

Securities Industry Association Futures Industry Association

March 3, 2006

Via E-mail

William Langford
Associate Director
Regulatory Policy and Programs Division
Financial Crimes Enforcement Network
P. O. Box 39
Vienna, VA 22182

Re: Final 312 Rule

Dear Mr. Langford:

In our letter to you dated February 23, 2006 (“Request for Extension Letter”), the Securities Industry Association and the Futures Industry Association¹ requested an extension of time beyond the present implementation date of April 4th for compliance with the regulations implementing the Final Rule for Special Due Diligence Programs for Certain Foreign Accounts under Section 312 of the USA PATRIOT Act (the “Final 312 Rule”).² As you are aware, that request described a number of practical issues that industry members face in meeting their

¹ The Securities Industry Association brings together the shared interests of approximately 600 securities firms to accomplish common goals. SIA’s primary mission is to build and maintain public trust and confidence in the securities markets. SIA members (including investment banks, broker-dealers, and mutual fund companies) are active in all U.S. and foreign markets and in all phases of corporate and public finance. According to the Bureau of Labor Statistics, the U.S. securities industry employs nearly 800,000 individuals, and its personnel manage the accounts of nearly 93 million investors directly and indirectly through corporate, thrift, and pension plans. In 2004, the industry generated \$236.7 billion in domestic revenue and an estimated \$340 billion in global revenues. (More information about SIA is available at: www.sia.com.)

The Futures Industry Association is a principal spokesman for the commodity futures and options industry. Its regular membership is comprised of approximately 40 of the largest futures commission merchants in the United States. Among its approximately 150 associate members are representatives of virtually all other segments of the futures industry, both national and international, including U.S. and international exchanges, banks, legal and accounting firms, introducing brokers, commodity trading advisors, commodity pool operators and other market participants, and information and equipment providers. Reflecting the scope and diversity of its membership, FIA estimates that its members effect more than 90 percent of all customer transactions executed on U.S. contract markets.

² Pub. L. No. 107-56 (2001); 71 Fed. Reg. 496 (Jan. 4, 2006).

obligations under the Rule. The letter also described in summary form the key issues which industry members believe require interpretive guidance from FinCEN in order to enable them to meet their obligations under the regulations in a timely manner. This letter is written as a follow-up to our Request for Extension Letter to expand on the need for more time and more fully describe the issues that we are requesting that FinCEN address through guidance.

First, as a practical matter, without an extension of time, firms are simply not able to finish all of the steps necessary to implement the Rule. As an initial matter, a significant amount of time has gone into, and continues to go into the analysis of the Rule. As a result, there are serious questions as to the scope and requirements that will require interpretive guidance. As a starting point, therefore, firms will need interpretive guidance on the issues outlined below in order to implement their new procedures correctly. Second, once those issues are resolved, firms will need to update their new account forms (and there are numerous types of these forms, depending on the type of account opened and the line of business) to capture the newly required relevant information. Third, once the forms are revised, the firms need to adjust their systems to capture the new information and to sort it as necessary for further analysis. Modifications to computer systems are complex processes that involve writing, installing and testing code before the system is implemented. Fourth, they must prepare written procedures describing the elements of this risk-based approach, which, as amendments to the AML Program, may require approval of senior management. Fifth, they must educate the business people about these issues and identify the resources necessary to meet the new requirements. Finally, they must prepare new training materials for employees and conduct training with respect to these new procedures. All of this simply addresses the issue of gathering, collecting and analyzing information for *new* accounts. It does not touch on the issues relating to existing accounts.

