and UBS. Even our own banks, including our largest, Bank of America, JP Morgan Chase and Citigroup, have paid settlements for apparent violations.

Often the violations are blatant, certainly not the inadvertent failure to comply with regulations too complex to understand. There is nothing subtle about selectively stripping identities of sanctioned parties from wire payment transfer messages exchanged via SWIFT, The Society of Worldwide Interbank Financial Telecommunications, one of the systems through which banks exchange wire transfer messages. Such deliberate evasions reveal a sophisticated understanding of the sanctions.

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The banks' own tell-tale internal emails belie an innocent misunderstanding (e.g., "please be careful in regard to the US, since it does violate OFAC"; "please do not mention OFAC names in the subject line of e-mails!"; "Let's also keep this e-mail strictly on a 'need-know' basis, no need to spread the news…[about] what we do under OFAC scenarios"[3]). Also indicative of their intentional disregard of the sanctions are their occasional disingenuous rationales to try to justify the evasions, such as invoking the bogus application of a "territoriality of the laws principle" that U.S. OFAC regulations do not reach abroad.[4]

Compromised Compliance

Why have Western banks so persistently tried to evade or enable evasion of the OFAC regulations? One reason may be a lack of respect for the regulations. Financing illegal narcotics trafficking or terrorist activity is a malum in se, an intrinsic wrong. No one will be heard to seriously defend such financing.

We regard our sanctions regulations as an integral part of our war against terrorism. But not all our allies share our insistence on embargoing trade with our sanctioned adversaries. Although the European Union has imposed its own trade restrictions, it remains Iran's fourth largest trading partner.[5] Apparently, our allies regard trade with states we have sanctioned not as a malum in se, but as a malum prohibitum, wrong only because we prohibit it.

OFAC's sanctions lists of targeted countries and their nationals may be seen abroad as "Dollar Diplomacy." We are able to enforce our sanctions because the rest of the world often wants to transact its business in the most stable and preeminent of reserve currencies, the U.S. dollar. We exert the strength of our currency to further our interests because we can, at least for now. But there could be pushback. One recent indication may be China's successful bid to establish its renminbi as an additional international reserve currency (albeit for a limited purpose), which it accomplished with the support of our Western allies over our initial objection and ultimate acquiescence.

Another reason for the Western banks' less than scrupulous observance of our OFAC regulations appears to be the financial rewards to be gained from trade with sanctioned parties. Surely no banker gets bent for the sake of an opportunity to charge miniscule wire transfer fees. But more is at stake. What is more broadly described as "U.S. dollar clearing services"[6] for sanctioned parties can amount to billions[7] and even tens of billions[8] of dollars in transactions annually for a single bank—business that, even at the lower end of the scale (tens of millions annually), apparently has been regarded as so profitable[9] as to violate or facilitate the evasion of U.S. sanctions.

An additional incentive is the attractive trade finance business for sanctioned state-owned and state-controlled[10] enterprises. Bankers wanting to pursue profitable work have thus been motivated to help find a way around the OFAC prohibitions.

When violations are discovered, authorities in the United States take remedial action. Fines are levied in the hundreds of millions and billions of dollars—record-setting fines, but the fines are paid with the shareholders' money. Criminal prosecutions are filed, but they are usually deferred. Culpable employees are fired, but they are mostly mid-level employees. Monitors are imposed, but all too often their focus is on the payment mechanics; assigning a battalion of technicians to comb through petabytes of messaging data. That work is necessary to be able to discover future violations, but it does not get at the root of the problem; it is not deterring future violations.

Personal Accountability

The New York State Department of Financial Services in December proposed new regulations modeled after the federal Sarbanes-Oxley legislation[11] requiring the banks' senior compliance officers (or their functional equivalents) to sign off personally each year on the adequacy of the banks' controls.[12] The proposed regulations are laudably intended to enforce personal accountability at a suitably responsible level of management. But would they work?

