



New Customer Identification Procedure Rules for Brokers and Dealers Take Effect

I. INTRODUCTION

Origins of the CIP Rule

On April 30, 2003, the U.S. Department of the Treasury (“Treasury”), along with the seven “federal functional regulators”¹ issued a final rule requiring all SEC-registered broker-dealers, to verify the identity of new customers (the “CIP Rule”). The CIP Rule, which came into effect on October 1, 2003, applies quite broadly and requires broker-dealers to establish and maintain procedures regarding customer identification.

Following the events of September 11, 2001, the United States Congress enacted the “Uniting and Strengthening America by Providing Appropriate Tools Required to Intercept and Obstruct Terrorism (USA PATRIOT ACT) Act of 2001” (the “Patriot Act”), in part, to address the impact of money laundering. Money laundering is generally defined as engaging in acts designed to conceal or disguise the true origins of criminally derived proceeds so that the unlawful proceeds appear to have been derived from legitimate origins or constitute legitimate assets. The adoption of the CIP Rule is intended to counteract persons that wish to conceal the origin or intended use of funds through the implementation of money laundering schemes.

The CIP Rule was established pursuant to Section 326 of the Patriot Act. That Act required the Secretary of the Treasury to promulgate regulations setting out minimum standards for financial institutions regarding the verification of the identity of a customer in connection with the opening of an account at a financial institution. Section 326 also

required certain minimum standards to be set out in the CIP Rule.² The CIP Rule is the latest in a series of anti-money laundering rules established pursuant to the mandate of the Patriot Act.³

General Overview of the CIP Rule

In general, a broker-dealer must establish and maintain a written customer identification program that meets the content, methodology, record-keeping and notification standards required by the CIP Rule. The CIP Rule sets out four general standards to be met: first, what information must be set out in the customer identification program. Second, the CIP Rule sets out what methods may—and in some cases must—be used to establish the identity of new customers. Third, the CIP Rule sets forth a description of the records that must be made and kept regarding the steps taken pursuant to the customer identification program. Finally, the CIP Rule describes what notices must be given to customers prior to commencing the information-gathering process.

¹ The seven federal functional regulators that jointly issued the CIP Rule along with Treasury are: the Securities and Exchange Commission (the “SEC”), the Board of Governors of the Federal Reserve System, the Commodity Futures Trading Commission, the Federal Deposit Insurance Corporation, the National Credit Union Administration, the Office of the Comptroller of the Currency, and the Office of Thrift Supervision.

² The Patriot Act mandated that the CIP Rule needed to, at a minimum, require financial institutions to implement procedures designed to (a) verify the identity of any person seeking to open an account to the extent reasonable and practicable, (b) maintain records of the information used to verify a person’s identity, including name, address, and other identifying information, and (c) consult lists of known or suspected terrorists or terrorist organizations provided to the financial institution by any government agency to determine whether a person seeking to open an account appears on any such list. The Patriot Act also requires financial institutions to give prospective customers notice of such customer identification procedures.

³ Section 352 of the Patriot Act required financial institutions to establish and maintain anti-money laundering programs. NASD Rule 3011, which came into effect in April of 2002, met this requirement by requiring broker-dealers to (a) establish anti-money laundering programs, (b) provide for independent testing of such anti-money laundering programs, (c) designate and identify to NASD the individual(s) responsible for implementing and monitoring the anti-money laundering program, and (d) provide ongoing training for appropriate personnel.

The CIP Rule requires that customer information must be gathered for all accounts (as that term is described below), and contains very few exceptions.

This client memorandum outlines the application of the CIP Rule and describes the requirements of the CIP Rule. For more information regarding the application and requirements of the CIP Rule, please contact any of the Shearman & Sterling LLP attorneys listed on the last page of this client memorandum.

