WILMER, CUTLER & PICKERING

Financial Institutions Group Newsletter

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TREASURY ISSUES KEY NEW RULES UNDER THE USA PATRIOT ACT

In the waning days of 2001, the U.S. Treasury Department ("Treasury") issued the first of the many rules and proposals that it is required to issue in the coming year to implement various anti-money laundering provisions of the USA PATRIOT Act ("Patriot Act"). Specifically, Treasury issued three rules for depository institutions, broker-dealers, and other trades and businesses regarding compliance with the requirements of the Patriot Act.

First, Treasury published a proposed rule that (1) bars depository institutions and broker-dealers from offering "correspondent accounts," directly or indirectly, to foreign "shell banks," and (2) requires depository institutions and broker-dealers that provide correspondent accounts to any foreign bank to maintain records of the ownership of such foreign bank and its agent in the United States for service of process. *See* 66 Fed. Reg. 67,459 (Dec. 28, 2001). Because of the breadth of the proposed definition of the term "correspondent account," Treasury's proposed rule affects practically *every account* that a broker-dealer or bank maintains for a foreign bank. The comment period on this proposal is open until February 11, 2002.

Second, Treasury issued its long-awaited proposed rule requiring securities broker-dealers to report suspicious transactions to Treasury's Financial Crimes Enforcement Network ("FinCEN"). Under the proposal, broker-dealers would be required to file Suspicious Activity Reports ("SARs") with FinCEN on transactions that involve at least $5,000 in funds or assets. *See* 66 Fed. Reg. 67,669 (Dec. 31, 2001). Treasury is accepting comments on the broker-dealer SAR proposal until March 1, 2002, and is required by the Patriot Act to issue a final broker-dealer SAR rule by July 1, 2002.

Third, Treasury issued an inter-related interim rule and proposal to implement the provisions of the Patriot Act that require all businesses to report currency transactions of more than $10,000 to FinCEN. *See* 66 Fed. Reg. 67,679 (Dec. 31, 2001); 66 Fed. Reg. 67,685 (Dec. 31, 2001). The comment period on the proposal closes on March 1, 2002.[1]

This Newsletter describes the key elements of each rule proposed rule and notes some of the issues raised by the proposals.

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[1] Similar reports currently are filed with the Internal Revenue Service ("IRS") and, in conjunction with the rule proposal, the IRS issued a final rule to make clear that cash-transaction information filed with it also must be reported to FinCEN. *See* 66 Fed. Reg. 67,687 (Dec. 31, 2001).

I. Foreign Shell Bank/Correspondent Account Proposal

A. *Background*.

Many of the anti-money laundering provisions of the Patriot Act focus on cross-border financial transactions in seeking to combat international money laundering and prevent terrorist access to the American financial system. Two of these provisions technically became effective on December 25, 2001, though as a practical matter, the deadline for compliance has been extended by Treasury's first proposed rule.

The first of these provisions, section 313(a) of the Patriot Act, applies to "covered financial institutions," a term defined in the Patriot Act to include, among others, depository institutions, U.S. branches of foreign banks and SEC-registered broker-dealers, but not insurance companies. It prohibits such institutions from establishing, maintaining, administering, or managing "correspondent accounts in the United States" for, or on behalf of, "shell banks" – that is, foreign banks lacking any physical presence. This section also requires covered financial institutions to take "reasonable steps" to ensure that their correspondent accounts with non-shell banks are not being used indirectly to provide banking services to shell banks.

The second statutory provision, section 319(b) of the Patriot Act, requires that covered financial institutions providing correspondent banking services to foreign banks maintain records of the owners of their foreign correspondent banks and agents authorized to accept service of legal process for such banks in the United States. These records identifying the designated agent for service of process are designed to facilitate the service of a summons or subpoena by the U.S. Government on a foreign correspondent bank.

Section 319(b) provides that either the Attorney General or the Secretary of the Treasury may serve a summons or subpoena on any foreign bank that has a correspondent account in the United States by serving its designated agent in the United States. The summons or subpoena may demand records "related to [the foreign bank's] correspondent account, including records maintained outside of the United States relating to the deposit of funds into the foreign bank." Section 319(b).[2] A covered financial institution must terminate a correspondent relationship with a foreign bank within 10 days of receiving notice from the United States that the foreign bank failed either to comply with a summons or subpoena or to contest it in a U.S. court. Failure to close an account results in a substantial civil penalty (of up to $10,000 per day) for the covered financial institution.

