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TREASURY'S NEW PROPOSED ANTI-MONEY LAUNDERING INITIATIVES: A "BRAVE NEW WORLD" FOR SECURITIES FIRMS?

The September 11th terrorists' attacks marked the beginning of a new anti-money laundering regulatory environment for the securities industry. For broker-dealers in particular, 2002 may serve as an official turning point, starting, as it has with two significant regulatory initiatives from the Department of Treasury ("Treasury") to implement the anti-money laundering provisions of the PATRIOT Act.[1] The first proposal seeks to regulate so-called "correspondent accounts" that broker-dealers may provide to foreign banks,[2] while the second would require broker-dealers to file Suspicious Activity Reports ("SAR") with Treasury's Financial Crimes Enforcement Network ("FinCEN").[3]

As currently drafted, these proposals are expected to have far reaching implications for the securities industry. In particular, they are likely to cause many broker-dealers to re-examine the various ways in which different types of customer accounts are opened and handled, including the manner in which accounts are administered by multiple parties as a part of standard clearing or prime brokerage arrangements. Indeed, virtually all broker-dealers coming into contact, directly or indirectly, with accounts used by foreign banks to effect securities transactions may be required to incorporate the anti-money laundering provisions as a part of their day-to-day compliance program.

In this newsletter, we first summarize the proposal relating to "correspondent accounts" and discuss its potential implications for different categories of broker-dealers, including clearing brokers and prime brokers. We then engage in a similar analysis of the second proposal relating to SAR filing. Both proposals are subject to the public comment process, presenting industry participants with opportunities for persuading Treasury to modify its proposed rules so that the

[1] See H.R. 3162, "Uniting and Strengthening America by Providing Appropriate Tools Required to Intercept and Obstruct Terrorism ("PATRIOT) Act of 2001," Pub. L. No. 107-56 (2001). Title III of the USA PATRIOT Act, referred to as the International Money Laundering Abatement and Anti-Terrorist Financing Act of 2001 ("MLAA"), arguably represents the most significant anti-money laundering legislation since the enactment of the original Bank Secrecy Act in 1970. For an overview of the MLAA, see The Money Laundering Abatement and Anti-Terrorist Financing Act of 2001, Wilmer, Cutler & Pickering Financial Institutions Group Newsletter (Nov. 6, 2001).

[2] See 66 Fed. Reg. 67,459 (Dec. 28, 2001).

[3] See 66 Fed. Reg. 67,669 (Dec. 31, 2001).

final rules are better tailored to the specific businesses in which broker-dealers engage. *The comment period on the"correspondent account" proposal is open until February 11, 2002. The comment period on the SAR proposal is open until March 1, 2002, with the adoption of a final rule statutorily mandated by July 1, 2002.*

I. Correspondent Account Proposal

A. Overview. Many of the anti-money laundering provisions of the PATRIOT Act focus on cross-border financial transactions and seek to combat international money laundering by preventing unlawful access to the American financial system. As currently drafted, Treasury's proposed rule requires *all* broker-dealers registered with the Securities and Exchange Commission ("SEC") – as well as banks and other 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, and the name and address of the agent for service of process in the United States for, their foreign correspondent banks.

B. Scope of Accounts. At the outset, it is important to note how broadly the proposed rule applies. It covers any "correspondent account" established, administered or maintained by a covered financial institution for a foreign bank.[4] The term "correspondent account" is broadly defined in the statute; as applied to banks, it covers any "account established to receive deposits from, make payments on behalf of a foreign financial institution, or handle other financial transactions related to such institution."[5]

Treasury has taken the position that in order to "maintain parity" between banks and broker-dealers, the correspondent account definition should apply equally broadly to broker-dealers. For example, the term "correspondent account" would include the following types of customer accounts provided by a broker-dealer:

(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.

Indeed, as proposed, practically any account that a broker-dealer offers to a foreign bank would be considered a correspondent account subject to the rule's requirements. 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.

C. Shell Bank Provisions. Under the proposed rule, a broker-dealer must ensure that each foreign bank to which it provides a correspondent account (1) is not

[4] In the preamble to the proposal, Treasury states that the proposed rule also applies to correspondent accounts provided by foreign branches of a covered financial institution. It is unclear whether this statement refers to foreign branches of a U.S. bank only or whether foreign branches of a U.S. broker-dealer are also included. Note that a broker-dealer may have a place of business outside the United States that is either an unincorporated office or a separately incorporated entity, but regulated in either case as a "foreign branch" under the rules adopted by the SEC and self-regulatory organizations ("SROs").

