

Notice to Members

AUGUST 2002

SUGGESTED ROUTING

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KEY TOPICS

Money Laundering Compliance
Programs

INFORMATIONAL

Treasury and SEC Request Comment on Proposed Regulation Regarding Broker/Dealer Anti-Money Laundering Customer Identification Requirements; Comment Period Expires September 6, 2002

Executive Summary

On October 26, 2001, President Bush signed into law the USA PATRIOT Act (PATRIOT Act). Title III of the PATRIOT Act, referred to as the International Money Laundering Abatement and Anti-Terrorist Financing Act of 2001 (Money Laundering Abatement Act), imposed obligations on broker/dealers under new anti-money laundering (AML) provisions and amendments to the Bank Secrecy Act (BSA) in an effort to make it easier to prevent, detect, and prosecute money laundering and the financing of terrorism.

Among other things, Section 326 of the Act required the Secretary of the Department of Treasury (Treasury) and the Securities and Exchange Commission (SEC or Commission) jointly to issue a regulation setting forth minimum standards for broker/dealers and their customers regarding customer identification in the account opening process.

On July 23, 2002, the Treasury and SEC published for comment the proposed regulation to implement Section 326.¹ The proposed regulation would require broker/dealers to, at a minimum: (1) adopt and implement reasonable procedures to verify the identity of any person seeking to open an account, to the extent reasonable and practicable; (2) maintain records related to the verification of the person's identity; and (3) determine whether the person appears on any lists of known or suspected terrorists or terrorist organizations provided by any government agency. The release was published in the *Federal Register*;² use this URL to view the text: <http://www.treas.gov/fincen/section326brokerdealers.pdf>.

Questions/Further Information

Questions regarding this *Notice to Members* may be directed to Kyra Armstrong, at (202) 728-6962, or Vicky Berberi-Doumar, at (202) 728-8905, both of the Department of Member Regulation; or Nancy Libin, at (202)-728-8835, or Grace Yeh, at (202) 728-6939, both of the Office of General Counsel, NASD Regulatory Policy and Oversight.

Background

Introduction

The PATRIOT Act is designed to deter and punish terrorists in the United States and abroad and to enhance law enforcement investigation tools by prescribing, among other things, new surveillance procedures, new immigration laws, and new and more stringent AML laws. The Money Laundering Abatement Act strengthens the AML provisions put into place by earlier legislation.

Among these obligations, broker/dealers are required to have in place as of April 24, 2002, an AML compliance program. NASD Rule 3011, which was approved by the SEC on April 22, 2002, requires that each member develop and implement, by April 24, 2002, a written AML program reasonably designed to achieve and monitor the member's compliance with the requirements of the BSA and the implementing regulations promulgated thereunder by the Treasury, including the obligation to establish reasonable customer identification and verification procedures. In addition to this *Notice*, members may also refer to *Notice to Members 02-21* (April 2002), which provides guidance to members regarding

the development of AML programs and procedures for account holder identification and verification.

Description of Proposed Regulation

The proposed regulation provides several definitions, which are briefly reviewed below.

1. Account. The proposed regulation defines "account" to include all types of securities accounts maintained by brokers or dealers.³ These include accounts to purchase, sell, lend, or otherwise hold securities or other assets, cash accounts, margin accounts, prime brokerage accounts that consolidate trading done at a number of firms, and accounts for repurchase and stock loan transactions.

2. Broker/dealer. "Broker/dealer" is defined to include any person registered, or required to be registered, with the Commission as a broker or dealer under the Securities Exchange Act of 1934 (Exchange Act), except persons who register, or are required to be registered, solely because they effect transactions in security futures products.⁴

3. Customer. "Customer" is defined as any person who opens a new account at a broker/dealer or is granted trading authority with respect to an account at a broker/dealer.⁵ Under this definition, a person who has an account at a broker/dealer prior to the effective date of the regulation *would not be* a customer. However, such a person becomes a customer if the person opens a new or different type of account. The proposed regulation also states that a person with trading authority *prior* to the effective date of the regulation *is not* a customer;

however, any person who was granted trading authority *after* the effective date is a customer.

The proposed regulation does not apply to persons seeking information about an account (such as a schedule of transaction fees) if an account is not opened. Transfers of accounts from one broker/dealer to another that are not initiated by the customer are not covered by the proposed regulation.⁶ Examples of an account transfer not initiated by a customer include a merger, acquisition, or purchase of assets or assumption of liabilities.