On November 20, 2001, Treasury issued "Interim Guidance" on which U.S. banks and other depository institutions could rely to meet their obligations under sections 313(a) and 319(b). Included in that guidance was a model certification form designed to be sent out by U.S. depository institutions (and U.S. branches and agencies of foreign banks) to their foreign correspondent banks and to be completed by such foreign banks. Using the certification forms, respondent foreign banks generally were asked to confirm that they were not "shell banks" for purposes of section 313(a) and to provide the necessary ownership and agent information for section 319(b).

B. *Analysis of the Proposed Rule*.

The proposed rule released by Treasury a few days ago carries forward the approach taken in the Interim Guidance. As such, the proposed rule generally requires "covered financial institutions" (1) to confirm that the foreign banks to which they offer "correspondent accounts" are not shell banks and are not using their U.S. correspondent accounts to provide services to shell banks; and (2) to obtain specific information regarding the ownership of their foreign correspondent banks and the name and address of the agent for service of process for such banks in the United States.

1. *Scope of the Proposed Rule*. The proposed rule is broad, encompassing all covered financial institutions, which term (as noted above) includes not only FDIC-insured banks, U.S. branches and agencies of foreign banks, credit unions and thrifts

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[2] This literal language could be read broadly to encompass records of the foreign bank that extend beyond the correspondent account in question. That would seem inconsistent with Congress's intent, but it is worth noting that the Justice Department has put out Field Guidance on the Patriot Act that seems to endorse just such a broad reading.

(all of which were subject to the Interim Guidance), but also SEC-registered broker-dealers. Broker-dealers, not covered by the previously issued guidance, are thus covered. Treasury explains in the preamble that it decided to include broker-dealers in the proposed rule to maintain "parity" of treatment among financial institutions.

The proposed rule covers any "correspondent account" established, administered or maintained in the United States for a foreign bank, and it defines "correspondent account" expansively both for U.S. depository institutions and for broker-dealers. For U.S. depository institutions, Treasury says that the term "correspondent account" encompasses not only transaction accounts with foreign banks – which are the types of accounts that most members of the banking industry consider to be correspondent accounts – but also clearance and settlement accounts, fiduciary accounts, and time deposit accounts maintained for foreign banks.

For broker-dealers, Treasury provides that "correspondent account" includes, among other things: (1) accounts to buy, sell, hold, and lend securities either in a proprietary account or an omnibus account for trading on behalf of a foreign bank's customers on a fully disclosed or non-disclosed basis; (2) prime brokerage accounts for foreign banks; (3) accounts for foreign banks for trading foreign currency; and (4) various forms of custody accounts for foreign banks.

This means that, as proposed, practically *any account* that a broker-dealer or bank maintains for a foreign bank would be a "correspondent account" covered by this rule. Treasury has requested comment on the scope of this definition. Specifically, it has asked whether certain types of accounts might pose such minimal money laundering risks that they should be excluded from the definition of a correspondent account. Treasury also has asked whether the inclusion of certain accounts in the definition would have adverse business consequences.[3]

There is some ambiguity in the proposed rule regarding "foreign branches." In the preamble to the rule, Treasury states that the proposed rule applies to *foreign branches* of covered financial institutions, but it is not entirely clear whether Treasury intends to cover only foreign branches of U.S. banks or whether Treasury seeks as well to apply the rule to foreign affiliates of broker-dealers. In any case, Treasury seeks comment on whether application of the proposed rule to foreign branches is warranted.

2. *Shell Bank Provisions*. Under the proposed rule, a covered financial institution must ensure that each foreign bank to which it provides a correspondent account (1) is not a "shell bank," and (2) is not using its U.S. correspondent account to provide services to any shell banks. A covered financial institution that does not obtain the necessary shell-bank information from a foreign bank must close its correspondent account with that bank.

Under the proposed rule, a shell bank is defined as a foreign bank that lacks physical presence – that is, a fixed address at which the bank conducts banking activities. Covered financial institutions may, however, maintain correspondent account relationships with foreign shell banks that are "regulated affiliates" – that is, (1) affiliates of a depository institution, credit union, or foreign bank, that are (2) subject to supervision and examination by a banking authority in the country regulating the depository institution, credit union or foreign bank.

