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MONEY LAUNDERING REQUIREMENTS FOR BROKER-DEALERS AND HEDGE FUNDS UNDER THE USA PATRIOT ACT OF 2001

Marc C. Cozzolino *

I. INTRODUCTION

Broker-dealers 1 have been subject to federal anti-money laundering laws imposing reporting and record keeping requirements since 1970. The USA Patriot Act of 2001 (Patriot Act), 2 however, aimed at giving the government new powers to combat terrorism, dramatically increases the anti-money laundering requirements imposed on financial institutions, and may also force broker-dealers and hedge funds to make many changes in their compliance programs, such as establishing anti-money laundering compliance procedures, verifying the identity of new accounts and filing suspicious activity reports (SARs).

II. BACKGROUND

Prior to the promulgation of the Patriot Act, the primary anti-money laundering rules for broker-dealers were found in the Bank Secrecy Act of 1970 3 (BSA). Under the BSA, broker-dealers that are subsidiaries of bank holding companies are required to report currency transactions in excess of $10,000 on a Currency Transaction Report (CTR). 4 The BSA also requires broker-dealers to file reports relating to the physical transportation of currency or bearer instruments in amounts over $10,000 into or outside of the United States on a Currency or Monetary Instrument Transportation Report (CMIR). 5

The U.S. Treasury Department (Treasury) has also adopted other record keeping rules, which have varying degrees of relevance to the securities industry. For example, in 1994, the BSA was amended to prohibit financial institutions from selling money orders, or bank, cashier's or traveler's checks for more than $3,000 in currency unless the institution first verifies and records the identity of the purchaser. Although most broker-dealers do not engage in cash transactions and do not sell these types of instruments, these responsibilities are still applicable

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1 The term “broker” means any person engaged in the business of effecting transactions in securities for the account of others, but does not include a bank. See 15 U.S.C. § 78c3(a)(4). The term “dealer” means any person engaged in the business of buying and selling securities for his own account, through a broker or otherwise, but does not include a bank, or any person insofar as he buys or sells securities for his own account, either individually or in some fiduciary capacity, but not as part of a regular business. See 15 U.S.C. § 78c3(a)(5).


4 See id.

5 See id.
to the securities industry. In 1995, Treasury promulgated a "Joint Rule" and a related "Travel Rule" requiring all financial institutions to maintain certain information regarding funds transfers of $3,000 or more,\(^6\) and to include the required information in the transmittal of funds.\(^7\)

Broker-dealers, like other financial institutions, also have been subject to the criminal provisions of the Money Laundering Control Act of 1986 (MLCA) since 1986.\(^8\) Among other things, the MLCA established two anti-money laundering criminal statutes that for the first time, made money laundering a crime in and of itself.\(^9\) The MLCA also added certain provisions to the BSA, which are also applicable to broker-dealers, including a specific prohibition against "structuring" transactions to avoid the impact of the BSA's reporting thresholds.

Broker-dealers that account for the vast majority of customer assets within the securities industry have been filing SARs, either voluntarily or as required pursuant to rules that apply to bank holding company subsidiaries. The SEC and the self-regulatory organizations (SROs) also have various existing regulations requiring the reporting of securities violations in order to ensure the safety and soundness of securities firms, see, e.g., Forms U-4, U-5 and RE-3.

Furthermore, broker-dealers, like other financial institutions, are subject to the sanctions programs administered by the Office of Foreign Assets Control (OFAC).\(^10\) These include prohibitions against trading with certain identified enemies of the United States, as set forth in various lists prepared and updated by OFAC and other government agencies.

Other types of requirements have also long existed at the due diligence stage of transactions, particularly through the application of the "know your customer" concept. That concept has developed in the securities industry largely from the rules of SROs designed to ensure that a recommended securities transaction is suitable for a particular customer. For example, New York Stock Exchange (NYSE) Rule 405 provides that "each member organization is required . . . to . . . [u]se due diligence to learn the essential facts relative to every customer, every order, every cash or margin account accepted or carried by such organization and every person holding power of attorney over any account accepted or carried by such organization."\(^11\) The National Association of Securities Dealers' (NASD) Conduct Rules\(^12\) similarly require securities firms to obtain basic information pertaining to the prospective customer at the time the account is opened, including the customer's name and residence and whether the customer is of

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\(^{6}\) See 31 C.F.R. §§ 103.33(e) & (f) (2000).