[5] See 31 U.S.C. 5318(A)(e)(1)(B).

a shell bank; and (2) is not using the U.S. account to provide services to any shell banks.[6] A broker-dealer that fails to obtain the necessary information from a foreign bank would be required to close its correspondent account with that bank. Note the foregoing restrictions against dealing with shell banks would not be applicable to foreign shell banks that are "regulated affiliates." Under the proposed rule, regulated affiliates are defined as affiliates of a depository institution, credit union, or foreign bank that are subject to supervision and examination by a banking authority in the country regulating the depository institution, credit union or foreign bank.

D. Foreign Bank Ownership Information. The proposed rule requires broker-dealers to obtain information and maintain records regarding the "owners" of each foreign bank to which they provide a correspondent account. Broker-dealers also must obtain the name and address of a person who resides in the United States and is authorized to accept service of legal process on behalf of the foreign bank.

Treasury proposes that the term "owner" include those capable of exercising substantial power over the foreign bank, consisting of the following:

(1) A "Large Direct Owner" is a person who or an entity that (A) has a 25% or greater voting interest in the foreign bank or (B) controls the election of a majority of the bank's board of directors or other ruling body. Broker-dealers must obtain the identity of each Large Direct Owner.

(2) A "Small Direct Owner" is a person who or an entity that has less than a 25% voting interest in the foreign bank. In general, broker-dealers need not know the identities of Small Director Owners, except as specified.

(3) An "Indirect Owner" is a person who or an entity that (A) has a 50% or greater voting interest ("majority ownership") in any Large Direct Owner of the foreign bank (or in a chain of majority owners) and is not, in turn, majority owned by some other person or (B) has a majority ownership of two or more Small Direct Owners that together own 25% or greater voting interest in the foreign bank and is not, in turn, majority owned by any other person. Broker-dealers must know the identities of all Indirect Owners.

E. Model Certification Forms. The proposed rule does not prescribe the method by which broker-dealers obtain the requisite shell bank status and ownership information from a foreign bank to which they offer a correspondent account. Treasury, however, has provided a model certification form that may be sent by broker-dealers to the foreign bank for the foreign bank to complete. Use of the certification form would provide a *"safe harbor"* for purpose of compliance with the relevant statutory and regulatory requirements.

As a practical matter, almost all covered financial institutions, including broker-dealers, are expected to rely on the Treasury supplied certification form. The certification must be signed on behalf of the foreign bank by an individual who attests (i) that he or she has "read and understands" the certification; (ii) that the information contained in it is "true and correct;" and (iii) 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. Treasury also mandates periodic verification and updating; at least once every two years, a covered financial institution must verify the information previously provided by the foreign bank. The proposed rule includes a "re-certification" form that may be used for this purpose.

F. Service of Summons of Subpoena. The government may subpoena records from a foreign bank that maintains a correspondent account with a broker-dealer and request records from that foreign bank related to the correspondent account, including deposit records of the foreign bank that are maintained outside the United States. If the foreign bank does not respond to the subpoena, the broker-dealer must terminate the

[6] The term "shell bank" refers to a foreign bank that lacks physical presence – that is, a fixed address at which the bank conducts banking activities.

correspondent relationship within 10 days. Failure to do so could result in a substantial civil penalty (of up to $10,000 per day) for the broker-dealer.

G. Compliance Deadlines. If a broker-dealer currently provides a correspondent account to a foreign bank, it must request all of the required information from the foreign bank within 30 *days after the publication of a final rule* and obtain the information within 90 days after such publication; failure to do so would mean that the broker-dealer must close that account. However, broker-dealers would be well advised to act more promptly — Treasury has made it clear that it expects all covered financial institutions *immediately* to cease providing correspondent accounts to any foreign bank that they have reason to know is a shell bank.

H. Potential Implications. Given the sweeping definition of what constitutes a "correspondent account," the proposed rule, if adopted in its current form, would have a substantial impact on existing account relationships and related arrangements found in the securities industry. It would affect a wide range of different customer accounts, causing many broker-dealers to re-examine various ways in which different types of customer accounts are opened and handled.

(1) *Clearing Brokers*. Broker-dealers that clear for introducing brokers on a fully disclosed basis should anticipate that their clearing business will be affected by the proposed rule. Under the proposed rule, if an introducing broker opened a brokerage account for a foreign bank, both the introducing broker and its clearing broker carrying the account would be deemed to be providing correspondent accounts. It is not clear to what extent compliance with the proposed anti-money laundering requirements may be allocated between the introducing broker and its clearing broker.