II. APPLICATION OF THE CIP RULE

a. General application of the CIP Rule

By its terms, the CIP Rule requires each broker-dealer to establish procedures for verifying the identity of each customer “to the extent reasonable and practicable.”⁴ The procedures established by each broker-dealer must permit it to form a reasonable belief that it knows the identity of its customer. Specifically, the CIP Rule requires the broker-dealer to establish account-opening procedures that ensure that in connection with the opening of any account, certain information will be gathered by the broker-dealer. Two key definitions therefore mark the parameters of the CIP Rule: the definition of “account” and the definition of “customer”.

b. What is an “account”?

The CIP Rule sets out an extremely broad definition of the term “account”. Specifically, an account is any formal relationship with a broker-dealer established for the purpose of effecting transactions in securities. The term account applies not only to classic transactions such as the purchase or sale of securities, but is defined to include, without limitation, securities lending and borrowing, and holding of securities or other assets for safekeeping or as collateral.⁵ On its face, the definition also includes relationships established for the purpose of effecting private placements or mergers and acquisitions.

There are two notable exceptions to the definition of the term “account”. Specifically, the following are not considered “accounts” for purposes of the CIP Rule:

⁴ See the CIP Rule, 31 U.S.C. §103.122, at Sections (b)(1) and (b)(2).

⁵ See the CIP Rule at Section (a)(1)(i).

- An account that the broker-dealer acquires through any acquisition, merger, purchase of assets, or assumption of liabilities;⁶ or
- An account opened for the purpose of participating in an employee benefit plan established pursuant to the Employee Retirement Income Security Act of 1974.⁷

c. What is a “customer”?

The CIP Rule sets out information that must be gathered for new accounts; the limitation of the scope of the CIP Rule to new accounts is achieved principally through the definition of the term “customer”. Under the CIP Rule, a “customer” is either (a) a person that opens a new account or (b) an individual who opens a new account for either an individual who lacks legal capacity to do so, or for an entity that is not a legal person.⁸

1. Exclusions from the definition of the term “customer”

There are several important exclusions from the definition of the term “customer”. These exclusions are generally meant to exclude those entities that hold an existing account with the broker-dealer, those entities (such as government entities) that pose little or no risk because they are unlikely to be engaged in money laundering or terrorist activities, and those entities that are subject to federal regulation from other sources. Excluded from the definition of the term “customer” are:

⁶ In its notice to members advising broker-dealers regarding the CIP Rule, NASD advises its members to consider under what circumstances it may be appropriate to verify the identity of customers whose accounts are being or have been transferred to the broker-dealer notwithstanding the possible exclusion of such accounts from the definition of “account” under the CIP Rule. See NASD Notice to Members 03-34 (the “CIP NTM”) at footnote 3.

⁷ In its release adopting the CIP Rule (the “Adopting Release”), Treasury states that accounts of this kind are less likely to be established for the purpose of furthering terrorism and/or money laundering because such accounts are funded through payroll deductions that themselves must comply with federal regulations, including regulations restricting contribution limits and distributions. See 68 Fed. Reg. 25 at 113 (May 9, 2003).

⁸ See the CIP Rule at Section (a)(4). Under this definition, the term “customer” does not refer to persons who fill out the papers opening the account, or to persons who provide information necessary to establish the account, unless those persons are themselves the account-holder. The CIP Rule seeks information regarding the holder of the account. See the CIP NTM at 347.

- A financial institution⁹ regulated by a federal functional regulator;
- A bank regulated by a state bank regulator;
- A department or agency of the United States, of any state, or of any political subdivision of any state;
- Any entity established under the laws of the United States, of any state, or of any political subdivision of any state, or under an interstate compact between two or more states, that exercises governmental authority on behalf of the United States or any such state or political subdivision;
- Any entity, other than a bank, whose common stock or analogous equity interests are listed on the New York Stock Exchange or the American Stock Exchange or on the NASDAQ National Market System¹⁰; and
- A person that has an existing account with a broker-dealer, provided that the broker-dealer has a reasonable belief that it knows the true identity of the person.

