The Asset Management Industry
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TREASURY PROPOSES BROKER-DEALER SUSPICIOUS ACTIVITY REPORTING RULES AND OTHER RULES TO IMPLEMENT THE USA PATRIOT ACT

[14287] January 8, 2002 TO: ACCOUNTING/TREASURERS MEMBERS No. 1-02 BROKER/DEALER ADVISORY COMMITTEE No. 1-02 CLOSED-END INVESTMENT COMPANY MEMBERS No. 3-02 COMPLIANCE ADVISORY COMMITTEE No. 2-02 INTERNATIONAL MEMBERS No. 2-02 SEC RULES MEMBERS No. 4-02 SMALL FUNDS MEMBERS No. 1-02 TRANSFER AGENT ADVISORY COMMITTEE No. 2-02 UNIT INVESTMENT TRUST MEMBERS No. 2-02 RE: TREASURY PROPOSES BROKER-DEALER SUSPICIOUS ACTIVITY REPORTING RULES AND OTHER RULES TO IMPLEMENT THE USA PATRIOT ACT The Department of the Treasury ("Treasury") has issued an interim rule and three rule proposals to implement provisions of the recently enacted USA PATRIOT1 Act (the "Act"). The rules address the following topics: • Broker-dealer suspicious activity reporting;2 • Correspondent accounts for foreign banks (including a prohibition on correspondent accounts for foreign shell banks;3 and • Reporting of cash and certain cash equivalents transactions by nonfinancial trades or businesses.4 The first two rule proposals listed above apply to all broker-dealers, including mutual fund principal underwriters. The third item applies to nonfinancial trades or businesses, 1 USA PATRIOT stands for Uniting and Strengthening America by Providing Appropriate Tools Required to Intercept and Obstruct Terrorism. 2 See 66 Fed. Reg. 67670 (December 31, 2001). 3 See 66 Fed. Reg. 67460 (December 28, 2001). 4 See 66 Fed. Reg. 67680 (December 31, 2001) (interim rule) and 66 Fed. Reg. 67685 (December 31, 2001) (proposed rule). 2 including mutual fund transfer agents that are not "financial institutions" as defined under the Bank Secrecy Act. Each of the items is discussed in greater detail below. Broker-Dealer Suspicious Activity Reporting Rule Proposal Section 356 of the Act required the Treasury Department, in consultation with the Securities and Exchange Commission and the Board of Governors of the Federal Reserve System, to publish by January 1, 2002 proposed rules requiring broker-dealers to report suspicious transactions. Pursuant to this provision and existing authority under the Bank Secrecy Act, Treasury has issued a proposed rule that would require every "broker or dealer in securities" to file with Treasury's Financial Crimes Enforcement Network ("FinCEN") a report of any suspicious transaction relevant to a possible violation of law or regulation. The proposed rule states that this includes any known or suspected violation of Federal law, or a suspicious transaction related to a money laundering violation or a violation of the Bank Secrecy Act. The definition of "transaction" is very broad and would expressly include transactions involving any "security," as defined in Section 3(a)(10) of the Securities Exchange Act of 1934. Under the proposal, a transaction would be reportable5 if it: 1. is conducted or

attempted by, at, or through a broker-dealer; 2. involves or aggregates funds or other assets of at least $5,000; and 3. is either: a. a transaction involving a known or suspected Federal criminal violation committed or attempted against or through a broker-dealer; or b. a transaction that the broker-dealer knows, suspects, or has reason to suspect:6 i. involves funds derived from illegal activity or intended or conducted in order to hide or disguise funds or assets derived from illegal activity; ii. is designed, whether through structuring or other means, to evade the requirements of the Bank Secrecy Act; or iii. appears to serve no business or apparent lawful purpose, and for which the broker-dealer knows of no reasonable explanation after 5 Voluntary reporting of transactions not required to be reported is specifically permitted, but would not relieve a broker-dealer from any applicable reporting requirements imposed by the SEC or any self-regulatory organization ("SRO"). 6 According to the notice of proposed rulemaking, "the 'knows, suspects, or has reason to suspect' standard incorporates a standard of due diligence in the reporting requirement." 3 examining the available facts relating to the transaction and the parties. The notice of proposed rulemaking indicates that a determination as to whether a report is required must be based on all the facts and circumstances relating to the transaction and customer of the broker-dealer in question. It further notes that "[t]he judgments involved will also extend to whether the facts and circumstances and the institution's knowledge of its customer provide a reasonable explanation for the transaction that removes it from the suspicious category." The proposed rule would provide two exceptions from the reporting requirements. First, lost, stolen, missing or counterfeit securities would continue to be reported under the requirements of Rule 17f-1 under the Securities Exchange Act. Second, a possible violation of the federal securities laws or SRO rules by the broker-dealer or any officer, director, employee, or other registered representative generally would be excepted from the suspicious activity reporting requirements if it is reported to the SEC or an SRO. In discussing the $5,000 reporting threshold, the notice of proposed rulemaking emphasizes that the rules are not intended to operate "in a mechanical fashion" but rather are intended to cause financial institutions to evaluate customer activity and relationships for money laundering risks. As an example, it states that securities trades by the pension fund of a publicly traded corporation likely would require more limited scrutiny than "less typical transactions" such as deposits of currency in a brokerage account or use of money orders to open a brokerage account. Under the proposal, reports of suspicious transactions would have to be made within 30 days after the broker-dealer becomes aware of the transaction. The reports would be made on Form SAR-BD which, according to the notice of proposed rulemaking, "will resemble the SAR used by banks to report suspicious transactions."7 Broker-dealer suspicious activity reports (like those filed by other types of financial institutions) would be maintained by FinCEN in an automated database. The proposed rule would require broker-dealers to maintain copies of SAR-BDs and supporting documentation for five years from the date of filing the SAR-BD. Supporting documentation would have to be identified as such, and would have to be made available upon request to FinCEN, any other appropriate law enforcement and regulatory authorities, and any SRO examining the broker-dealer for compliance with the rule. Financial institutions and their directors, officers, employees and agents are prohibited from notifying any person involved in a suspicious transaction that the transaction has been reported. Under the proposed rule, broker-dealers would be required to decline any subpoena or other request to produce an SAR-BD or any information that would disclose that an SAR-BD has been prepared or filed, unless the disclosure is requested by FinCEN, the SEC, another appropriate law enforcement or regulatory agency, or an SRO that examines the broker-dealer for compliance with the rule. Broker-dealers would be required to notify FinCEN of any such request and the response made. 7 The notice of proposed rulemaking indicates that a draft form will be made available for public comment in the Federal Register. 4 Consistent with

