AUTHENTICATED
U.S. GOVERNMENT
INFORMATION
GPO

S. HRG. 108–752

OVERSIGHT OF THE EXTENDED CUSTODIAL INVENTORY PROGRAM

HEARING

BEFORE THE

COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS UNITED STATES SENATE

ONE HUNDRED EIGHTH CONGRESS

SECOND SESSION

ON

THE RECENT EVENTS INVOLVING THE UNION BANK OF SWITZERLAND-ZURICH WHICH VIOLATED ITS ECI AGREEMENT WITH THE FEDERAL RESERVE BANK OF NEW YORK BY ENGAGING IN U.S. DOLLAR BANK-NOTE TRANSACTIONS WITH COUNTRIES SUBJECT TO SANCTIONS BY THE U.S. DEPARTMENT OF THE TREASURY'S OFFICE OF FOREIGN ASSETS CONTROL, WHICH ADMINISTERS AND ENFORCES ECONOMIC SANCTIONS AGAINST TARGETED FOREIGN COUNTRIES

MAY 20, 2004

Printed for the use of the Committee on Banking, Housing, and Urban Affairs

U.S. GOVERNMENT PRINTING OFFICE

98–014 PDF WASHINGTON : 2005

For sale by the Superintendent of Documents, U.S. Government Printing Office
Internet: bookstore.gpo.gov Phone: toll free (866) 512–1800; DC area (202) 512–1800
Fax: (202) 512–2250 Mail: Stop SSOP, Washington, DC 20402–0001

COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS

RICHARD C. SHELBY, Alabama, *Chairman*

ROBERT F. BENNETT, Utah
WAYNE ALLARD, Colorado
MICHAEL B. ENZI, Wyoming
CHUCK HAGEL, Nebraska
RICK SANTORUM, Pennsylvania
JIM BUNNING, Kentucky
MIKE CRAPO, Idaho
JOHN E. SUNUNU, New Hampshire
ELIZABETH DOLE, North Carolina
LINCOLN D. CHAFEE, Rhode Island

PAUL S. SARBANES, Maryland
CHRISTOPHER J. DODD, Connecticut
TIM JOHNSON, South Dakota
JACK REED, Rhode Island
CHARLES E. SCHUMER, New York
EVAN BAYH, Indiana
ZELL MILLER, Georgia
THOMAS R. CARPER, Delaware
DEBBIE STABENOW, Michigan
JON S. CORZINE, New Jersey

KATHLEEN L. CASEY, *Staff Director and Counsel*
STEVEN B. HARRIS, *Democratic Staff Director and Chief Counsel*
DOUGLAS R. NAPPI, *Chief Counsel*
MARK F. OESTERLE, *Counsel*
SKIP FISCHER, *Professional Staff*
STEPHEN R. KROLL, *Democratic Special Counsel*
JOSEPH R. KOLINSKI, *Chief Clerk and Computer Systems Administrator*
GEORGE E. WHITTLE, *Editor*

C O N T E N T S

THURSDAY, MAY 20, 2004

	Page
Opening statement of Chairman Shelby	1

WITNESSES

R. Richard Newcomb, Director, Office of Foreign Assets Control, U.S. Department of the Treasury	2
Thomas C. Baxter, Jr., Executive Vice President and General Counsel, Federal Reserve Bank of New York	3
Prepared statement	18

OVERSIGHT OF THE EXTENDED CUSTODIAL INVENTORY PROGRAM

THURSDAY, MAY 20, 2004

U.S. SENATE,
COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS,
Washington, DC.

The Committee met at 10:08 a.m., in room SD–538, Dirksen Senate Office Building, Senator Richard C. Shelby (Chairman of the Committee) presiding.

OPENING STATEMENT OF CHAIRMAN RICHARD C. SHELBY

Chairman SHELBY. The hearing will come to order.

The purpose of today's hearing is to conduct oversight of the Federal Reserve's operation of its Extended Custodial Inventory, or ECI, program.

This program, which is administered by the Federal Reserve Bank of New York, was established to address the significant issues associated with the fact that a huge amount of U.S. currency circulates outside of the United States.

By partnering with United States and foreign banks at various locations throughout the world, the program is intended to enhance the ability of the Federal Reserve to deal with counterfeiting, to promote repatriation of old U.S. banknotes, to recirculate fit new U.S. banknotes, and to facilitate the international distribution of U.S. currency.

Unfortunately, recent events make it abundantly clear that the oversight of this program deserves a good portion of this Committee's time and attention.

Last week, the Federal Reserve announced that it was imposing a $100 million fine against the Union Bank of Switzerland, or UBS, as punishment for serious transgressions the Swiss Bank committed in its capacity as an ECI program participant.

Apparently, from the time UBS began working with the Fed in 1996 until sometime last year, UBS employees were conducting business through the ECI program with entities from nations restricted by the Office of Foreign Asset Control or OFAC.

While these activities were strictly prohibited under the terms of the ECI contract, UBS employees were able to engage in this deceptive conduct for a prolonged period by falsifying documents they were required to provide to the Federal Reserve.

Ultimately, UBS used the Federal Reserve to conduct billions of dollars worth of transactions with entities in Cuba, Iran, Libya, and Yugoslavia. Billions to Cuba, Iran, Libya, and Yugoslavia.

While we will never know the full extent of the damage, we do know that our national security and economic interests were significantly compromised by these despicable acts.

This morning, we will look at the circumstances that made it possible for the Federal Reserve to be repeatedly and systematically deceived by UBS, as well as the operation and oversight of the overall program.

In consideration of the amounts of money involved, we must be sure that the Federal Reserve employs the appropriate procedural safeguards, and perhaps more importantly, we must be sure that the staff of the Federal Reserve have the requisite frame of mind to aggressively and consistently apply those safeguards.

In the end, I believe we must look to the matter of ECI contract compliance as something requiring far more consideration than it seems to have been given in the past.

This morning we have as our witnesses, Richard Newcomb, Director, Office of Foreign Assets Control, U.S. Department of the Treasury, and Thomas C. Baxter, General Counsel and Executive Vice President of the Federal Reserve Bank of New York, and we have a number of people accompanying them, but Mr. Newcomb and Mr. Baxter, I believe will testify.

We will start with you, Mr. Newcomb.

STATEMENT OF R. RICHARD NEWCOMB
DIRECTOR, OFFICE OF FOREIGN ASSETS CONTROL
U.S. DEPARTMENT OF THE TREASURY

Mr. NEWCOMB. Thank you, Mr. Chairman. I want to thank you for inviting me to testify today about the Extended Custodial Inventory program. It is a pleasure to be here again to work with you and with your staff as we have over the years, and to discuss the Office of Foreign Assets Control and its relationship with the Federal Reserve Bank.

As you know, the primary mission of the Office of Foreign Assets Control is to administer and enforce economic sanctions against targeted foreign countries and groups and individuals, including terrorists, terrorist organizations, and narcotics traffickers which pose a threat to the national security, foreign policy, and economy of the United States. We act under general Presidential wartime and national emergency powers, as well as specific legislation to prohibit transactions and freeze assets subject to U.S. jurisdiction. Economic sanctions are intended to deprive the target of the use of its assets and deny the target access to the U.S. financial system, and the benefits of trade, transactions, and services involving U.S. markets. These same authorities have also been used to protect assets within U.S. jurisdiction of countries subject to foreign occupation and to further important U.S. nonproliferation goals.

We currently administer and enforce some 28 economic sanctions programs pursuant to Presidential and Congressional mandates. These programs are a crucial element in preserving and advancing the foreign policy and national security objectives of the United States, and are usually taken in conjunction with diplomatic, law enforcement, and occasionally military action.

Enforcement of these programs is defined by our jurisdiction, which extends to all U.S. citizens and permanent resident aliens,

regardless of where they are located, all persons and entities within the United States and all U.S. incorporated entities and their foreign branches. In the case of Cuba, we also have jurisdiction with regard to foreign subsidiaries owned or controlled by U.S. companies. For the purposes of our discussion, let us call these "U.S. persons."

OFAC has always had an outstanding relationship with the Federal Reserve, especially with the Federal Reserve Bank of New York. Because of this outstanding relationship, in early July 2003, the Federal Reserve Bank of New York contacted us to indicate that it had learned that U.S. dollar banknotes held in the Union Bank of Switzerland-Zurich, or UBS, may have been illegally bought or sold to sanctioned countries by UBS in violation of their Extended Custodial Inventory agreements with the Federal Reserve Bank of New York. I understand that the Federal Reserve Bank of New York has not previously been aware of the situation because officers and employees of UBS in Zurich had submitted deliberately falsified statistical reporting data.

