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Anti-money laundering regulations for broker-dealers: Treasury Department publishes final rules implementing Section 312 of the Patriot Act relating to foreign correspondent accounts and private banking accounts

I. Introduction

In December 2005, the Financial Crimes Enforcement Network of the Department of the Treasury (“FinCEN”) published final regulations¹ implementing the foreign (*i.e.*, other than U.S.) correspondent account provisions and the private banking provisions required by Section 312 of the USA PATRIOT Act of 2001.² The Rules were published in the Federal Register on January 4, 2006.³ Generally speaking, the Rules require that certain financial institutions, including U.S. securities broker-dealers, subject certain accounts to anti-money laundering due diligence procedures that are reasonably designed to ensure that those accounts, and by extension the broker-dealers holding those accounts, are not being used for money laundering purposes. The Rules generally apply to two kinds of accounts: First, the Correspondent Account Rule requires broker-dealers to apply due diligence to correspondent accounts held by them for certain foreign financial institutions. Second, the Private Banking Rule applies to private banking accounts. The Rules require that broker-dealers (and other covered financial institutions)

assess the risks involved with each account, and apply due diligence procedures to each account commensurate with the level of risk posed by the account.

At the same time, FinCEN published proposed regulations (the “Proposed Rule”) relating to the minimum enhanced diligence procedures that broker-dealers and other covered financial institutions will be required to apply to correspondent accounts maintained by U.S.-registered broker-dealers for specific, higher-risk foreign banks.⁴

The purpose of this client publication is to alert interested persons to the Rules and to the Proposed Rule, and to provide a general overview of each. This client publication is not, and does not purport to be, a complete discussion of the issues that it describes. Interested persons should contact any of the Shearman & Sterling personnel named on the last page of this publication.

What follows is an executive summary of the Rules, followed by a description of the effective date of the Rules and some brief conclusions.

II. Executive Summary of the Rules

The Rules require certain financial institutions, including U.S. securities broker-dealers, to apply risk-based due diligence procedures to foreign correspondent accounts and private banking accounts. The Rules become effective for new accounts on **April 4, 2006**, which is 90 days

¹ The regulations are, for foreign correspondent accounts, 31 CFR §103.176 (the “Correspondent Account Rule”), and for private banking accounts, 31 CFR §103.178 (the “Private Banking Rule”, and together with the Correspondent Account Rule, the “Rules”).

² For a general overview of the USA PATRIOT Act of 2001 and of existing broker-dealer anti-money laundering regulations relating to customer identification, please see “New Customer Identification Procedure Rules for Brokers and Dealers Take Effect” (October 2003), currently available at http://www.shearman.com/cm_1003.

³ See 71(2) Fed. Reg. (January 4, 2006) at page 496.

⁴ See 71(2) Fed. Reg. (January 4, 2006) at page 516.

following the publication of the Rules in the Federal Register. For existing accounts, the Rules become effective on **October 2, 2006**, which is 270 days following the publication of the Rules in the Federal Register. In general, the Rules are summarized as follows:

Definitions of “covered financial institutions” and “foreign financial institution”

- The Rules apply to “covered financial institutions,” a defined term including: (a) U.S. insured and commercial banks, (b) agencies or branches of foreign banks in the United States, (c) federally insured credit unions, (d) broker-dealers, (e) futures commission merchants or introducing brokers, and (f) mutual funds.
- For purposes of the Rules, a “foreign financial institution” is defined as: (a) a foreign bank, (b) any branch or office located outside the United States of any financial institution, or any other person organized under foreign law, that, if it were in the United States, would be a broker-dealer, futures commission merchant or introducing broker, or mutual fund, and (c) any person organized under foreign law that is engaged in the business of, and is readily identifiable as, a currency dealer or money transmitter.

Risk-based procedures for correspondent accounts maintained with foreign financial institutions

- The Correspondent Account Rule requires covered financial institutions, including broker-dealers, to establish and maintain risk-based procedures that are designed to enable such financial institutions to detect and report known or suspected money laundering activity (or suspicious activity) involving any correspondent account established by the financial institution on behalf of a foreign financial institution.
- A correspondent account is defined 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.”

Risk-based procedures for private banking accounts, including identification of owners

- The Private Banking Rule requires each covered financial institution (including U.S.-registered broker-dealers) to establish and maintain procedures that are reasonably designed to detect and report known or suspected money laundering activity (or suspicious activity) conducted through or involving any private banking account. This Rule also requires enhanced scrutiny of any private banking account that is held by any senior foreign political figure.
- “Private banking account” is defined for these purposes as any account or combination of accounts that: (a) requires a minimum aggregate deposit of assets (including securities) of \$1,000,000 or more, (b) is established for the benefit of one or more non-U.S. persons that are the direct or beneficial owners of the account, and (c) is assigned to, or is administered or managed by, in whole or in part, an officer, employee, or agent of a covered financial institution acting as liaison between the covered financial institution and the owner(s) of the account.
- The due diligence requirements must ensure, at a minimum, that the covered financial institution takes reasonable steps to (a) identify all nominal and beneficial owners of (*i.e.*, persons that have control over) a private banking account, (b) determine whether any nominal or beneficial owner of any such account is a senior foreign political figure, (c) ascertain the sources of funds deposited into the account, and the purpose(s) and expected use(s) of the account, (d) review the activity of the account to ensure consistency with the information obtained about the account, and (e) report known or suspected money laundering or suspicious activity.

III. Effective Dates for the Rules

The Rules become effective for new accounts on **April 4, 2006**, which is 90 days following the publication of the

Rules in the Federal Register. For existing accounts, the Rules become effective on **October 2, 2006**, which is 270 days following the publication of the Rules in the Federal Register. With respect to enhanced due diligence for specified accounts with certain “higher-risk” foreign financial institutions, the Rules contain specific exemptions from this requirement pending the effectiveness of the Proposed Rule.

IV. Conclusion

Since the 2001 passage of the USA PATRIOT Act, regulation relating to anti-money laundering has been among the highest profile – and highest priority – activity of securities and financial institution regulators. Law and regulation seeking to prevent money laundering and terrorist financing have been among the major regulatory actions taken by U.S. regulators, and have firmly placed U.S. broker-dealers on the front lines of money laundering prevention. Consequently, anti-money laundering rules and regulations have become a major aspect of compliance programs at every U.S. broker-dealer, notwithstanding the complexity of anti-money laundering regulation.

The Rules add substantially to the complexity of anti-money laundering regulation for at least three reasons. First, the Rules place very broad-based requirements on broker-dealers, and require broker-dealers to make

judgments regarding both the level of risk posed by certain accounts and the appropriate diligence that may be necessary to ensure that each such account is not being used for money laundering purposes. Second, the Rules also require monitoring and judgment of account activity to ensure, first that the nature of the account has not changed, and second, consistency between the information known about each account and the actual activity in those accounts. Finally, the Rules, particularly as they relate to private banking, take unusual steps to limit the practice of dealing with undisclosed principals. Particularly with respect to the judgments that the Rules require broker-dealers to make, hindsight violations are now a major concern of compliance personnel. Broker-dealers and other covered financial institutions must now act quickly to ensure that their anti-money laundering policies and procedures permit them to effectively comply with the additional complexity that the Rules will bring.

This publication is comprised of an executive summary of the Rules, which are quite complex. Additional definitions, issues, and FinCEN guidance contained in the various releases should be considered when preparing policies and procedures to comply with the Rules.

This client publication is not, and does not purport to be, a complete discussion of these issues. For more information, please contact any of the Shearman & Sterling LLP personnel named on the last page of this publication.

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.

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