THE REVIEW OF
SECURITIES & COMMODITIES REGULATION
AN ANALYSIS OF CURRENT LAWS AND REGULATIONS AFFECTING THE SECURITIES AND FUTURES INDUSTRIES

Vol. 35 No. 11 June 12, 2002

ANTI-MONEY LAUNDERING PROVISIONS FOR BROKER-DEALERS

The Patriot Act of 2001 Together with New and Proposed Regulations Have Significantly Increased the Anti-Money Laundering Duties of Broker-Dealers. The Author Reviews the New and Proposed Regulations and Outlines Supervisory Procedures and Programs that Broker-Dealers Will Need to Comply with the Rules.

by Paul B. Uhlenhop*

For the last four years, money laundering has been a priority of bank and financial service regulators, including the Securities and Exchange Commission ("SEC"). As a result of the September 11, 2001 terrorist attacks, the anti-money laundering campaign has received the highest priority from all government enforcement agencies, including the SEC. In particular, Congress responded to September 11 by passing the "U.S.A. Patriot Act," Title III of which is known as the International Money Laundering Abatement and Anti-Terrorist Financing Act of 2001 (the "Patriot Act"). This law substantially expanded the obligations of broker-dealers to detect and prevent money laundering. In addition, the Patriot Act added or amended provisions of the Bank Secrecy Act ("BSA") applicable to broker-dealers.[1]

1. 12 U.S.C. §1829(b) and §§1951-1958; 31 U.S.C. §5311; 31 C.F.R. Part 103.

* *PAUL B. UHLENHOP is a member of Lawrence, Kamin, Saunders & Uhlenhop, L.L.C. in Chicago, Illinois. His e-mail address is puhlenhop@lksu.com.*

CRIMINAL VIOLATIONS

Prior to September 11, 2001, the United States Criminal Code in Sections 1956 and 1957[2] made it illegal for any person or entity to participate knowingly (including willful blindness or deliberate indifference) in the transfer of funds that are proceeds or result from over 100 specified types of unlawful activities. These illegal activities include drug trafficking, RICO violation, wire or mail fraud and securities fraud.

Sections 1956 and 1957 are very complicated and the discussion below is only a summary. Section 1956, entitled "Laundering of Monetary Instruments," criminalizes virtually all dealings with the proceeds of specified unlawful activity. "Monetary instrument" includes currency,

2. 18 U.S.C. §§1956 & 1957.

IN THIS ISSUE
- **Anti-Money Laundering Provisions For Broker-Dealers**

travelers checks, wire transfers, personal checks, and similar cash substitute instruments. The government has various elements that it must prove under Section 1956, including the following: a financial transaction was conducted or attempted; the defendant had knowledge that the property involved in the transaction came from specified unlawful activities; and the property in the transaction was used in connection with the unlawful activity. The activities must be done or with an intent to assist the carrying out of specified unlawful activity, or to conceal the proceeds of the activity, or to avoid a transaction-reporting requirement under federal or state law.

The statute is also violated by an attempt to transport or the transportation of a monetary instrument into or from the United States with (1) intent to promote the carrying on of specified unlawful activities, or (2) knowledge that the funds involved represented proceeds of some form of unlawful activity and the transfer was designed to conceal the proceeds or to avoid a transaction-reporting requirement. Section 1956 is also violated if a person conducts or attempts to conduct a financial transaction involving property represented to be the proceeds of specified unlawful activity or property used to conduct or facilitate specified unlawful activity with one of the intentions described above.

Section 1957 is violated if a person knowingly attempts to or engages in a monetary transaction involving criminally derived property having a value greater than $10,000, if the property is derived from specified unlawful activity. The intent set forth above for Section 1956 also applies to Section 1957: the defendant only needs to know that the money was derived from some sort of unlawful activity. The word "knowingly" in the statute has been interpreted so that it can be met if there is evidence of willful blindness.[3] Thus, if an institution or its employees consciously avoid learning about the criminal origin of funds, they can be convicted.