\(^{7}\) See 31 C.F.R. §§ 103.33(e), (f) and (g) (2000).


\(^{10}\) See <http://www.treas.gov/ofac/>

\(^{11}\) NYSE Rule 405.

\(^{12}\) See NASD Conduct Rule 2310(a). See also Section 11 of the NASD By-Laws and AMEX Office Rule 411. In addition, various SROs impose suitability requirements on broker-dealers.
legal age. Additionally, for certain types of accounts, securities firms must make reasonable efforts to obtain, prior to the settlement of the initial transaction in the account, "the customer's tax identification or Social Security number, occupation of the customer and name and address of employer, and whether the customer is an associated person of another member."^{13}

In addition, commodities firms, who may sponsor U.S.-based hedge funds, apply a similar "know your customer" concept. Although the Commodity Exchange Act^{14} (CEA) and its rules do not expressly establish the concept, the National Futures Association (NFA) has adopted a "know your customer" rule^{15} that requires commodity professionals, including commodity trading advisors (CTAs)^{16} and commodity pool operators (CPOs),^{17} to obtain information designed to ascertain the identity of the customer and its suitability to trade futures contracts, and to make appropriate risk disclosures to the customer in light of information gained from the customer. For example, the information to be obtained from a customer must include at least the following: (i) the customer's true name, address and principal occupation or business; (ii) the customer's current estimated annual income and net worth; (iii) the customer's approximate age; and (iv) an indication of the customer's previous investment and futures trading experience.^{18} Interestingly, if the customer refuses to provide such information, the CTA or CPO merely makes a notation of the refusal, and the rule does not require such a record to be made in the case of a non-U.S. customer.^{19} For institutional customers, the CTA or CPO must obtain a certified resolution or other document authorizing such institution to transact in commodity futures and options.^{20} The corporate resolution must be sealed and the documents must include a designation of all persons authorized to act on behalf of the entity.^{21} Additionally, the

13 NYSE Rule 405.


16 A "commodity trading advisor" means any person who (i) for compensation or profit, engages in the business of advising others, either directly or through publications, writings, or electronic media, as to the value of or the advisability of trading in (I) any contract of sale of a commodity for future delivery made or to be made on or subject to the rules of the contract market; (II) any commodity option authorized under section 4c; or (III) any leverage transaction authorized under section 19; or (ii) for compensation or profit, and as part of a regular business, issues or promulgates analyses or reports concerning the activities referred to in clause (i). See 7 U.S.C. § 1a(5).

17 A "commodity pool operator" means any person engaged in a business that is of the nature of an investment trust, syndicate, or similar form of enterprise, and who, in connection therewith, solicits, accepts, or receives from others, funds, securities, or property, either directly or indirectly through capital contributions, the sale of stock or other forms of securities, or otherwise, for the purpose of trading in any commodity for future delivery on or subject to the rules of any contract market, except that the term does not include such persons not within the intent of the definition of the term as the Commission may specify by rule, regulation, or order. See 7 U.S.C. § 1a(4).

18 NFA Rule 2-30.

19 See id.

20 See id.

21 See id.
documents must indicate what type of trading the individual(s), who are authorized to trade for the account, are allowed to do.\textsuperscript{22}

The new Patriot Act legislation,\textsuperscript{23} signed into law on October 26, 2001, contains the most significant anti-money laundering provisions since the 1970 passage of the Bank Secrecy Act. During 2002, several agencies will promulgate many regulations implementing key provisions of the law.