We kept in touch with the Federal Reserve Bank of New York while UBS, at the Fed's insistence, and under the oversight of the Swiss banking authorities, initiated an internal investigation into this matter. UBS issued an initial report of findings on December 1, 2003, and a supplemental report dated January 26 of this year. The initial report was provided to the Federal Reserve Bank with a request that it be shared with OFAC. OFAC received it electronically on January 20 of this year with the supplemental report received on the January 29. We immediately reviewed the material and initiated an enforcement investigation into any possible activities on the part of "U.S. persons" over whom we would have jurisdiction.

The UBS/Zurich ECI contract was terminated for breach on October 28, 2003, and UBS, as you know, has paid a significant fine to the Federal Reserve Bank of New York for deception. We have met with all of the key players of the Federal Reserve Bank of New York and understand that the Bank, through new contracts made effective in February of this year, has taken very substantial steps to enhance controls over all remaining ECI's with respect to sanctions compliance. We applaud the Fed for these efforts.

I would like to thank you once again, and the Committee, for the opportunity to speak here this morning, and when we conclude we will be happy to answer any questions you may have.

Chairman SHELBY. Thank you, Mr. Newcomb.

Mr. BAXTER.

STATEMENT OF THOMAS C. BAXTER, JR.
EXECUTIVE VICE PRESIDENT AND GENERAL COUNSEL
FEDERAL RESERVE BANK OF NEW YORK

ACCOMPANIED BY:
RICHARD ASHTON, ASSOCIATE GENERAL COUNSEL AND
MICHAEL LAMBERT, FINANCIAL SERVICES MANAGER, CASH SECTION,
DIVISION OF RESERVE BANK OPERATIONS AND PAYMENT SYSTEMS
BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM

Mr. BAXTER. Thank you, Mr. Chairman.

Chairman Shelby, distinguished Members of the Committee, my name is Thomas Baxter and I am the General Counsel and Executive Vice President of the Federal Reserve Bank of New York.

At the New York Fed, I have responsibility for the law function, security, and the Corporate Secretary's Office. I appreciate your invitation, and I am honored to appear before you to discuss the Federal Reserve's operation of our Extended Custodial Inventory program, and our response to UBS's misconduct in operating one of our ECI facilities.

The U.S. dollar is the most desired form of money in the world. In many ways our dollar represents the strength of the American economy. The dollar is so desired around the world because it is a stable, always reliable medium of exchange and store of value.

Today, I will be speaking about the Federal Reserve's operation of our ECI program. I should start by describing it. In operation since 1996, when the Treasury, Secret Service, and Federal Reserve collectively decided to launch it, the ECI program has been a great success. The program sustains the quality of the U.S. dollar banknote, helps to deter counterfeiting, and provides an efficient and effective mechanism for the distribution of those notes in what is our largest market, the market outside of the United States.

We estimate that up to two-thirds of our currency circulates outside of the United States. The ECI program involves the use of financial institutions, mainly commercial banks, that are highly active in the international currency distribution business as Federal Reserve contractors. They agree to extend the Federal Reserve's reach into major financial centers of other countries, and hold inventory of our most popular product, the Federal Reserve note. They do this by holding in custody for us in their vaults U.S. dollar notes that we expect to distribute abroad, or old and unfit notes that we wish to repatriate.

The Extended Custodial Inventory facility helps to assure the quality of our product and its efficient distribution. With respect to quality, the ECI facility performs two important functions. First, it positions us to better monitor and better control the quality of our product by identifying counterfeit notes. The ECI's are well situated to detect such notes, to remove them from circulation, to provide intelligence to law enforcement authorities here and abroad, and to distribute new authentic notes. They perform similar functions with respect to what we call "unfit" notes, which is a cash processing code word for worn and dirty.

As for the efficiency of our distribution network, through our ECI contract partners we are positioned in the high volume wholesale banknote markets. Currently these markets are located in London, Frankfurt, Zurich, Hong Kong, and Singapore. Our ECI contractors are the market makers in those markets. At the present time we have ECI contracts with American Express, Bank of America, HSBC, Royal Bank of Scotland, and United Overseas Bank. Our ECI contractors bring into the markets they serve new fit notes quickly, and with similar expedition they repatriate unfit or old design notes to the United States for destruction.

With respect to repatriation, let me highlight one technical but very important point. Before the ECI program, wholesale dealers in U.S. dollars had a financial incentive to recirculate the unfit and

old design notes that came into their possession, because the time to transport those notes to the United States carried a corresponding delay in credit. The ECI program changed that, and as a consequence, the unfit and old design notes move into our custody much sooner. A credit for those notes passes from the Federal Reserve to the ECI contractor earlier, providing a financial incentive for quality control. Finally, our ECI contractors have ready a substantial inventory of banknotes to satisfy the periodic spikes in supply and demand encountered in a world full of uncertainties. Because these notes are Federal Reserve property, the ECI contractors do not have to finance the inventory when it is not needed.

This leads me to my first point. The experience that we have had with UBS does not change the fact that the ECI program is a success. I hasten to add that I am in no way trying to minimize what UBS did. The breach by UBS of our contract was wrongful, and the concerted acts of deception by UBS, carried out over a long period of time, violated our laws. The Federal Reserve terminated the contract with UBS in October 2003, and we assessed a $100 million civil money penalty against UBS on May 10 of this year, thereby remedying the breach and punishing the deception.

This leads me to my second point, which looks at how we respond when someone doing our business performs badly. The prompt corrective action taken to terminate the Federal Reserve's contractual relationship with UBS and to punish deception by UBS with a large monetary penalty, demonstrates a resolve that Federal Reserve operations will be conducted to the highest standards and in full compliance with U.S. legal requirements. In this regard it is noteworthy that our ECI contracts, in essence, export U.S. legal requirements including OFAC restrictions to offshore facilities.

When the Federal Reserve learned that UBS had breached its contractual obligations to abide by the restrictions of the U.S. sanctions program and engaged in U.S. dollar transactions with impermissible jurisdictions, we acted swiftly and surely. We terminated our contract with UBS and debited UBS's account with us for the entire inventory maintained in the Zurich vault. In a day, UBS lost an entire business line that had been profitable throughout the 8 years that UBS served as an ECI contractor.

The forfeiture of a profitable business is a financial consequence. UBS also suffered a reputational injury. Through the related action of our colleagues at the Swiss Federal Banking Commission, UBS is forbidden from reentering the wholesale external banknote business without the permission of that Commission.

This leads to my third point. The Federal Reserve will not tolerate deception. We will not tolerate deception from those banking organizations that we supervise, and we will not tolerate deception from those with whom we contract to execute important Federal programs. The ECI program is one such program. To transact business out of the Zurich facility with Iran, Cuba, Libya, and Yugoslavia, UBS personnel needed to act covertly and to hide their activity from the Federal Reserve. For a time they succeeded in their deceptive scheme, but we put a stop to it just about a year ago.

The people who engaged in such conduct in Switzerland have lost their jobs. The business franchise is no more. In the civil money

penalty that we announced on May 10, UBS paid a heavy price for the deceit of the banknote personnel which it formerly employed.

Turning for just a moment back to the ECI program, the imposed penalty gave our remaining ECI contractors 100 million reasons to remain truthful.

And on top of all of that, the Swiss Federal Banking Commission issued a formal public reprimand to the largest bank in Switzerland. The banknote personnel of UBS deceived people at the Banking Commission just as they deceived us. Our colleagues at the Banking Commission joined with us in finding such deception inexcusable and warranting reprimand.

This brings me to my fourth and final point. At the Federal Reserve we are dedicated to continuous improvement, and we know that all internal controls can be bolstered through the lessons of experience, including our own unfortunate experience with the UBS case.

That experience has shown that our primary control for compliance with country restrictions, truthful monthly reporting of currency transactions by country, was just not sufficient. Since February of this year, our ECI contracts have a number of new features that enhance the control environment. One is the requirement that management of our ECI contractors attest yearly on contract compliance and on accurate reporting, and that an independent public accounting firm certifies to the Federal Reserve that the management attestation is fairly stated. This Sarbanes-Oxley inspired change shows our commitment to continuous improvement.

Let me also acknowledge a lesson learned. With the country reports we receive from UBS, we did not follow the old audit admonition, "trust but verify." Going forward, verification of the accuracy in reporting by our ECI contractors will come from the certifications of those attestations from public accounting firms.