As summarized in our Request for Extension Letter, the issues we have identified to date for which we are now seeking interpretive guidance are: 1) whether the industry's longstanding treatment of Intermediaries as the customer in certain relationships, even when the Intermediary acts on behalf of foreign financial institutions remains applicable under the Rule; 2) how to evaluate whether a foreign entity organized under foreign law would be a covered financial institution under U.S. law if located in the United States (*e.g.*, whether a foreign investment company would be required to be registered as a mutual fund under the Investment Company Act of 1940); 3) how to evaluate the "purpose of the account" or predict "anticipated activity" in the context of a securities or futures account; 4) how to apply the private banking account definition and due diligence obligations in the context of these industries, and in particular, in the context of clearing arrangements; and (5) whether member firms can utilize the risk-based approach adopted in the Final Rule to determine which of the due diligence factors should be followed in implementing the correspondent account obligations. Set forth below is a discussion of each of these issues in more detail.

With respect to the need for interpretive guidance discussed above, it would be exceedingly difficult for our members even to begin to implement the due diligence programs without clarification regarding these issues. The interpretation of the Final Rule will greatly impact how the risk-based approach is implemented, which accounts of foreign entities constitute correspondent accounts in need of review, and which entity constitutes the customer where an Intermediary is involved, among other basic issues. Several of these issues touch on

the very concepts of “customer” and “account” and therefore make it very difficult even to establish the rudiments of these due diligence programs without further guidance.

1. Application of the Rule to Intermediated Relationships

It has been the longstanding practice of the industry, based upon the practical reality of the relationship, to treat intermediaries as the accountholder when the underlying client is not disclosed, or is only partially disclosed to the financial institution, and the financial institution has no direct contact with the underlying client. This practice was acknowledged in the Preamble to the Final CIP Rules Implementing the Customer Identification Program, and in subsequent guidance issued by the Securities and Exchange Commission.³ Although securities firms, Futures Commission Merchants (“FCMs”) and introducing brokers (“IBs”) deal with Intermediaries in the same manner when they deal with correspondent accounts as defined in Rule 312, that acknowledgement is absent from Rule 312. It is equally important for such financial institutions to treat the Intermediary as the customer in the context of such correspondent account relationships. The inability to treat that Intermediary as the customer for 312 purposes would undermine the nature of the relationship and significantly change the manner in which financial institutions conduct their business.

2. Determination of “Foreign Financial Institution”

The Final 312 Rule requires a covered financial institution to apply its due diligence obligations to the correspondent accounts of foreign financial institutions. The definition of “foreign financial institution” encompasses, among other entities, non-U.S. entities that, if located in the U.S., would be a securities broker-dealer, FCM or mutual fund and non-U.S. entities that are engaged in the business of, and are readily identifiable as, a currency dealer or exchanger or a money transmitter.⁴ We therefore seek clarification as to the methods by which financial institutions should determine which entities in this category will be considered foreign financial institutions under the Final 312 Rule.

Determining which entities would be broker-dealers, FCMs or mutual funds *if organized in the United States* will be extremely difficult, if not impossible. Such a determination would involve a legal analysis of the activities of the entity in the U.S. context – facts to support such an analysis likely will be difficult to obtain.

³ 68 Fed. Reg. 25113, 25116 (May 9, 2003). In response to issues relating to certain types of sub-accounts that Intermediaries hold at financial institutions, on October 1, 2004 Treasury and the Securities and Exchange Commission (“SEC”) issued a Q & A that addressed the ability of a securities firm to treat the Intermediary as the customer for purposes of the CIP rule even where the relationship was with the Intermediary, but the underlying beneficial owners held sub-accounts with the financial institution. On February 14, 2006, 2006 in a Q&A issued by Treasury and the Commodity Futures Trading Commission (“CFTC”), similar guidance was issued for FCMs. See, e.g., 68 Fed. Reg. at 25116; “Question and Answer Regarding the Broker-Dealer Customer Identification Program Rule” (October 1, 2003), available at <http://www.sec.gov/divisions/marketreg/qa-bdidprogram.htm>; “Frequently Asked Question regarding Customer Identification Programs for Futures Commission Merchants and Introducing Brokers (31 CFR 103.123),” FIN-2006-G004 (Feb. 14, 2006), available at http://www.fincen.gov/reg_guidance.htm. In these instances, the financial institution only knows the Intermediary and interacts only with the Intermediary for its instructions.