Violations have severe penalties consisting of up to 20 years and fines of up to $50,000 or twice the value of the property involved. Also, forfeiture of assets involved is permitted. Firms can be sanctioned even if they have compliance procedures, if the procedures are not enforced or are not reasonable.

CURRENCY TRANSACTIONS

SEC Rule 17a-8[4] incorporates the requirements of the Currency and Foreign Transaction Reporting Act of 1970,[5] and the recordkeeping and other rules adopted under 31 C.F.R. Part 103 as part of the SEC rules and regulations. Under SEC Rule 17a-8, any longer time peri-

3. *See United States v. Jansen*, 69 F.3d 906, 912 (8th Cir. 1995).
4. 17 C.F.R. 240.17a-8.
5. Pub.L. No. 91-508, 84 Stat. 1118 (1970).

Standard & Poor's
A Division of The McGraw-Hill Companies

Published 22 times a year by Standard & Poor's, a division of The McGraw-Hill Companies. Executive Office 55 Water Street, New York, New York 10041. Editorial Office, 299 Park Avenue 16th floor, New York, New York 10171. Subscription rates: $855 per year in U.S., Canada and Mexico; $900 elsewhere (air mail delivered). Subscribers to both *The Review of Securities & Commodities Regulation* and *The Review of Banking and Financial Services* who receive both publications at the same address are eligible for a $250 discount. In addition, a 15% discount is available for qualified academic libraries and universities. General Editor: Michael O. Finkelstein. Associate Editor: Sarah Strauss Himmelfarb. ISSN: 0884-2426. Information has been obtained by *The Review of Securities & Commodities Regulation* from sources believed to be reliable. However, because of the possibility of human or mechanical error by our sources, *The Review of Securities & Commodities Regulation* does not guarantee the accuracy, adequacy, or completeness of any information and is not responsible for any errors or omissions or for the results obtained from the use of such information.

od required by 31 C.F.R. Part 103 than required by SEC Rule 17a-4 is the time period for recordkeeping. Currency transactions over $10,000 must be reported, including multiple currency transactions which aggregate to $10,000. Broker-dealers are in general required to:

- File Form 4789 (CTR report) of currency transaction reports with the Financial Crimes Enforcement Network (FinCEN) for "currency" (cash) transactions over $10,000 or multiple transactions aggregating over $10,000 in any one day;
- File Form 4790 with the U.S. Customs Service for the transportation of currency or "monetary instruments" over $10,000 in or out of the United States; and
- Report interest in foreign financial accounts.

ELECTRONIC FUND TRANSFERS

Banks, broker-dealers and other financial institutions are required to collect certain information and maintain records for domestic and international fund transfers of $3,000 or more. There is also a travel rule requiring that most of the information required under the rule be included with the transmittal of funds (the Traveling Rule).[6] All of the information required to be maintained by the transmitter's financial institution must be included in the transmittal order, including the name and address or other identifier of the transmitter's financial institution, except less information is required for established customers.

Transfers for amounts over $3,000 require that certain information be recorded and retained regardless of *whether the transfer is a domestic or international transfer*. The transmitter's financial institution is required to maintain the following information for each payment order that it accepts for $3,000 or more:

- The transmitter's name and address.
- The amount of the transmittal.
- Execution date of payment order.
- Payment instructions from the transmitter received with the payment order.
- Identity of recipient financial institution. Recipient financial institutions are required to retain the payment order containing the information from the transmitter's financial institution.
- Information regarding the wire transfer's customer's name and account number must be retrievable.
- The transmitter's financial institution must be able to retrieve information by the name of the transmitter.
- For recipient financial institutions, information must be retrievable by the name of the recipient and the account number, if such exists.

Intermediaries must maintain the same information. Transfers to the following are exempt:

- A domestic bank or wholly-owned subsidiary.
- A domestic broker-dealer or wholly-owned subsidiary.
- The United States or agency or instrumentality.
- A state or local government or agent or instrumentality.
- Transfer between a party's own account at the same bank, broker-dealer or other financial institutions.

