Testimony of Wayne Abernathy

On Behalf of the

AMERICAN **BANKERS** ASSOCIATION

Before the

Subcommittee on Domestic and International Monetary Policy

Committee on Financial Services

United States House of Representatives

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Chairman Gutierrez, Ranking Member Paul, and members of the Subcommittee, my name is Wayne Abernathy, Executive Vice President, Financial Institutions Policy and Regulatory Affairs, of the American Bankers Association (ABA). ABA brings together banks of all sizes and charters into one association. ABA works to enhance the competitiveness of the nation's banking industry and strengthen America's economy and communities. Its members – the majority of which are banks with less than $125 million in assets – represent over 95 percent of the industry's $12.7 trillion in assets and employ over 2 million men and women.

We appreciate the opportunity to comment on the Unlawful Internet Gambling Enforcement Act of 2006 (UIGEA) and the Prohibition on Funding of Unlawful Internet Gambling (Proposed Rule) issued recently by the Federal Reserve Board and the Department of the Treasury (Agencies). There is no question that prosecuting unlawful Internet gambling poses numerous law enforcement challenges. Therefore, during Congressional consideration of UIGEA, the ABA stated clearly that while we did not support the legislative proposal, if the Congress chose to proceed with legislation, care was needed to avoid applying burdensome unworkable regulation to insured depository institutions. Unfortunately, the statute as enacted and the regulations as proposed are both burdensome and unworkable and are unlikely to result in stopping illegal Internet gambling.

ABA members have invested enormous resources in fulfilling their obligation to report criminal or otherwise suspicious activity under the Bank Secrecy Act and anti-money laundering laws. These efforts to maintain the integrity of the financial system demonstrate that banks are dedicated partners in combating all forms of financial crime. But the UIGEA takes banks beyond the role of reporting ***potentially or allegedly*** illegitimate financial activity, and makes banks and

other financial institutions police, prosecutors, judges, and executing marshals in place of real law enforcement officers when it comes to one of the most elusive of modern crimes, namely, unlawful Internet gambling.

Banks are saddled with this exceptional burden, as stated in the UIGEA, "because traditional law enforcement mechanisms are often inadequate for enforcing gambling prohibitions or regulations on the Internet, especially where such gambling crosses State or national borders."[1] In other words, all the sophistication of the FBI, Secret Service, and other police computerized detection systems and investigative expertise devoted to fighting terrorism and financial crime are inadequate to the task of apprehending the unlawful gambling business or confiscating its revenues. ABA believes that punting this obligation to the banking industry and the other participants in the U.S. payment system is an unprecedented delegation of governmental responsibility with no prospect of practical success in exchange for the burden it imposes. Further, despite the hard work of the Treasury and the Federal Reserve to resolve issues raised by the statute, the Proposed Rule does not provide enough clarity in its definitions or overcome the limits of requiring foreign entities to abide by U.S. regulations.

While the Agencies have succeeded in addressing some of the issues raised by the UIGEA, the regulatory regime proposed would remain unworkable. Three fundamental issues would continue:

- The payments system is not an appropriate or effective enforcement tool.

- "Unlawful Internet gambling" is practically undefined in the Act, rendering prospects for success in controlling it unfavorable from the start. Regulation does not seem to fix this deficiency.

- It is virtually impossible to identify and stop cross-border payments that are not subject to U.S. law.

1 31 U.S.C. § 5361(a)(4)

The Payments System Is Not an Appropriate or Effective Enforcement Tool

The UIGEA requires that financial institutions play a major role in combating unwanted behavior, specifically unlawful Internet gambling. ABA members want to do their part to help fight financial crime. However, there are realistic limits to how ***the payments system*** can be used effectively to solve these problems.