In summing up, let me restate my four points. The ECI program is important and successful because it fosters the excellent quality of U.S. currency and its efficient distribution outside the United States. When someone performs poorly in the ECI program you can be assured that the Federal Reserve will respond with prompt corrective action. If there is deception in addition to poor performance, as was the case with UBS, the consequences will be severe. Finally, we will strive to continuously improve our internal controls by borrowing the best ideas and by learning lessons from our experiences.

Thank you for your attention and I look forward to answering any questions you may have.

Chairman SHELBY. Thank you. I would like to acknowledge the presence of Richard Ashton, Associate General Counsel, and Michael Lambert, Financial Services Manager, Cash Section, Division of Reserve Bank Operations and Payment Systems, Board of Governors of the Federal Reserve. Welcome to both of you gentlemen.

Mr. Baxter, if you could, walk us through how the ECI program should have ideally worked from the Fed's perspective by walking us through a buy and sell order. Explain, if you could, how it was used and operated by UBS in contravention of your agreement and how they deceived you. Can you do that, just slowly?

Mr. BAXTER. The first way they deceived us, Chairman, was by not telling the truth. We will start out with the breach of the contract, and the contract exported the restrictions that Director Newcomb spoke about in his testimony this morning. We export those restrictions from the United States to our ECI facilities, and one was in Zurich.

One of the restrictions was that the UBS facility could not send cash from our ECI vault to Iran. That provision in the contract was breached, so that is the first provision that would have prevented this that was violated by UBS. The control on that particular contract provision is the monthly reports that the contract also requires be rendered by an ECI operator.

Chairman SHELBY. Were those reports false?

Mr. BAXTER. You will not be surprised to hear, Chairman, that the reports rendered by UBS's facility never showed Iran, and so, yes, sir, they were false. We had the breach and the doing of the business of Iran and then we have the deception with respect to the falsification of the monthly reports. Had the reports been truthful, then the activity would have been revealed to us and we would have addressed it immediately.

Chairman SHELBY. How much money was involved here, billions, was it not?

Mr. BAXTER. Between $4 and $5 billion aggregate for the jurisdictions that it should not have done business with.

Chairman SHELBY. Was the deception facilitated to some degree by failure to audit primary documentation that would have evidenced OFAC violations? In other words, from your standpoint, you cannot just trust somebody in a blanket way, can you?

Mr. BAXTER. In some of your contractual dealings, Chairman, with respect to some contractual provisions, it is customary to rely on reps and warranties from your counterparty, and there is a basic business principle that your counterparty will tell you the truth.

Here we did not entirely trust our counterparty because we did audit the cash in the vaults to be sure. We went over with our auditors to make sure that the money in the vaults belonging to the Federal Reserve was accurate in count.

With respect to the representation concerning OFAC restrictions, which was breached, there we did not audit for compliance. Instead we relied in the past on the monthly reporting information from the ECI operator. Of course, that has changed. That has changed because going forward we are going to receive the management attestation and then the independent check of the public accounting firm that will have to assure us in a certification that there is a fair basis for that attestation.

Chairman SHELBY. Under the terms of the ECI agreement, in addition to receiving statistical data, reports for money laundering, and OFAC compliance, the Federal Reserve Bank retained the right to enter, "the ECI operation on an announced or unannounced basis to conduct audits of the Bank's assets as well as request," in this case UBS, "to account for and reconcile in the Bank's presence," in your presence, "all other United States currency on the books at UBS." This is from the document.

What was the purpose of this provision? Why were these rights necessary?

Mr. BAXTER. We wanted to have the ability of our audit personnel to go in and assure themselves and us——

Chairman SHELBY. Unannounced too.

Mr. BAXTER. Unannounced or announced, that the cash that was expected to be in the vault was there, and that we did. What we did not do is——

Chairman SHELBY. Did you ever go unannounced? Did the Fed ever conduct unannounced audits of the ECI?

Mr. BAXTER. I do not believe so, Chairman.

Chairman SHELBY. Will you check for the record? You think not?

Mr. BAXTER. I think they always knew we were coming.

Chairman SHELBY. Did the Federal Reserve ever request or conduct a review of U.S. currency transactions on UBS's books over the course of the contract? You acknowledged a minute ago you went in and counted the money, but did you ever conduct a review of U.S. currency transactions on the UBS books over that contract?

Mr. BAXTER. Let me answer it in this way, Chairman, because there are really two steps. There is the transaction between UBS and our vault, and of course, that is closely monitored, and then there is the next layer of transaction between UBS and its counterparties, and it was the next layer we never actually looked at that segment, but we certainly were looking——

Chairman SHELBY. You wish you had though, do you not?

Mr. BAXTER. Now I do.

Chairman SHELBY. Mr. Baxter, what about an oversight regime seemingly dependent upon the voluntary compliance of the banks which you contracted to hold U.S. currency? In other words, you are basically voluntary.

It is my understanding that the Federal Reserve Bank did not suspect that there could be a problem with at least one of its contractors because of the false reports filed with the Fed by those contractors. In other words, you relied on them.

Are you comfortable with a compliance system that relies so heavily on voluntary compliance with the integrity of a major U.S. international economic program; that is, our ability to combat counterfeiting, our ability to enforce sanctions against rogue regimes and a heck of a lot of cash here at stake? What measures has the Fed taken or do you plan to take so that it is less reliant on an apparently flawed compliance system? In other words, you just told us that you did not go the second layer. You did not go to examine what they were doing, what UBS was doing. You counted the money, so to speak.

Mr. BAXTER. Yes, Chairman.

Chairman SHELBY. What is the Fed doing now?

Mr. BAXTER. First, let me part company with the word "voluntary" because there was a contract. The contract required the rendering of monthly reports, then and now. So it was not that it was voluntary. It was required, and the failure to provide those reports would be a breach. I would not characterize the reporting as voluntary. It was mandatory, then and now.

The problem with the reporting is we trusted the truthfulness of our reporter, and our reporter here was being deceptive, and that

we have addressed through the public accounting firm certification. What we have not done, and it would be very, very difficult to do, would be to go to the next layer and say, "Okay," with an institution, for example, the size of HSBC, "we want to see every currency transaction between HSBC anywhere it is in the world and all of its counterparties" because it has branches in many, many different jurisdictions, there are currency transactions between HSBC and many, many other banks. So, to take it to that level would be very, very difficult.

And that gets into one of the fundamental problems here, trying to trace banknotes, once they are outside of the United States, from hand-to-hand. And in an organization the size of an HSBC or a Bank of America, that becomes extremely difficult.

Chairman SHELBY. Were the monthly reports basically just computer spreadsheets that you were getting?

Mr. BAXTER. What the monthly reports would show is a listing of all of the countries that you either received cash into our ECI facility from or you sent cash from our ECI facility to. You have all of those countries, and then you would have amounts for shipments out and receipts. That is what those reports show.

That is exactly why the reports rendered by UBS were false because they were missing countries, first, and, second, the amounts that were shown for those countries were being placed in a different place on the reports.

Chairman SHELBY. Totally fraud, in a sense.

Mr. BAXTER. Deception, no question.

Chairman SHELBY. Mr. Baxter, I understand that the banknote trading business was supposed to be kept operationally separate from the extended custodial inventory program. There does seem to be some confusion regarding the extent to which these two activities may have been blurred together.

Were the same people who traded the banknotes for the ECI program also involved in, for example, UBS's proprietary banknote trading operation?

Mr. BAXTER. The ECI facility——

Chairman SHELBY. Do you understand my question?

Mr. BAXTER. I do understand, Chairman.

The ECI facility in Zurich was run out of the airport there. In the airport, there were operational personnel who prepared the monthly reports that were deceptive, that contain false entries, and then there were trading personnel. And there was a form of Great Wall of China between those two operations.

Chairman SHELBY. Could you see through it?

Mr. BAXTER. Not only could you see through it, Chairman, not only was there deception, but there was also a conspiracy among the deceivers who were preparing the reports and also who were doing the trading. So you had the worst of all worlds. You had deceptive activity, and you had conspiracy between people on the operational side and people on the trading side.

Chairman SHELBY. What has happened to these people who were involved in this conspiracy at UBS? In other words, I know you fined them $100 million, but have they violated Swiss law here? Have they violated our laws or what have they done? Are you looking at it closely?