⁹ For these purposes, the term “financial institution” is defined by reference to the Bank Secrecy Act’s extremely broad definition. As fully described in the CIP NTM, a financial institution is defined to include an insured bank (as defined in the Federal Deposit Insurance Act); a commercial bank or trust company; a private banker; a branch of a foreign bank in the United States; an insured institution (as defined in the National Housing Act); a thrift institution; a broker or dealer registered with the SEC under the Exchange Act; a broker or dealer in securities or commodities; an investment banker or investment company; a currency exchange; an issuer, redeemer, or cashier of travelers’ checks, checks, money orders, or similar instruments; an operator of a credit card system; an insurance company; a dealer in precious metals, stones, or jewels; a pawnbroker; a loan or finance company; a travel agency; a licensed sender of money; a telegraph company; a business engaged in vehicle sales, including automobile, airplane, and boat sales; persons involved in real estate closings and settlements; the United States Postal Service; a casino, gambling casino, or gaming establishment with an annual gaming revenue of more than \$1,000,000 which is licensed as a casino, gambling casino, or gaming establishment under the laws of any state or any political subdivision of any state (including certain Indian gaming operations conducted pursuant to the Indian Gaming Regulatory Act); or any business which engages in any activity which the Secretary of the Treasury determines, by regulation, to be an activity which is similar to, related to, or a substitute for any activity in which any business described in the definition of “financial institution” is authorized to engage; or any other business designated by the Secretary of the Treasury whose cash transactions have “a high degree of usefulness” in criminal, tax or regulatory matters. See the CIP NTM at 348.

¹⁰ Note that, for purposes of this provision, a person that is a financial institution, other than a bank, is an exempt person only to the extent of its domestic operations. Customer information must still be gathered in respect of the foreign operations of such an entity.

2. Entity or omnibus accounts as “customers”

The Adopting Release clarifies the treatment of entity or omnibus accounts as customers for purposes of the CIP Rule. Specifically, the Adopting Release requires that customer information must only be established with regards to the specific account holder itself, and no “look-through” to other entities is necessary. The Adopting Release states that:

“a broker-dealer is not required to look through a trust, or similar account to its beneficiaries, and is required only to verify the identity of the named account-holder. Similarly, with respect to an omnibus account established by an intermediary, a broker-dealer is not required to look through the intermediary to the underlying beneficial owners, if the intermediary is identified as the account-holder seeking information about individuals with authority or control over the account in order to verify the customer’s identity.”¹¹

III. CIP RULE REQUIREMENTS

In general, the CIP Rule establishes a procedures requirement: broker-dealers must establish and maintain a written customer identification program that is appropriate for the firm’s size and business, that is part of the firm’s anti-money laundering compliance program, and that contains minimum procedures for the identity verification, record keeping, mandatory comparison with government lists, and providing notice to customers.

In order to comply with the CIP Rule, each customer identification program must include risk-based customer identification procedures that are based on the broker-dealer’s assessment of the relevant risks in the context of its business, including (a) the risks presented by the kinds of accounts opened and held by the broker-dealer, (b) the methods by which the broker-dealer permits customers to open accounts, (c) the identifying information available to the broker-dealer, and (d) the size, location and customer base of the broker-dealer.

a. **Information that must be obtained regarding each customer prior to opening the account**

The CIP Rule requires that each broker-dealer obtain the following information prior to opening each account:

- The name of the customer;
- The date of birth of an individual customer;

¹¹ See the Adopting Release at 116.

- The address of the customer,¹² and
- An identification number for the customer.¹³
For a U.S. person, the identification number required is that person's taxpayer identification number (i.e., for an individual, a social security number).¹⁴

b. When does information have to be verified?

The CIP Rule states that each broker-dealer must verify the required information within a "reasonable time" before or after the opening of the customer's account. The flexibility afforded to broker-dealers to verify customer information within a reasonable time before or after opening the account must be exercised reasonably by each broker-dealer: verifications obtained too far in advance run the risk of becoming stale, while verifications after the fact run a risk of permitting money laundering to occur while verification is taking place. The Adopting Release notes that the appropriate amount of time required in order to verify the customer's information will depend on the type of account opened, whether the customer opens the account in person, and the kinds of information available to identify the customer.¹⁵

¹² The address of the customer must be a residential or business street address for an individual. If an individual has no residential or business address, the broker-dealer must identify an Army post office box or fleet post office box number, or the residential or business street address of a next of kin or another contact individual. For any person that is not an individual (including any corporation, partnership or trust), the broker-dealer must obtain that person's principal place of business, local office or the address of another physical location for that person.