The modern payments system is large, fast moving, and complex while at the same time responding to uncompromising demands for high levels of safety, security, and efficiency. It is constructed to facilitate payments from one entity to another as speedily and reliably as possible, and at low cost. It is no exaggeration to say that nearly all other economic activity in the nation in one way or another relies upon the payments system dependably fulfilling its function. It is one of the key infrastructures operating in the background that allow all of us to do what we do every day. The burdens placed upon financial institutions by the UIGEA and its implementing regulation would compromise the efficiency of the payments system, and yet there would be little reason to suppose that prohibited transactions would be effectively curtailed.

The Agencies recognized the challenges of using financial institutions to enforce the unlawful Internet gambling Proposed Rule, first of all, by exempting portions of check, Automated Clearing House (ACH), and wire transactions from the blocking requirements of the Act. Hundreds of millions of these payments are processed by banks ***every day***, and accounts are credited and debited automatically across the country. The Federal Reserve's most recent Payment Study reported that more that 93 billion payments were processed by financial institutions in 2006. These payment systems use bank routing numbers and individual account numbers to identify where the funds should be transmitted. The system does not take the names of account owners into consideration when moving funds in the automated programs. To do so would be impractical, given the demands for the efficiency, accuracy, and speed of payments. ABA appreciates that the Agencies recognize this fact.

Practical Barriers Remain for Non-exempt ACH, Check, and Wire Participants

Despite the partial exemption, the Proposed Rule still would impose on banks – those banks having direct commercial customer relationships to Internet gambling businesses – the obligation to establish policies and procedures to block ACH, check, and wire transfers involving unlawful

Internet gambling transactions. Unfortunately, this focus on the bank's relationship with its commercial customers falls short of resolving several remaining quandaries faced by those asked to implement the Act:

- Identifying commercial customers engaged in unlawful Internet gambling is difficult. It can be just as hard to identify those who are not so engaged. All commercial customers would be susceptible to being subjected to any screen, filter, and whatever other processes were developed in the effort to enforce the law. The major problem is that the effort almost entirely depends on information obtained from the customers, which are prone to be untruthful in the case of those seeking to avoid the restrictions of the law. That places a substantial investigative burden on banks that they are not well-equipped to meet. Banks could conduct extensive and intrusive initial inquiries of all companies with transactional websites to find out whether their businesses harbor prohibited gambling operations. The unscrupulous customer will likely find ways to evade discovery in such efforts, and legitimate customers will justly be offended and, at least at the margin, will find doing business with a bank less attractive. Even then, a clean bill of health means that the bank will next need to perform careful ***monitoring*** of transaction activity to detect suspect payments as indicators that the enterprise might have since become engaged in unlawful gambling contrary to its original account opening disclosures or promises. And since neither illegal Internet gambling enterprises nor their customers are likely to be upfront about their activities, it is more than likely that transaction monitoring will fail to catch most gambling payments.

- All of that, in turn, assumes that banks have a usable definition of "unlawful Internet gambling" to work with—something which neither the statute nor the regulations provide. Properly categorizing commercial customers operating Internet gambling businesses as unlawful gambling enterprises is severely complicated by the need to define which gambling businesses or activities are "unlawful." Instructing banks that they are on their own and should do their best is only a trap to catch banks that fail in this impossible task, not a means for stopping illegal Internet gambling.

- Even if one could distinguish between unlawful and lawful Internet gambling activities, segregating the two when they take place within the same commercial customer depends on

the customer's proper processing of its transactions to refrain from submitting the unlawful transactions with the legal—an effort that is sure to defy the bank's ability to monitor or audit.

Although banks have heavily invested in compliance programs to monitor customer acquisition and subsequent activity for suspicion of money laundering, terrorist financing or other financial crimes, the demands of UIGEA extend far beyond the normal capabilities of these Bank Secrecy Act (BSA) ***reporting*** processes. The Internet gambling legislation requires banks to do more than detect suspicious or unusual activity and report it to enforcement agencies for the decision by enforcement agencies about how to pursue the lead. In the UIGEA case, banks must make judgment calls from limited and probably conflicting information about what is unlawful under a complex legal structure of state and federal laws, evaluate the business activities of their commercial customers, and then intercept transactions or close customer accounts based on such judgments upon pain of regulatory penalties for non-compliance. By placing on banks the onus for actually interdicting unlawful Internet gambling transactions, rather than on government enforcement agencies and the court system, UIGEA imposes on banks, as they carry out their core duties to operate an efficient payments system, the impossible combined role of policeman, judge, jury, and enforcer.