3. *Provisions Regarding Ownership and Agent for Service of Process*. The proposed rule requires covered financial institutions to obtain information and maintain records regarding the "owners" of their foreign correspondent banks. Covered financial institutions also must obtain the name and address of a person who resides in the United States and who is authorized to accept service of legal process on behalf of each foreign correspondent bank.

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[3] Treasury has defined "foreign bank" to mean a company that: (1) is organized under the laws of a foreign country, (2) engages in the business of banking, (3) is recognized by the bank supervisory authority of a foreign country, and (4) receives deposits in the regular course of business. A foreign bank does not include (1) a U.S. agency or branch of a foreign bank, or (2) a foreign branch of a U.S.-based bank (both of which are covered financial institutions). A foreign bank generally also does not include foreign central banks and international aid and development banks.

The Patriot Act did not define the term "owner" of a foreign bank, and there is much controversy over how that term should be defined. Treasury proposes that "owner" include all those capable of exercising substantial power over the foreign bank and divides such "owners" into three groups: (i) "large direct owners," (ii) "indirect owners," and (iii) "small direct owners."[4]

- Large Direct Owners. A Large Direct Owner is a person who, or an entity that, (1) has a 25%-or-greater voting interest in the foreign bank, or (2) controls the election of a majority of the bank's board of directors or other ruling body. Covered financial institutions must obtain the identity of each Large Direct Owner of a foreign correspondent bank.

- Small Direct Owners. A Small Direct Owner is a person who, or an entity that, has less than a 25% voting interest in the bank. As a general matter, covered financial institutions need not obtain the identities of their foreign correspondent banks' Small Director Owners. There is, however, an exception to this general rule – the identities of Small Direct Owners must be disclosed if (1) two or more Small Direct Owners together own 25%-or-greater voting interest in a foreign bank, and (2) the two or more Small Direct Owners are owned by the same Indirect Owner.

- Indirect Owners. An Indirect Owner is a person who, or an entity that, (1) has a 50%-or-greater voting interest ("majority ownership") in any Large Direct Owner of a foreign bank (or in a chain of majority owners) and is not, in turn, majority owned by some other person; or (2) has a majority ownership of two or more Small Direct Owners that together own 25%-or-greater voting interest in a foreign bank and is not, in turn, majority owned by any other person. Covered financial institutions must know the identities of all Indirect Owners of their foreign correspondent banks.

4. *Model Certification Forms*. The proposed rule does not prescribe the method by which covered financial institutions must obtain the required information from their foreign correspondent banks. But the rule includes, as an appendix, a certification form that may be sent by covered financial institutions to their foreign correspondent banks for the foreign correspondents to complete and return. Use of the certification form, while not mandated, provides a "safe harbor" for purpose of compliance with sections 313(a) and 319(b) of the Patriot Act. (However the information is obtained, it is required to be kept for five years after the date that the covered financial institution no longer maintains any account for the foreign bank.)

As a practical matter, almost all covered financial institutions will rely on the Treasury supplied certification forms to meet their statutory and regulatory responsibilities. The obligation to ensure that the certification form is properly prepared is shared, in a very real sense, between the foreign bank and the U.S. covered financial institution. The certification and re-certification forms must be signed on behalf of the foreign bank by an individual who attests (1) that he or she has "read and understands" the certification; (2) that the information contained in it is "true and correct;" and (3) that he or she understands that the statements in the certification may be provided to the U.S. government for purpose of fulfilling official U.S. government functions. Clearly, the intent of including the acknowledgements with the signature is to bring the statements made in the certification within the scope of the U.S. "false statements" law. As a result, if the person who signs the certification "knowingly and willfully" provides false information, he or she may be prosecuted for the criminal offense of making a false statement to the U.S. government.

Treasury also mandates periodic verification and updating of the information that covered financial institutions need to keep. If a covered financial institution has reason to believe that it is relying on outdated information regarding a foreign bank, the covered financial institution must request that that bank verify the information. In any event, at least once every two years, a covered financial institution must verify the information previously provided by each foreign correspondent bank. The proposed rule

[4] For purposes of these definitions, members of the same family are treated as one person, and each family member who has an ownership interest in the foreign bank must be identified.

includes a "re-certification" form that may be used for this purpose.

