

NYDFS Issues Final Rule on Transaction Monitoring and Filtering Programs for Regulated Institutions

July 22, 2016

Introduction

On June 30, 2016, the New York State Department of Financial Services (“**DFS**”) issued a **Final Rule** requiring regulated institutions to maintain “Transaction Monitoring and Filtering Programs” reasonably designed to (i) monitor transactions after their execution for compliance with the Bank Secrecy Act (“**BSA**”) and anti-money laundering (“**AML**”) laws and regulations, including suspicious activity reporting requirements; and (ii) prevent unlawful transactions with targets of economic sanctions administered by the U.S. Treasury Department’s Office of Foreign Assets Control (“**OFAC**”).¹ The Final Rule also requires regulated institutions’ boards of directors or senior officer(s) to make annual certifications to the DFS Superintendent confirming that they have taken all steps necessary to ascertain compliance with the Transaction Monitoring and Filtering Program requirements and that, to the best of their knowledge, the Program complies with the Final Rule. These requirements go into effect on January 1, 2017, and regulated institutions are required to file their first annual compliance certification by April 15, 2018.

In announcing the adoption of the Final Rule, DFS Superintendent Maria Vullo stated, “It is time to close the compliance gaps in our financial regulatory framework to shut down money laundering operations and eliminate potential channels that can be exploited by global terrorist networks and other criminal enterprises.”² According to DFS, during its compliance investigations and regular safety/soundness examinations, it identified shortcomings in the Transaction Monitoring and Filtering Programs of regulated institutions attributable to a “lack of robust governance, oversight, and accountability at senior levels.”³ Based on this experience, the DFS issued the Final Rule to “clarify the required attributes” of such programs. The issuance of the Final Rule follows DFS’s December 1, 2015 proposed regulation (the “**Proposed Rule**”).⁴ DFS stated that the Final Rule takes into consideration comments that were submitted by the financial services industry and others on the Proposed Rule during an extended comment period that ended March 31, 2016.

Overview

The Final Rule – which applies to all banks, trust companies, private bankers, savings banks, and savings and loan associations chartered pursuant to the New York Banking Law and all New York-licensed

¹ Banking Division Transaction Monitoring and Filtering Program Requirements and Certifications, N.Y. State Department of Financial Services, Superintendent’s Regulations Part 504 (June 30, 2016) (to be codified as Part 504 of the DFS Superintendent’s Regulations) (“**Final Rule**”), <http://www.dfs.ny.gov/legal/regulations/adoptions/dfsp504t.pdf>.

² Press Release, N.Y. State Department of Financial Services, “DFS Issues Final Anti-Terrorism Transaction Monitoring and Filtering Program Regulation” (June 30, 2016) <http://www.dfs.ny.gov/about/press/pr1606301.htm> (“**DFS June 2016 Press Release**”).

³ Final Rule at 1 (to be codified at NYDFS Superintendent’s Regulations § 504.1).

⁴ Banking Division Transaction Monitoring and Filtering Program Requirements and Certifications, N.Y. State Department of Financial Services, Superintendent’s Regulations Part 504 (proposed Dec. 1, 2016) (the “**Proposed Rule**”), <http://www.dfs.ny.gov/legal/regulations/proposed/rp504t.pdf>.

branches and agencies of foreign banks, check cashers, and money transmitters (collectively, “**New York Regulated Institutions**”) – details a number of specific attributes (outlined below) that New York Regulated Institutions will be required to include in their Transaction Monitoring and Filtering Programs. Such programs may be either manual or automated.

In contrast to the Proposed Rule, which used prescriptive language in setting out the required attributes, the Final Rule includes new language that allows for more flexibility; requiring instead that the programs be “reasonably designed” to meet their purpose and that the specific attributes of such programs be included “to the extent applicable” and “as relevant.”⁵ This new language appears designed to address concerns raised during the public comment period that the Proposed Rule’s requirements were overly broad and inconsistent with the risk-based approach of federal regulators.⁶ Missing from the Final Rule is language from the Proposed Rule that would have established criminal penalties for the filing of a false or incorrect certification. Despite these changes, the Final Rule still goes beyond the federal laws and regulations upon which it is predicated by establishing binding standards for a Transaction Monitoring and Filtering Program to be administered and enforced at the state level.