Card System Participants Have Similar Barriers to Achieving UIGEA Compliance

The Proposed Rule does not exempt participants in card network transactions, including credit, debit, prepaid, and stored value cards. Both card issuers and merchant acquirers are ostensibly covered participants. Although the Agencies reason that the card networks are closed systems and merchants are granted entry to the system through a financial institution and can be tracked by the assigned merchant codes identifying their category of business, the reality is that the challenge of identifying offending transactions suffers from all the same pitfalls as have been enumerated for the other payment systems: Has an illegal gambling enterprise been accurately identified? Is the wagering involved "unlawful" in the relevant jurisdictions? Has a particular transaction been properly coded in a way that facilitates blocking? Have business lines, laws, customers, or other relevant factors changed since the last look?

A fundamental challenge is to ensure that Internet gambling businesses are identified as such and are assigned the correct ***merchant and transaction codes***. If an Internet gambling business is not accurately identified as to type of business when brought into the card network, then it will not be detectable by means of its code. Neither would transactions be captured by this method if an existing Internet business customer decides to start up a new gambling sideline. Such a business should, but very well may not, request a new code in view of its new line of gambling services. The Act and the Proposed Rule will only be effective with entities that do not hide their true business—all the while creating incentives for the unscrupulous to mask their gambling operations.

In addition, the transaction codes would have to differentiate between lawful and unlawful gambling transactions so that financial institutions could stop payments associated with prohibited activities. This challenge could prove insurmountable. If the card networks used the existing merchant code that has been developed for betting transactions (which includes lottery tickets, casino gaming, and off-track horse race betting), they would need to have more specific transaction codes to be assigned to different types of wagering since each type of betting may have its own structure of circumstances for when it is legal or illegal. For example, while it might be legal to use a credit card at the casino, it might be illegal to use it for the same wager over the Internet. Or, as another example, it may be legal to conduct an Internet wager of some type when all parties are in the same state (a lottery bet, perhaps) but not be legal across state lines. As a third example, while one form of gambling may be legal on the Internet or within a particular state, another may not be even if all parties are in the same state (such as sports gambling). Even if this were ***technically*** possible, implementation would be very complex and would still rely on the honesty and accuracy of the parties involved in the Internet gambling transaction—unlikely to be had in the case of illegal activities.

Even if a full range of codes could be established, it is still necessary to rely on an Internet gambling business to categorize its transactions accurately. Let us consider an example of a customer who places two separate bets, one lawful and one unlawful, paid for with a card. The amounts would have to be allocated to one merchant code and two separate transaction codes with two different authorizations and approvals. The Internet gambling business would be the one choosing whether to enter a transaction code where it would be approved or one that would be declined. If the gambling business is forced to choose between identifying a transaction as a horse

racing bet or a sporting event wager (for example), the odds are that it will ***not*** choose the clearly unlawful bet – on the sporting event – to avoid causing the transaction to be declined.

The next challenge is the creation of an effective system used by the card issuing bank to determine if it should approve a gambling transaction. According to the Proposed Rule, the financial institution is allowed to rely on the policies and procedures established by the network in this regard. For example, an issuing bank receives a request for authorization for a card transaction initiated by one of its customers at an entity with an Internet gambling merchant code and a transaction code indicating a horse racing wager. The bank, under the Proposed Rule, may rely upon those codes as being accurate, but the bank still must have a system in place to accept or reject the transaction. The same situation would hold for payments for lottery sales, sports wagering, poker payments, and any other type of transaction code associated with betting. Once identifying a transaction as a form of gambling, the bank must make an informed decision on whether the transaction constitutes "unlawful" gambling. Alternatively, while the law does not require it, the bank could choose to decline all transactions from Internet gambling businesses and risk "over blocking" some payments, that is risk blocking payments that either are not gambling or are not "unlawful gambling." This regulatory overkill and erosion in the quality of payments services from the bank may be the only safe avenue for the bank to follow to avoid a noncompliance problem with the statute. Customers would then have to seek alternative payments system avenues for their transactions not made illegal by the Act but rendered too risky for the bank to handle.