31 U.S.C. 5318(g), as amended by the Act, the proposed rule contains a safe harbor that protects a broker-dealer and any director, officer, employee or agent that makes a report (pursuant to the rule, other authority, or voluntarily), from liability to any person for making reports of suspicious transactions, and for failures to disclose the fact of such reporting. As provided in the Act, the safe harbor extends to arbitration proceedings. The notice of proposed rulemaking notes that the safe harbor does not override the non-disclosure provisions. Thus, for example, during an arbitration proceeding, a broker-dealer cannot give an SAR-BD, or disclose that one was filed, to any participant in the proceeding, including the arbitrator. The proposed rule provides that the new requirements would take effect 180 days after the date on which final regulations are published in the Federal Register.8 Comments on the proposal must be filed with FinCEN by March 1, 2002. Requirements for Broker-Dealers Related to Correspondent Accounts for Foreign Banks Treasury also has issued a proposed rule to implement provisions of the Act that: (1) prohibit certain financial institutions, including broker-dealers, from providing correspondent accounts to foreign shell banks and require such financial institutions to take reasonable steps to ensure that correspondent accounts provided to foreign banks are not being used to indirectly provide banking services to foreign shell banks;9 and (2) require certain financial institutions that provide correspondent accounts to foreign banks to maintain records of the ownership of such foreign banks and of their agents in the United States designated for service of legal process, and require the termination of correspondent accounts of foreign banks that fail to turn over their account records in response to a lawful request by the Treasury Secretary or the U.S. Attorney General.10 The statutory provisions became effective on December 25, 2001. Substantial parts of the proposed rule directly track the statutory provisions. For purposes of these provisions, the term “correspondent account” is defined with respect to banking institutions as “an account established to receive deposits from, make payments on behalf of a foreign financial institution, or handle other financial transactions related to such institution.” In its notice of proposed rulemaking, Treasury states that it is proposing to apply the same definition to broker-dealer accounts. Thus, according to the notice, broker-dealers must comply with Section 5318(j) and Section 5318(k) with respect to “any account they provide in the U.S. to a foreign bank that permits the foreign bank to engage in securities transactions, funds transfers, or other financial transactions through that account.” 8 Under the Act, final regulations must be published by July 1, 2002. 9 31 U.S.C. Section 5318(j) (Section 313(a) of the Act) (“Section 5318(j)”). Under Section 5318(j), a “covered financial institution” is not prohibited from providing a correspondent account to a foreign bank if the foreign bank is a regulated affiliate of a foreign bank that maintains a physical presence in the United States or a foreign country and is subject to supervision by a banking authority in that country. 10 31 U.S.C. Section 5318(k) (Section 319(b) of the Act) (“Section 5318(k)”). 5 The proposed rule extends to correspondent accounts established, maintained, administered, or managed by a foreign branch of a covered financial institution.11 Under the proposed rule, a “foreign bank” generally would be defined as any organization that (1) is organized under the laws of a foreign country, (2) engages in the business of banking, (3) is recognized as a bank by the bank supervisory or monetary authority of the country of its organization or principal banking operations, and (4) receives deposits in the regular course of its business. Section 5318(j) defines a “foreign shell bank” as a foreign bank without a physical presence in any country, and provides that “physical presence” means a place of business that is maintained by a foreign bank and is located at a fixed address, other than solely a post office box or an electronic address, in a country in which the foreign bank is authorized to conduct banking activities, at which location the foreign bank (1) employs one or more individuals on a full-time basis, (2) maintains operating records related to its banking activities, and (3) is subject to inspection by the banking authority that licensed that bank to conduct banking activities. The proposed rule