¹³ For a non-U.S. person, the broker-dealer must obtain one or more of the following forms of identification: (i) a taxpayer identification number, (ii) a passport number and country of issuance, (iii) an alien identification card number, or (iv) the number and country of issuance of any other government-issued document evidencing nationality or residence, provided that these forms of government-issued documents must bear a photograph or "similar safeguard". When opening an account for a foreign entity that does not have an identification number, the broker-dealer must request some alternate government-issued document certifying the existence of the business or enterprise. As noted above, the standard to be met is that the broker-dealer must have procedures that permit it to form a reasonable belief that it knows the identity of its customer.

¹⁴ Where a customer is in the process of applying for a taxpayer identification number, the CIP Rule permits the broker-dealer to confirm that an application for a taxpayer identification number was filed by the customer prior to the customer's opening of the account, and to obtain the customer's taxpayer identification number within some reasonable period of time after the account is opened.

¹⁵ See the Adopting Release at 119.

c. Methods for obtaining information regarding each customer

The CIP Rule sets forth two principal methods for verifying customer information: documentary methods and non-documentary methods. The broker-dealer's customer identification procedure must identify when the broker-dealer will rely on documentary identification procedures, when it will rely on non-documentary identification procedures, and when it will rely on a combination of documentary and non-documentary procedures.

1. Documentary procedures

Where the broker-dealer intends to rely on documents to verify the customer information, the broker-dealer's customer identification procedures must identify the documents that the broker-dealer will use to verify customer information. The CIP Rule sets forth a list of documents that may be used by a broker-dealer in this regard.

For individuals, the CIP Rule states that appropriate documents may include an unexpired, government-issued identification document that provides evidence of that person's nationality or residence, and that contains a photograph or "similar safeguard". The CIP Rule specifically states that a driver's license or passport may meet this requirement. If the customer is a person other than an individual, the CIP Rule requires the broker-dealer to verify the customer's information through documents evidencing the entity's existence, such as "certified" articles of incorporation, a government-issued business license, a partnership agreement, or a trust instrument.¹⁶ A broker-dealer may use other documents, provided that those documents permit the broker-dealer to verify the customer information to the standard and within the time frame required by the CIP Rule.¹⁷ The Adopting Release encourages broker-dealers to obtain more than one form of documentary evidence, particularly where the broker-dealer is unable to examine the original document or documents.¹⁸

2. Non-documentary procedures

The CIP Rule sets forth a number of non-documentary methods by which a broker-dealer may verify the identity of its customers. Like the list of documentary methods, this list is non-exclusive. Specifically, the CIP Rule states that non-documentary procedures for verification of customer identity may include (a) contacting the customer directly, (b) comparing information provided by the

¹⁶ See the CIP Rule at Section (b)(2)(ii).

¹⁷ See the CIP NTM at 351.

¹⁸ See the Adopting Release at 119.

customer with information received by the broker-dealer from a publicly available source such as a consumer reporting agency or public database, (c) checking the customer's references with other financial institutions, or (d) obtaining financial statements from the customer. In light of the recent growth in identity theft, the Adopting Release specifically recommends the use of non-documentary methods in combination with documentary methods.¹⁹

In addition, the CIP Rule sets forth a number of circumstances which themselves may require the use of non-documentary methods. Specifically, the broker-dealer's customer identification procedures must address the use non-documentary methods of verification when:

- an individual is unable to present an unexpired government-issued identification document that bears a photograph or similar safeguard;
- the broker-dealer is not familiar with the documents presented;
- the account is opened without obtaining documents;
- the customer opens the account without appearing in person at the offices of the broker-dealer; and
- the broker-dealer is presented with circumstances that increase the risk that verification of the true identity of a customer through documents will be impossible.