Key Provisions of the Final Rule

Transaction Monitoring Program

Section 504.3(a) requires each New York Regulated Institution to maintain a Transaction Monitoring Program “reasonably designed for the purpose of monitoring transactions after their execution for potential BSA/AML violations and Suspicious Activity Reporting.”⁷ Such a program shall include the following attributes, to the extent they are applicable:

- be based on the institution’s Risk Assessment,⁸
- be reviewed and periodically updated at risk-based intervals to take into account changes to applicable BSA/AML laws, regulations and regulatory warnings, and other relevant information;
- appropriately match BSA/AML risks to the institution’s businesses, products, services, and customers/counterparties;
- design BSA/AML detection scenarios to detect potential money laundering or other suspicious or illegal activities;

⁵ See, e.g., Final Rule at 3-4 (to be codified at NYDFS Superintendent’s Regulations § 504.3(a)-(b)).

⁶ See, e.g., Comment Letter from Rob Nichols, President, American Bankers Association, to Gene C. Brooks, First Assistant Counsel, N.Y. Department of Financial Services 5-9 (Mar. 31, 2016), <https://www.aba.com/Advocacy/commentletters/Documents/ci-NYDFS-TransactionMonitoring2016.pdf>; Comment Letter from Michael P. Smith, President, N.Y. Bankers’ Association, to Gene C. Brooks, First Assistant Counsel, N.Y. Department of Financial Services 4-7 (Mar. 29, 2016), http://www.nyba.com/wp-content/uploads/2016/04/NYBA_Comment-Letter_DFS_-AML-Proposal.pdf; Comment Letter from Paige E. Pidano, Managing Director, The Clearing House Association, to Gene C. Brooks, First Assistant Counsel, N.Y. Department of Financial Services 7-16 (Mar. 21, 2016), <https://www.theclearinghouse.org/issues/articles/2016/03/20160321-tch-comments-on-nydfs-bsa-aml-and-cco-cretification-proposal>.

⁷ The Final Rule defines “Suspicious Activity Reporting” as a report required pursuant to 31 U.S.C. § 5311 et seq, that identifies suspicious or potentially suspicious or illegal activities. See Final Rule at 2 (to be codified at NYDFS Superintendent’s Regulations § 504.2(h)).

⁸ “Risk Assessment” means an on-going comprehensive risk assessment, including an enterprise-wide BSA/AML risk assessment, that takes into account the institution’s size, staffing, governance, businesses, services, products, operations, customers, counterparties, other relations and their locations, as well as the geographies and locations of its operations and business relations. Final Rule at 2 (to be codified at NYDFS Superintendent’s Regulations § 504.2(f)).

- comprehensively test the Transaction Monitoring Program pre- and post-implementation;⁹
- articulate in documentation the institution's current detection scenarios and the underlying assumptions, parameters, and thresholds;
- set forth protocols to show how alerts will be investigated, the process for deciding which alerts will result in a filing or other action, responsible functions and individuals, and documentation of the investigative and decision-making process; and
- be subject to an on-going analysis to assess the effectiveness of the detection scenarios, the underlying rules, threshold values, parameters, and assumptions.¹⁰

Filtering Program

Section 504.3(b) requires each New York Regulated Institution to maintain a Filtering Program "reasonably designed for the purpose of interdicting transactions that are prohibited by OFAC." Unlike the Proposed Rule, which would have required the filtering program to interdict transactions prohibited by "applicable sanctions, including OFAC and other sanctions lists and internal watch lists," the Final Rule only applies to transactions prohibited by OFAC. The Final Rule requires filtering programs to include the following attributes, to the extent applicable¹¹:

- be based on the institution's Risk Assessment;
- be based on technology, processes, or tools for matching names and accounts;¹²
- comprehensively test the Filtering Program pre- and post-implementation;¹³
- be subject to ongoing analysis to assess the logic and performance of the matching systems and the threshold settings; and
- articulate in documentation the intent and design of the Filtering Program tools, processes or technology.

Transaction Monitoring and Filtering Program

The Final Rule also sets out the following additional attributes required, to the extent applicable, of the entire Transaction Monitoring and Filtering Program:

- identification of all data sources;
- validation of data integrity, accuracy, and quality;

⁹ DFS notes that such testing would include, as relevant, "a review of governance, data mapping, transaction coding, detection scenario logic, model validation, data input and Program input," but does not define these terms. Final Rule at 3 (to be codified at NYDFS Superintendent's Regulations § 504.3(b)(3)).

¹⁰ Final Rule at 3 (to be codified at NYDFS Superintendent's Regulations § 504.3(a)(1)-(8)).

¹¹ Final Rule at 3-4 (to be codified at NYDFS Superintendent's Regulations § 504.3(b)(1)-(5)).

¹² The Final Rule does not mandate the use of any particular technology, only that the system or technology used must be reasonably designed to identify prohibited transactions. Final Rule at 4 & n.4 (to be codified at NYDFS Superintendent's Regulations § 504.3(b)(2)).