Mr. BAXTER. Let me answer this in two ways. First, the people have been fired. Second, there are continuing investigations with respect to potential actions against those people not only here in the United States, but also in Switzerland. And as I said in my opening statement, there was deception not only to the Federal Reserve, but also to the Swiss Federal Banking Commission.

Chairman SHELBY. Mr. Newcomb, I believe it is your responsibility at the Treasury to enforce the U.S. economic sanctions against countries like Cuba, Iran, Libya, and under its old regime of Yugoslavia, what used to be Yugoslavia. These have been some of the key countries I think have been a concern for the United States in other words, for Treasury for many years.

Notwithstanding changes with respect to U.S. relations with Yugoslavia and Libya, has the integrity of the sanction regimes that have been an essential and important tool of U.S. foreign policy been harmed by UBS's conduct and Los Angeles oversight on the part of the Federal Reserve?

Mr. NEWCOMB. Mr. Chairman, let me answer that question in this way. Whenever we find hemorrhaging like this, it is significant to——

Chairman SHELBY. It is a lot of money, is it not?

Mr. NEWCOMB. It is a lot of money.

Chairman SHELBY. It evens it out.

Mr. NEWCOMB. It affects the ability of us to administer sanctions programs.

We have unilateral sanctions programs.

Chairman SHELBY. I know.

Mr. NEWCOMB. It is unilateral on Iran, it is unilateral on Cuba, and it was, for a time, on Yugoslavia unilateral. So you cannot, other than jawboning foreign governments to go along with your programs, it is very difficult in all instances to get cooperation. Some governments, in fact, have blocking statutes prohibiting their nationals from cooperating in administering sanctions programs.

I think what we have here is a very significant event and, as Mr. Baxter has pointed out, lessons learned. Though we do not have jurisdiction over UBS Zurich—there is no enforcement action that we can take against that bank—we do have other matters open that I cannot comment about to determine if there is U.S. jurisdiction and if U.S. laws have been violated. But we do look forward to cooperating with the Fed. We have met with them twice in the last month and anticipate next week to continue to see, though we do not have jurisdiction, to see what further steps we can take to ensure that these and other agreements for distribution of dollars are consistent with our goal in implementing the sanctions programs.

Chairman SHELBY. Mr. Newcomb, when entities are sanctioned for OFAC violations, how much money is usually involved in the underlying transaction? Does it vary?

Mr. NEWCOMB. It depends on what the country is and the timing of the sanctions program. If it is an oil-rich country, where there is an element of surprise, there can be billions and sometimes tens of billions of dollars involved. In other situations where relationships have deteriorated, there usually is a very small amount blocked, but the size of transactions can be anywhere in the hundreds of dollars up to the billions of dollars, depending on the par-

ticular facts and circumstances of the country program and point in time.

Chairman SHELBY. Did you rely on the same reporting requirements to check compliance in your areas that they did?

Mr. NEWCOMB. Well, we are not involved in the ECI program. It goes to banks over which we do not have jurisdiction. Any reliance we would have would be on the contractual relationship that the Fed would have with its ECI counterparties to control what is taking place within those institutions. But we have no jurisdiction, for example, to go and look in a foreign bank, so there would be no way we could oversee the activities.

Chairman SHELBY. But to help coordinate your job, do you rely, in this case, on some of their information?

Mr. NEWCOMB. Yes, we do.

Chairman SHELBY. And obviously a lot of it was false, was it not?

Mr. NEWCOMB. The information that UBS had given to the Fed was false. I will say, as soon as the Fed was aware of it last July, they notified us immediately, and as developments occurred in July, I think again in October, and then in January, gave us a reporting. As I mentioned since, in recent weeks, we have met twice and are looking forward to the cooperation of the Fed to see what steps we might be able to bootstrap, recognizing that we do not have jurisdiction over foreign banks, but we are very concerned about the sanctions program implementation.

Chairman SHELBY. Sure.

Mr. Baxter, if one of the purposes behind the distribution of new dollars in the ECI program was to curtail counterfeiting, why was a Swiss location used? In other words, the contracts require cooperation with the New York Federal Reserve and the Secret Service in investigating counterfeits. Was there a concern that Swiss Bank secrecy law would inhibit the Secret Service access to useful information for combatting counterfeiting on a real-time basis? And was there any explicit or implicit agreement with the Swiss authorities regarding access to information that would be necessary to investigate counterfeiting in Switzerland, for example?

Mr. BAXTER. Originally, in 1996, UBS was selected in Zurich as one of our ECI counterparties and for a very specific reason, Chairman. At the time, the United States was introducing a new $100 note, and one of the places that note was going to be most highly prized was the former Soviet Union.

The key point for shipment of dollars into the former Soviet Union was Zurich. UBS was an institution that was very interested in the Russian business. So it was for those reasons that we originally started our ECI operation in Zurich with UBS.

With respect to counterfeiting, we get excellent cooperation from the Swiss government. There is an international convention that deals with the counterfeiting of another state's currency within your territory, and that is one of the things that is highly useful in these matters.

In addition, what we have with respect to the ECI program is a capability, when a counterfeit note is detected in a place like Zurich, to alert the Secret Service in the United States as to the country of origin for that counterfeit note, and that was also another key factor because, with respect to terrorism, there was a concern,

with respect to the $100 note, that certain countries were active in supporting counterfeiting of our currency really to call into question the strength of the dollar.

Another aspect of this, in quartering a facility in a place like Zurich, was to get into the market that would lead to the early detection of the counterfeiting and the possible use of money as a hostile attack on the U.S. dollar. So those were all considerations.

Swiss secrecy law, which was also in your question, was certainly acknowledged as an issue, but an issue that we did not think would interfere with our getting the country information, and the country information was seen to be most important, then and now.

Chairman SHELBY. Mr. Baxter, the opinion letter of UBS's counsel makes it clear that the New York Fed would have absolutely no recourse, under Swiss law, if it became necessary to obtain customer-specific information. As a matter of fact, under paragraph 10(2) of the original 1996 contract, the New York Fed stipulated that it was not acting "as a foreign government body," arguably giving up what limited recourse might be available to foreign governments, like us, for law enforcement information through the Swiss judicial system.

Don't these limitations in some way diminish the value of the Zurich ECI with respect to law enforcement efforts. I know you wanted to launch your new $100 bill there, but you did have to give up some other things, did you not?

Mr. BAXTER. You are correct, Chairman, that to conduct Governmental activity on the soil of Switzerland would be a violation of the Swiss penal law. However, with respect to secrecy, I have yet to meet, in my 24-year career as a lawyer, a secrecy law that did not have some weaknesses in it, and one of them—and you can see it here, Chairman—is you can find a gateway usually through a supervisor. That is why, on July 22, I went to Bern, Switzerland, and I met with people who I have known for years at the Swiss Federal Banking Commission, and I asked for their assistance in getting information through them, not directly, because there are legal prohibitions to get it directly, but if you get it through the supervisory authority, you can find a gateway through secrecy, and that is exactly what I was looking for on January 22. That is exactly what the Federal Reserve got because we received the information that we needed to take the action, and the action was taken in October and May.

So secrecy laws did not stand in the way because the Federal Reserve knew how to find the gateway.

Chairman SHELBY. But that was after 7 years of violations, was it not?

Mr. BAXTER. And the violations resulted from the deception, no question, Chairman.

Chairman SHELBY. Seven years. Were you or the Secret Service ever alerted by UBS of counterfeit evidence over the course of the contract?

Mr. BAXTER. I do not know, Chairman.

Chairman SHELBY. Can you check that out for the record?

Mr. BAXTER. Yes.

Chairman SHELBY. Mr. Baxter, why would you use a foreign bank as an ECI contractor? Would the Fed not have useful leverage

over the U.S. bank with foreign operations? In other words, we have huge banks headquartered here. I could name, you could name them all, that do business all over the world. We have Citicorp, we have Bank of America, you can go on and on, and you would have some jurisdiction over these U.S. banks, as opposed to a foreign bank to deal with U.S. dollars, distribution, repatriating, and so forth. The merits of it. Could you discuss the relative merits of using UBS, as opposed, say, to Citicorp or Bank of America or, gosh, you name it, JP Morgan Chase. I better name them all.

[Laughter.]

Mr. BAXTER. Chairman, two points. First, with respect to the selection of an ECI contractor, we look at the place, and we look at who can make markets or make markets in those places. So you have to be active in the banknote business, and there are only about 30 banks worldwide that are active in that business. Not all of them are American banks.

Chairman SHELBY. Are some of the American banks active in the banknote business?