(2) *Prime Brokers*. Treasury has specifically identified a prime brokerage account provided to a foreign bank as a correspondent account. It is unclear, however, if an account established by an executing broker in the name of the prime broker for the benefit of the foreign bank would also qualify as a correspondent account and, if so, whether and how the prime broker and the executing broker (and potentially, the executing broker's clearing broker) might allocate the regulatory responsibility for complying with the proposed requirements.

(3) *Mutual Fund Accounts*. A number of broker-dealers allow their customers to purchase mutual fund shares through accounts that are held directly with mutual funds, rather than through standard brokerage accounts. Although mutual fund companies are not subject to Treasury's correspondent account proposal, it is unclear whether these accounts, if used by a foreign bank for its own behalf or on behalf of its customers, could be viewed as a type of correspondent account offered by the broker-dealer, given its role as the "broker of record" for the transaction.

(4) *Wrap and Other Managed Accounts*. Treasury has indicated that various custody accounts provided by broker-dealers to foreign banks would qualify as correspondent accounts. A number of investment advisory services entail establishing custody arrangements with broker-dealers. For example, a "wrap program" is typically centered around a broker-dealer that has accounts of the participating customers separately opened and identified on its books. Again, it is unclear whether a wrap program or any investment managed account service provided by a broker-dealer to a foreign bank for the benefit of the foreign bank's customers would give rise to a correspondent account.

(5) *Foreign Bank Affiliates of Domestic Broker-Dealer*. Accounts held by U.S. broker-dealers in the name of their foreign bank affiliates meet the definition of correspondent account in the proposed rule. Thus, the domestic broker-dealer will be required to collect and maintain ownership information related to their affiliates. Further, the U.S. government may subpoena the foreign bank for records related to the account. If the foreign bank does not respond, the U.S. broker-dealer must sever the

correspondent relationship. This dramatically increases the U.S. government's leverage over foreign banks with U.S. affiliates. It also puts the foreign bank in a very difficult position, especially where there are privacy laws restricting the production of the subpoenaed documents in the jurisdiction where the foreign bank affiliate is located.

(6) *Outstanding Obligations Due from Foreign Correspondent Banks*. A U.S. broker-dealer that has outstanding contracts with a foreign correspondent bank in an account at the U.S. broker-dealer may be at risk in the event the U.S. government delivers a notice to the broker-dealer requiring that it terminate the relationship within 10 days. U.S. broker-dealers may want to review the default provisions in agreements with foreign correspondent banks to ensure that the broker-dealer may close-out any contracts in the event the broker-dealer receives a notice to terminate the relationship.

II. Broker-Dealer SAR Proposal

A. Background. Treasury has long promised that it would extend the existing SAR regime (currently applicable to banks and their affiliates) to all broker-dealers; for one reason or another, however, it never issued a rule requiring broker-dealers to file SARs with FinCEN. Section 356 of the PATRIOT Act finally forced Treasury's hand, mandating that a final rule be promulgated by July 1, 2002. Under the proposed rule, broker-dealers must report suspicious transactions to FinCEN on a new form entitled "Suspicious Activity Report – Brokers or Dealers in Securities ("SAR-BD"), which will be separately released in draft form for public comment. In general, the substance of the proposed rule closely tracks the existing SAR requirements that apply to banks; as such, there appears to be little in the rulemaking that is wholly unexpected.

B. Scope. The proposed rule applies to all broker-dealers registered or required to be registered with the SEC, including insurance broker-dealers whose business is limited to the sale of variable annuity products. It 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."

C. Reporting Requirements. The proposed rule requires reporting of suspicious transactions that are "conducted or attempted by, at or through" a broker-dealer that involve at least *$5,000* in funds or assets.[7]

A transaction should be reported by a broker-dealer where the broker-dealer knows or suspects that the transaction involves any federal criminal violation committed or attempted against or through a broker-dealer, or where the broker-dealer "knows, suspects, or has reason to suspect" that the transaction (i) involves funds derived from an illegal activity, or was conducted in order to disguise funds or assets derived from illegal activity, (ii) was designed to evade the requirements of the Bank Secrecy Act, or (iii) appears to serve no business or apparent lawful purpose or is not of a type in which that particular customer would be expected to engage.

FinCEN has provided a number of examples in which the facts would suggest that a report should be filed under the proposed rule, including the following:

(1) frequent and large-scale use of wire transfer facilities with nominal or nonexistent securities transactions;

(2) a refusal to provide information necessary for the broker-dealer to make reports or keep records required by law;

(3) the provision of false information;

[7] Where a suspicious transaction requires "immediate attention, such as ongoing money laundering schemes," the broker-dealer must immediately contact the appropriate law enforcement agency and the SEC in addition to filing a SAR-BD.