\section*{III. USA PATRIOT ACT OF 2001}

The Patriot Act provides simply that “each financial institution shall establish anti-money laundering programs.”\textsuperscript{24} Although simple, this statement will have widespread ramifications in the financial services industry. The new duties imposed by the Patriot Act will have four requirements: (i) development of internal policies, procedures, and controls; (ii) designation of a compliance officer; (iii) provision of on-going employee training programs; and (iv) performance of independent audits to test programs.\textsuperscript{25} The foregoing requirements are effective 180 days from the enactment of the Patriot Act.\textsuperscript{26} In addition, Treasury must prescribe regulations within that 180-day period that consider the extent to which the requirements imposed under Section 352 of Title III of the Patriot Act are commensurate with the size, location, and activities of the financial institutions to which such regulations apply.\textsuperscript{27}

Section 326 of Title III requires the Treasury, jointly with the Securities and Exchange Commission (SEC) and other specified federal regulators, to adopt regulations setting forth minimum standards for financial institutions with regard to the identification and verification of customers in the opening of an account.\textsuperscript{28} The regulations, at a minimum, will require financial institutions to implement “reasonable procedures” to verify the identity of any person seeking to open an account, maintain records of the information used to verify a person’s identity and consult government lists of known and suspected terrorists or terrorist organizations.\textsuperscript{29} In adopting these regulations, Title III specifically requires Treasury to consider various types of accounts maintained by different financial institutions, methods of opening accounts, and types

\footnotesize{
22 See id.

23 H.R. 3162, “Uniting and Strengthening America by Providing Appropriate Tools Required to Intercept and Obstruct Terrorism Act of 2001” (USA Patriot Act of 2001) [hereinafter, the “Patriot Act”].

24 See 31 U.S.C. § 5318(h)(1). Applies to all “financial institutions” as defined in the Patriot Act unless “exempted” by the Treasury Department. This took effect on April 24, 2002.


26 See Patriot Act at § 352(b).

27 See id. at § 352(c).


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of information available to make identifications. Final regulations are required to take effect within one year from the legislation's enactment.

A. IMPACT ON BROKER-DEALERS

For purposes of the Act, a broker-dealer is a “financial institution” subject to the reporting requirements discussed in Title III, Section 356 of the Patriot Act. The Secretary of the Treasury (the Secretary), after consultation with the SEC and the Board of Governors of the Federal Reserve System (Federal Reserve) must publish proposed regulations in the Federal Register before January 1, 2002 that require brokers and dealers registered with the SEC under the Securities Exchange Act of 1934 (1934 Act) to submit SARs. Such regulations must be published in final form not later than July 1, 2002.

According to the GAO Report, *Anti-Money Laundering Efforts in the Securities Industry*, one question being debated is whether the $5,000 threshold for reporting suspicious activities that applies to banks should also apply to the securities industry. The GAO Report indicates that “[s]ecurities industry and regulatory officials explained that this reporting threshold reflects the cash-intensive nature of the banking industry and its vulnerability to money laundering at the placement stage and, as such, should not be applied to [broker-dealers].” The GAO Report also states that the banking threshold does not reflect the numerous high-dollar securities transactions that range from $25,000 to $100,000 and that large securities firms currently use thresholds ranging from $250,000 to $1 million in their proprietary systems for monitoring suspicious transactions. Moreover, securities industry representatives also pointed out that a low SAR threshold could result in an inordinate number of SAR filings from the industry, which might undermine the ability of law enforcement agencies to use the reports effectively. Interestingly, according to the GAO Report, “Federal Reserve officials supported a

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32 A broker-dealer registered with the SEC is defined as a “financial institution” under the Bank Secrecy Act. See 31 U.S.C. § 5312(a)(2)(G).
33 See 31 U.S.C. § 5318(g).
34 See Patriot Act at § 356(a).
36 Id. at 19.
37 See id.
38 See id.
higher SAR threshold for the securities industry, in part because they thought it could help justify a higher reporting threshold for the banking industry as well.\textsuperscript{39}

\section*{B. Impact on Hedge Funds}

Section 356(c) of Title III of the Patriot Act requires the Treasury, the Federal Reserve and the SEC to jointly submit a report to Congress no later than one year after the date of enactment of the Patriot Act, with recommendations for effective regulations that would apply the requirements of the BSA to investment companies.\textsuperscript{40} For these purposes, “investment companies”\textsuperscript{41} include both entities that are investment companies under the Investment Company Act of 1940 (1940 Act) and entities that would be investment companies under the 1940 Act but for Sections 3(c)(1)\textsuperscript{42} or 3(c)(7)\textsuperscript{43} of the 1940 Act, \textit{i.e.}, hedge funds. Section 356(c)(3)

\textsuperscript{39} \textit{Id.} at 20.

