WILMER, CUTLER & PICKERING

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TREASURY ISSUES REGULATIONS ON ANTI-MONEY LAUNDERING PROGRAMS

The USA PATRIOT Act ("Patriot Act"),[1] enacted last fall in response to the September 11 terrorist attacks, swept into law a variety of important changes in the way U.S. financial institutions will have to confront the threat of money laundering. One of the most potentially significant provisions in the Patriot Act is section 352, which requires all "financial institutions" to establish anti-money laundering ("AML") programs to guard against money laundering that include, at a minimum: (1) internal policies, procedures, and controls; (2) the designation of a compliance officer; (3) an ongoing employee training program; and (4) an independent audit to test the program.

The potential significance of the law is partly a function of its scope: Congress has defined the term "financial institution" to include a broad (and somewhat eclectic) array of entities – from traditional financial institutions such as banks and broker-dealers to entities not ordinarily associated with the financial system, such as jewel dealers, travel agencies, and vehicle dealers[2] – all of which must implement an AML program unless the Treasury Department ("Treasury") chooses to issue permanent exemptions. As a result, a great many American businesses, many of which have not previously been subject to substantial federal regulation, fall within the purview of the AML program requirement. The Patriot Act directs Treasury to issue regulations to implement this requirement by April 24, 2002, and many "financial institutions" – at least many of those aware of the requirements – have been looking for guidance from Treasury about what, if anything, they must do to comply.

On April 29, 2002, Treasury published in the *Federal Register* four "interim final rules" to implement the AML program requirement.[3] The new rules delayed the AML program requirements for several classes of financial institutions and granted a temporary exemption to several other classes of financial institutions, as discussed below. Comments on the interim final rules are due by the close of business on May 29, 2002.

First Interim Rule: A Temporary Exemption for Some; Nothing New for Others

A Temporary Exemption. One of the most significant provisions in the new rules is a *temporary* exemption from the AML program requirement of up to six months for all financial institutions other than those specifically covered in the new rules. The financial institutions covered by the new rules and therefore *not* exempt from the AML program requirement are: (1) depository institutions, securities broker-dealers, futures commission merchants, and casinos; (2) operators of credit card systems; (3) mutual funds; and (4) money

[1] Pub. L. No. 107-56 (2001).

[2] The statutory list of "financial institutions" includes, among other entities, depository institutions; securities, broker-dealers; dealers in precious metals, stones, or jewels; pawnbrokers, loan or finance companies; travel agencies; telegraph companies; vehicle sellers; private bankers; insurance companies; commodity pool operators; commodity trading advisors; futures commission merchants; and investment companies. *See* 31 U.S.C. § 5312.

[3] 67 Fed. Reg. 21,109 (April 29, 2002). An "interim final rule" is "final" in the sense that it is effective when it is issued, but the "interim" qualifier reflects Treasury's expectation that the rule will be superseded by a subsequent rule.

services businesses, such as money transmitters, currency dealers, check cashers, and issuers, sellers, and redeemers of traveler's checks, money orders, and stored value.

Among the institutions not currently required to implement AML programs are insurance companies and certain investment companies other than mutual funds.[4] These and other "financial institutions" have until October 24, 2002 to establish AML programs unless Treasury issues a rule before that date specifying the requirements for a particular type of financial institution and setting an earlier effective date. Treasury officials have indicated, for example, that Treasury intends to issue a proposed rule applying the AML program requirement to insurance companies well before October.

Treasury also has stated that other entities such as hedge funds, private equity funds, and venture capital funds likely will be classified as financial institutions and, accordingly, will be required to implement AML program requirements.[5] Until Treasury issues such rules, these fund vehicles are not obligated to implement AML programs. Nonetheless, given the likelihood that Treasury will, in short order, declare investment vehicles of this kind to be financial institutions, it is prudent for these entities to begin considering how they will implement an AML program.

Banks, Securities Broker-Dealers, Future Commission Merchants, and Casinos. The interim rule applicable to depository institutions, securities broker-dealers, futures commission merchants, and casinos does not add any new substantive requirements to the AML obligations of these institutions. This rule states (1) that banks and other covered institutions must comply with the AML requirements imposed by the "relevant functional regulator" and with the AML rules of any self-regulatory organization and (2) that casinos must also comply with a pre-existing AML regulation. Institutions that comply with these requirements will be deemed to comply with the Patriot Act's AML program requirement.