  There is a conditional exemption to the Travel Rule for institutions using automated customer information files ("CIF") that contain the customer's account number but either a post office box rather than address or a special or coded name rather than customer's actual name. Under the CIF system, the transmitter must be able to identify the customer and associated required information.

6. *See* 31 C.F.R. §§103.33(e), (f) and (g).

COMPLIANCE PROCEDURES

The BSA, as amended by Section 352 of the Patriot Act, now includes broker-dealers within the definition of defined financial institutions covered by parts of the BSA. Broker-dealers were required to implement an anti-money laundering program by April 24, 2002, which includes the following minimum requirements:

- Internal policies, procedures and controls with respect to preventing money laundering;
- A designated compliance officer for money laundering;
- A training program on an on-going basis for employees; and
- An independent audit program to test the anti-money laundering program.

The Patriot Act required the Secretary of Treasury to adopt appropriate regulations prior to April 24, 2002. On April 23, 2002, the Department of Treasury adopted regulations under its Part 103.[7] Under Rule 103.120,[8] broker-dealers that are registered or required to be registered must follow the rules of their self-regulatory organization as defined in Rule 103.120. A financial institution shall be deemed to satisfy the requirements of the Patriot Act §352 if it complies with the applicable regulations of its Federal Functional Regulator and it implements and maintains an anti-money laundering program that complies with the requirements of its self-regulatory organization. The self-regulatory organization requirements must have been approved by the Federal Functional Regulator, which is defined to include the SEC. Self-regulatory organizations are those defined in Section 3(a)(26) of the 34 Act,[9] which includes the NASDR and the NYSE. The NASDR has issued a new Rule 3011, which has been approved by the SEC and is applicable to NASDR members. This rule mimics Section 352 and provides some additional guidance, but little information regarding methodology and exemptions. Also, on April 23, 2002, the SEC approved NYSE Rule 445, which again mimics Section 352.

NASDR Rule 3011 requires that member firms, at a minimum:

- establish and implement policies and procedures that can be reasonably expected to detect and cause the reporting of suspicious transactions;
- establish and implement policies, procedures, and internal controls reasonably designed to assure compliance with the BSA and implementing regulations;
- provide for independent testing for compliance to be conducted by member personnel or by a qualified outside 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 accompanying notice to members accompanying Rule 3011 provides additional guidance.[10]

Section 326 of the Patriot Act requires the Secretary of Treasury to adopt regulations establishing minimum requirements for client identification when accounts are opened. Regulations will require financial institutions by October 26, 2002, to implement, and customers to comply with, reasonable procedures for establishing the identity of any person who opens an account. These procedures are required to be reasonable and practical but, at a minimum, they require the person's name, address, and other information, and a check against list of known terrorists, suspected terrorists, or terrorist organizations. The delegation of authority by the Treasury Department to the SEC and securities self-regulatory organizations appears to include the rules to be issued under Section 326. The NASDR rule and NYSE rules have not yet been clearly tailored to the various different types of customer accounts, with the amount of information depending on the type of account. Further, there may be some accounts that will eventually be excluded, such as registered broker-dealers, United States banks and similar type organizations. As discussed later, the job of complying with these provisions places a significant burden on certain

7. 31 C.F.R. Part 103.
8. 31 C.F.R. 103.120.
9. 15 U.S.C. 78c(a)(26).
10. NASD Notice to Members 02-21 (April 2002).

firms, such as on-line firms that do not have face-to-face meetings with clients.

Under the NASDR's guidance, broker-dealers should perform the following additional due diligence when opening an account, depending on the nature of the account, and to the extent reasonable and practicable:

- inquire about the source of the customer's assets and income so that the firm can determine if the inflow and outflow of money and securities is consistent with the customer's financial status;
- gain an understanding of what the customer's likely trading patterns will be, so that any deviations from the patterns can be detected later on, if they occur;
- maintain records that identify the owners of accounts and their respective citizenship;
- require customers to provide street addresses to open an account, and not simply post office addresses, or "mail drop" addresses;
- periodically contact businesses to verify the accuracy of addresses, the place of business, the telephone, and other identifying information; and
- conduct credit history and criminal background checks through available vendor databases.

