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Client Alert

A report for clients and friends of the firm

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Broker-Dealer Compliance with Anti-Money Laundering Provisions Under the USA PATRIOT Act

In response to the September 11th attacks, the Uniting and Strengthening America by Providing Appropriate Tools Required to Intercept and Obstruct Terrorism Act, or the USA PATRIOT Act (the "Act"), was enacted on October 26, 2001. Under the Act, financial institutions, including all broker-dealers, will be required to establish anti-money laundering compliance programs meeting certain minimum standards by April 24, 2002. In addition, the Act requires that regulations be adopted by the Department of the Treasury ("Treasury") requiring all broker-dealers to file Suspicious Activity Reports ("SARs") with the Financial Crimes Enforcement Network ("FinCEN") arm of the Treasury. Current regulations require such reporting only by banks and their affiliates, including their subsidiary broker-dealers. Proposed rules for all other broker-dealers were issued by the Treasury during the first week in January. Final regulations will be issued and become effective no later than July 1, 2002. Regulations also will prohibit broker-dealers from establishing correspondent accounts for foreign shell banks. Interim Guidance concerning the prohibition on correspondent accounts with foreign shell banks was issued on November 20, 2001.

Existing Requirements

Broker-dealers have been subject to various laws and regulations relating to money laundering prior to the adoption of the Act. The basic criminal statutes (18 U.S.C. Sections 1956 and 1957) prohibit knowing participation in financial transactions involving the proceeds of a number of specified crimes, including drug trafficking, mail and wire fraud and "RICO" violations. Broker-dealers may be held to be both primarily liable for engaging in such transactions and liable for aiding and abetting violations. This latter offense can arise from "willful blindness" to facts *that could give reason* to suspect that illegal money laundering activities are being conducted.

Broker-dealers are also subject to the Bank Secrecy Act ("BSA"), which is a record keeping and reporting statute. Under the BSA, all broker-dealers are required to: (i) file Currency Transaction Reports ("CTRs") with the Internal Revenue Service ("IRS") for cash transactions over $10,000 (including "structuring" transactions for less than $10,000 that are done to avoid the reporting requirement) within fifteen (15) days of the transaction; (ii) report the transit of currency over $10,000 into or out of the U.S. to the U.S. Customs Service on the Currency and Monetary Instrument Transportation Report Form ("CMIR") within fifteen (15) days after the transport; and (iii) report interests in foreign financial accounts to the IRS by June 30 of each year. SEC Rule 17a-8 incorporates the record keeping provisions of the BSA and applies them to broker-dealers under the Securities Exchange Act of 1934. Violations of this rule can lead to SRO failure to supervise charges.

In addition, broker-dealers are required to abide by various sanctions orders issued by the President and administered by the Office of Foreign Assets Control ("OFAC") of the Treasury Department prohibiting trading and other economic activities with identified individuals, entities and countries suspected of engaging in or supporting terrorist or drug trafficking activities. Depending on the terms of the individual order, transactions with such parties must be blocked or rejected. The list of embargoed parties can be found at www.treas.gov/ofac.

Establishment of Systems

The Act requires broker-dealers to enact programs that meet a minimum standard of compliance that involve (i) drafting and implementation of policies, procedures, and controls; (ii) designation of a compliance officer within the firm responsible for the programs; (iii) employee training and education; and (iv) implementation of measures to test the effectiveness of the procedures. The new regulations will require affirmative steps to establish such controls, satisfaction of minimum standards for their implementation and provide for oversight of broker-dealers by appointed agencies in order to monitor and correct deficiencies in the programs.

On January 30, 2002, the National Association of Securities Dealers, Inc. ("NASD") proposed a rule setting forth the requirements of anti-money laundering compliance programs for its members. The proposed rule would require member firms to develop, and a member of the firm's senior management to approve, programs designed to achieve compliance with the Act and related regulations, including the Treasury regulations on suspicious activity reporting and dealing with foreign correspondent banks.[1]

Specifically, the proposed NASD rule would require members to:

- Establish and implement policies and procedures that can be reasonably expected to detect and cause the reporting of transactions that raise a suspicion of money laundering;
- Establish and implement policies, procedures and internal controls reasonably designed to achieve compliance with the BSA and regulations thereunder;
- Provide for independent testing for compliance to be conducted by member personnel or by a qualified third party;
- Designate an individual or individuals responsible for implementing and monitoring the day-to-day operations and internal controls of the program; and
- Provide ongoing training for appropriate personnel.

The NASD rule has been submitted to the Securities and Exchange Commission ("SEC") for publication in the Federal Register for public comment. After adoption in final form, the NASD will incorporate it into its examination program and assist members in establishing Best Practices.

Compliance

Any violation of the Act or its regulations will be deemed a violation of the BSA. As a result, a violation could subject a broker-dealer to administrative, civil, and criminal penalties that could include forfeiture, fines and imprisonment.