5. *Compliance Deadlines*. By the terms of the statute, covered financial institutions were required to close accounts with shell banks and to obtain the ownership and agent information from their foreign correspondent banks within 60 days after enactment of the Patriot Act – i.e., by December 25, 2001. Treasury's proposed rule extends the deadline as follows: If a covered financial institution maintains a correspondent account for a foreign bank, the covered financial institution must, within 30 days after the publication of a *final rule* (presumably some weeks after the close of the comment period), request the foreign bank to provide the required shell bank, agent and ownership information and must receive such information from the foreign bank within 90 days after the publication of a final rule. This means that securities firms and other covered financial institutions likely will have until summer to comply with the rule, as it will probably take until the spring for Treasury to consider the comments it receives on the proposal and issue a final rule.

Notwithstanding this extension of the compliance deadline, Treasury has made it clear that it expects covered financial institutions to cease immediately providing correspondent banking services to those foreign banks that the covered financial institutions know to be shell banks.

II. Broker-Dealer SAR Proposal

A. *Background*.

Treasury has long possessed the statutory authority to require financial institutions to report suspicious transactions to the U.S. government. For several years, Treasury has noted the need to extend the SAR regime beyond depository institutions and their affiliates, to which it currently applies, and has promised to publish a rule requiring securities broker-dealers to file SARs. But, for one reason or another, Treasury never issued such a rule.

Section 356 of the Patriot Act finally forces Treasury's hand. The statute imposes strict deadlines on Treasury to issue a broker-dealer SAR rule. Specifically, the statute imposed a deadline of January 1, 2002 for Treasury – after consulting with the SEC and Federal Reserve – to publish a proposed regulation requiring broker-dealers to file SARs. Section 356 also requires Treasury to promulgate a final rule by July 1, 2002, although the law does not require the new regulation be effective on this date.

B. *Key Aspects of the Proposed Rule*.

Treasury met its first deadline: It issued a notice of proposed rulemaking for a broker-dealer SAR rule on December 31, 2001. Treasury's proposed rule generally would require broker-dealers to report suspicious transactions to FinCEN on a new form entitled "Suspicious Activity Report – Brokers or Dealers in Securities ("SAR-BD"), which will be released separately in draft form for public comment. As a general matter, the rule is based on the existing SAR requirements that apply to banks; as such, there is little in the proposed rule that is wholly unexpected. Nonetheless, there are several aspects of the proposed rule that deserve attention and possibly comment to Treasury.

1. *Scope*. The proposed SAR rule applies to all broker-dealers registered or required to be registered with the SEC. Treasury notes that insurance companies and their affiliates required to be registered with the SEC to sell variable annuity products would be subject to the rule.

As written, the proposed regulation does not appear to exclude non-U.S. broker-dealers that are registered with the SEC or non-U.S. offices of U.S. broker-dealers. This may be a point on which clarification is necessary in a final rule.

The rule also appears to apply to bank-affiliated broker-dealers, which are currently subject to the bank SAR rules. Treasury notes: "It is anticipated that, when this proposed rule becomes effective, the federal bank supervisors will amend or repeal, as appropriate, any duplicative suspicious activity reporting requirements for [bank-affiliated] broker-dealers."

2. *Reporting Requirements*. The proposed rule requires reporting of suspicious transaction that are "conducted or attempted by, at or through" a broker-dealer that involve at least $5,000 in funds or assets. The rule requires the reporting of all activity "relevant to a possible violation of law or regulation," including any known or suspected violation of federal

law, a suspicious transaction related to money laundering activity or a violation of the Bank Secrecy Act. In general, a broker-dealer would file a SAR-BD within 30 days of detecting a suspicious transaction.[5]

The proposed rule requires reporting of two general categories of transactions. The first mandates that broker-dealers report "any known or suspected Federal criminal violation, committed or attempted against, or through, a broker-dealer." The second category requires broker-dealers to report a transaction if the broker-dealer "knows, suspects, or has reason to suspect" that the transaction – (1) involves funds derived from illegal activity or is intended to disguise funds derived from illegal activity, (2) was designed to the requirements of the Bank Secrecy Act, or (3) appears to serve no business or other lawful purpose.