Although the Proposed Rule only requires policies and procedures to identify and block transactions related to unlawful Internet gambling, a "safe harbor" is provided for financial institutions to block a transaction if (1) the transaction is restricted; (2) such a person reasonably believes the transaction to be restricted; or (3) the person is a participant in a payment system and blocks a transaction relying on the policies and procedures of that payment system in an effort to comply with the regulation. Some payment system operators and many banks have stated that they do not process any gambling transactions at all. ABA believes the "safe harbor" provision should be strengthened by recognizing the right of financial institutions to block all gambling related transactions for their own reasons or discretion. We concur in the Agencies' belief that "… the Act does not provide the Agencies with the authority to require designated payment systems or participants in the systems to process ***any*** gambling transactions, including those transactions excluded from the Act's definition of unlawful Internet gambling, if a system or participant ***decides***

for business reasons not to process such transactions."[2] [Emphasis added.] We have urged the Agencies to include this essential discretionary option expressly within the breadth of the Proposed Rule's so-called safe harbor or over blocking section.

While it may be tempting to seek to block undesirable behavior by exploring the restrictions on closed payments networks such as those used for debit and credit cards, ultimate success is likely to remain elusive. It is reasonable to expect that Internet gambling enterprises will be working to overcome any card payment restrictions meant to halt payments. In the meanwhile, banks will expend enormous resources on sophisticated efforts with no real hope of effectiveness. ABA believes that UIGEA, even with the commendable efforts by the Agencies to make it workable through the Proposed Rule, condemns the banking industry to a Sisyphean exercise that is more likely to catch banks in a compliance trap than it will stop gambling enterprises from profiting on illegal wagering. In the process, the efficiency of the payments system, vital to nearly all in our nation, is likely to be harmed.

"Unlawful Internet Gambling" is Practically Undefined in the Act and Regulation Does Not Fix This Deficiency

ABA believes that the flaws in the definition of "unlawful Internet gambling" are fatal to this proposal as a legal, policy, and practical matter. What banks are required to do under the Act relates to and is derived from actions that constitute "unlawful Internet gambling." It is the reference point from which all bearings are to be taken. A unified, practically workable definition of "unlawful Internet gambling" must be included in either the statute or in the implementing regulations. Without such a clear reference point it is impossible for banks to know where to land for a successful implementation of the statute. Moreover, given its central role, an appropriate definition of "unlawful Internet gambling" would require at the least a re-proposal of implementing regulations.

To begin with, "unlawful Internet gambling" is too vague a term by itself to be operationally useful. As drafted, § ___ 2(t) of the Proposed Rule does not narrow the uncertain breadth of the term as used in the Act. This means that the regulation retains all of the complicated problems in the

[2] 72 Federal Register at 56688, October 4, 2007.

statute regarding what is unlawful versus what is lawful Internet gambling. These include such issues as who (minors, residents, insiders, public officials, licensed or unlicensed operators, convicted felons) is engaging in what conduct (games of chance, amateur sports, professional sports, horse racing, dog racing, lotteries, and so forth), where (on location, in the same state, across state lines, across international boundaries, in the air, on rivers or at sea, on reservations, and so forth), and when (after hours, Sundays, holidays, before or during events being wagered on). In addition, all the basic proof problems that have plagued law enforcement prosecution are passed along under this proposed program to the participants in the payments system. All of the hurdles that the Agencies have identified in connection with a government obligation to create a list of unlawful Internet gambling businesses are left to each and every U.S. bank individually to clear, including "ensur[ing] that the particular business was, in fact, engaged in activities deemed to be unlawful Internet gambling…requir[ing] significant investigation and legal analysis … complicated by the fact that the legality of a particular Internet gambling transaction might change depending on the location of the gambler at the time the transaction was initiated, and the location where the bet or wager was received."[3]

