Financial Services Regulatory Highlights*

volume 9 no. 8 August 2007

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Civil Money Penalties Assessed for Bank Secrecy Act Violations

On August 6, 2007, the Board of Governors of the Federal Reserve and the Financial Crimes Enforcement Network (FinCEN) assessed a civil money penalty against American Express Bank International (AEBI) and American Express Travel Related Services Company, Inc., (collectively, American Express) in the total amount of $65 million. AEBI's AML Program was deficient in three of the four core elements. AEBI failed to implement adequate internal controls, failed to conduct adequate independent testing, and failed to designate compliance personnel to ensure compliance with the Bank Secrecy Act (BSA). Additionally, a review of American Express Travel Related Services Company revealed a substantial number of failures to file timely, accurate and complete Suspicious Activity Reports (SARs) involving over $500 million in suspicious transactions.

Internal Controls

AEBI failed to implement internal controls reasonably designed to comply with the BSA and conducted business without adequate systems and controls. AEBI also did not demonstrate the practicality to detect and timely report suspicious activity, particularly with regard to customers presenting a higher risk for money laundering. AEBI repeatedly failed, over the course of multiple regulatory examinations to implement effective account monitoring controls to ensure compliance. For example:

- Review parameters for customer account activity were not risk focused, nor designed to target specific account activity with an elevated potential for money laundering;
- Review parameters for transaction activity in a number of customer accounts were set at a high or excessive level, thereby substantially reducing the likelihood that suspicious activity would be detected;

- Processes for exempting certain accounts from transaction monitoring reviews to detect suspicious activity lacked any written justification or rationale for the exemptions;
- Measures to fully identify account relationships involving Private Investment Companies (PICs) and bearer share accounts, to assess and manage the potential risk for money laundering in these accounts were not effectively implemented; and
- Periodic reviews of high-risk accounts, to determine whether account activity deviated from expected activity in customer profiles, were not conducted in a manner to adequately detect and report suspicious activity, or in accordance with AEBI's policy. These periodic reviews were conducted on an individual account level, as opposed to an entire aggregate customer relationship basis.

The internal control processes governing the suspicious activity-reporting program were not sufficient to comply with the BSA. For example:

- The monitoring system exhibited persistent data integrity issues and as a result there was a backlog of hundreds of suspicious activity alerts awaiting review; and
- Having only one individual with the authority to clear suspicious activity alerts without adequate oversight or controls to ensure appropriate and timely disposition of the alerts resulted in a failure to timely file suspicious activity reports.

Independent Testing

The independent testing of its BSA program was ineffective. Internal Audit Staff lacked sufficient training and knowledge to facilitate compliance with the BSA. For example:

- Audit scopes were not always tailored or designed to capture and test for compliance with certain requirements;
- Staff failed to conduct sufficient customer transaction testing to adequately evaluate the overall sufficiency of the AML program;
- Staff failed to conduct adequate testing of the suspicious activity monitoring system or identify the numerous concerns associated with the monitoring system for an extended period of time; and
- Staff failed to assist management with tracking and following-up on previously identified regulatory examination deficiencies.

Designation of Personnel to Ensure AML Compliance

In view of the scope, volume and nature of activity at AEBI, management failed to designate enough personnel to ensure day-to-day compliance with BSA. In addition, compliance roles and responsibilities were not adequately defined and implemented with respect to gathering, integrating and responding to information such as validating customer records, reconciling data involving high-risk customers with customer profile documentation, and escalating or sharing negative customer information among appropriate personnel.

Violations of the Requirements to Report Suspicious Transactions

FinCEN has determined that American Express violated the suspicious transaction reporting requirements of the BSA and regulations issued pursuant to that Act. Specifically, American Express failed to timely and/or accurately file a substantial number of SARs. For example, numerous filings contained multiple errors where sections of the form requiring data were left blank, incorrectly completed, or referred to another section of the form that lacked the referenced information.

Our Perspective: Common Elements of a Strong AML Independent Review Program

In light of civil money penalties assessed in recent weeks, as discussed above, we thought it was practical to republish a thought leadership piece that PricewaterhouseCoopers first published in the Securities Industry and Financial Markets Association Internal Auditors Division (IAD) Newsletter. This thought leadership piece addresses common elements of a strong AML independent review program and was originally published in the IAD's June 2007 Newsletter.