would codify, with some modifications, interim guidance that Treasury issued on November 20, 2001 for depository institutions,12 and extend the same requirements to broker-dealers. It does not prescribe the manner in which broker-dealers and other covered financial institutions must satisfy their obligations under Section 5318(j) or obtain information concerning the identity of owners13 of foreign banks and their agents in the U.S. authorized to receive service of legal process for purposes of Section 5318(k); however, it provides a safe harbor if certain model certifications set forth in Appendices A and B to the proposed rule are used.14 A covered financial institution that does not obtain the information needed to fulfill these obligations within the time periods prescribed by the proposed rule would have to terminate its relationship with the foreign bank concerned. The notice of proposed rulemaking states that Treasury expects that a covered financial institution "will immediately terminate all correspondent accounts with any foreign bank that it knows to be a shell bank that is not a regulated affiliate, and will terminate any correspondent account with a foreign bank that it knows is being used to indirectly provide banking services to a foreign shell bank." Commercially reasonable discretion may be used in liquidating open securities positions, but reasonable steps must be taken to ensure that an account that is in the process of being terminated is not permitted to establish new positions. 11 The notice of proposed rulemaking explains that because foreign branches legally are part of covered financial institutions, Treasury considers these correspondent accounts to be maintained in the United States for purposes of Section 5318(j). 12 See 66 Fed. Reg. 59341 (November 27, 2001). 13 The proposed rule would define "owner" to mean any "large direct owner, indirect owner, and reportable small direct owner," each of which is also defined in the proposed rule. The proposed rule contains complex provisions governing identification of owners. 14 The model certification form would require information about foreign banks that are not shell banks and those that are exempted regulated affiliates, including whether the foreign bank provides banking services to foreign shell banks, ownership information, and service of process agent information. 6 Under the proposed rule, a covered financial institution would have to verify the information provided by each foreign bank for which it maintains a correspondent account at least once every two years or whenever it has reason to believe that information previously provided is no longer correct. The forms provided in the Appendices to the proposed rule may be used to comply with this requirement. The proposed rule would require a covered financial institution to retain the original of any document provided by a foreign bank, and the original or a copy of any document otherwise relied upon by the institution, for purposes of the rule, for at least five years after the institution no longer maintains any account for such bank, or for such longer period as the Treasury Secretary may direct. Comments on the proposed rule must be filed with Treasury by February 11, 2002. The notice of proposed rulemaking seeks comments on a number of topics including, in particular, the breadth of the definition of "correspondent account." In this regard, it inquires about (1) the extent to which different types of accounts may be used to provide financial services directly or indirectly to foreign shell banks, (2) the extent to which different types of accounts may be used to facilitate money laundering, terrorist financing, or other criminal transactions, (3) whether particular types of accounts pose so little vulnerability to criminal transactions as to merit exclusion from the broad definition of "correspondent account," and (4) the adverse business implications, if any of adopting a broad definition of "correspondent account" for purposes of Section 5318(j). Requirement that Nonfinancial Trades or Businesses Report Certain Currency Transactions Section 365 of the Act added a currency transaction reporting requirement for nonfinancial trades or businesses to the Bank Secrecy Act. Pursuant to this section, Treasury has issued identical interim and proposed rules requiring nonfinancial trades and businesses to file reports with Treasury if they receive more than $10,000 in cash (and, in certain circumstances, cash equivalents) in a single

transaction or two or more related transactions. The rule is substantially similar to the requirements currently imposed on nonfinancial trades or businesses under Internal Revenue Code Section 6050I and its implementing regulation (26 CFR 1.6050I-1), and should have virtually no practical impact on entities required to file reports under those provisions. Section 6050I remains in effect, and 26 CFR 1.6050I-1 has been amended to provide that the filing of a Form 8300 with the IRS will satisfy reporting requirements under the BSA as well. The interim rule took effect on January 1, 2002. Comments on the proposed rule must be filed with FinCEN by March 1, 2002. Institute Member Working Group The Institute has formed a working group of members to assist it in formulating positions and drafting comments on these and other proposed money laundering regulations. Institute members who are interested in joining the working group should contact Amanda Busick at 202/326-5836 or by email at abusick@ici.org. 7 Frances M. Stadler Deputy Senior Counsel Attachments Note: Not all recipients receive the attachments. To obtain copies of the attachments, please visit our members website (http://members.ici.org) and search for memo 14287, or call the ICI Library at (202) 326-8304 and request the attachments for memo 14287. Attachment no. 1 (in .pdf format)