Building and operating a compliance system sufficient to satisfy the requirements of the regulations will depend upon the nature of the broker-dealer's business, particularly whether the kinds of customers or transactions handled are of a type that give rise to money-laundering concerns. In general, identification of and familiarity with customers and clients and conscientious monitoring of transactions will ensure that a broker-dealer is able to distinguish patterns of suspicious trading activity. Diligence should begin with the account opening process, where it is essential that the broker-dealer obtain accurate documentation of the identity of the client and of the beneficial owner of the account. Beyond what is necessary under the suitability doctrine, a broker-dealer should also become familiar with the financial status and trading patterns of each client. As the client conducts transactions, the broker-dealer should maintain sufficient oversight so as to ascertain, on a subjective basis, when any particular activity appears suspicious.

Generally, red flags that broker-dealers should remain aware of include, but are not limited to:

1. Customer alteration or cancellation of a transaction after becoming aware of reporting or identification requirements;[2]
2. Disproportionate wire transfer activities;
3. Disproportionate liquid assets;
4. Attempts to hide the source or destination of funds or assets;
5. Use of the account as a temporary resting place for funds;
6. Frequent transfers to unrelated third parties;
7. Transfers to nations known for banking secrecy;
8. Frequent exchange of liquid assets;
9. Large numbers of small transactions;
10. Transactions involving offshore holding companies;
11. Customer unwillingness or inability to provide information regarding identity, occupation or assets;
12. Client's lack of concern for risk, commissions or investment objectives;
13. Indications of undisclosed principal or beneficial owner; and
14. Provision of false information.

Suspicious Activity Reports

Bank-affiliated broker-dealers currently are required to file Suspicious Activity Reports ("SARs") to FinCEN. A cornerstone

1 While the enhanced compliance programs are required to be implemented by April 26, 2002, final regulations for SAR reporting and foreign correspondent bank record-keeping need not be adopted until July 1, 2002. It is recommended that broker-dealers begin to establish a reporting and record keeping infrastructure in anticipation of the adoption of the final regulations.

2 Broker-dealers will not be permitted to inform customers that they intend to file or have filed an SAR-BD, as described below.

of the Act is the extension of this reporting requirement, through regulation, to all broker-dealers. Many non-bank-affiliated broker-dealers already file such reports on a voluntary basis. Although the proposed regulations are subject to a public comment period and need not be implemented under the Act until July 1, 2002, it is likely that they will be adopted in similar form to the proposal since they substantially reflect the current requirements applicable to banks and their affiliates. Under the Act and the regulations, broker-dealers are required to actively monitor customer transactions. An SAR should be filed whenever a financial institution observes or facilitates a suspicious financial or asset transaction.

The proposed regulations will *encourage* the filing of an SAR in the event of (i) any known or suspected violation of Federal law; or (ii) any suspicious transaction related to potential money laundering or a violation of the BSA; or (iii) any suspicious transaction that is believed relevant to the possible violation of any law or regulation. The proposed regulations will require the filing of an SAR in the event of any transaction of an aggregate of $5,000 in funds or other assets involving (i) any known or suspected Federal criminal violation, or pattern of criminal violations; or where (ii) the broker-dealer suspects, or has reason to suspect, that the transaction (a) involves assets derived from illegal activity or is intended to hide or disguise funds or assets derived from illegal activity or is intended to avoid any transaction reporting requirement under federal law or regulation, (b) is designed to evade requirements of the BSA or any regulations promulgated under the BSA, or (c) has no business purpose or apparent lawful purpose or is unusual with regard to the particular customer and the broker-dealer does not know of any reasonable explanation for the transaction in light of the background of the client and possible purposes of the transaction.

Best practice would be to file an SAR any time a transaction appears suspicious, regardless of whether filing would be required or only encouraged under the rules. Filing in either instance would be recommended in order to take advantage of the safe-harbor, immunity and confidentiality provisions discussed below. Further, filing might otherwise avoid the appearance of inattentiveness, or worse, an unintended violation of the BSA or its regulations.

SAR Filing by Broker-Dealers

An SAR filing by a broker-dealer will be made by (i) collecting and compiling supporting documentation of the suspicious activity; (ii) completing a Suspicious Activities Report-Brokers or Dealers ("SAR-BD"); and (iii) submitting the SAR-BD to FinCEN. The filing must be made within thirty (30) days of the time that the broker-dealer first becomes aware of the facts that form the basis for filing of the SAR-BD. This deadline may be extended to a maximum of sixty (60) days in the event that the broker-dealer may require the extension in order to identify the suspect party. In the event that the situation requires immediate attention, the broker-dealer will be required to notify the authorities by telephone.