The NASDR's Notice to Members 02-21 provides significant additional guidance with respect to the items to be included in procedures, some of which are discussed later in this article.

SUSPICIOUS TRANSACTION REPORTING

Section 356 of the Patriot Act requires broker-dealers to file suspicious activity reports (SARs) with respect to suspicious activity as defined by the Act. Broker-dealers that are subsidiaries of Bank Holding Companies are currently required to file SARs. The SEC and the SROs have encouraged broker-dealers for some time to file SARs for suspicious activity and many firms do. The current legislation makes filing SARs mandatory, not only for broker-dealers, but also for future commission merchants, commodity trading advisers, and commodity pool operators. Proposed regulations were published in late December and are discussed below.[11] Final regulations are to be published prior to July 1, 2002. This statute has significant criminal and civil penalties for failure to report.

Importantly, the legislation provides a broad safe harbor for reporting entities to protect them from civil liability if they report activity by a client that is suspicious. In the past when clients found out that their activity had been reported, they have sued financial institutions. The courts have not always sided with the institutions.[12] The new amendments appear to protect institutions from civil liabilities arising under contracts and enforceable legal agreements (including arbitration clauses). This is primarily designed to protect employers with arbitration provisions under employment agreements. The safe harbor also extends protection when a financial institution reports suspicious activity in employment references or termination notices that are provided in accordance with rules of the SRO, the SEC, or the CFTC, such as on Forms U-4, U-5, 8-R or similar type reports.

The Treasury Department has *proposed* a series of suspicious activity reporting rules.[13] Proposed Rule 103.19(a)(i) requires reports of suspicious transactions as defined in proposed Rule 103.11(ii) if they involve or aggregate at least $5,000 in funds or other assets. It should be noted that this is not a currency reporting requirement. Any transaction involving $5,000 or more that meets the test for suspicion must be reported. The categories of transactions that must be reported are as follows:

- Transactions which the broker-dealer knows or suspects involve a federal criminal violation committed or attempted against or through a broker-dealer;
- Transactions which the broker-dealer suspects, believes, or has reason to believe (after due diligence): involve funds derived from illegal activity or intended or conducted in order to hide or disguise funds or assets derived from illegal activities; or is

11. 31 C.F.R. Part 103.
12. *See Lopez v. First Union Nat. Bank of Florida*, 129 F.3d 1186 (11th Cir. 1997). Contra, *Lee v. Bankers Trust Co.*, 166 F.3d 540 (2d Cir. 1999). The new Act does not directly resolve this split, although it appears to broaden the safe-harbor and makes clear that it applies in any litigation, including suit for breach of contract or in an arbitration proceeding.
13. *See* n.5 *infra*.

designed, whether through structuring or other means, to evade the requirements of the Act; or appear to serve no business or apparent lawful purpose and for which the broker-dealer knows of no reasonable explanation after examining available facts relating to the transaction and the parties.

It should be noted that there are two different knowledge tests. In the first test, reporting is for transactions that the broker-dealer knows or suspects involve criminal activity; in the second test, reporting is for transactions that the broker-dealer knows, suspects, or has *reason to suspect* involve criminal activity.

The report must be filed within thirty days of a suspicious transaction by completing Form SAR-BD and filing it with FinCEN. A delay of an additional thirty days is permitted if there is not an initial detection or identification of a suspect. In case of facts indicating that immediate attention is required, broker-dealers must telephone law enforcement authorities and the SEC in addition to filing an SAR-BD. Most importantly, *the statutory provisions prohibit disclosure to a client or third parties of the filing of an SAR.*

Supporting documentation is to be obtained and maintained by the broker-dealer. The proposed rules require record retention of SARs and supporting documents for five years.