3. Additional verification for certain customers

The Adopting Release acknowledges that in the majority of situations, a broker-dealer will be able to sufficiently identify customers' identities through documentary and non-documentary means.²⁰ However, the CIP Rule also deals with situations where documentary and non-documentary methods of verification are inadequate, such as where an entity investor is located in a jurisdiction that has been identified as non-cooperative by an international body.²¹

¹⁹ See the Adopting Release at 120.

²⁰ See the Adopting Release at 120.

²¹ One of the most commonly cited of such lists is the OECD's Financial Action Task Force Non-Cooperative Countries and Territories list, which as of the date of this publication can be found at http://www.fatf-gafi.org/NCCT_en.htm. It is recommended that a broker-dealer establishing a new account for a foreign account-holder check this list to identify whether the jurisdiction of the prospective account holder is identified on that list.

In order to account for these circumstances, the broker-dealer's customer identification procedures must address those situations where, on the basis of the broker-dealer's risk assessment of a new entity account, the broker-dealer, in addition to obtaining information regarding the entity account holder will obtain information regarding those individuals who have authority or control over that account. This verification method will only apply in those situations where the broker-dealer in question cannot verify the true identity of the foreign entity using documentary and non-documentary verification methods described earlier.²²

4. Lack of verification

In addition to including procedures for verification of each new customer, the CIP Rule mandates that each customer identification procedure must address those circumstances in which the broker-dealer cannot form a reasonable belief that it knows the true identity of a customer. The CIP Rule states that such procedures should describe:

- When the broker-dealer should refuse to open an account;
- The terms under which a customer may conduct transactions while the broker-dealer attempts to verify the customer's identity;
- When the broker-dealer should close an account after attempts to verify a customer's identity fail; and
- When the broker-dealer should file a Suspicious Activity Report in accordance with applicable law and regulation.²³

d. Record-keeping requirements

In addition to the substantive requirements of the CIP Rule, Section (b)(3) of the CIP Rule sets out certain record-keeping requirements. Specifically, each broker-dealer must make and maintain records, that, at a minimum, contain:

- All of the identifying information regarding each customer obtained in connection with the CIP Rule;
- A description²⁴ of any document that was relied on for purposes of verifying the information obtained, which description

²² See the CIP Rule at Section (b)(2)(ii)(C).

²³ See the CIP Rule at Section (b)(2)(iii).

²⁴ The CIP Rule does not require that a copy of each such document be made, only a description of that document. See the Adopting Release at 121.

should make a note of the type of document, any identification number contained in the document, the place of issuance, and, if any, the date of issuance and expiration date of the document;

- A description of the non-documentary or additional methods (as described above) used to verify the customer's identity and a description of the results of any measures undertaken to verify the identity of a customer; and
- A description of the resolution of each substantive discrepancy discovered by the broker-dealer when verifying the identifying information obtained from each customer pursuant to the CIP Rule.²⁵

Under the CIP Rule, each broker-dealer must retain records regarding account information for five years after the closure of each account, and must retain information regarding account verification procedures and results for five years after each such record is made. In all other respects, records relating to customer accounts must be made and retained in accordance with SEC Rule 17a-4.²⁶

e. Comparison with government lists

In accordance with the requirements of the Patriot Act, the CIP Rule also requires that each broker-dealer determine whether a customer appears on "any list of known or suspected terrorists or terrorist organizations issued by any Federal government agency and designated as such by Treasury in consultation with the Federal functional regulators."²⁷

The broker-dealer's customer identification procedures must further require the broker-dealer to check these lists no later than "within a reasonable period of time after the account is opened". The CIP Rule does, however, state that a broker-dealer may be

²⁵ See the CIP Rule at Section (b)(3)(i).