The SAR-BD initially will be submitted unaccompanied by the supporting documentation. However, the supporting documentation and a copy of the SAR-BD must be retained by the broker-dealer. These records must be maintained for five (5) years following the submission of the report and must be made available during that time to FinCEN upon request. A broker-dealer will not be required to file an SAR-BD in the event of lost, stolen or missing securities, or in order to notify the authorities of a violation of securities laws or the rules of any SRO. Such reports will be made in their customary manner (such as on Forms U-4, U-5 or NYSE Form RE-3). However, the broker-dealer may be required to demonstrate that it has made the customary filing and thus will also need to maintain the records of such filings for five (5) years.

Confidentiality

No broker-dealer, or any agent, employee, officer or director thereof, may notify any person involved in the suspicious transaction that the transaction will be or has been reported. Any person that is requested or subpoenaed to disclose information about the filing of an SAR-BD, except where the request is made by an authority approved under the regulations, must decline to provide any information whatsoever, including that which would disclose that an SAR-BD has been prepared or filed, or the nature of the contents thereof. Further, any person subjected to such a request must notify FinCEN of the request and of any responses given thereto.

Safe-Harbor for SAR Reporting

The Act states that no broker-dealer may be held liable for filing an SAR-BD or for failing to disclose the fact that the filing was made.[3] The safe-harbor applies for reports submitted on a voluntary basis as well as those submitted on a mandatory basis. Moreover, the safe-harbor applies in the event of information sharing as encouraged under the Act and proposed regulations or when the issue may arise in arbitration proceedings. While an incorrect application of law by an arbitrator may, as a practical matter, be difficult to overturn, the Act itself is clear and unambiguous that no liability should result from the reporting of suspicious trading activity.[4]

3 The safe-harbor provision would not limit the liability of any party that disclosed information that it was required by law or regulation to keep confidential.

4 The safe-harbor would at least provide legal immunity for any SAR made in good faith. One court declined to allow a [BSA] safe-harbor to stand where the reporting entity neglected to include in its report known facts that would have mitigated the appearance of suspiciousness of the activity in question. Digby v. Texas Bank, 943 S.W.2d 914 (Tex. Ct. App. 1997). Another court refused to apply a safe harbor provision in order to dismiss a complaint where the plaintiff held one out of 1,100 accounts reported and it was unclear whether all the accounts were actually under suspicion. Coronado v. Bank Atlantic Bancorp, Inc., 129 F.3d 1186 (11th Cir. 1997).

Customer Identity

The Act requires financial institutions to verify the identity of their customers. Regulations to be proposed will set minimum standards for verification, maintenance of verification records and also will require that customer identities are checked against government lists of known or suspected terrorists. In addition, penalties may apply under the BSA to customers who provide false information.

Information Sharing

The Act encourages information sharing among financial institutions to better assist any efforts to detect and report money laundering or the financial activities of terrorist groups. Institutions who share information must provide notice to the Secretary of the Treasury of any plans to share information. This sharing of information is an exception to the confidentiality provisions described above. Also, institutions which share information under this provision will be afforded the safe-harbor protection from liability for sharing information or from failing to notify the suspect party that such sharing has taken place and will also not be considered in violation of the privacy provisions of the Gramm-Leach-Bliley Act. Under the Act, new regulations must be promulgated by the Secretary of the Treasury to promote information sharing and are expected to outline the scope of the safe-harbor provision as applied to information sharing.

Foreign Shell Banks

Under the Act, broker-dealers are prohibited from maintaining correspondent accounts for foreign shell banks. "Foreign shell bank" means a foreign bank without a physical presence in any country. Broker-dealers also are required to take reasonable steps to ensure that correspondent accounts provided to foreign banks[5] are not being used to indirectly provide banking services to foreign shell banks. Financial institutions which provide correspondent accounts to foreign banks will be required to maintain records of the ownership of such banks and their agents in the U.S. designated for service of legal process for records regarding the correspondent account. They also will be required to terminate correspondent accounts of foreign banks which fail to turn over account records in response to a lawful request of the Secretary of the Treasury or the Attorney General of the U.S.

5 "Correspondent account" is defined broadly to include "an account established to receive deposits from, make payments on behalf of a foreign bank, or handle other financial transactions related to such bank."

Conclusion

Ultimately, while broker-dealers will be held accountable for the efficacy of their anti-money laundering programs, the decision of how to monitor transactions and whether to submit an SAR-BD will be a subjective one. No "one-size-fits-all" procedure or decision-making process could, or should, be devised. Broker-dealers will need to be knowledgeable about the new rules and remain alert to their customers' status and activities. Determining whether a particular transaction is suspicious will require a facts and circumstances analysis; however, establishing procedures reasonably designed to assure compliance with these new requirements and implementing an appropriate system of oversight are fundamental to compliance.

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Client Alert

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