The Evolving AML Regulatory Environment

We recently have marked the five-year anniversary of the effective date (April 24, 2002) of Section 352 of the USA PATRIOT Act requiring broker/dealers to establish an anti-money laundering program including written policies and procedures, a designated AML compliance officer, an ongoing employee training program and requiring the independent testing of that AML program on an annual basis. Congratulations, over the course of those five years the quality of many firms AML programs have evolved from the year one programs that borrowed heavily from the NASD Small Firm Template, to sophisticated, effective controls.

Consequently, regulatory examinations have evolved, as well. The initial AML examinations of broker/dealers were very focused on the existence and documentation of all of the required elements of an AML program (as set forth in NASD's Small Firm Template). There were very few findings regarding the effectiveness of AML program elements or on the quality of the independent reviews. Moreover, during the first three years after the effective date there were no significant AML-related enforcement actions.

In the past few years, however, the SEC and SROs have stepped up their expectations of broker/dealer AML programs and have accordingly modified their examination approach to more rigorously evaluate the quality and effectiveness of the program. The results of the more vigorous examination approach can be seen in an increase in significant fines and enforcement actions. Some recent examples include:

- April 2007 - The SEC issued a cease and desist order against Park Financial Group for failure to file SARs.
- January 2007 - The NASD fined Banc of America Investment Services $3 million for failure to follow AML procedures for verifying beneficial owners of certain high-risk accounts.
- May 2006 - The SEC issued a cease and desist order against Crowell Weedon for failing to adequately document its customer identification program.

The Value of a Robust Independent Review Program

The increasing regulatory focus on the effectiveness of AML programs and the escalating risk of fines and/or enforcement actions has placed more importance on having a strong independent AML review program. A robust independent review can help a firm reduce its financial, regulatory and reputational risks by identifying and addressing potential issues or control weaknesses prior to them creating a problem or being identified by regulatory examiners. A weak independent review program can increase financial, regulatory and reputational risks. Inadequate independent review programs are one of the most frequently cited examination criticisms and the substance of many public enforcement actions. Conversely, a strong independent review program can convey a message that the firm is committed to having a robust and effective AML program and in preventing money-laundering activities from occurring at or through the firm. Moreover, the better the quality of the review program, the more examiners can rely on that program.

Top 8 Elements of a Strong Independent Review Program

Our experience in conducting independent AML reviews and in reviewing the AML programs of

many of the top broker/dealers has found that there are certain elements that are found in all of the best programs. We have outlined below the top eight.

1. A Risk-Based and Comprehensive Coverage of Topics

An effective AML independent review program must evaluate and test those AML program elements and controls that address the areas that create the greatest risk to the firm. At the same time, the scope of the review cannot be purely risk-based. Certain elements of the AML program should be evaluated or tested every year despite the fact that they may be deemed lower risk (e.g., identification of the AML contact person). The following areas should typically be covered to some extent each year:

- Written AML compliance policies and procedures;
- Designation of the AML compliance officer;
- Senior management approval;
- Customer Identification Program;
- Customer due diligence and high risk accounts;
- OFAC screening;
- Foreign correspondent accounts;
- Private banking accounts for non-U.S. persons;
- Suspicious activity monitoring and reporting process;
- CTRs and other BSA reporting requirements;
- AML training program;
- Monitoring employee conduct and accounts;
- Confidential reporting of AML non-compliance;
- Allocation of AML compliance requirements between a broker/dealer and its clearing broker;
- AML recordkeeping; and
- Responding to requests for information from FinCEN and Federal Law Enforcement Agencies and sharing information with other financial institutions.

The review scope will change each year, and firms should implement a formal scoping and planning process each year to re-assess the firm's AML risk profile and to identify those higher risk areas of review. As a starting point in determining the scope, the independent review team (whether internal audit or a qualified third-party) should at a minimum review the prior year's independent review report, internal audit reports that addressed AML issues and the most recent regulatory examination reports. The AML compliance officer should also be interviewed to identify particular areas of compliance concern. Finally, it is important to understand the recent areas of focus by the SEC and SROs.