Sarbanes-Oxley requires chief executives and chief financial officers to certify in writing that they have personally satisfied themselves of the adequacy of their companies' control mechanisms. It is intended to cut off the Bernie Ebbers' defense. Ebbers is the convicted former CEO of the now defunct WorldCom, once the nation's second-largest long distance telephone company. He claimed at trial not to know about the company's accounting frauds; he was only the CEO.[13]

However, it is a practical impossibility for the CEO or CFO personally to satisfy himself as to the adequacy of a public company's internal controls. There are literally thousands of such controls. So, to deal with the magnitude of the undertaking, a practice of sub-certifications has developed; junior managers certify compliance to their supervisors and so on up the line to the CFO and CEO who rely on the certificates of their managers in signing their own certificates of compliance. Thus, an erosion of the senior-most officers' personal accountability; they can claim—as they must—that they rely on their managers.

The focus of the proposed DFS regulations is appropriately narrower than that of Sarbanes-Oxley. They aim not at all at the banks' internal controls, but only at those for "monitoring transactions after their execution for potential BSA/AML [Bank Secrecy Act/Anti-Money Laundering] violations and Suspicious Activity Reporting."[14] But if sub-certifications are relied upon, personal accountability of the senior compliance officer may be compromised. And with their focus on already executed transactions, the proposed regulations may catch violations, but not necessarily prevent them. One hopes that with a high degree of success in accomplishing the former, the latter objective would also be achieved, but the large number of persistent violations leaves room for doubt.

Of course compliance systems must continue to be monitored as well as the performance of compliance personnel. Those personnel should be judged by appropriate criteria that may differ from those applied to line officers. Incentive compensation for compliance officers should not be tied to the profitable performance of the bank, but measured by their performance in achieving their compliance goals. In addition, incentive compensation should be deferred and subject to claw-back. And there should be independent third-party compliance audits.

But getting right the incentives for the compliance personnel does not deal with the fundamental problem arising from the prospective loss of profitable business. A sovereign and its state enterprises deal with their bank's most senior managers, a country head or perhaps vice chairman, a member of the highest echelon of management who is generally more senior than a chief compliance officer. It is difficult for a subordinate compliance officer to rein in the bank's senior officers who want to accommodate the demands of the bank's substantial customers. At stake are lucrative business to the bank and lucrative personal incentive compensation to the senior officers in building the bank's business. The "commercial stakes are significant.... Compliance does not want to stand in the way...."[15]

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Reforms and Incentives

Recent DFS consent orders provide for monitors to be assigned to review not only the banks' compliance programs, but also their corporate governance policies and practices as they affect their operations in New York and throughout the world.[16]

The recent focus on governance is not only appropriate, but critical to encourage compliance. With the right incentives, the proper payment mechanics will fall into place. Or, to paraphrase the vernacular, "Grab them in their wallets, and their hearts and minds will follow."

Some Suggestions

Here, then, are a few suggestions for consideration in addition to those mentioned above. Some are compliance measures, others governance. None may be new; all should be considered.

First, as a banker well-experienced in operations told me, don't overlook the obvious—someone with a well-earned reputation for unimpeachable integrity, independent of the reputation of the bank, should be put in charge of compliance. Often such an accomplished individual does not want to be the chief compliance officer. But the compliance function should be under his or her control.

Second, subject the compensation of not only compliance officers, but also line officers and senior management members to and through whom they report, to back-charges in the event of a violation of regulations.

Third, the decision whether to back-charge the compensation of a senior officer or to take other disciplinary or remedial action should be made by the board (initially, perhaps, by a board committee reporting to the board) and the rationale for taking or deciding not to take such action should be in writing and communicated to the appropriate regulator(s).

Fourth, the banks should diligently and effectively monitor emails using key-term searches such as sanctions, OFAC etc. to identify potential violations, and prohibit any communications of the banks' business outside the monitored system (e.g., personal emails or text messages). Such monitoring has been adopted by a number of major banks in recent years, and avoidance of the systems is a firing offense. Having the capacity to monitor and store the emails is not enough. Management should monitor the message traffic continuously to try to prevent violations before they occur. Afterwards the regulators and prosecutors may subpoena the stored messages to prove the violations. So turn what can be evidence into advance warnings for prevention.

These are measures to encourage compliance and assure personal accountability throughout the bank, particularly among its most senior officers. If they were widely adopted by major banks, none of them would be competitively disadvantaged from a loss of sanctions-prohibited business. Where else could the sanctioned states and their state enterprises turn for U.S. dollar clearing services? True, there may be the occasional outliers, but such banks would likely be too small to provide full service on a scale sufficient to facilitate billions and tens of billions of dollars of transactions annually. And, importantly, the banks complying with U.S. sanctions would be spared the fines and settlement payments amounting to hundreds of millions and billions of dollars.