Mr. BAXTER. Yes. In fact, three of our ECI operators are American. We have American Express, we have Bank of America, and HSBC, our contract is with HSBC USA.

Chairman SHELBY. A British bank, right?

Mr. BAXTER. Well, our contract is with the American subsidiary. So three of our five are American.

Chairman SHELBY. Have you had trouble with HSBC? Are you auditing HSBC?

Mr. BAXTER. Well, remember, we audit all of our facilities with respect to the cash in the vault.

Chairman SHELBY. Is your auditing going to the second-tier audit now? You did not with UBS, but are you looking at the others more thoroughly now? And if not, why not?

Mr. BAXTER. What our first line of defense is, is the public accounting certification of both contract compliance and accuracy in reporting. So we are not doing it using our own personnel, Chairman. We are using the personnel of public accounting firms for that purpose.

Chairman SHELBY. I hope they are accurate.

Mr. BAXTER. The other point about UBS, Chairman, that I was going to offer, I know it is commonplace to think of UBS as a Swiss institution, and it does have a Swiss license, but it is a trillion-dollar bank with $600 billion of its assets in the United States and 22,000 employees in the United States.

Chairman SHELBY. We understand that. We know they are a good bank, but we also know that they have done some awful things for the Fed to fine them $100 million. That is not just a slap on the wrist, monetarily speaking, right?

Mr. BAXTER. Correct, Chairman.

Chairman SHELBY. Now, you are not trying to defend their conduct, are you?

Mr. BAXTER. Absolutely not, Chairman.

Chairman SHELBY. In light of the fact that we now know that UBS falsified records relating to OFAC issues, has there ever been a question as to their records with respect to counterfeiting and money laundering? In other words, if they would falsify the records

dealing with rogue nations, what about counterfeiting and money laundering? What about terrorist financing, you know, or anything? I think these questions should be followed anyway. In other words, if you do those kinds of things what else would you do? Do you see my question?

Mr. BAXTER. I do, Chairman.

Chairman SHELBY. Is anybody looking at that?

Mr. BAXTER. I know that the Swiss Federal Banking Commission has looked at those issues with respect to Swiss banks, generally, and with respect to UBS, specifically, and that is one of its charges, as the home country supervisor of UBS, and I know the people there carry that out quite seriously. I also know, Chairman, from the testimony of others, like David Aufhauser, Juan Zarate, that there is an opinion in the Government today that the Swiss are doing more than ever before not only in the antimoney laundering area, but also in the terrorist finance area.

Chairman SHELBY. Are they doing enough?

Mr. BAXTER. I do not know if any of us are doing enough, Chairman.

Chairman SHELBY. It begs the question here, I think, if they would falsify dealing with rogue nations, what else would they do? Maybe nothing. Maybe this is all they did, but it makes you wonder—it does me, and I am sure it does others that deal with money laundering, terrorist financing, everything else—because if you are dealing with some of these rogue nations in that regard, would you be dealing with them in other respects? I do not know that question, I do not know the answer to it.

Mr. Baxter, the operations manual for UBS, Union Bank of Switzerland, makes continued reference to the Avix computer system. What is the AVIX system?

Mr. BAXTER. My belief is the AVIX system that we use with respect to counterfeit identification, and that is one of the purposes of an ECI is the early detection of the counterfeit market.

Chairman SHELBY. Does it provide a real-time relay of information to the New York Fed? Is that part of it?

Mr. BAXTER. I do not know that, Chairman, as I sit here.

Chairman SHELBY. Can counsel answer that? Does the AVIX computer system provide a real-time relay of information to the New York Fed?

Mr. Lambert, do you want to answer that?

Mr. LAMBERT. Yes, Mr. Chairman. That system is a real-time system that will convey information from the ECI facilities back to New York on payment and receipt activity. So it is a real-time system.

Chairman SHELBY. So this system would provide a field for designating the source of a deposit or a request for cash?

Mr. LAMBERT. It is basically the payment to and receipt from information.

Chairman SHELBY. Do all ECI contractors use the same program and manual for controls and operations here, do you know?

Mr. LAMBERT. Yes, they do.

Chairman SHELBY. Who insures the integrity of the data that the New York Fed receives from the ECI operators? Is Mr. Lambert the proper one to answer that?

Mr. LAMBERT. I think perhaps Mr. Baxter may be able to.

Chairman SHELBY. Mr. Baxter.

Mr. BAXTER. With respect to cash into or out of an ECI vault, there would be records that would be maintained on both the credit and the debt side, and there would be records on the custody side, which is out at the ECI facility itself. And when our audit personnel go out to an ECI to do an audit, that is exactly what they are looking at, Chairman.

Chairman SHELBY. Mr. Baxter, we are talking about trust, but you know you can trust too much sometimes. You have to verify, you have to check, especially when significant amounts of money are involved, and there were $4 or $5 billion—I believe that was your number—involved here. Is there a cultural issue at the New York Federal Reserve that made it difficult for you to adopt a rigorous verification program. In other words, why did you not have a rigorous verification program?

Mr. BAXTER. Mr. Chairman, with respect to the culture at the Federal Reserve Bank of New York, our culture has always been rigorous with respect to compliance and with respect to the enforcement of U.S. sanctions regime.

I can tell you, Chairman, as a very young lawyer, I started my career in the summer of 1980 at the New York Fed working on the Iranian hostage crisis. I am one of the very few people probably left who has actually been involved with sanctions longer than Director Newcomb, who I think started in 1981. I learned from my seniors then, and I have carried with through today, a very healthy respect for that regime of sanctions. It is part of our culture. It is part of my being, I believe in it, and part of the culture of compliance.

Chairman SHELBY. But this undermines the sanctions.

Mr. BAXTER. Absolutely, and that is why we responded swiftly and surely, sir.

Chairman SHELBY. You responded that—I understand that—and I commend you for that. But an overarching concern that a lot of us have is that it took the discovery of a $600-million cash hoard in Iraq, as reported by *The New York Times*, to make you aware of what could be characterized as a fairly significant and material fraudulent conduct here and this, after at least two major revisions of the contract and numerous other amendments of the contract terms, over the course of the life of the contract from 1996 through 2003.

You significantly altered the terms of your contracts after this discovery. Are you confident, Mr. Baxter, that such conduct could be detected in the future from other banks that you have contracted with? And if so, how? In other words, how has your compliance changed in your examination? In other words, if you have not changed, how are you, other than somebody discovering it for you or alerting you to it, how are you going to find out what is really going on with your contract banks in this regard?

Mr. BAXTER. I think the first thing that you need, and this gets to the culture question, Chairman, is you need to be attentive and responsive, and if you look at how this started, it started on Sunday, April 20, 2003, when I saw in *The New York Times* this reference to our money being found in Baghdad. And, of course, the

first question was how could that happen not only with U.S. sanctions, but also with UN sanctions? How could that happen?

The beginning of the tracing exercise was symptomatic of a culture that we cannot sit still when we see problems. That is exactly what you see in the chronology of the Federal Reserve's response.

Chairman SHELBY. But a thorough audit might have prevented those problems early on, could it? Maybe, maybe not.

Mr. BAXTER. Truthfulness by our ECI contractor would have prevented it, and that is why I think it is so important, when we see deception, that we respond not only swiftly and surely, but we also respond aggressively, and that is what happened here. That is what we did.

Chairman SHELBY. How many foreign banks—even if they are based somewhere, if they are based in London, they are based in Zurich, they are based in Frankfurt, or wherever or Tokyo or you name it in the world—are your contractors in this regard?

Mr. BAXTER. Two—Royal Bank of Scotland and United Overseas Bank.

Chairman SHELBY. I thought HSBC was one you——

Mr. BAXTER. Our contract is with the American subsidiary.

Chairman SHELBY. Now, what has changed in your audit, in other words your compliance, since last year to now is what I am getting at or is it the same procedure you had?

Mr. BAXTER. We first added, in both the contract and the manual of procedures, many more provisions dealing with antimoney laundering and OFAC compliance, including having a compliance program for OFAC compliance, appointing a compliance officer. So there is a much more robust control environment imposed by contract. That is the first point.

Chairman SHELBY. But that is a contract.

Mr. BAXTER. That is correct.

Chairman SHELBY. But what are you doing yourself to make sure that contract is complied with?

Mr. BAXTER. And then the second thing——

Chairman SHELBY. In other words, a thorough audit.

