Regulatory Bulletin

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TO: Pacific Exchange Members, Member Organizations, ASAP Members, ETP Holders, ETP Firms and Equity ASAP Holders

FROM: Regulation Division

RE: Anti-Money Laundering Programs

The USA PATRIOT Act, which was signed into law on October 26, 2001, is designed to deter terrorism in the United States and abroad and to enhance law enforcement investigating tools by prescribing, among other things, new surveillance procedures and stringent anti-money laundering laws. Section 352 of the USA PATRIOT Act, referred to as the International Money Laundering Abatement and Anti-Terrorist Financing Act of 2001 ("Money Laundering Act"), focuses on strengthening the anti-money laundering provisions put in place by earlier legislation. The Money Laundering Act imposes certain obligations on broker-dealers through new anti-money laundering provisions. Among other things, broker-dealers will be required to implement anti-money laundering programs, prepare and file suspicious activity reports, and follow new "know-your-customer" procedures.

All broker-dealers are required to develop and put into place anti-money laundering programs prior to the **April 24, 2002 deadline** of Section 352 of the USA PATRIOT Act. Rules addressing compliance with the Money Laundering Act have been developed through a combination of SRO rule proposals, informal guidance from SEC officials, and "best practices" published by the Anti-Money Laundering Committee of the Securities Industry Association.

Section 352 of the Money Laundering Act requires member broker-dealers to:

- establish and implement policies, procedures, and internal controls reasonably expected to detect and cause the reporting of suspicious transactions;
- provide for independent testing of compliance with the broker-dealer's anti-money laundering procedures;
- designate persons responsible for implementing and monitoring the day-to-day operations and internal controls of the program;
- provide training for appropriate personnel;
- appoint a "compliance officer" to oversee a broker-dealer's anti-money laundering program; and
- adopt an audit function to test the effectiveness of the broker-dealer's anti-money laundering program.

Anti-Money Laundering Procedures

The topics that a broker-dealer's anti-money laundering procedures should cover include:

- procedures to "know your customer" ("KYC");

- description of the broker-dealer's efforts to monitor account activity for unusual or suspicious transactions;
- procedures to prevent and detect suspicious activity; and
- description of supplemental procedures, transactions or accounts deemed by the broker-dealer to pose a heightened risk for money laundering activity (e.g., acceptance of cash and cash equivalents).

"Know-Your-Customer"

KYC procedures should permit a broker-dealer to make a reasonable risk-based determination as to its customers, its customers' sources of income, and expected activity. A broker-dealer may accomplish this by, among other things:

- evaluating its business to identify areas of suspicious or potentially illegal activity (e.g., by evaluating the special risks different types of accounts may present), and
- for each identified area, determining the amount and nature of customer identification and documentation that should be required and the extent of account monitoring in which the broker-dealer will engage.

KYC responsibilities and Introducing/Clearing Firm relationships

As between introducing and clearing firms, the responsibility to "know the customer" logically falls upon the introducing broker. However, as part of its anti-money laundering program, a clearing firm should:

- allocate (for example, in the clearing agreement) responsibilities relating to U.S. anti-money laundering laws, rules and regulations, related SEC and SRO rules, and Bank Secrecy Act ("BSA") reporting and recordkeeping responsibilities;
- make exception reports available to the introducing firm, which assist analyzing transactional data of its customers; and
- communicate with the introducing firm whenever it detects questionable activity.

Monitoring account activity and Suspicious Activity Reports ("SARs")

The types of suspicious activity may be broken into three groups: (1) wire transfer activity, (2) deposits, and (3) monetary instruments. A broker-dealer's monitoring efforts should cover these areas if applicable.

As part of an efficient system for reporting SARs, it is recommended that broker-dealers should, among other things: (1) centralize its SAR practices; (2) designate a particular person to determine whether activity is reportable; (3) designate a person responsible for maintaining SARs, and (4) evaluate and comply with relevant state reporting laws where required.

Firms that do not accept customer funds or securities

The requirements of Section 352 are not limited to broker-dealers that accept customer funds or securities. Section 352 requires all broker-dealers to have anti-money laundering programs in

place. Broker-dealers that do not handle money or securities logically may face less risk of customers engaging in money laundering, and this should be a consideration when developing anti-money laundering programs. However, regardless of a broker-dealer's size or business, **all broker-dealers** must have anti-money laundering programs in place before April 24, 2002. **Furthermore, all broker-dealers can expect to have their anti-money laundering programs examined by regulators.**

Anti-money laundering will be a key focus of the SEC's examination program, and joint sweeps are expected by the SEC, NASD, and NYSE in this area. However, it is assumed that broker-dealers should not be caught off guard by the regulatory attention on anti-money laundering programs, as they have long been subject to the currency transaction reporting requirements of the Bank Secrecy Act and Rule 17a-8 of the Securities Exchange Act of 1934.

Steps to be taken by broker-dealers to meet the April 24 deadline

Below is an anti-money laundering checklist, which breaks down the key steps a brokerage firm should take in developing an anti-money laundering program:

- Adopt a broad statement that sets forth the firm's anti-money laundering policy.
- Designate in the firm's written supervisory procedures a compliance officer for the firm's anti-money laundering program and persons responsible for implementing and monitoring day-to-day operations and internal controls for the program.
- Develop written procedures and internal controls designed to "Know your customer" by obtaining the type and amount of information appropriate to the nature of the customer and likelihood of potentially illegal or suspicious activity and establish clear internal channels for reporting suspicious activity.
- Designate a person or persons responsible for determining whether a SAR should be filed and maintaining copies of all SARs filed.
- Monitor accounts for suspicious activity, in a manner appropriate for the firm's business and level of money laundering risk. At a minimum, monitoring should cover wire transfer activity, deposits, and monetary instruments.
- Incorporate into the firm's internal audit program a review of the firm's anti-money laundering program or arrange for an independent review of the program to be performed by an outside party.
- Identify appropriate personnel for anti-money laundering training and develop training that explains the firm's anti-money laundering program and other related subjects appropriate to the scope of the firm's business and customers.

Questions regarding this Bulletin should be directed to Frank Troutman, Director, Financial and Operational Compliance Department, at (415) 393-4135; Hassan Abedi, Manager, Equity Enforcement, at (415) 393-5958; or Karen Hanson Wellman, Managing Director, Enforcement, at (415) 393-7949.