The banks' senior officers, those who manage the banks, must become convinced that the cost of non-compliance, both for the banks and for themselves personally, is too great to risk. With greater conviction should come better compliance.

1. U.S. Department of the Treasury, OFAC Regulations for the Financial Community at 2 (Jan. 24, 2012), https://www.treasury.gov/resource-center/sanctions/Documents/facbk.pdf .

2. Office of Foreign Assets Control, 31 C.F.R. subtit. B, ch. V. The objectives of the OFAC regulations may be found at a number of places on the U.S. Department of the Treasury's website, such as at https://www.treasury.gov/resource-center/sanctions/Pages/default.aspx. According to the U.S. Department of Treasury OFAC website listing fines and penalties, https://www.treasury.gov/resource-center/sanctions/CivPen/Pages/civpen-index2.aspx, since the beginning of 2011, fines and penalties have totaled $3.18 billion. However, that amount does not include approximately $10.9 billion of additional fines and penalties paid to the New York State Department of Financial Services and other New York State and federal authorities. Those additional amounts may be found by searching the New York DFS Enforcement Actions website, http://www.dfs.ny.gov/about/eagen.htm#contentarea and the NY DFS Press Release website, http://www.dfs.ny.gov/about/dfs_press.htm .

3. Consent Order, *In the Matter of Deutsche Bank*, pars. 21, 23 (N.Y. Dep't Fin. Svcs., Nov. 3, 2015) (DFS–Deutsche Bank Consent Order), http://www.dfs.ny.gov/about/ea/ea151103.pdf .

4. Consent Order, *In the Matter of Crédit Agricole*, par. 7 (N.Y. Dep't Fin. Svcs., Oct. 15, 2015) (DFS–Crédit Agricole Consent Order) http://www.dfs.ny.gov/about/ea/ea151019.pdf .

5. European Commission trade website, http://ec.europa.eu/trade/policy/countries-and-regions/countries/iran/ .

6. Consent Order, *In the Matter of BNP Paribas, S.A. New York Branch*, par. 1 (N.Y. Dep't Fin. Svcs., June 29, 2014) (DFS–BNP Consent Order"), http://www.dfs.ny.gov/about/ea/ea140630.pdf.

7. DFS–Crédit Agricole Consent Order, supra note 4, page 1 (U.S. dollar transactions valued at more than $32 billion during the period 2003 through 2008).

8. DFS–BNP Consent Order, supra note 6, par. 1 (U.S. dollar transactions valued at more than $190 billion during the period 2002 through 2012); Consent Order, *In the Matter of Commerzbank*, page 2 (N.Y. Dep't Fin. Svcs., March 11, 2015) (DFS–Commerzbank Consent Order), http://www.dfs.ny.gov/about/ea/ea150312.pdf (U.S. dollar transactions valued at more than $253 billion during the period 2002 to 2008).

9. DFS–Commerzbank Consent Order, supra note 8, par. 41 (U.S. dollar transactions valued at more than $224 million during the period 2002 to 2006 represented a "profitable market" in Sudan).

10. DFS–BNP Consent Order, supra note 6, pars. 31 and 34.

11. Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, 15 U.S.C. §§7201 et seq. as amended.

12. Banking Division Transaction Monitoring and Filtering Program Requirements and Certifications, http://www.dfs.ny.gov/legal/regulations/proposed/rp504t.pdf, (proposed Dec. 1, 2015) (to be codified at 3 NYCRR Part 504) (Proposed Trans. Monitoring Reg.) §504.2(c).

13. Ken Belson, "Ebbers Mounts an 'I Never Knew' Defense," N.Y. Times, March 1, 2005, http://www.nytimes.com/2005/03/01/business/ebbers-mounts-an-i-never-knew-defense.html?_r=0 .

14. Proposed Trans. Monitoring Reg. §504.3 (a).

15. DFS–BNP Consent Order, supra note 6, par. 24.

16. See, e.g., DFS–Deutsche Bank Consent Order, supra note 3, par. 32; DFS–Crédit Agricole Consent Order, supra note 4, par. 29; DFS–Commerzbank Consent Order, supra note 8, par. 49.