⁴ 31 C.F.R. § 103.175(h)(1).

There are other interpretive difficulties in applying the rule to broker-dealers and mutual funds. As the provisions listing broker-dealers and mutual funds as foreign financial institutions incorporate by reference the characteristics of the equivalent U.S. entities, it is unclear whether certain entities such as foreign investment advisors or an open-end investment fund in a foreign jurisdiction must meet the U.S. requirements that the fund be “registered or required to be registered” under U.S. law, *i.e.*, whether our member firms must conduct an analysis as to whether a foreign investment advisor performs functions requiring broker-dealer registration under the Securities Exchange Act of 1934 and whether a foreign mutual fund meets the criteria for registration under the Investment Company Act of 1940.⁵

It is also difficult to determine which foreign entities would be considered a U.S. currency dealer or exchanger or money transmitter covered by the Rule and, in particular, non-regulated offshore entities that may be conducting currency exchanges or transmittals without self-disclosure.

3. Application of the Due Diligence Factors in the Context of a Risk-Based Approach

The Final Rule adopted a risk-based approach in evaluating correspondent and private banking accounts for potential illegal activity. Whereas the Proposed Rule had set forth the minimal requirements for a due diligence program for correspondent accounts, in the Final Rule, Treasury identified five risk factors for the covered financial institution to consider as part of its risk assessment.⁶ The question arises as to whether the five risk factors must be applied to all accounts or whether, as part of a risk-based approach, the initial account evaluation may include an analysis of which, if any, of the five specific risk factors must be applied in a given instance. Treasury has consistently acknowledged that it is more effective and efficient for financial institutions to concentrate their resources on high risk accounts, and the PATRIOT Act implementing rules reflect this philosophy throughout. Application of this philosophy in the context of the five risk factors would equally warrant a preliminary risk-based analysis to determine whether some, all or any of the factors should be applied. Broker dealers and FCMs believe that these factors should be considered as appropriate after the covered financial institution makes an initial determination as to whether the foreign financial institution presents risks meriting further due diligence.

4. Evaluation of the Purpose and Anticipated Activity of an Account

Included among the factors identified as part of the due diligence obligations for correspondent accounts, where appropriate, is the type, purpose and anticipated activity of the account.⁷ Consideration of the purpose and anticipated activity of an account in the securities or futures industry context is very different than that in the banking context. We suggest therefore that this language be clarified to make clear that for purposes of this factor, *i.e.*, the relevant type, purpose and anticipated activity, the information to be obtained relates to the flow of money

⁵ We note that a footnote in the Preamble suggests that mutual funds are not covered under this functional test, but we are unable to determine where that exception is included in the rule itself. See 71 Fed. Reg. at 502 n.37.

⁶ 31 C.F.R. § 103.176(a)(2).

⁷ 31 C.F.R. § 103.176(a)(ii).

through the account (*e.g.*, wire activity and third party transfers) rather than for securities transactions through the account.

We believe that this is a problem that arises from the application of a banking concept to the securities industry. As FinCEN has acknowledged:

The application of the correspondent account definition to non-bank financial institutions is one of the most difficult interpretative issues in this rulemaking. Because the Act has taken a term – correspondent account – that has been associated with the banking industry, and has extended it to other account and account-like relationships maintained by various financial institutions, the term’s application to non-bank financial institutions is not readily apparent.⁸

It is our view that in drafting Rule 312, which is directed toward correspondent accounts, Congress intended to capture the type of activity that previously had taken place through traditional correspondent accounts at banking institutions. While Congress was equally concerned that such activity could take place at a securities or futures firm, that concern really stemmed from the movement of funds and not activity relating to securities or futures transactions. Citing the legislative history, FinCEN itself explained that “[t]he goal of section 312 is to help prevent money laundering through accounts that give foreign financial institutions a base for moving funds through the U.S. financial system.”⁹ And while we understand the regulations are designed to capture accounts that handle securities and futures related activity, we read the Preamble to indicate that Treasury also intended the activity at issue to be the movement of funds that takes place through traditional correspondent accounts.