¹³ DFS notes that such testing would include, as relevant, "a review of data matching, an evaluation of whether the OFAC sanctions list and threshold settings map to the risks of the institution, the logic of matching technology or tools, model validation, and data input and Program output," but does not define these terms. Final Rule at 4 (to be codified at NYDFS Superintendent's Regulations § 504.3(a)(5)).

- processes to ensure data is successfully transferred from its original source to any automated systems that are used;
- governance/management oversight, including policies and procedures to ensure that changes to the programs are defined, managed, controlled, reported, and audited;
- a process for selecting any vendors that are used;
- adequate funding;
- qualified personnel or outside consultant(s) responsible for administering the programs; and
- periodic training of all stakeholders.

The Final Rule also requires New York Regulated Institutions, to the extent they have identified areas that require material improvement, to document the identification of such areas and the planned remedial efforts, and to make such documentation available for inspection by the DFS Superintendent. Importantly, the Final Rule removes the Proposed Rule's controversial prohibition against making changes to Transaction Monitoring and Filtering Programs "to avoid or minimize filing suspicious activity reports, or because the institution does not have the resources to review the number of alerts generated by a Program established pursuant to the requirements of this Part, or to otherwise avoid complying with regulatory requirements."¹⁴ Industry groups had noted that this aspect of the Proposed Rule conflicted with federal guidelines, which permit risk-based filtering decisions, and would result in an increase in suspicious activity reporting that would not be helpful or useful to law enforcement.

Annual Board Resolution or Senior Officer Compliance Finding

The Final Rule additionally requires each New York Regulated Institution to attest – to the best of the knowledge of its Board or Senior Officer(s) – that it is in compliance with the Final Rule, by adopting and submitting to the DFS Superintendent either a Board Resolution or a Senior Officer Compliance Finding to that effect. This differs from the Proposed Rule, which would have required a certification by a New York Regulated Institution's chief compliance officer. The Board Resolution or Senior Officer Compliance Finding must be submitted by April 15 of each year in the form set out in Attachment A of the Final Rule.¹⁵ Specifically, the Board of Directors or Senior Officer(s) must certify that:

- The Board of Directors or Senior Officer(s) has reviewed documents, reports, certifications and opinions of such officers, employees, representatives, outside vendors and other individuals as necessary to provide the certification;
- The Board of Directors or Senior Officer(s) has taken all steps necessary to confirm that the New York Regulated Institution has a Transaction Monitoring and Filtering Program that complies with the Program requirements; and
- To the best of the Board's or Senior Officer(s)' knowledge, the Transaction Monitoring and Filtering Program of the Regulated Institution for the prior calendar year complies with the Program requirements.

¹⁴ Proposed Rule at 5 (proposed § 504.3(d)).

¹⁵ Final Rule at 6-7 (Attachment A).

Penalties

The Final Rule notes that the regulation “will be enforced pursuant to, and is not intended to limit, the Superintendent’s authority under any applicable laws.”¹⁶ Notably, the Final Rule omits language from the Proposed Rule that explicitly threatened criminal penalties for a certifying officer “who files an incorrect or false” annual certification.¹⁷ However, even though the Final Rule does not establish a separate basis for criminal liability, it is still possible to be criminally liable for violations of the Final Rule under existing New York banking and penal laws, such as falsifying business records, offering a false instrument for filing, and failing to maintain accurate books and records.¹⁸

Conclusion

The Final Rule addresses some of the concerns raised by the financial services industry in response to the Proposed Rule. Nonetheless, it imposes significant new responsibilities on New York Regulated Institutions, and they will need to devote substantial financial and other resources to ensure compliance. New York Regulated Institutions must now ensure that their Transaction Monitoring and Filtering Programs comply with the Final Rule, in addition to meeting their federal BSA/AML and OFAC requirements. Institutions can expect DFS to enforce the new rule aggressively, as it has its other authorities, although it is not yet clear how DFS will interpret the newly-required attributes of the Program, which contain broad, undefined terms subject to differing interpretation and methods of implementation (including data mapping, detection scenario logic, and model valuation) or evaluate institutions’ efforts to comply therewith.

¹⁶ Final Rule at 5 (to be codified at NYDFS Superintendent’s Regulations § 504.5).

¹⁷ Proposed Rule at 5 (proposed § 504.5).

¹⁸ See New York Penal Law §§ 175.10 (Falsifying Business Records); 175.35 (Offering False Instrument for Filing); New York Banking Law § 672.1 (Falsification of Books and Reports).

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