Mr. BAXTER. —is the management attestation of two things, Chairman. First is contract compliance. So all of those new provisions now are going to get a management official who is going to attest to compliance with all of those new provisions, and that management official is also going to attest to truthful, accurate reporting.

And, the third level, we have a public accounting firm that is going to come in, and here they are essentially doing the inspection in place of us, and they are looking at those management attestations with respect to compliance and with respect to accurate reporting, and they are saying directly to the Fed, "You can rest comfortably, you can take assurance——"

Chairman SHELBY. Were they doing this before? Were they doing this a year ago, these accounting firms? Were they doing the——

Mr. BAXTER. They were not, Chairman. This was put into place in February of this year.

Chairman SHELBY. They were not. So this is a change you have brought about.

Mr. BAXTER. Yes, Chairman.

Chairman SHELBY. And what level of management is involved in the oversight of this at the Fed?

Mr. BAXTER. Well, I am at the executive vice president level. I am essentially second level down from the first vice president and the president. So you have it at my attention, and I am on the Management Committee. I am a very senior person at the New York Fed.

Chairman SHELBY. Do you feel like this is not going to happen again? You cannot predict that, can you?

Mr. BAXTER. Well, I have learned in my career never to say never, Chairman. I certainly will use my best efforts to assure that it does not happen again.

Chairman SHELBY. We appreciate your appearance here today. Senator Sarbanes has a number of questions for the record. We will leave that open if others do. There are a lot of meetings going on, but we think this is important to hold this oversight.

Thank you a lot.

The hearing is adjourned.

[Whereupon, at 11:07 a.m., the hearing was adjourned.]

[Prepared statements supplied for the record follow:]

PREPARED STATEMENT OF THOMAS C. BAXTER, JR.

EXECUTIVE VICE PRESIDENT AND GENERAL COUNSEL
FEDERAL RESERVE BANK OF NEW YORK

MAY 20, 2004

Introduction

Chairman Shelby, Senator Sarbanes, and Members of the Committee, I am pleased to be here this morning to discuss certain recent events relating to the Federal Reserve's Extended Custodial Inventory (ECI) program. More specifically, I will focus on conduct by one of the former operators of an ECI facility, namely UBS, a Swiss banking organization. UBS operated a site in Zurich, Switzerland until late October 2003 when the Federal Reserve Bank of New York (New York Fed) terminated its contract with UBS for serious breaches. More recently, the Federal Reserve assessed a $100 million civil money penalty against UBS for deceptive conduct both in connection with its performance under the ECI contract, and with respect to the investigation into that performance.

My remarks today will cover four topics. First, I will provide some background regarding the ECI program. Second, I will review the chronology surrounding our discovery that UBS had violated its ECI Agreement with the Federal Reserve Bank of New York by engaging in U.S. dollar (USD) banknote transactions with countries subject to sanctions by the U.S. Department of the Treasury's Office of Foreign Assets Control (OFAC), and, moreover, that certain former officers and employees of UBS had intentionally deceived the Federal Reserve Bank of New York in order to conceal those transactions. Third, I will explain the rationale behind our decision to assess a civil money penalty in the amount of $100 million and will distinguish this punitive action from the earlier action for breach of contract and the remedial action of the Swiss supervisor, the Swiss Federal Banking Commission (referred to as the "EBK"). Fourth, I will discuss the steps the New York Fed has taken with respect to its remaining ECI operators so as to improve the controls relating to OFAC compliance.

Background on the ECI program

Let me now begin with some background on the ECI program.

The ECI program serves as a means to facilitate the international distribution of U.S. banknotes, permit the repatriation of old design banknotes, promote the recirculation of fit new-design currency, and strengthen the U.S. information gathering capabilities on the international use of U.S. currency and sources of U.S. banknote counterfeiting abroad. ECI facilities function as overseas cash depots operated by private sector commercial banks. These banks hold currency for the New York Fed on a custodial basis.

It is estimated that as much as two-thirds of the value of all Federal Reserve notes in circulation, or over $400 billion of the $680 billion now in circulation, is held abroad. The billions of dollars held overseas represent a financial benefit to U.S. taxpayers. While many financial institutions trade U.S. dollars in the foreign exchange markets, no more than thirty institutions worldwide participate in the wholesale buying and selling of physical USD banknotes. At the present time, the principal hubs for the distribution of U.S. banknotes are: Frankfurt, London, Zurich, Hong Kong, and Singapore. Wholesale banknote dealers purchase approximately 90 percent of the U.S. banknotes that are exported to international markets from the New York Fed.

Working with the U.S. Department of the Treasury, the Federal Reserve introduced the ECI program as a pilot in 1996 to aid in the introduction of the $100 new currency design note, and in recognition that an assured supply of U.S. currency abroad would help to alleviate any uncertainty that might have been associated with a new design. The pilot program succeeded in ensuring the orderly introduction of the new design banknotes by providing ready supplies of such notes, particularly in the European and former Soviet Union markets.

After the successful introduction of the new design $100 banknote, the primary purpose of the ECI program shifted to enhancing the international banknote distribution system. The ECI program was placed into full operation in January 1998 with ECI facilities in London, Frankfurt, and Zurich, and soon thereafter, Hong Kong. In 2000, an ECI facility was established in Buenos Aires, but the site was closed in February 2002 because of unpredictable economic and political conditions. The Singapore ECI started operation in 2002. Currently, a total of eight ECI facilities are operated in five cities by five banks: American Express Bank (London), Bank of America (Hong Kong, Zurich), HSBC (London, Frankfurt, Hong Kong), Royal Bank of Scotland (London), and United Overseas Bank (Singapore).

The New York Fed manages the ECI program and provides management oversight and monitoring of it. We coordinate the shipment and receipt of currency between our offices and the ECI's. All banknotes contained within an ECI vault and while being transported between the New York Fed and an ECI vault, remain on the books of the New York Fed. When banknotes are withdrawn from the ECI vault to fill a banknote order to third parties, or for an ECI operator's use, the ECI operator's account at the New York Fed is debited accordingly. When banknotes are deposited into the ECI vault to augment the New York Fed inventory, the operator's account at the New York Fed is credited.

The relationship between ECI operators and the New York Fed is governed by an ECI Agreement and a Manual of Procedures for the ECI program (Manual of Procedures). From the start of the ECI program, the ECI Agreement has specifically prohibited ECI operators from engaging in transactions affecting ECI inventory with OFAC sanctioned entities. In addition, since the beginning of the program, the ECI Agreement and the Manual of Procedures have required ECI operators to provide the New York Fed with monthly reports showing all countries that engaged in U.S. dollar transactions with the operator during the preceding month and the volume of those transactions.

The ECI program facilitates the international distribution of U.S. currency by maintaining sufficient inventory of Federal Reserve Notes in strategically located international distribution centers. The ECI's also are a key part of the Federal Reserve's and Treasury's efforts to distribute currency to the major global financial markets during times of crises. In the wake of the September 11 attacks, when air transportation was seriously disrupted, having U.S. currency already positioned at the ECI facilities helped enable the Federal Reserve to continue satisfying international demand for U.S. currency in the major financial markets without any interruption of service.

In addition to its role in international currency distribution, the ECI program is critical to ensuring the quality of U.S. currency abroad. ECI's are required to sort currency purchased from market participants both by currency design (old and new) and into fit and unfit notes. These requirements ensure that old design and unfit notes are removed from circulation in a timely fashion. ECI's are also responsible for authenticating banknotes purchased in the market. Therefore, the ECI's detect counterfeit notes as they circulate in significant offshore money markets, and quickly report information on the geographic sources of these counterfeit notes to the Secret Service.

Finally, the information provided by the ECI's to the New York Fed regarding country level flows of payments, and receipts of U.S. dollars, has given the U.S. Government a valuable tool for estimating stocks and flows of U.S. currency abroad, particularly for countries about which little information was available previously.

The Chronology

I will now turn to the chronology of events surrounding the discovery that UBS had engaged in ECI transactions with OFAC sanctioned countries and had concealed those transactions from the New York Fed.

On April 20, 2003, the Sunday *New York Times* reported that U.S. armed forces had discovered, in Baghdad, approximately $650 million in United States currency. According to the article, the wrapping on the currency indicated that it originated, in part, from the New York Fed. Upon reading this article, I sent an e-mail directing staff at the New York Fed to attempt to determine how currency bearing the mark of the Federal Reserve Bank of New York might have traveled from our offices to Baghdad. Around the same date, staff from the Board of Governors of the Federal Reserve System (Board of Governors) in Washington were contacted by the Treasury Department and asked to assist in tracing the same currency. Also at this time, staff at the New York Fed and other Reserve Banks received telephone calls from agents of the United States Customs Service seeking information regarding the discovered banknotes.