The proposed rules contain exemptions for (i) securities that are lost, stolen, missing or counterfeit that are reported to the Securities Information Center; and (ii) reporting violations of the federal securities laws by an employee or other registered representative of a broker-dealer under existing industry procedures, other than the SEC money-laundering rules of SEC Rule 17a-8.[14]

Private and Correspondent Accounts

In general, Section 312 of the Patriot Act requires financial institutions that have correspondent accounts or private banking accounts to establish policies, procedures, controls, and due diligence in order to detect and report money laundering through such accounts. Private banking accounts are defined as accounts of not less than $1 million that are established on behalf of one or more individuals. If an account is a private banking account, then the financial institution must take steps to learn the identity of the nominal and beneficial owners of the account and the sources of the funds. The financial institution must conduct scrutiny to determine if there is any "senior foreign political figure" or immediate family or close associate who participates in the accounts. A correspondent account is "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." With respect to foreign bank correspondent accounts, the beneficial owners of those accounts must be identified. If the account is a pooling account, and the owner is a bank or is another account that pools, the ultimate beneficial owners must be determined. With respect to both private banking accounts and correspondent accounts, records of the required information must be maintained. Neither of these types of accounts on their face appear to apply to broker-dealers. Nevertheless, the proposed regulations will likely include all broker-dealers having such activity. The Treasury recently promulgated proposed regulations under Section 312[15]. It has not met that deadline. The effective date is July 23, 2002.

Shell Banks

Section 313 of the Patriot Act prohibits securities firms and banks from maintaining correspondent accounts for shell banks. The Treasury Department proposed rules on December 19, 2001, which make it clear that these regulations apply to broker-dealers,[16] although the rules are proposed Section 313 is currecently effective. To achieve this objective, a broker-dealer or other financial institution having a correspondent account for *any foreign bank* must obtain significant information to verify that the bank is not a prohibited shell bank. "Shell banks" are defined as foreign banks having no physical presence in the country in which they are authorized to do business and are not subject to and regulated by licensed banking authorities. Shell banks that are part of an international banking group or financial institution are exempted. The foreign bank "correspondent account" definition includes omnibus, proprietary, prime brokerage, foreign currency, conversion, custody, futures and derivative accounts and any similar types of accounts. The proposed rules permit

14. 17 C.F.R. 240.17a-8.

15. 31 C.F.R. 103.175 et seq. (May 22, 2002).
16. 31 C.F.R. Part 104.

a broker-dealer to obtain a certification from a foreign bank that it is not a shell bank within the meaning of the Patriot Act. In each case, the certification must contain the information specified in the rule.

The required form of certification is six pages. The certification must reveal the direct and indirect owners (corporate or individual) of the foreign bank and identify an agent in the United States who is designated to accept legal process. The certification will also require a foreign bank to specify whether it is a regulated bank or a shell bank that is affiliated with a regulated bank and the name and address of its regulator.

These provisions present a number of problems for broker-dealers. Any correspondent, omnibus or similar account with *any foreign bank* would be subject to the provisions unless the firm has obtained the information required by the rules. Therefore, broker-dealers will have to obtain certifications from *all foreign banks* that they are not shell banks and to complete the certification that is included with the proposed regulations. The certification needs to be updated annually. Failure to obtain the initial or annual certifications will require termination of business relationships. The Treasury may also, under certain circumstances, give notice to terminate a relationship.

CONCENTRATION ACCOUNTS

The Secretary of Treasury has been given authority by Section 325 of the Patriot Act to promulgate regulations governing "concentration accounts" so that the identity of the client whose funds are moving through the concentration account and the specific amount of those funds can be determined. The statute does not define the phrase, but it appears that concentration accounts may include omnibus and other accounts maintained by broker-dealers and other financial institutions. For this reason, correspondent omnibus agreements may require provisions to identify all clients whose funds either are moving or will move through the account at the request of the account holder. Such agreements would be particularly difficult to obtain and implement.