The regulations, not specifying which transactions qualify as "unlawful Internet gambling," point those affected by the law to "underlying substantive State and Federal gambling laws and not… a general regulatory definition" to determine the scope of what unlawful Internet gambling comprises. This is a judicial function that banks are not qualified to fill. Requiring banks to be arbiters of the actions of individuals and businesses with regard to the interaction of gambling laws for all states, as well as federal gambling laws, is infeasible and would place a crippling processing burden and unbounded litigation risk on the nation's payments system participants. The vagaries of what constitutes "unlawful Internet gambling" cannot be resolved by passing the burden on to the banking industry.

Nevertheless, the definition of "unlawful Internet gambling" is pivotal to the operation of the statute and the Proposed Rule. As another example, without a workable definition of "unlawful Internet gambling," it is impossible to determine what constitutes an "unlawful Internet gambling ***business***" [emphasis added] for purposes of determining the customer relationship. This deficiency goes to the heart of the compliance process; if it is impossible to determine what an "unlawful

[3] 72 Federal Register at 56690, October 4, 2007.

Internet gambling business" is, it is impossible to determine which bank possesses the customer relationship with such business and the associated duties that come with that customer relationship.

It is one thing for banks to report suspicious activity based on their judgment of the possibility of potential illegal conduct; it is quite another to require a bank to act on its own judgment about legality and to impose sanctions for such *ex parte* determinations. While ABA believes banks and other payments system participants must retain the operational flexibility to refuse any gambling or otherwise uncertain transactions for compliance or business reasons, and without legal liability for doing so, such latitude for voluntary business judgment is quite a different thing from a government mandate to deny payments services based on a set of facts that a bank is not well constituted to prove or to investigate, viewed in the context of complex and changing legal standards that a bank is not in a position to interpret. In effect, the Act and the Proposed Rule would establish a law enforcement regime resting on a program of private sector decree. The banking industry understandably shies away from that role.

Would a Government List of Unlawful Internet Gambling Businesses Solve the Definition Problem?

Although the option of a government list of unlawful gambling businesses was not included in the Proposed Rule, the Agencies asked for comment on whether government maintenance of such a list is appropriate. Establishing and maintaining a sanction list presents challenges. However, given the lingering problem of an impossibly vague definition of "unlawful Internet gambling," ABA believes that a government generated list could have potential merit, but only if certain essential conditions are met and so long as depository institutions are absolved from other requirements intended to block unlawful gambling transactions.

Of course, ownership and upkeep responsibilities for such a list cannot and must not fall on financial institutions. Identifying the targets for such sanctions is a law enforcement role, and shifting it to banks would involve banks in the same definitional and judgment dilemmas identified above. Moreover, there is no way that any one bank would have broad enough information to develop a list comprehensive enough to be useful. Rather, it is the federal government that has the authority and experience in implementing sanction programs, as exemplified by the programs managed by the Treasury Department's Office of Foreign Assets Control.

ABA stresses that in connection with consideration of establishing such a sanctions list, the scope of the list should occupy at least a functionally comprehensive segment of the payments system. The list must be definitive, not illustrative. For instance, a list that leaves to banks an obligation to bar transactions with entities ***not on the list*** under additional circumstances would be of very little value.

Any such a list must also meet the following essential conditions:

- The listed names would be searched only against data fields normally recorded in connection with the payment method;
- Participants would not have any further identifying or blocking obligations beyond the list with respect to the set of designated payments;
- Reasonable policies and procedures for the designated payments would be deemed compliant if limited to verifying customers against the list and blocking only covered transactions with those listed customers; and
- Any list would contain only commercial customers (and not individual gamblers).

It is Virtually Impossible to Identify and Stop Cross-border Payments That are Not Subject to U.S. Law

ABA believes that while well-intentioned, the Agencies' efforts at cross-border implementation by requiring U.S. participants to engage foreign correspondent banks in identifying and blocking unlawful Internet gambling-related transactions raises more problems than it solves.