Within days, the New York Fed received serial numbers for a small sample of the banknotes found in Iraq. By April 24, 2003, our cash staff in East Rutherford, New Jersey had determined, using serial number records, that the sampled notes were part of twenty-four shipments that had been sent from our offices to three of our ECI facilities: HSBC in London, Bank of America in Zurich, and UBS in Zurich. Over the next few weeks, we received additional serial numbers from other samples of the discovered currency as well as serial numbers from samples of an additional $112 million that was discovered shortly after the initial hoard. We successfully traced those serial numbers to the same three ECI facilities, as well as to HSBC's ECI facilities in Frankfurt and London; to the Royal Bank of Scotland's ECI facility

in London; to a number of commercial banks in the United States and abroad; and to several foreign central banks.

In an effort to follow the currency trail further, in early May 2003 we contacted each of the ECI operators, and one of the commercial banks that had done a large volume of relevant currency purchases, and asked them to provide us with information regarding the counterparties to whom they sold the identified banknotes. By the end of May, we had received responses from HSBC and Bank of America that included, for HSBC, specific counterparty information, and for Bank of America, more general country information, for the relevant shipments. No transactions with Iraq or any other OFAC sanctioned countries were contained in these responses. Our investigative efforts to follow the trail of the currency discovered in Iraq are continuing.

UBS responded to our inquiry by advising that it did not track serial numbers for its banknote sales. In the alternative, UBS agreed to provide information regarding shipments of currency from the ECI that corresponded closely to the dates on which the notes found in Iraq had been shipped from the New York Fed's New Jersey office to the UBS ECI. UBS also informed the New York Fed that Swiss law considerations precluded the sharing of specific counterparty names. Accordingly, only country destinations could be provided. On June 25, 2003, UBS provided a report to one of our cash officers, who was in Zurich for a periodic site inspection. The report purported to list the relevant shipments by date and included the countries to which the banknotes were sold and the amounts in each shipment. While no transactions with Iraq were identified, included in this report were entries representing eight shipments of banknotes to Iran. Of course, we had not expected such a disclosure as currency transactions with Iran were expressly prohibited by the ECI Agreement.

Upon learning that UBS had sold banknotes to Iran, we asked UBS to explain how these Iranian transactions could have occurred in view of the clear contractual prohibition in the ECI Agreement against shipping currency to countries that are the subject of regulations issued by OFAC. We also inquired as to why these transactions had not appeared on the monthly dollar transaction reports that UBS was required to provide to the New York Fed pursuant to the ECI Agreement. UBS responded that the transactions with Iran were done by mistake. Further, with respect to our specific questions directed at the false monthly reports, UBS banknote personnel provided a facially plausible, but false, explanation. The explanation was that the reports were the result of an innocent mistake and not an intentional deception.

In early July 2003, New York Fed management concluded that the transactions by our ECI operator, UBS, with Iran constituted a material event that needed to be reported. Consequently, on July 11, 2003, I sent a memorandum reciting the facts known then to the New York Fed's Board of Directors, which, under Section 4 of the Federal Reserve Act, exercises "supervision and control" of the Bank management. In addition, the New York Fed disclosed what we knew to senior staff at OFAC, the Board of Governors, and the Department of the Treasury. On July 17, 2003, the UBS situation was discussed with the New York Fed's Board of Directors at its July meeting. The directors concurred in the management recommendation to more fully understand the facts by involving UBS' home country supervisor, the EBK, and when the facts were fully understood, to make a decision with respect to contract termination.

On July 22, 2003, I met with representatives of the EBK in Switzerland to discuss how to move forward with an inquiry. I explained to the representatives that, to avoid termination of its ECI contract, UBS would have to provide the New York Fed with reassurance as to its compliance. I emphasized that the New York Fed would not tolerate a repeat violation. I also told the EBK that I was not satisfied with the explanation proffered by UBS concerning the monthly reports. It was agreed that the New York Fed would draft questions regarding UBS' compliance with OFAC regulations in the operation of the ECI and that Ernst and Young (E&Y), UBS' outside auditor, would review the operation and prepare responses to our questions.

In late July 2003, E&Y began its review of UBS' ECI operation. During the course of this review, E&Y learned that in addition to the transactions with Iran, UBS had also engaged in banknote purchase transactions with Cuba, another country on the OFAC list, and that the banknotes had been deposited into the ECI. E&Y also learned that, in preparing the monthly dollar transaction reports, personnel in UBS' banknotes operation had concealed the Cuban transactions from the New York Fed. E&Y informed senior UBS personnel of its findings and encouraged UBS to disclose the information to the EBK and to the New York Fed.

In mid-October, UBS disclosed to the EBK that, in addition to the transactions with Iran, it had engaged in USD banknote transactions with Cuba that involved

the ECI. The EBK advised UBS to disclose the transactions to the New York Fed. Late on Friday, October 24, 2003, representatives of UBS met with me at the New York Fed. They told me that UBS had engaged in transactions not only with Iran, but also with Cuba, and Libya, yet another country on the OFAC list. On Tuesday, October 28, 2003, the New York Fed terminated its ECI Agreement with UBS for breach of Articles 8 and 9 of the Agreement which dealt with, respectively, UBS' monthly reporting obligations and its OFAC compliance obligations. Within a week of the termination, UBS disclosed that it had also engaged in transactions with Yugoslavia (the Republics of Serbia and Montenegro) during the time that Yugoslavia was subject to OFAC sanctions. On November 10, 2003, I provided a written report on the termination decision to New York Fed Board of Directors, and reviewed it with the Board at their meeting on November 20.

After terminating the contract for breach, the New York Fed needed UBS' continuing cooperation in the investigation of the facts regarding the breach and the false reports. Senior management of UBS did cooperate with us in these specific matters. Further, we received extraordinary assistance from our supervisory colleagues at the EBK.

Following the termination of the ECI Agreement, UBS appointed an investigative steering committee and retained two respected law firms to conduct a full investigation into the operation of the Zurich ECI. The internal and external auditors of UBS were asked to assist. The EBK agreed to allow UBS to share the results of this investigation with the New York Fed on a confidential basis.

Over the next 6 months, the investigative team interviewed forty-eight UBS employees, many on multiple occasions, and reviewed several thousand documents, including e-mails. On December 3, 2003, the first report from the investigation was provided to the New York Fed. Between delivery of the first report and April 2004, I, along with other New York Fed officers, met with representatives of UBS on three occasions and had numerous telephone conversations. We reviewed the status of the investigation, and requested that more work be done on specific issues. During this same time period, the UBS investigative team also provided us with numerous supplemental responses, documents, and updated chronologies. True to its commitment during the summer of 2003, the EBK enabled UBS to make full disclosure of the investigative results, and also enabled the New York Fed to interview members of the E&Y team that had reviewed UBS' ECI operations. On April 16, 2004, UBS provided the New York Fed with its final supplement to the December report.

The investigation confirmed that UBS engaged in USD banknote transactions, through the ECI, with four OFAC sanctioned countries: Cuba, Libya, Iran, and the former Yugoslavia. UBS consistently engaged in these transactions from the inception of the ECI program, notwithstanding the fact that the UBS personnel involved clearly understood that the ECI Agreement prohibited such transactions. Moreover, UBS personnel took affirmative steps to conceal these transactions from the New York Fed, including, but not limited to, falsifying the monthly U.S. dollar transaction reports that it was contractually obligated to submit. UBS personnel continued their efforts to conceal these transactions even after the investigation was underway. The banknote personnel of UBS also affirmatively misled the EBK.

In early May 2004, the New York Fed engaged the EBK in discussions regarding the appropriate supervisory response to UBS' conduct. Our goal was for the EBK to take remedial action in its capacity as UBS' home country supervisor, and for the Federal Reserve to take punitive action against UBS for its deceptive conduct with respect to an important U.S. program—our sanction regime. On May 10, 2004, the EBK publicly reprimanded UBS for the failures in internal control that permitted both the breach of contract and the deception. The EBK's decision acknowledged that UBS planned to discontinue its banknotes trading business, and forbade UBS from restarting this business without the EBK's consent. Simultaneous with the EBK's announcement of its supervisory decision, the Federal Reserve announced the assessment of a $100 million civil money penalty against UBS.