\textsuperscript{40} The Bank Secrecy Act also includes an investment company in the definition of a “financial institution”\textsuperscript{.} See 31 U.S.C. § 5312(a)(2)(I).

\textsuperscript{41} 15 U.S.C. § 80a-3(a)(1) states:

When used in this subchapter, “investment company” means any issuer which -

(A) is or holds itself out as being engaged primarily, or proposes to engage primarily, in the business of investing, reinvesting, or trading in securities;

(B) is engaged or proposes to engage in the business of issuing face-amount certificates of the installment type, or has been engaged in such business and has any such certificate outstanding; or

(C) is engaged or proposes to engage in the business of investing, reinvesting, owning, holding, or trading in securities, and owns or proposes to acquire investment securities having a value exceeding 40 per centum of the value of such issuer's total assets (exclusive of Government securities and cash items) on an unconsolidated basis.

\textsuperscript{42} 15 U.S.C. § 80a-3(c)(1) states:

Notwithstanding subsection (a) of this section, none of the following persons is an investment company within the meaning of this subchapter:

(1) Any issuer whose outstanding securities (other than short-term paper) are beneficially owned by not more than one hundred persons and which is not making and does not presently propose to make a public offering of its securities. Such issuer shall be deemed to be an investment company for purposes of the limitations set forth in subparagraphs (A)(i) and (B)(i) of section 80a-12(d)(1) of this title governing the purchase or other acquisition by such issuer of any security issued by any registered investment company and the sale of any security issued by any registered open-end investment company to any such issuer. For purposes of this paragraph:
specifically provides that the recommendations may be different for the different types of investment companies covered. To date, the SEC has not yet issued proposed regulations. When issued, those regulations will be likely to affect both U.S. and offshore investment companies with respect to the filing of SARs and minimum standards for the identification and verification of customers opening an account as part of an overall anti-money laundering compliance program mandated by the Patriot Act. 44

According to Title III, Section 356(b) of the Patriot Act, the Secretary, in consultation with the Commodity Futures Trading Commission (CFTC) may prescribe regulations requiring

(A) Beneficial ownership by a company shall be deemed to be beneficial ownership by one person, except that, if the company owns 10 per centum or more of the outstanding voting securities of the issuer, and is or, but for the exception provided for in this paragraph or paragraph (7), would be an investment company, the beneficial ownership shall be deemed to be that of the holders of such company’s outstanding securities (other than short-term paper).

(B) Beneficial ownership by any person who acquires securities or interests in securities of an issuer described in the first sentence of this paragraph shall be deemed to be beneficial ownership by the person from whom such transfer was made, pursuant to such rules and regulations as the Commission shall prescribe as necessary or appropriate in the public interest and consistent with the protection of investors and the purposes fairly intended by the policy and provisions of this subchapter, where the transfer was caused by legal separation, divorce, death, or other involuntary event.

43 15 U.S.C. § 80a-3(c)(7) states:

Notwithstanding subsection (a) of this section, none of the following persons is an investment company within the meaning of this subchapter:

(A) Any issuer, the outstanding securities of which are owned exclusively by persons who, at the time of acquisition of such securities, are qualified purchasers, and which is not making and does not at that time propose to make a public offering of such securities. Securities that are owned by persons who received the securities from a qualified purchaser as a gift or bequest, or in a case in which the transfer was caused by legal separation, divorce, death, or other involuntary event, shall be deemed to be owned by a qualified purchaser, subject to such rules, regulations, and orders as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors.