A determination as to whether a SAR-BD will need to be filed will require knowledge of the facts and circumstances relating to each customer of a broker-dealer. As a practical matter, this means that each broker-dealer would be required to have appropriate "know-your-customer" ("KYC") procedures in place so that it can discern "red flags" indicative of activities and transactions that require reporting. These KYC concepts are far more expansive than the suitability requirements with which broker-dealers are already familiar.

Treasury has given examples of the sorts of "red flags" that may signal reportable transactions. These "red flags" include – (1) frequent or large-scale wire transfers, with nominal or non-existent securities purchases or sales in an account; (2) refusal of a customer to provide information necessary for broker-dealer records or reports, or the provision by a customer of false information; (3) attempts to change or cancel transactions after a customer is informed of currency transaction reporting or recordkeeping requirements; or (4) transmission or receipt of funds transfers without normal identifying information or information that indicates country of origin.[6]

3. *Reporting Threshold*. As noted above, the proposed rule requires reporting of suspicious transactions of $5,000 or more. Many in the securities industry had hoped the reporting threshold would be higher (and, say, apply only at $25,000 or even $100,000) and have been concerned that this lower reporting requirement would be overly burdensome.

4. *Exceptions to Reporting*. The proposed rule creates two exceptions from SAR reporting. The first applies to reporting of lost, stolen, missing or counterfeit securities, the reporting for which is to occur in accordance with existing SEC rules. The second exception permits reporting of a violation of federal securities laws by an employee or registered representative of a broker-dealer under existing industry procedures (e.g., on Forms U-4 and U-5), unless the employee's violation also involved a possible violation of currency transaction reporting requirements.

5. *Retention of Records*. The proposed rule requires broker-dealers to maintain copies of SAR-BDs filed, and any supporting documentation, for five years from the date of filing.

6. *Confidentiality and Safe Harbor from Liability*. The proposed rule tracks the language of the Patriot Act and bars the disclosure of information filed in a SAR, or the fact of filing a SAR, except to law enforcement, regulatory agencies and self-reporting organizations. In addition, the proposed rule protects broker-dealers from liability, including in arbitration actions, for reporting suspicious transactions.

7. *Effective Date*. Treasury has proposed that the effective date of the broker-dealer SAR rule would be 180 days after the date on which a *final regulation* is published in the Federal Register. As

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[5] If no suspect is identified on the date of the initial detection, a broker-dealer may delay filing a SAR-BD for an additional 30 days to attempt to identify a suspect. In no case is reporting to be delayed more than 60 days after the date of the initial detection.

[6] Treasury notes that, given the continually evolving techniques of money launderers, there is no way to provide an exhaustive list of suspicious transactions. Treasury expects that FinCEN will "continue its dialogue with the securities industry about the manner in which a combination of government guidance, training programs, and government-industry information exchange can smooth the way for operation of the new suspicious activity reporting system."

noted above, the Patriot Act mandates that Treasury publish such final regulation not later than July 1, 2002. Assuming that Treasury's final rule is issued by the statutory deadline, the broker-dealer SAR rule would be effective by the end of December 2002.

III. CTR Reporting Requirements

Section 365 of the Patriot Act requires any person who, while engaged in a trade or business, receives more than $10,000 in coins or currency in one transaction (or two or more related transactions) to file a transaction report with FinCEN. Substantially similar reports are already required to be filed with the Internal Revenue Service under 26 U.S.C. 6050I and 26 CFR 1.6050I.

Given the substantial similarity between the two reporting regimes, Treasury has proposed that trades and businesses be required to report currency transactions over the $10,000 threshold under a joint FinCEN/IRS form with the IRS. The proposed rule adopts the definition of "currency" used in 26 CFR 1.6050I. That definition generally includes not only cash but also cashiers' checks, bank drafts, traveler's checks, and money orders if those instruments have a face amount of $10,000 or less and are either: (1) used in connection with a retail sale of a "consumer durable," "collectible," or 'travel or entertainment activity"; or (2) received by someone who knows that the instrument is being used to avoid the currency reporting requirement. Under the dual FinCEN/IRS-reporting regime, only one reporting form need be filed.

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