First, for the reasons recited earlier, U.S. participants have none of the system capabilities that enable them to identify and block restricted transactions conducted vis-à-vis ACH, checks, or wire transfers when they are not the bank with the customer relationship with the Internet gambling business.

Second, the Proposed Rule relies on an implicit assumption that the correspondent relationship among banks executing gambling transactions parallels the relationship among banks monitoring for money laundering transactions. This assumption is not warranted. International standards for anti-money laundering and counter terrorism financing controls have been adopted in nearly all international jurisdictions. Not only are there no similar international control standards for

Internet gambling transactions, there is broad international resistance to such controls. Consequently, there is little basis upon which a U.S. and a foreign correspondent could practically agree to implement effective controls to block unlawful cross-border gambling transactions. Indeed, we cannot dismiss the possibility that too much pressure in this area on foreign counterparts could compromise cooperation with anti-money laundering efforts.

Third, the levels of corresponding relationships between the foreign correspondent (that has direct dealings with a U.S. participant) and the ultimate foreign bank that has the gambling business customer relationship may have several intermediate levels. This nesting defies any realistic expectation that a contractual agreement between the U.S. bank and its immediate foreign counterparty will effectively screen out "unlawful Internet gambling" transactions initiated by U.S. gamblers with commercial customers of foreign banks in off-shore jurisdictions.

Fourth, the cross-border system proposed is dependent on a foreign bank's unlikely ability to distinguish what is or is not "unlawful" Internet gambling in any of the 50 United States and therefore be in a position to comply with any contractual undertakings with U.S. payment system participants. Why should we expect a foreign bank to be more successful than its U.S. counterpart in unraveling the mystery of the definition of "unlawful" Internet gambling?

Fifth, the proposal fails to consider the issue of when a foreign correspondent's home country expressly prohibits it from having policies and procedures required by the Proposed Rule or cooperating in its enforcement. For instance, if a British bank has policies and procedures to identify and block transactions which qualify as "unlawful Internet gambling" in the U.S., but these same transactions are legal in the U.K., the bank could be subject to litigation or enforcement actions in its home country. Some foreign correspondent banks may be prohibited by their home country laws from adopting policies and procedures to identify such transactions. Furthermore, if a foreign correspondent bank fails to comply with the Proposed Rule, the remedial action of blocking its access to the U.S. payments systems, as provided in § ___.6, seems to be a rather harsh penalty with little likely offsetting benefit. Exposing foreign correspondent banks to such risks seems an unacceptable byproduct of the Proposed Rule, especially since the institutions likely to be affected are not located in the United States.

Conclusion

The UIGEA relies on financial institutions to enforce the law where federal agents could not. The Proposed Rule recognizes the inadequacy of using the payments system as a law enforcement tool in certain circumstances by exempting some types of payments. Moreover, to be effective, it relies primarily on Internet gambling businesses to commit to an "honor system" whereby they would voluntarily identify themselves to credit card networks to deny themselves payments. This is not a realistic expectation.

The intent of the UIGEA, and the Proposed Rule, is to block unlawful Internet gambling, but there is no clear definition of what constitutes unlawful Internet gambling. Banks would be required to institute policies and procedures to block these unlawful transactions without being sure of what they should be blocking to and from whom. This is not a reasonable undertaking.

The cross-border provisions of the UIGEA and the Proposed Rule require financial institutions in the United States to rely on foreign correspondent banks to interpret and enforce the UIGEA even though domestic banks consider it a daunting challenge considering the current lack of clarity and guidance. This is not a feasible requirement.

The UIGEA and the Proposed Rule do not provide a rational path towards halting unlawful Internet gambling. The path leads to an increased cost and administrative burden to the banks and an erosion in the performance of the payments system, but it will not result in stopping illegal Internet gambling transactions. Imposing this enormous unfunded law enforcement mandate on banks in place of the government's law enforcement agencies is not likely to be a successful public policy.