2. An Experienced and Qualified Review Team

With increasing sophistication of AML compliance programs, firms require better trained auditors to execute independent reviews. When a regulator is evaluating a firm's commitment to its independent review program the first question that will be asked by examiners will be about the qualifications and experience of the review team. A second question will be whether the review team is truly independent of the AML compliance team, as well as broker dealer staff executing or processing transactions or new account openings.

Obviously, the degree of experience or expertise will be dependent on the size of the firm and whether or not a qualified third party is used. Whether or not a firm is large enough to conduct the review by utilizing their own personnel or hiring a third party, a common denominator is to ensure that those performing the review have a solid, working knowledge of applicable AML rules and regulations. At larger firms (particularly diversified financial services firms) where the AML review is embedded in broader business unit or functional audits, the question often arises whether a specialized AML team should be used to conduct the AML element of the audit. This will once again be dependent on the size of the firm and the internal audit group. It is best practice to have a core AML audit team or at least an AML specialist on each audit team where feasible. Having a core team of AML specialists addressing AML issues across the firm is also helpful in developing an enterprise-wide assessment of the overall firm AML program. Where an internal team is used, they should be subjected to regular AML training and

understand the key issues and risks of the current regulatory environment.

From an independence perspective, the team performing the AML independent review must neither be performing an AML control function, nor executing, or processing transactions or new customer account information. In addition, the AML compliance officer and the internal audit unit should not be reporting to the same person in the broker dealer's management.

3. Enterprise-Wide Approach

Firms are expected to manage and control their AML risk across the entire organization, taking into account different business lines, legal entities, and international business operations. While many firms have developed a strong enterprise-wide compliance program with a centralized AML compliance officer, many firms still manage their AML compliance requirements in "silos" by legal entity or business unit.

Regardless of how the firm has organized its AML compliance functions, the best in class AML independent review programs take an enterprise-wide approach to their reviews. Even when AML testing is done during a business unit audit, firms are highly encouraged to consolidate and report AML-related findings in enterprise-level AML reports. Typically, with an enterprise-wide approach a core AML review team will be involved in all AML reviews across the organization. Depending on the size of the organization, that may be a core group that conducts all AML reviews or a single AML review team. An enterprise-wide approach has several advantages. One, it permits the independent review team to evaluate and report on enterprise-wide trends in compliance violations, control weaknesses or potentially suspicious transactions. Another advantage is that by having a core team conduct all AML reviews across an organization, that team gains additional AML expertise and experience.

4. A Well-Defined Sample Selection Methodology

A critical element of the planning and execution process for an independent review is the development of the populations and samples to be selected for testing. Some of the key factors to be considered in properly determining sample selection sizes are:

- Ensuring that the populations to select from are all encompassing (i.e., that no areas of the broker dealer are overlooked for the specific products, customer types or geographies that are going to be tested for the presence and effectiveness of an AML control).
- Once the entire population is determined, it is important to document the methodology for determining the sample size to be selected from the population. Items influencing the sample size selection include: frequency of the control being applied, size of the overall population, risk based assessment to the institution of the specific control failing, and the amount of automation versus manual processes used in the application of the control.
- A consistent approach to the sample selection process should be maintained throughout the testing process. Inconsistency in the sample selection approach undermines the testing results creating uncertainty as to whether all of the relevant risks were properly and sufficiently tested. This does not mean the sampling approach must be exactly the same for each control to be tested. Approaches can be modified based upon the factors listed above, but consistency in how changes in sample approach are made and documented is critical.

5. An Assessment of the Effectiveness of KYC vs. Actual Activity

One area of focus for an AML independent review is whether the actual activity of a customer properly aligns with their expected activity. The expected activity is determined from the customer due diligence (CDD) information gathered at the time of account opening and updated periodically. The accuracy of this information is the centerpiece of an effective AML suspicious activity monitoring program.

As seen throughout the testing sections of the FFIEC's BSA AML Examination Manual an independent review must test this alignment to see if the CDD process is working and the baseline KYC information is accurate. The testing of actual transactional activity against CDD information on a sample of customers,

across customer classes and products is designed to determine whether that KYC information is accurate. Any inconsistency in actual activity to KYC information could be due to one or a combination of factors including: poor or outdated CDD information on the customer, poor filtering or rule settings in the AML monitoring system, not all transactional activity being reviewed by the AML monitoring system or poor manual review and analysis of warnings coming out of the AML monitoring system. This testing may actually identify certain transactions that are out of the range of ordinary transactions for the customer and may be indicative of suspicious activities and may warrant additional review by the independent testing team. If a control gap is identified in the CDD process, additional testing may be required to determine how deep and broad the control lapse is across the institution (i.e., products, customers and geographic regions) and whether there were certain suspicious transactions that would have been identified had the CDD process been effective and KYC information accurate.