(B) Notwithstanding subparagraph (A), an issuer is within the exception provided by this paragraph if -

(i) in addition to qualified purchasers, outstanding securities of that issuer are beneficially owned by not more than 100 persons who are not qualified purchasers, if -

(ii) prior to availing itself of the exception provided by this paragraph -

(I) such issuer has disclosed to each beneficial owner, as determined under paragraph (1), that future investors will be limited to qualified purchasers, and that ownership in such issuer is no longer limited to not more than 100 persons; and (II) concurrently with or after such disclosure, such issuer has provided each beneficial owner, as determined under paragraph (1), with a reasonable opportunity to redeem any part or all of their interests in the issuer, notwithstanding any agreement to the contrary between the issuer and such persons, for that person's proportionate share of the issuer's net assets.

futures commission merchants (FCMs), CTAs, and CPOs registered under the CEA to submit SARs (the latter two registrants may be sponsors to U.S.-based hedge funds). It is important to note that the term “investment adviser” is absent from the Patriot Act’s definition of “financial institution.” Therefore, the Patriot Act technically has no applicability to investment advisers. One would expect, however, that this technical oversight will be corrected either through subsequent legislation or regulation and that any proposed regulation will also apply to unregistered advisers which primarily manage both U.S. and offshore hedge funds.

In addition problems within the SAR rule itself, some unique characteristics of the securities industry, including the variety of business structures and processes, product lines, and client bases, may complicate implementation of the rules. Because not all firms in the industry perform similar activities, firms may have to work with other firms, such as prime brokers, fund administrators, and registrar and transfer agents, to fulfill their SAR-related responsibilities.

IV. PROPOSED, INTERIM AND FINAL REGULATIONS

C. General

The Patriot Act requires the Treasury to issue implementing regulations. Accordingly, on December 21, 2001, the Treasury issued three proposed regulations under the BSA that affect every securities dealer and “non-financial business” in the United States and nearly all banks outside the United States.

One set of regulations became effective on July 1, 2002, and require approximately 8,000 broker-dealers in the U.S. to report suspicious activity in a way similar to that of the current reporting system for banks. A special reporting form is being devised by Treasury and will be issued in 2002. The proposed rule would codify, with some modifications, interim guidance that the Treasury issued on November 20, 2001 for depository institutions, and extend the same requirements to broker-dealers. It is not yet clear how the proposed regulations for due diligence

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45 See id. at § 5318(h). It should be noted that the Bank Secrecy Act includes in the definition of a “financial institution” a broker or dealer in securities or commodities. See 31 U.S.C. § 5312(a)(2)(H).

46 “Investment adviser” means any person who, for compensation, engages in the business of advising others, either directly or through publications or writings, as to the value of securities or as to the advisability of investing in, purchasing, or selling securities, or who, for compensation and as part of a regular business, issues or promulgates analyses or reports concerning securities. See 15 U.S.C. § 80b-2(11).


48 See id.

49 See Final Regulations, Department of the Treasury, Internal Revenue Service, 26 C.F.R. 1.60501-0; Notice of Proposed Rulemaking, Department of the Treasury, 31 C.F.R. § 104.10 et seq. [hereinafter, “Proposed Rulemaking”].

50 See Interim Rule, Department of the Treasury, Financial Crimes Enforcement Network, 31 C.F.R. § 103.30 et seq. [hereinafter “Interim Rule”].
for private banking and correspondent accounts and the prohibition against shell banks will apply to broker-dealers in their role as principal underwriter/distributor for an investment company, as that term is defined in the Patriot Act. The Investment Company Institute (ICI), however, has indicated that these regulations will apply also to registered broker-dealers, including mutual fund principal underwriters.51 In addition, another set of proposed regulations would require broker-dealers to implement anti-money laundering compliance programs by April 24, 2002. Therefore, the proposed regulations that appear most relevant effect the following categories: (1) reporting of suspicious activities; (2) recordkeeping; and (3) implementing an anti-money laundering compliance program.