A Few Twists for Mutual Funds and a Potential Issue for Hedge Funds

Mutual Fund Rule. The interim rule applicable to mutual funds sets forth new requirements. The rule states that, effective July 24, 2002, each mutual fund must develop an AML program that is approved in writing by the mutual fund's board of directors or trustees. The rule then reiterates the statutory requirements for an AML program: (1) policies and procedures designed to prevent the mutual fund from being used for money laundering or the financing of terrorist activities; (2) independent testing of the program; (3) a designated AML compliance officer; and (4) training for appropriate persons. The preamble to the rule provides some examples of "red flags" that an AML program should be designed to detect, including share purchases made on behalf of investors by third parties, frequent wire transfer activity to and from a cash reserve account, large deposits with small fund investments, frequent share purchases followed by large redemptions, and transfers to accounts in countries known to present high money laundering risks.

The preamble to the rule provides a few more important details. It notes that mutual funds often conduct activities through independent service providers and states that this practice generally is acceptable with respect to AML program requirements: "It is permissible for a mutual fund to contractually delegate the implementation and operation of its anti-money laundering program to another affiliated or unaffiliated service provider." The preamble also states, however, that a mutual fund that delegates responsibility for its AML program must obtain written consent from the delegate to ensure the ability of federal examiners to (1) obtain from the delegate information concerning the AML program, and (2) inspect the delegate for the purposes of the AML program.

Moreover, the preamble makes clear that each mutual fund has ultimate responsibility for ensuring compliance with the AML program requirements. Specifically, a mutual fund is supposed to identify any aspects of its operations that may be vulnerable to money laundering, must develop and implement a compliance program that addresses such vulnerabilities, and must monitor the implementation of that program, including monitoring to ensure that any entity to which the mutual fund delegates AML program duties is performing those duties adequately. Delegation cannot be done blindly. As the preamble says, "it would not be sufficient to simply obtain a certification from [a] delegate that [the delegate] 'has a satisfactory AML program.'"

[4] Treasury has defined a "mutual fund" as an open-end company within the meaning of section 5(a)(1) of the Investment Company Act of 1940 (15 U.S.C. § 80a-5(a)(1)).

[5] *See* footnote 7 in the interim rule, 67 Fed. Reg. 21,112, which sets forth the types of institutions that are currently covered by the section 352 obligation and those that have been given a temporary exemption.

The preamble also recognizes that broker-dealers and other financial intermediaries may have omnibus accounts with mutual fund complexes. In such cases, the broker-dealer, rather than the mutual fund, would have the relevant information about the customers whose funds are in the omnibus account. The preamble explains that a mutual fund need not obtain information about customers using these omnibus accounts, but a mutual fund must analyze money laundering risks based upon an evaluation of the intermediary holding the omnibus account, including, in particular, the viability of that entity's AML program.

Potential Issue for Hedge Funds. The statement in the preamble requiring a mutual fund service provider with AML responsibilities to consent to federal inspection could be problematic if it were applied to hedge funds. Many hedge funds use offshore administrators, for example, and likely would rely on these administrators to implement the funds' AML program requirements. Such administrators, however, are likely to balk at subjecting themselves to U.S. government inspection. As noted above, hedge funds are not currently subject to the AML program requirement, and it is not clear that this federal inspection requirement for service providers would ever be applied to hedge funds.

Substantial Due Diligence for Operators of Credit Card Systems

The interim rule covering credit card system operators is applicable only to a small number of institutions – Visa, MasterCard, and a few others. The rule does not apply to issuers of so-called private label cards or, more generally, to issuing or acquiring institutions.[6] Rather, the rule requires credit card system operators to establish an AML program – effective July 24, 2002 – that ensures that the operator will screen issuing and acquiring institutions to guard against money laundering.