6. Confirming the Integrity and Accuracy of AML Technology

Another indication of the growing sophistication of AML compliance programs is the broader use of technology in the AML compliance process. Whether it is management information systems related to reportable transaction identification, OFAC interdiction software or suspicious activity monitoring systems, technology plays a large part in the overall AML control environment. With such reliance on technology, an AML review program is not complete without the assessment of the integrity and accuracy of that technology, as well as the controls surrounding that technology (e.g., access controls, changes to AML filtering rules, etc.).

The review of AML compliance technology should, at a minimum, include:

- An evaluation of the methodology of the system and what it is designed to identify;
- An assessment of whether the system is capturing and evaluating all of the customers and activities that it should be capturing;
- Testing of the system to determine whether it is identifying or capturing reportable events or suspicious activities;
- A review of change management procedures and user access controls; and
- An evaluation of the process in place to follow-up on identified items.

Where the testing of the AML technology determines that the AML controls provided by the technology are weak or inadequate, additional transactional testing may need to be performed. The initial goal of the additional transactional testing will be to determine the extent of the control weakness and the need to perform additional and more detailed transactional testing.

7. A Detailed Review Report

One of the most common examination criticisms of broker/dealer independent reviews is that the reports generated by the review do not provide sufficient detail about what was tested, how it was tested and the findings identified by the testing. The single page report that indicates that an AML compliance program is "Adequate" or "Satisfactory" is not sufficient. The best reports will detail the AML requirements being tested, provide observations regarding documented policies and procedures, document findings on the effectiveness of controls and provide recommendations to address identified gaps. The report should also include management responses to recommendations and time frames for completion of the recommendations and assignment of responsibility for addressing the finding.

8. *A Formal Escalation and Remediation Process*

Firms should have a formal process in place to report the findings from the independent review to the AML Compliance Officer, management and in some cases the Chief Compliance Officer, General Counsel and/ or the Chief Risk Officer. We also recommend that the report be provided to the CEO or Senior Executive responsible for approving the AML program. As the report would be done by either Internal Audit or a qualified third party, the report may also be provided to the Audit Committee of the Board of Directors.

While it is important to provide the report to management, having a process in place to ensure that any identified findings are remediated in a timely and efficient manner is even more critical. The NASD has indicated that they will expect that any findings from the independent review, as well as any related recommendations, will be addressed in a timely manner. The best independent review programs utilize a formal issue tracking mechanism or leverage existing internal audit processes to identify parties responsible for remediation and to track identified issues to resolution. Extended delays in closing findings and implementing agreed upon recommendations should also be reported back to senior management and the Audit Committee so that delays in closing AML controls can be addressed in an expedited fashion and have management's focused attention.

Conclusion

In today's regulatory environment, broker/dealers cannot afford to have a weak or ineffective independent AML review program. If the experience of the banking industry provides any lesson, it is that the cost of non-compliance with AML requirements can be extremely high through regulatory fines and the expenses associated with detailed transactional lookbacks. A robust independent review program including all of the elements described above can help identify and address AML control weaknesses before they become a problem or before they are identified during a regulatory examination. The more robust the independent review program the more the regulator can rely on it to oversee the broker dealer's AML program.

If you have any questions about this article, please contact David Sapin, Stephen Lurie, or Karen Severe.

OTS Issues Advance Notice of Proposed Rulemaking on Unfair and Deceptive Acts and Practices

On August 3, 2007, the Office of Thrift Supervision (OTS) issued an advance notice of proposed rulemaking (ANPR) seeking comment on the approaches that the agency should consider in expanding its regulatory authority to address Unfair and Deceptive Acts and Practices (UDAP) in the thrift industry.

The OTS issued the ANPR to solicit public comment on whether a UDAP regulation could provide greater clarity to thrifts and benefit thrift customers by promoting fair and equitable practices in lending, deposit-taking and related activities.