It should be noted that international banks do not limit their correspondent accounts in the United States to commercial banks. They also keep many such accounts at broker-dealers.52 In one of its recently issued proposed regulations,53 Treasury cites several types of accounts that U.S. broker-dealers provide to foreign banks, which may also be relevant to hedge funds. Among them:

- “omnibus accounts for trading on behalf of the foreign bank’s customers on a fully disclosed or non-disclosed basis”54
- “prime brokerage accounts that consolidate trading done at a number of firms and lend stock”55
- “various forms of custody accounts for the foreign bank and its customers.”56

The Treasury issued another set of regulations on April 23, 2002 that apply to broker-dealers, among other financial institutions, and would require the establishment of anti-money laundering compliance programs. The Treasury imposed, however, a temporary suspension of the requirement for exempted investment companies (hedge funds), commodity pool operators, and commodity trading advisors.

D. REQUIREMENTS UNDER U.S. LAW

1. Availability of Bank Records

Some provisions in the Patriot Act will assist in the procurement of certain records from covered financial institutions for applicable federal regulators and law enforcement authorities.57

51 See Investment Company Institute Memorandum No. 14287, Treasury Proposes Broker-Dealer Suspicious Activity Reporting Rules and Other Rules to Implement the USA Patriot Act, January 8, 2002.

52 See generally Money Laundering Alert, January 2002.

53 See 31 C.F.R. § 104.10 et seq.

54 Id. at 8.

55 Id.

56 Id.
Another provision requires a covered financial institution, upon request of the appropriate federal regulator, to produce records relating to anti-money laundering compliance or its customers within 120 hours of the request.\footnote{See 31 U.S.C. § 5318(k) (effective date Dec. 25, 2001). See generally Federal Reserve Board, Supervisory Letter SR 01-29 on the USA Patriot Act and the International Money Laundering Abatement and Anti-Terrorism Financing Act of 2001 [hereinafter “SR Letter”).}

Furthermore, the Patriot Act allows the Treasury or the United States Attorney General to issue a subpoena or summons to any foreign bank with a correspondent account in the United States and request records relating to that account, including records maintained abroad about deposits into the foreign bank. These records must be provided within seven days.\footnote{See id. at 2.} A covered financial institution, such as a broker-dealer, that has a correspondent account for a foreign bank must maintain in the United States: (1) records identifying the owners of the foreign bank; and (2) the name and address of a person in the United States who is authorized to accept service of legal process on behalf of the foreign bank.\footnote{Id.} This means that the foreign bank must designate an agent for services of process. The Treasury has developed a “certification” process to assist covered financial institutions to comply with Sections 313 and 319(b) of the Patriot Act. It worked with industry officials and other federal regulators in developing the process.\footnote{See id. See also Interim Guidance, Department of the Treasury, November 21, 2001 [hereinafter, “Interim Guidance”].}

2. Broker-Dealer Suspicious Activity Reporting

Pursuant to the Patriot Act, the Treasury issued a proposed rule that would require every “broker or dealer in securities” to file with the Treasury’s Financial Crimes Enforcement Network (FinCEN) a report of any suspicious transaction relevant to a possible violation of law or regulation.\footnote{See 66 Fed. Reg. 67670 (Dec. 31, 2001). See 31 U.S.C. § 5318(g).} The proposed rule applies to “any known or suspected violation of Federal law, or a suspicious transaction related to a money laundering violation or a violation of the BSA.”\footnote{66 Fed. Reg. 67670.} Pursuant to the proposed rule, the definition of “transaction” is expansive and would expressly include transactions involving any “security” as defined in Section 3(a)(10) of the 1934 Act.\footnote{66 Fed Reg. at 67672.}
Under the proposal, a transaction is reportable if it:

(a) is conducted or attempted by, at, or through a broker-dealer;

(b) involves or aggregates funds or other assets of at least $5,000; and

(c) is either:

(i) a transaction involving a known or suspected Federal criminal violation committed or attempted against or through a broker-dealer; or

(ii) a transaction that the broker-dealer knows, suspects, or has reason to suspect:

(1) involves funds derived from illegal activity or intended or conducted in order to hide or disguise funds or assets derived from illegal activity;

(2) is designed, whether through structuring or other means, to evade the requirements of the BSA; or

(3) appears to serve no business or apparent lawful purpose, and for which the broker-dealer knows of no reasonable explanation after examining the available facts relating to the transaction.