Likewise, the same language is utilized as a factor to be considered for private banking. With respect to private banking accounts, covered financial institutions must take reasonable steps to ascertain, among other things, “the purpose and expected use of the account.”¹⁰ We believe that the same clarification should be provided for private banking accounts. Again, the historical focus of Congress in this regard, in our view, was money flow from non-U.S. persons and in particular from senior foreign political figures. There was little Congressional concern that such activity would be focused on securities or futures transactions or that deviations from such a profile would be meaningful. The industry members do not believe that collecting such information would be helpful in predicting account activity in the context of securities and futures accounts, such that a departure from a given range of activity would help to capture possible money laundering or other illegal activity through the account.

Of course, for purposes of monitoring these transactions, such securities and futures activity would continue to be monitored and subject to SAR reporting. However, for purposes of profiling, we believe that the purpose and anticipated activity should be focused on money movements.

⁸ 71 Fed. Reg. at 499.

⁹ 71 Fed. Reg. at 499 and n.16.

¹⁰ 31 C.F.R. § 103.178(b)(3).

We therefore respectfully request guidance, with respect to securities and futures accounts, as to the particular types of information these categories were intended to capture.

5. Application of the Due Diligence Obligations to the Clearing Context

We request clarification of the obligations imposed on introducing and clearing brokers in the context of the private banking requirements as expressed in footnote 68 of the Final Rule. In footnote 68 of the Final 312 Rule, Treasury states that where IBs and CBs share private banking accounts, each is independently responsible for ensuring compliance with 312.¹¹ Moreover, apportionment of functions between the entities

should include adequate sharing of information to ensure that each institution can satisfy its obligations under this rule. For example, an introducing firm would be responsible for informing the clearing firm of the customers holding private banking accounts and for obtaining the necessary information from and about these customers, while both firms would be responsible for establishing adequate controls to detect suspicious activity.¹²

The establishment and maintenance of a private banking account in the IB/CB context is performed almost exclusively by the IB (except in the rare instance when the CB establishes such an account, which is not in issue here, and in which case the CB would be responsible.) The IB is not only better suited to perform the due diligence obligations with respect to such accounts under Rule 312, but they are again the only ones that can set the standards for whether or not an account is a private banking account. We note that while IBs may maintain private banking accounts that clear through the CB, unless the CB has a mandatory minimum aggregate deposit of funds or other assets of not less than \$1,000,000 and a liaison between the institution and the owner of the account, the account is not a private banking account at the CB.

For example, the first step in implementing those obligations is to determine whether a given account meets the definition under Rule 312 of a private banking account. Of necessity, it is the IB that determines whether or not a minimum deposit of \$1,000,000 is required. It is the IB that collects the information as to whether the account is established for one or more non-U.S. persons who are direct or beneficial owners of the account. And it is the IB who determines to assign the account to an officer, employee or agent (one of the IB's employees) who serves as liaison between the covered financial institution and owner. Moreover, even if the IB notified the CB of the fact that this was a private banking account, the CB would have difficulty determining what constitutes suspicious activity in a particular account without background knowledge regarding the account holder(s), as they have no contact with and no information from the private banking client. In fact, CBs traditionally have played no role in collecting such identifying information.

We seek clarification as to whether Treasury meant to impose a new obligation on clearing firms that does not comport with their current means of doing business with respect to a

¹¹ 71 Fed. Reg. at 508 n.68.

¹² 71 Fed. Reg. at 508 n.68.

CB/IB relationship. In the event that Treasury intended this interpretation as such, we seek regulatory relief in the form of a safe harbor similar to that which exists under the CIP Rule.

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We very much appreciate the opportunity to express our concerns. Should you have any questions, please contact Alan Sorcher of the Securities Industry Association at (202) 216-2000 or Betty Santangelo of Schulte Roth and Zabel LLP at (212) 756-2587.

Sincerely,

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