The ANPR solicits comment on the scope of entities, practices, products and/or customer relationships that should be covered by a revised UDAP regulation. It also seeks comment on whether the OTS needs to expand its regulation in this area, and whether other approaches, such as guidance, may be appropriate.

The ANPR reviews OTS legal authority for issuing a UDAP regulation and discusses various approaches that the agency could take in issuing such a regulation. The ANPR seeks input on a wide range of issues and questions, including the potential approaches and the prospective benefits, costs, and impacts of each approach.

The OTS recognizes that the financial services industry and consumers have benefited from consistency in the rules and guidance adopted by the federal banking agencies. The agency affirms the goal of consistent interagency standards relating to unfair or deceptive acts or practices.

The ANPR will be open for public comment until November 6, 2007.

SEC Amends Regulation SHO and Proposes Additional Changes

On August 7, 2007, the SEC enacted several changes to Regulation SHO to make the rule consistent with other regulations, reduce the number of fails in threshold securities and address settlement issues for Rule 144 sales.

Rule 200(e)(3) of Regulation SHO was made consistent with NYSE Rule 80A by referencing the NYSE Composite Index (NYA) instead of the DJIA to determine the market decline limitation. The SEC also incorporated how the two percent market decline limitation is calculated instead of referencing the methodology contained in NYSE Rule 80A. The two percent limitation will be calculated at the beginning of each quarter and will be two percent, rounded down to the nearest 10 points, of the average closing value of the NYA for the last month of the previous quarter and remain in effect for the remainder of the trading day and will terminate at the end of the trading day instead of the closing value on the next trading day.

The SEC eliminated the grandfather provision and amended Rule 203 to require that all fails to deliver in threshold securities be closed out within either 13 consecutive settlement days or, in the case of a previously grandfathered fail to deliver position in a security that is a threshold security on the effective date of the amendment, 35 consecutive settlement days from the effective date of the amendment. An additional amendment to Rule 203 extends the close-out requirement from 13 to 35 consecutive settlement days for fails to deliver resulting from sales of threshold securities pursuant to Rule 144 and extends the pre-borrow requirement of Rule 203(b)(3)(iii) of Regulation SHO, for these fails to deliver. Consequently, if the fail to deliver position persists for 35 consecutive settlement days, the amendment will prohibit a participant of a registered clearing agency, and any broker-dealer for which it clears transactions, including market makers, from accepting any short sale orders or effecting further short sales in the particular threshold security without borrowing, or entering into a bona-fide arrangement to borrow, the security until the participant closes out the entire fail to deliver position by purchasing securities of like kind and quantity.

The above amendments become effective on October 15, 2007.

The SEC is also seeking comments on proposed changes to Regulation SHO intended to reduce the number of persistent fails by eliminating the options market maker exception and requiring that brokers/dealers marking a sale as “long” document the present location of the securities being sold. The comment period ends on September 13, 2007.

FinCEN Issues Final Rule for Section 312 of the USA PATRIOT Act

On August 9, 2007, the FinCEN issued a final rule clarifying the risk-based procedures that U.S. financial institutions should use in tailoring their enhanced due diligence to assess the risks of certain foreign banking relationships.

Section 312 of the USA PATRIOT Act requires U.S. financial institutions to establish due diligence (and in some cases enhanced due diligence) policies, procedures, and controls reasonably designed to detect and report money laundering through correspondent accounts and private banking accounts maintained for non-U.S. persons.

The final rule outlines the enhanced due diligence programs that U.S. financial institutions should implement when providing correspondent banking services to certain foreign financial institutions. These foreign financial institutions include institutions operating under an offshore banking license and institutions operating under a license issued by countries that the US Government has determined present a money laundering risk.

The rule obligates U.S. based financial institutions providing correspondent services to these foreign banks to conduct a risk assessment of the money laundering risks presented by offering correspondent services to such respondent banks. The final rule emphasizes that the level of enhanced due diligence performed should be calibrated to the money laundering risk that a specific respondent bank presents.