Within thirty days after the broker-dealer becomes aware of the transaction, it must report the transaction. The reports would be made on Form SAR-BD, which "will resemble the SAR used by banks to report suspicious transactions." Broker-dealer suspicious activity reports (like

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65 See 66 Fed. Reg. at 67673 n.20. 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).

66 See id. at 67672.

67 See id.

68 See id. at 67673.

69 See id. 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."

70 See id.

71 See id.

72 See id.

73 See id. 67674.
those filed by other types of financial institutions) would be maintained by FinCEN in an automated database.\textsuperscript{75}

Under the proposed rule, broker-dealers also would be required to maintain copies of SAR-BDs and supporting documentation for five years from the date of filing.\textsuperscript{76} Broker-dealers must also properly identify original related documentation and make those documents available upon request to FinCEN, any other appropriate law enforcement and regulatory authorities, and any SRO examining the broker-dealer from compliance with the rule.\textsuperscript{77}

The proposed rule also prohibits any financial institutions and their directors, officers, employees and agents from notifying any person involved in a suspicious activity transaction that the transaction has been reported.\textsuperscript{78} In addition, broker-dealers would be required to decline any subpoena request for a SAR-BD, unless FinCEN, the SEC, or another appropriate law enforcement or regulatory agency requests disclosure, or an SRO asks the broker-dealer for compliance with the rule.\textsuperscript{79} Broker-dealers must notify FinCEN of any such request and the response made.\textsuperscript{80}

There is a safe harbor, however, that protects the broker-dealer and any director, officer, employee or agent who makes a report from liability to any person for making reports of suspicious transactions, and for failing to disclose the facts of such reporting.\textsuperscript{81} The safe harbor also extends to arbitration proceedings.\textsuperscript{82}

### 3. Anti-Money Laundering Compliance Program for Broker-Dealers

The SEC approved NASD proposed Rule 3011 on April 22, 2002.\textsuperscript{83} As of April 24, 2002, each broker-dealer that is a NASD member will have developed and implemented a written anti-money laundering program reasonably designed to achieve and monitor the member’s compliance with the requirements of the BSA and the implementing regulations

\textsuperscript{74} A draft form will be made available for comment in the Federal Register.

\textsuperscript{75} See 66 Fed. Reg. at 67674.

\textsuperscript{76} See id.

\textsuperscript{77} See id.

\textsuperscript{78} See id.

\textsuperscript{79} See id.

\textsuperscript{80} See 66 Fed. Reg. 6764.

\textsuperscript{81} See id.

\textsuperscript{82} See id.

promulgated thereunder by the Treasury. Each member organization’s anti-money laundering program must be approved, in writing, by a member of senior management. The anti-money laundering program required by this Rule will, at a minimum:

(a) Establish and implement policies and procedures that can be reasonably expected to detect and cause the reporting of transactions required under 31 U.S.C. 5318(g) and the implementing regulations thereunder;

(b) Establish and implement policies, procedures, and internal controls reasonably designed to achieve compliance with the BSA and the implementing regulations thereunder;

(c) Provide for independent testing for compliance to be conducted by member personnel or by a qualified outside party;

(d) Designate an individual or individuals responsible for implementing and monitoring the day-to-day operations and internal controls of the program; and

(e) Provide on-going training for appropriate personnel.

4. Anti-Money Laundering Compliance Programs for Hedge Funds

The Treasury and FinCen, pursuant to their authority under BSA Section 5318(a)(6), have decided to exempt temporarily certain financial institutions from the requirement in Section 5318(h)(1) that they establish anti-money laundering compliance programs. The temporary exemption in regulation Section 103.170 applies to certain investment companies, commodity pool operators, and commodity trading advisors.

Under federal law, investment companies are governed by the 1940 Act which defines the term “investment company” to encompass several different types of entities. Entities such

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84 The NASD issued a Special Notice to Members to provide guidance to NASD member firms concerning anti-money laundering programs required by federal law. See Special NASD Notice to Members 2-21 (Apr. 2002).