(4) attempts to change or cancel a transaction after learning of currency transaction reporting or information verification or recordkeeping requirements;

(5) attempts to transmit or receive funds in a manner that disguises the country of origin or destination, or the identity of any of the parties; or

(6) repeated use of an account as a temporary storage place for funds from multiple sources without a clear business purpose for such use.

D. Exceptions. The proposed rule sets out two exceptions to the new reporting requirements. First, broker-dealers need not file a SAR-BD to report lost, stolen, missing, or counterfeit securities. Broker-dealers instead will continue to report such incidents under existing SEC rules. Second, a SAR-BD does not need to be filed to report a violation of federal securities laws or rules of a self-regulatory organization by an employee or other registered representative of the broker-dealer (unless it is a possible violation of the currency and foreign transactions reporting and recordkeeping requirements).

E. Non-Disclosure & Civil Liability Safe Harbor. The proposed rule prohibits both the disclosure of information (except to law enforcement and regulatory agencies) filed in a SAR-BD and disclosure of the fact that a transaction was reported. This prohibition applies regardless of whether the report was filed voluntarily or was required under the rule. The proposed rule provides protection from liability for reporting suspicious transactions and for failing to disclose that a transaction has been reported. This safe harbor applies to reports that were voluntarily made as well as reports that were required to be filed. The proposed rule also clarifies that the safe harbor applies to arbitration proceedings.

F. Potential Implications. 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 customers" (KYC) procedures in place so that the broker-dealer can discern "red flags" indicative of activities and transactions that require reporting. Indeed, the development of such procedures should be a major component of a comprehensive anti-money laundering program that all broker-dealers will be required to implement under Section 352 of the PATRIOT Act.[8] As with the correspondent account proposal, the broker-dealer SAR filing requirement is expected to affect a wide range of different customer accounts.

(1) *Clearing Brokers*. Under the proposed rule, a clearing broker is not exempt from the SAR filing requirement with respect to customers of an introducing broker for whom it clears. Indeed, for some of the "red flags" identified by FinCEN (e.g., unusual wire transfers), a clearing broker arguably would be in the best position to detect any suspicious activity. Moreover, it is unclear to what extent, if any, a clearing broker would be required to review transaction data across customer accounts at multiple introducing brokers, where the clearing broker somehow has a reason to know that such accounts are controlled by a single customer.

(2) *Prime Brokers*. Similar to clearing brokers, a prime broker is responsible for handling customer funds and securities, while customer orders may be executed away from the prime broker. While the suitability concepts imposed under the SRO rules may be allocated to the executing broker for regulatory compliance purposes, it appears reasonably clear that the

[8] Section 352, which takes effect on April 24, 2002, mandates that all financial institutions, including broker-dealers, establish anti-money laundering programs that include: (1) internal policies, procedures, and controls; (2) designation of a compliance officer; (3) development of employee-training programs; and (4) establishment of an independent audit program to test the implementation of the anti-money laundering program.

prime broker would not be exempt from the SAR filing requirement with respect to an unusual movement of funds and securities initiated by any customer through the prime brokerage account.

(3) *Online Brokerage Accounts*. The fact that an online brokerage firm does not solicit any customer orders or make any recommendations for the purchase or sale of a security does not mean that it would be exempt from the SAR filing requirement. Because the KYC procedures called for by an anti-money laundering program do not hinge on whether or not a broker-dealer has made an investment recommendation, even an online brokerage firm should have an appropriate compliance program in place to prevent the firm from being used by potential money launderers.

(4) *Investment Advisory Services*. The proposed rule does not provide any guidance on what information a broker-dealer should review in order to determine what is an unusual or suspicious activity. For example, it is unclear if a broker-dealer who is dually registered as an investment adviser must review all customer information potentially available to the firm, regardless of whether such information is obtained in the context of providing brokerage account services or investment advisory services. To the extent that there are "information barriers" (or a Chinese Wall) separating the broker-dealer operations from the investment-advisory operations within one legal entity, it is unclear if information should be shared across such barriers for the SAR filing purposes.

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For an analysis of how Treasury's rules and proposals implementing the PATRIOT Act affect financial institutions more generally, see *Treasury Issues Key New Rules Under the USA PATRIOT Act*, Wilmer, Cutler & Pickering Financial Institutions Group Newsletter (January 23, 2002).

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