FOREIGN ASSET CONTROL REGULATIONS

Financial institutions, including broker-dealers, are also subject to the foreign asset control provisions and may not move funds or assets of designated groups, businesses or persons or with respect to certain countries pursuant to the orders and regulations of the Office of Foreign Asset Control ("OFAC"). OFAC maintains on its website a list of persons, groups, and countries to which assets may not be moved and whose assets must be frozen by financial institutions, including broker-dealers. For further information on OFAC, see http://www.ustreas.gov/ofac. Under OFAC rules,[17] the President may impose sanctions for trade and business purposes against various regimes, entities or persons. The sanctions may be imposed against countries (such as Cuba or Iraq), groups within such countries (such as the Taliban or Hamas), or individuals or entities. The details of OFAC's regulations are beyond this section, but financial institutions must implement procedures to prevent violations. One of the troubling problems for broker-dealers and other financial institutions monitoring the OFAC list is that it constantly changes and must be checked against all parties with whom the financial institution does business, not just customers. This can only be accomplished by sophisticated software that constantly monitors the OFAC website for its list of prohibited parties and countries and checks that list against the financial institution's customer list and the list of other people with whom the customer transacts business. This is a monumental project for most firms.

There are a variety of sanctions that can be imposed by the Secretary of Treasury under this legislation. Violation by a broker-dealer can result in a penalty of up to $1 million and twelve years in jail. OFAC can also independently impose civil penalties of up to $275,000 per violation.

OTHER AUTHORITY OF THE SECRETARY OF TREASURY

Section 311 of the Patriot Act also permits the Secretary of Treasury to employ various measures against foreign jurisdictions or a foreign financial institution depending on the type of transaction or account, if they are determined to constitute a primary money laundering concern. These measures may include such things as requiring United States financial institutions to:

- maintain records, file reports on particular types of transactions, including the identity of the participants or beneficial owners;

17. 31 C.F.R. §§500-596.

- record information of a beneficial owner of any account opened and maintained by any foreign person;
- obtain and identify information about customers permitted to use a foreign bank payable through or correspondent accounts; or
- limit payable through or correspondent accounts.

Similar types of accounts held by other financial institutions, including broker-dealers, commodity trading advisers, futures commission merchants, may also be regulated by the Secretary of Treasury even though these are not bank accounts.

DUE DILIGENCE AND COMPLIANCE REQUIREMENTS

General

Financial institutions and broker-dealers need to have compliance programs and supervisory procedures to prevent violations and to implement the recordkeeping and reporting provisions of the Patriot Act and OFAC regulations. Most broker-dealers limit or prohibit acceptance of cash or other forms of payment that may be indicative of money laundering activities. Most importantly, a financial institution needs to know not only its customers, but other parties with whom the customer does business and their sources of funds and assets. Funds from or controlled through countries that have a money laundering reputation or lax laws regarding money laundering are particularly suspect and must be investigated. Enhanced due diligence policies should be implemented with respect to account opening policies and procedures. Furthermore, employees should be trained to look for suspicious activities that might involve money laundering or raise a red flag. Additional procedures in the operations and settlement areas should be implemented for identifying, evaluating and reporting cash transactions, suspicious transactions, and for complying with the recordkeeping provisions.

Supervisory Procedures and Programs

Each firm needs to develop the following, at a minimum:

- set of supervisory policies, procedures and controls;
- internal policies;
- designation of a compliance officer;
- an employee training program; and
- a method to independently test the implementation of anti-money laundering programs.

Each of these will need to be tailored to the particular firm, taking into consideration the nature of its business, primarily the identity of its customers and the customers of its correspondent and introducing firms. Broker-dealers servicing foreign clients or having foreign branches or affiliates will have to be particularly careful in establishing these procedures and controls.

Monitoring Suspicious Activity

Broker-dealers have procedures to detect red flags in connection with trading and a variety of other activities. The monitoring of suspicious activity is much more difficult than monitoring for complaints and other activities. New education and procedures will be required to identify red flags involving suspicious activity. All current accounts will have to be reviewed for suspicious activity. Supervisors and compliance personnel will need to be trained as to what might be such activities. Employees, who are the first line of defense, will also need to receive such training. Employees, particularly in the securities business, welcome new business with open arms and it will be contrary to the culture of most securities representatives to question their client's sources of funds. Many United States clients will resist providing this information. Foreign clients will be particularly resistant.