The AML program must include the statutory requirements of policies, procedures, and controls; an AML compliance officer; training for appropriate employees; and an independent audit. The interim rule makes clear, however, that the AML program for credit card system operators should be targeted to the specific risk encountered by these systems. The preamble to the rule notes that many key anti-money laundering functions are carried out by the issuing and acquiring institutions, which, for example, maintain detailed information on cardholders and merchants, respectively. What is uniquely within the control of the credit card operators is the initial and continuing authorization of the issuing and acquiring institutions, and it is in that authorizing process that the card operators are instructed to perform careful due diligence.

The preamble recognizes that the information to be considered in performing this due diligence will likely include many of the same factors that credit card system operators consider when determining whether an issuing or acquiring institution presents a risk of fraud or insolvency. The scope of this due diligence, however, should be expanded to cover AML risks. Operators are instructed to consider information relating to the institutions, the jurisdictions in which they are licensed or do business, and other relevant information from the government or from publicly available sources. The preamble further advises that, in some circumstances, operators may need to obtain information from an issuing or acquiring institution about its AML controls.

To clarify the kind of additional risk factors that credit card system operators should watch for, the interim rule lists six categories of persons or institutions that are presumed to carry a heightened risk of money laundering. These are:

(1) any foreign "shell bank" (i.e., a bank without a physical presence);
(2) any person on the Specially Designated Nationals List issued by Treasury's Office of Foreign Assets Control;
(3) any person in a jurisdiction that the State Department has identified as a sponsor of international terrorism;
(4) any foreign bank operating under an offshore banking license (one that allows banking activities only with respect to persons outside of the jurisdiction in which the bank is located);
(5) any person in a jurisdiction that has been deemed by an intergovernmental body to be "noncooperative" with international AML principles; and
(6) any person in a jurisdiction that has been deemed by Treasury as warranting "special measures" because of AML concerns.

[6] The rule defines an "issuing institution" as a person authorized by the operator of a credit card system to issue the operator's credit card. The rule defines an "acquiring institution" as a person authorized by the operator of a credit card system to contract, directly or indirectly, with merchants or other persons to process transactions, including cash advances, involving the operator's credit card.

If any institution in these categories is allowed to act as an issuing or acquiring institution, the operator must ensure that it has conducted a thorough AML risk assessment.

Because credit card system operators are required by the rule to conduct due diligence with respect to issuing and acquiring institutions, those issuing and acquiring institutions may start to receive requests from the operators regarding the institutions' AML programs.

Money Services Businesses Rule Impacts Small Businesses

Whereas the financial institutions covered by the rules discussed above are generally highly capitalized, the money services businesses rule applies to institutions large and small. Specifically, the money services businesses rule applies to entities such as money transmitters, currency dealers, check cashers, and issuers, sellers, and redeemers of traveler's checks, money orders, and stored value.[7] Many of these money services businesses are "mom and pop" operations and may include, for example, some local grocers, convenience stores, and gas stations.

All money services businesses – whether nationwide operations such as Western Union or the local grocer that engages in a check cashing business – must develop anti-money laundering programs effective July 24, 2002. The AML program should be commensurate with the risks posed by the location and size of the money services business. At a minimum, however, all of the AML programs for money services businesses must include written policies and procedures to guard against money laundering, a designated compliance officer, training for appropriate personnel, and an independent "review" to ensure the adequacy of the AML program. The rule provides that a business that is a money services business solely because it acts as an agent for another money services business, and the money services business for which it acts as an agent, may by agreement allocate between them responsibility for developing policies, procedures, and internal controls (although such allocation would not relieve either entity of the ultimate responsibility for maintaining an effective AML program).

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For further information regarding anti-money laundering or Patriot Act issues, please contact:

Todd Stern	202-663-6940 tstern@wilmer.com
Satish Kini	202-663-6482 skini@wilmer.com
David Cohen	202-663-6925 dcohen@wilmer.com
Bruce Newman	212-230-8835 bnewman@wilmer.com
Stephen Heifetz	202-663-6558 sheifetz@wilmer.com

[7] With respect to currency dealers, check cashers, and issuers, sellers, and redeemers of traveler's checks, money orders, and stored value, such entities generally are money services businesses (and therefore covered by the AML program requirement) only if they engage in money services transactions in amounts greater than $1,000 for any person on any day. *See* 31 C.F.R. 103.11(uu).