The Civil Money Penalty Assessment

I now turn to my third topic and focus on the amount of the civil money penalty assessed by the Federal Reserve Board against UBS. At the outset let me emphasize that the civil money penalty is directed at deception and the violation of U.S. laws relating to deception. The remedy for breach of contract was contract termination, and that occurred more than 6 months ago.

The Federal Reserve's statutory authority to assess a civil money penalty is expressly set out in Section 8(i) of the Federal Deposit Insurance Act (FDI Act). When the Federal Reserve determines that a financial institution has violated the law, as UBS did here, and that such a violation justifies the assessment of a civil money penalty, we look first to Section 8(i) to determine the range of the penalty that

might be imposed. The statute carefully lays out a three-tiered approach to assessment. The tiers focus on both the likelihood that the violation will cause financial harm to the institution and on the degree of willfulness demonstrated by the institution in committing the violation. The greater the likelihood of harm and the more deliberate the act, the higher the maximum penalty.

UBS' conduct here constituted a tier two violation. Section 8(i)(2)(B) of the FDI Act provides that any depository institution that violates any law, which violation is part of a pattern of misconduct, shall pay a civil money penalty of not more than $25,000 for each day during which such violation continues. This formula, applied to UBS' multiple violations of law, permitted the Federal Reserve to assess a civil money penalty of $100 million.

While UBS is a $1 trillion institution, and has abundant financial resources, banknote trading was a very small piece of UBS' overall business. For the years 1999–2003, UBS' banknote trading business for all currencies with all countries had aggregate net profit of approximately $87 million. From 1996 through 2003, UBS earned net profit of slightly less than $5 million from its banknote transactions with countries subject to OFAC sanctions. Thus, the $100 million civil money represents a penalty that is approximately twenty times the amount of the net profit that UBS derived from its wrongful conduct.

Clearly, however, we recognized the severity of UBS' actions. UBS had deceived us over an 8-year period in several different ways. In assessing the civil money penalty, however, we were mindful that the assessment should not be made in a vacuum. Other than the $200 million penalty the Board of Governors assessed against BCCI, the $100 million civil money penalty assessed against UBS is equal to the highest penalty the Federal Reserve has ever assessed against an institutional respondent. Last year, in conjunction with a criminal disposition by the U.S. Department of Justice, the Federal Reserve assessed Credit Lyonnais a $100 million civil money penalty. While no two cases are alike, Credit Lyonnais engaged in a similar pattern of deliberate and repeated false statements to the Federal Reserve in connection with its secret acquisition of the Executive Life Insurance Company.

In considering whether the amount of the civil money penalty was sufficiently large, it is not enough to look only at the size of UBS' balance sheet and net profit. It is important to keep in mind that UBS is a Swiss institution with its own banking supervisor, the EBK, which has no authority to impose money penalties. A Swiss governmental reprimand to the largest bank in Switzerland, as occurred in this case is, to our knowledge, unprecedented in Swiss history. The EBK took that action, in no small measure, to demonstrate that it would not tolerate deception any more than we would. We gave special consideration to the EBK's views also because, as senior Treasury officials have noted in testimony before Congress, the EBK has demonstrated exceptional cooperation in matters relating to the global fight against terrorist financing. As a bank supervisor active in that fight, the Federal Reserve appreciates the value of global cooperation.

In short, the $100 million civil money penalty that we assessed against UBS was appropriate. It was within the range permitted by statute. It was in proportion to the revenues UBS derived from its unlawful actions. It was in line with the Federal Reserve's history of civil money penalties. And, it was appropriate because we were able to act together with the EBK to craft supervisory action that is both punitive and remedial.

Remedial Measures With Other ECI Operators

I will now turn to my final topic and address the steps the New York Fed has taken with respect to its remaining ECI operators so as to improve the controls relating to OFAC compliance.

Immediately following the discovery that UBS had engaged in transactions with Iran, in July 2003, we directed inquiries toward each of the five banks with which we continue to maintain an ECI relationship. The banks responded by detailing for us the procedures each had in place to ensure their contractual compliance with the OFAC regulations and various antimoney laundering (AML) statutes and regulations. These responses gave us sufficient confidence to carry us through for the period necessary until we could amend our contracts to strengthen the OFAC and AML compliance provisions.

In the fall of 2003, the New York Fed began a process of amending its contracts with the remaining ECI banks to incorporate new controls into the ECI Agreements and add new compliance sections to the ECI Manual of Procedures. Prior to these amendments, the Federal Reserve relied on several means of oversight for the ECI program. All ECI operations were subject to regular audits by (1) the New York Fed's audit function, (2) the banks' own internal auditors, and (3) the banks' external auditors. Our primary means of oversight for OFAC compliance, however, was

the monthly dollar transaction reports required by Article 8 of the ECI Agreement and by the Manual of Procedures. These reports were reviewed by New York Fed staff to ensure that the reported numbers corresponded to the amounts shipped from, and received by, each ECI in the given month. UBS' manipulation of these reports effectively concealed its transactions with OFAC sanctioned countries from the New York Fed, and thwarted this oversight mechanism.

In revising the ECI Agreements, two major changes were made to the OFAC Compliance Section. First, language was added to expressly provide that the ECI bank "agrees that ECI Banknote Activity is subject to the jurisdiction of the U.S. Department of Treasury's Office of Foreign Assets Control." Second, the Agreement was amended to include an acknowledgement from the operating bank that, with respect to banknote transactions, it must comply with the provisions of the United States Trading with the Enemy Act, the International Emergency Economic Powers Act, the Antiterrorism and Effective Death Penalty Act, and "any other similar asset control laws, to the extent that they are implemented by OFAC regulations."

Perhaps the most significant changes, however, relate to new audit requirements for the ECI's. A new section was added to the ECI Agreement requiring an annual audit of the operating bank's AML and OFAC Compliance programs. The ECI Agreement provides that a management representative must attest that the ECI operator is complying with the contract. Then, the contract requires that a public accounting firm, hired at the ECI operator's expense, must attest to the management assertion, and specifically, whether the assertion is fairly stated. The public accounting firm must also render an opinion on whether the monthly reports that the ECI bank has provided to the New York Fed are accurate.

As part of these remedial measures, major changes were also made to the Manual of Procedures. The Manual of Procedures now contains sections setting forth specific requirements for AML Compliance and OFAC Compliance programs. With respect to OFAC Compliance, the ECI operator must (1) establish a system of internal controls to ensure compliance with all OFAC regulations; (2) perform and document a comprehensive OFAC risk assessment of all aspects of ECI Banknote Activity; (3) designate a Compliance Officer responsible for monitoring compliance with all OFAC laws and regulations, and an officer responsible for overseeing any funds blocked as a result of any OFAC law or regulation; (4) implement an audit program that will provide for independent testing of all aspects of the OFAC Compliance program, and for an annual comprehensive audit of each line of business relating to the ECI Banknote Activity; (5) provide appropriate OFAC Compliance training for the appropriate employees; (6) maintain the most current OFAC List of prohibited countries, entities, and individuals; (7) retain all OFAC related records for a period of not less than 5 years; and (8) require the OFAC Compliance Officer to develop a program to screen customers and transactions for OFAC compliance.

Finally, in order to ensure that the New York Fed can react quickly to any compliance problems that may arise, there is a new procedural section requiring the ECI operator to notify the New York Fed immediately of any activity that violates the compliance requirements of the ECI Agreement.

The new contracts were all executed and became fully effective in February 2004. I should note that, following the announcement of the assessment of the $100 million civil money penalty against UBS, we again directed inquiries to our ECI operators to learn their reactions to the Federal Reserve's action. All of the ECI operators viewed the penalty as significant and understood that it reflected the importance the New York Fed places on both strict compliance with the OFAC requirements of the ECI Agreement and the Manual of Procedures, and on the integrity of its ECI operators.

Conclusion

The ECI program serves an important function by ensuring that we supply USD banknotes to the global market in an efficient manner, and that the quality of, and confidence in, our currency is maintained at a high level. UBS' egregious conduct should not overshadow the ECI program's benefits. In terminating the UBS ECI contract, in assessing a $100 million civil money penalty against UBS for its deceptive conduct as a former ECI operator, and in working with the EBK to craft a coordinated regulatory response, the Federal Reserve acted decisively and properly to send a message about the importance it places on OFAC compliance. The remedial measures that have been put into place underscore that message and, we believe, will promote such compliance in the future.

I thank you for the opportunity to appear before you today and look forward to answering any questions you may have.