Broker-dealers' front and back offices will need to institute programs to monitor wire transfers, cash, negotiable securities, cashier's checks, personal checks, traveler's checks, money orders, third party checks, foreign bank drafts, and transfers of funds to unrelated parties. Procedures need specifically to include transactions where money comes in and goes out for no apparent purpose. A large number of transfers within a short period of time should raise a red flag. Many of these potential red flags will necessarily need to be monitored by exception reports from computer programs. Computer programs will need to be designed to monitor customer accounts for these types of activities and to create exception reports. How-

ever, the best procedure will be to educate all employees to have a good healthy suspicion about transactions that don't make sense or significant amounts of money that seem to come from unusual sources. In addition to monitoring supervisory procedures, broker-dealers should have procedures to handle requests for information from law enforcement authorities, including FinCEN.

Sharing Information Among Financial Institutions

Broker-dealers should have procedures in place to comply with the Treasury's interim rule that became effective March 4, 2002 for sharing information among financial institutions. To be able to share information about an account or suspicious activity between financial institutions, the broker-dealer must comply with the Treasury's interim rule.[18] The rule requires a broker-dealer to first file a certification with the Treasury Department (which is included as Appendix to the Department of Treasury's rules) which requires, among other things, a description of the type of financial institutions with which the information may be shared. The certification must be updated annually. The rules also require that there be a confidentiality agreement with the financial institution receiving the information and provisions that the information may be used only for the purposes specified in the rule. Broker-dealers receiving the information need to have in place security procedures to maintain the confidentiality of such information.

Opening Account Procedures

Firms will need to establish more diligent opening account procedures to determine from where a client receives its money. Red flags that should be noted and investigated as noted in the NASD Notice to Members 02-21, include the following:

- The customer exhibits unusual concern regarding the firm's compliance with government reporting requirements and the firm's AML policies, particularly with respect to his or her identity, type of business and assets, or is reluctant or refuses to reveal any information concerning business activities, or furnishes unusual or suspect identification or business documents.
- The customer wishes to engage in transactions that lack business sense or apparent investment strategy, or are inconsistent with the customer's stated business strategy.
- The information provided by the customer that identifies a legitimate source for funds is false, misleading, or substantially incorrect.
- Upon request, the customer refuses to identify or fails to indicate any legitimate source for his or her funds and other assets.
- The customer (or a person publicly associated with the customer) has a questionable background or is the subject of news reports indicating possible criminal, civil, or regulatory violations.
- The customer exhibits a lack of concern regarding risks, commissions, or other transaction costs.
- The customer appears to be acting as an agent for an undisclosed principal, but declines or is reluctant, without legitimate commercial reasons, to provide information or is otherwise evasive regarding that person or entity.
- The customer has difficulty describing the nature of his or her business or lacks general knowledge of his or her industry.
- The customer attempts to make frequent or large deposits of currency, insists on dealing only in cash equivalents, or asks for exemptions from the firm's policies relating to the deposit of cash and cash equivalents.
- The customer engages in transactions involving cash or cash equivalents or other monetary instruments that appear to be structured to avoid the $10,000 government reporting requirements, especially if the cash or monetary instruments are in an amount just below reporting or recording thresholds.
- For no apparent reason, the customer has multiple accounts under a single name or multiple names, with a large number of inter-account or third-party transfers.

18. 31 C.F.R. 103.90 to 110.

- The customer is from, or has accounts in, a country identified as a non-cooperative country or territory by the Financial Action Task Force (FATF).

- The customer's account has unexplained or sudden extensive wire activity, especially in accounts that had little or no previous activity.

- The customer's account shows numerous currency or cashiers check transactions aggregating to significant sums.

- The customer's account has a large number of wire transfers to unrelated third parties inconsistent with the customer's legitimate business purposes.