²⁶ In this regard, the NASD has created a table comparing the record-keeping requirements of the CIP Rule with the general record-keeping requirements set forth by SEC Rules 17a-3 and 17a-4: see <http://www.nasdr.com/pdf-text/aml_cust_id.pdf>. For further information regarding broker-dealer record keeping requirements under SEC Rules 17a-3 and 17a-4, see "SEC Amendments to Books and Records Requirements for Brokers and Dealers Under the Securities Exchange Act of 1934 Take Effect", currently available at http://www.shearman.com/documents/CM_04_05_03.pdf.

²⁷ See the CIP Rule at Section (b)(4). The Adopting Release notes that Treasury and the Federal functional regulators have not at this time designated any government lists with which information must be confirmed pursuant to the CIP Rule: see the Adopting Release at 122.

required by another federal law or regulation, or by a federal directive issued in connection with the applicable list, to make this determination at an earlier period. Under the CIP Rule, the broker-dealer's customer identification procedures must also require the broker-dealer to follow all directives issued in connection with such lists.

It is noteworthy that, while no list has yet been designated by Treasury in respect of the CIP Rule, firms must, pursuant to other regulatory requirements, check the OFAC List to ensure that potential customers and existing customers, on an ongoing basis, are not prohibited persons or entities and are not from embargoed countries or regions before transacting any business with them.²⁸

f. Notice requirements to customers

In accordance with the requirements of the Patriot Act, each broker-dealer must provide prospective customers with notice that it will be requesting information in order to verify the identity of new customers. Notice to a customer is considered by the CIP Rule to be adequate if it generally describes the information to be obtained and verified prior to the time at which the account is opened.²⁹

g. Reliance on other financial institutions

The CIP Rule provides a limited means by which a broker-dealer may rely on the customer identification procedures of another financial institution. Under the CIP Rule, reliance by a broker-dealer is permitted if:

- (a) The customer is opening, or has already opened, an account (or has established a similar relationship) with the other financial institution to provide services, or to engage in or other financial transactions;
- (b) Such reliance is reasonable under the circumstances;

²⁸ See the CIP NTM at page 354.

²⁹ The CIP Rule specifically states that such notice might well be placed in a broker-dealer's lobby, on its internet website, or on the account opening application; the CIP Rule also states that oral notice will suffice for purposes of meeting this requirement. See the CIP Rule at Section (b)(5)(ii). The CIP Rule provides a sample form of notice that reads as follows: "**Important Information About Procedures for Opening a New Account:** To help the government fight the funding of terrorism and money laundering activities, Federal law requires all financial institutions to obtain, verify, and record information that identifies each person who opens an account. What this means for you: When you open an account, we will ask for your name, address, date of birth and other information that will allow us to identify you. We may also ask to see your driver's license or other identifying documents." See the CIP Rule at Section (b)(5)(iii).

- (c) The other financial institution is required by law to implement the anti-money laundering compliance program requirements of the Patriot Act;
- (d) The other financial institution is regulated by a federal functional regulator; and
- (e) The other financial institution “enters into a contract requiring it to certify annually to the broker-dealer that it has implemented its anti-money laundering program, and that it will perform (or its agent will perform) specified requirements of the broker-dealer’s CIP.”³⁰

³⁰ See the CIP Rule at Section (b)(6).

The Adopting Release points out that this “contract and certification” requirement permits a broker-dealer to demonstrate the extent to which it is relying on other financial institutions with respect to its customer identification.³¹ While a broker-dealer is permitted to rely on another financial institution in accordance with these requirements, it is important to note that the broker-dealer and the financial institution on which it is relying pursuant to the “contract and certification” standard must be able (between them) to certify all of the requirements of the CIP Rule.

³¹ See the Adopting Release at 123. The Adopting Release also states that if the extent to which the broker-dealer relies on others is not clear from its “contract and certification” documents, then that broker-dealer must be able to otherwise demonstrate the extent of the reliance relationship as well as full compliance with the Rule.

This memorandum is intended only as a general discussion of these issues. It should not be regarded as legal advice. We would be pleased to provide additional details or advice about specific situations if desired. For more information on the topics covered in this issue, please contact:

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