In certain instances, the rule requires a covered financial institution to establish enhanced due diligence procedures that at a minimum, include taking reasonable steps to:

- Conduct risk-based enhanced scrutiny of correspondent accounts established or maintained for respondent banks to guard against money laundering and to identify and report suspicious transactions;
- Determine whether the subject respondent bank in turn maintains correspondent accounts for other foreign banks that enable those other foreign banks to gain access to the respondent's bank correspondent account with the covered financial institution and, if so, take reasonable steps to obtain information to assess and mitigate the money laundering risks associated with such accounts; and
- Determine the identity of each owner of a respondent bank whose shares are not publicly traded, and the nature and extent of each owner's ownership interest.

The rule becomes effective September 10, 2007.

Federal Financial Regulators Propose Illustrations of Consumer Information to Support Their Statement on Subprime Lending

On August 14, 2007, the federal financial regulatory agencies issued proposed illustrations of consumer information for certain adjustable-rate mortgage products described in the Statement on Subprime Lending.

The Statement on Subprime Lending (effective July 10, 2007) recommends communications that ensure that consumers have clear, balanced, and timely information about the relative benefits and risks of certain adjustable rate products. The proposed illustrations are intended to assist institutions in providing this information. The illustrations consist of an explanation of key features and risks including payment shock and a chart demonstrate the potential consequences of a payment shock in a concrete, readily understandable manner.

Comments must be received on or before October 14, 2007.

OCC Encourages National Banks to Test Readiness for Pandemic Crisis

On August 13, 2007, the Office of the Comptroller of the Currency (OCC) encouraged national banks to participate in a Treasury Department sponsored exercise designed to test the financial sector's ability to respond to a pandemic like crisis.

The OCC believes that the exercise provides an excellent opportunity for organizations to test their pandemic plans and identify opportunities for improvement.

From September 24 through October 12, the Financial Banking Information Infrastructure Committee and the Financial Services Sector Coordinating Council will be conducting a pandemic flu exercise for the financial services sector in the United States. The exercise is sponsored by the US Department of Treasury

and the Securities Industry and Financial Markets Association.

The objectives for the exercise include:

- Enhancing the understanding of systemic risks to the sector;
- Providing an opportunity for firms to test their pandemic plans; and
- Examining how the effect of a pandemic flu on other critical infrastructures will impact the financial services sector.

Key Facts:

- The exercise is open to all members of the financial services industry in the US.
- Participation is voluntary and free of charge.
- The exercise will be conducted through a secure website, and anonymity will be respected.

Terrorism Risk Insurance Revision and Extension Act Passed

On August 3, 2007, the House Financial Services Committee passed H.R. 2761, the Terrorism Risk Insurance Revision and Extension Act of 2007 (TRIREA). The bill will next move to an as-yet-unscheduled vote by the full House. TRIREA would extend the current Terrorism Risk Insurance Act (TRIA) for 15 years. It would also:

- Expand TRIA's "make available" requirement to include nuclear, chemical, biological and radiological attack coverage;
- Change TRIA's definition of terrorism to include acts of domestic terrorism;
- Set the program trigger at $50 million;
- Add group life insurance to the lines of insurance for which terrorism coverage must be made available;
- Decrease deductibles for terrorist attacks over $1 billion and decrease the trigger after such events; and
- Continue to require studies of the development of a private market for terrorism risk insurance.

A group of representatives from New York State successfully passed an amendment to extend the program for an additional 5 years from the 2017 date originally included in the TRIREA bill, moving the sunset date to 2022.

The Bush administration immediately expressed displeasure with the bill. Assistant secretary of the Treasury, David Nason, stated, “We are particularly disappointed with the committee’s decision to extend the program for 15 additional years. This extension runs counter to the public policy goal of reducing and eventually eliminating the federal government’s role in the terrorism insurance market.”

Agencies Release Revised Bank Secrecy Act/Anti-Money Laundering Examination Manual

On August 24, 2007, the Federal Financial Institutions Examination Council (FFIEC) released the revised Bank Secrecy Act/Anti-Money Laundering (BSA/AML) Examination Manual. Updates made to the Examination Manual reflect the ongoing commitment of the federal and state banking agencies and the Financial Crimes Enforcement Network (FinCEN) to provide current and consistent guidance on risk-based policies, procedures and processes for banking organizations. The updated Examination Manual also further clarifies supervisory expectations, as well as an index. The Examination Manual can be located on the FFIEC BSA/AML InfoBase.

Additional Information

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