- The customer's account has wire transfers that have no apparent business purpose to or from a country identified as a money laundering risk or a bank secrecy haven.

- The customer's account indicates large or frequent wire transfers, immediately withdrawn by check or debit card without any apparent business purpose.

- The customer makes a funds deposit followed by an immediate request that the money be wired out or transferred to a third party, or to another firm, without any apparent business purpose.

- The customer makes a funds deposit for the purpose of purchasing a long-term investment followed shortly thereafter by a request to liquidate the position and transfer of the proceeds out of the account.

- The customer engages in excessive journal entries between unrelated accounts without any apparent business purpose.

- The customer requests that a transaction be processed in such a manner to avoid the firm's normal documentation requirements.

- The customer, for no apparent reason or in conjunction with other "red flags," engages in transactions involving certain types of securities, such as penny stocks, Regulation "S" (Reg S) stocks, and bearer bonds, which although legitimate, have been used in connection with fraudulent schemes and money laundering activity. (Such transactions may warrant further due diligence to ensure the legitimacy of the customer's activity.)

- The customer's account shows an unexplained high level of account activity with very low levels of securities transactions.

- The customer maintains multiple accounts, or maintains accounts in the names of family members or corporate entities, for no apparent business or other purpose.

- The customer's account has inflows of funds or other assets well beyond the known income or resources of the customer.[19]

Notwithstanding that any of the above may reasonably raise suspicions, the transactions may involve a legitimate, bona fide client with no money laundering activity. Nevertheless, firms will need to establish procedures to detect any of the above activity and investigate it. As noted above, the failure to do so could result in significant penalties.

On-Line Firms

There is no good answer as to how on-line firms will obtain the kinds of information described above, but they will need to address these issues. It is possible that they all can be addressed on-line, but it may be more difficult to do so than in the traditional broker-dealer context.

Clearing Firms and Introducing Brokers

Clearing firms will be required to develop computer programs and exception reports for their own purposes because they too will be required to monitor for suspicious activity and institute anti-money laundering compliance for introducing accounts. Consequently, it is expected that clearing firms will include within their computer programs the tools necessary for introducing broker compliance. There will likely be a bit of a struggle between clearing firms and introducing brokers as to who is contractually responsible for compliance with the anti-money laundering laws with respect to customers of the introduc-

19. Notice to Members 02-21, at p. 10 (April 2002).

ing broker. It is expected that the clearing firms will put most of the responsibility on the introducing broker because clearing agreements require the introducing broker to know the customer. However, this contractual shifting of responsibility will not relieve the clearing firms of their regulatory responsibilities for compliance with the anti-money laundering rules. Since introducing brokers are generally in the best position to know their customer and identify potential money laundering concerns at the account opening stage, the introducing broker will have to have substantial procedures in place for account openings and the responsibility will be largely that of the introducing broker by contract and by law. However, the clearing firm will in most cases be in a better position to monitor customer transaction activity including trading, wire transfers with deposits and withdrawals and other types of transactions. In that case, the clearing firm necessarily will have the systems in most cases to monitor on-going transactions. Since clearing firms are in the best position to monitor transactional information, they should have systems to create exception reports. Copies of those reports should be provided to introducing brokers to provide them with their knowledge of the customer. SROs and clearing firms should also provide education for the supervisory personnel of small introducing brokers and either on-line or other training for associated persons. The NASD, in its Notice to Members 02-21, provides a significant amount of guidance. Also, the NASD has a training program on-line which provides for training of employees.

Small Firms

Many small firms do not have sophisticated compliance systems. It will be necessary for these firms to understand the money laundering concepts and objectives, to learn how to detect money laundering, and what reports need to be filed. The SROs need to conduct a significant amount of education and training for supervisors in these firms. The firms also need to educate their associated persons and their back offices. The SEC is hopeful that many of the clearing firms of introducing brokers will provide electronic computer programs to monitor transactions of customers of introducing brokers and to create exception reports. As noted above, the NASDR provides a training course for associated persons and supervisors on the NASD website for a cost of $35.00 for each use. ■