85 See SR-NASD-2002-24 at 3.

86 See id.

87 See id.

88 See id.

89 See id.


92 15 U.S.C. § 80a1-80a64.

93 See supra note 41.
as hedge funds, private equity funds, and venture capital funds are specifically excluded from the
definition of investment company for purposes of the 1940 Act either pursuant to Section
3(c)(1)\textsuperscript{94} or Section 3(c)(7).\textsuperscript{95} Section 356 of the Patriot Act requires the Treasury, Federal
Reserve and SEC to submit a joint report to Congress not later than October 26, 2002.\textsuperscript{96} The
report must contain recommendations for regulations that implement the requirements of the
BSA with respect to investment companies, including entities that, but for exemptions or
exclusions, would be investment companies under the 1940 Act.\textsuperscript{97} Accordingly, the Treasury
anticipated that the CFTC would be a participant in the development of this report because a
significant percentage of hedge funds are registered and regulated as commodity pool
operators.\textsuperscript{98} Therefore, subject to further review, the Treasury has temporarily exempted
investment companies, other than “open-end companies,” (commonly referred to as “mutual
funds”) as defined in Section 5(a)(1)\textsuperscript{99} of the 1940 Act, from the requirements of BSA Section
5318(h)(1).\textsuperscript{100} In addition, subject to further review, the Treasury also deferred a determination
of the scope of the BSA definition of “investment company,” but anticipated that it was likely
that unregistered investment companies, otherwise excluded from the application of the 1940
Act, would be subject to anti-money laundering program requirements.\textsuperscript{101}

\textsuperscript{94} 15 U.S.C. § 80a-3(c)(1). See supra note 42.

\textsuperscript{95} 15 U.S.C. § 80a-3(c)(7). See supra note 43.

\textsuperscript{96} Patriot Act at § 356.

\textsuperscript{97} Id.

\textsuperscript{98} Interim Final Rule at 8 n.7. See supra note 17.

\textsuperscript{99} 15 U.S.C. § 80a-5(a)(1) states an "open-end company" means a management company which is offering for sale
or has outstanding any redeemable security of which it is the issuer. Note, Treasury issued an interim final rule
regarding anti-money laundering programs for mutual funds that is effective on April 24, 2002 with compliance
required by July 24, 2002. See generally Department of the Treasury, Financial Crimes Enforcement Network; Anti-
Money Laundering Program for Mutual Funds, Interim Final Rule, 31 C.F.R. § 103.130 et seq.

\textsuperscript{100} See Interim Final Rule at 8 n.7.

\textsuperscript{101} See id. Despite this, the Managed Funds Association ("MFA"), a U.S.-based trade group representing hedge
funds and hedge fund managers, issued preliminary guidance for hedge funds and hedge fund managers on
developing anti-money laundering compliance programs. Accordingly, "MFA believes that hedge funds and their
hedge fund managers should adopt effective anti-money laundering programs for a number of compelling reasons,
including (but not limited to) ensuring compliance with applicable blocking statutes and other restrictions on
assisting money laundering and terrorist financing, satisfying the potential requirements of prime brokers and other
institutions subject to the provisions of and regulations promulgated under the USA Patriot Act and the Bank
Secrecy Act regarding the soundness of their customer due diligence procedures and minimizing exposure to
reputational and legal risks....” Managed Funds Association, Preliminary Guidance for Hedge Funds and Hedge
Fund Managers on Developing Anti-Money Laundering Programs, March 2002 (Release No. 1), at 2 [on file with
author].
CONCLUSION

Although the Act is hardly a panacea for all of the assorted ills of money laundering, at a minimum it is a firm declaration of intent. The Act will have a significant impact on broker dealers and hedge funds (unregistered investment companies) and, eventually, their investment advisers (both registered and unregistered). Therefore, it will be incumbent upon practitioners and compliance professionals, in conjunction with U.S. and global regulators, to execute the mandates of the Act and the regulations that will be promulgated under it in order to restrict the scope and breadth of money laundering on a global scale.