4. Person. “Person” is defined to include natural persons, corporations, partnerships, trusts or estates, joint stock companies, associations, syndicates, joint ventures, any unincorporated organizations or groups, Indian tribes, and all entities cognizable as legal entities.⁷

5. U.S. person. “U.S. person” is defined as a U.S. citizen, or for persons other than natural persons, an entity established or organized under the laws of a State or the United States.⁸

6. Non-U.S. person. A “Non-U.S. person” is defined as a person that is not a U.S. person as that term is defined in the regulation.⁹

7. Taxpayer Identification number. “Taxpayer identification number” is defined to have the same meaning as determined under the provisions of Section 6109 of the Internal Revenue Code and the regulations of the Internal Revenue Service thereunder.¹⁰

Customer Identification Program

A key aspect of the proposed regulation is the requirement that broker/dealers establish and operate a customer identification program (CIP).¹¹ A CIP must be

part of a firm’s overall AML compliance program as required under Section 352 of the PATRIOT Act.¹² It must be approved by the most senior level of the firm, which can be the board of directors, managing partners, board of managers, or other governing body performing similar functions, or by persons authorized to approve such a program.¹³ A CIP’s procedures also must enable the firm to form a reasonable belief that it knows the true identity of the customer.

Several factors must be considered in creating and developing CIPs. Firms should consider the types of identifying information available for customers and the methods available to verify that information. The release notes that while the proposed regulation sets forth certain minimum required information and suitable verification methods, firms should consider on an ongoing basis whether additional information and methods are appropriate. In addition, firms should consider the risks associated with their business operations. In considering the risks, firms should consider the following factors:

- (1) the broker/dealer’s size;
- (2) the broker/dealer’s location;¹⁴
- (3) the method by which customers open accounts at the broker/dealer;¹⁵
- (4) the types of accounts the broker/dealer maintains for customers;¹⁶
- (5) the types of transactions the broker/dealer executes for customers;¹⁷
- (6) the customer base; and
- (7) the broker/dealer’s reliance on another broker/dealer with which it shares an account relationship.¹⁸

This last risk factor refers to shared accounts subject to a carrying or clearing agreement governed by NASD Rule 3230 or NYSE Rule 382.¹⁹ The proposed regulation notes that firms sharing accounts may share responsibilities pursuant to their clearing agreements. For example, the correspondent firm may undertake to obtain the identifying information while the clearing firm may undertake the verification. Nonetheless, the proposed regulation makes it clear that both firms are responsible for ensuring that each requirement in the regulation is met with respect to each customer. Therefore, broker/dealers must continually assess whether the other firm can be relied on to perform its responsibilities. A broker/dealer is expected to cease such reliance if it is no longer reasonable.

Required Information

A broker/dealer's CIP must have customers provide, at a minimum, certain identifying information before an account is opened for the customer or the customer is granted trading authority over an account. The firm must obtain from each customer, his or her:

- ▶ Name;
- ▶ Date of birth, for a natural person;
- ▶ Address(es):
 - ▶ Residence and mailing (if different) for a natural person; or
 - ▶ Principal place of business and mailing (if different) for a person other than a natural person; and
- ▶ Documentary Number:
 - ▶ For each customer that is a U.S. person, a taxpayer identification number (such as a Social Security

number or employer identification number); or

- ▶ For each customer that is a non-U.S. person,
 - a U.S. taxpayer identification number;
 - a passport number and country of issuance;
 - an alien identification card number; or
 - the number and country of issuance of any other government-issued document evidencing nationality or residence and bearing a photograph or similar safeguard.²⁰

Firms should determine whether other identifying information is necessary to form a reasonable belief concerning the true identity of each customer during this process. The proposed regulation notes that there may be certain situations or customers that may cause the firm to obtain additional information. CIPs should have guidelines for such situations to assist in making such determinations.

The Treasury and the SEC have proposed a limited exception to the requirement that a taxpayer identification number be provided prior to opening an account or the granting of trading authority. For new businesses that have applied for, but not received, employer identification numbers (EINs) from the Internal Revenue Service, the CIP may allow the EIN to be provided within a reasonable time after the account is opened. However, CIPs must require the broker/dealer to obtain a copy of the EIN application prior to the account opening or to the grant of trading authority.

Verification Procedures

The procedures for verifying the accuracy of the information must be undertaken within a reasonable time before or after an account is opened or a customer is granted trading authority. There is some flexibility in determining what is a reasonable time. The amount of time may depend on the type of account opened, whether the account was opened in person, and on the type of identifying information available. Although an account is opened, a firm may choose to place limits on the account until the customer's identity is verified. Therefore, firms may use a risk-based approach to determine when the identity of a customer must be verified relative to the opening of an account or the granting of trading authority.

The proposed regulation explains that the verification requirements would apply every time a person opens a new account at a firm or is granted trading authority with respect to an account. However, if a customer whose identification has been verified previously opens a new account or is granted new authority, the firm would not need to verify the customer's identity a second time, provided the broker/dealer (1) previously verified the customer's identity in accordance with procedures consistent with the proposed regulation; and (2) continues to have a reasonable belief that it knows the true identity of the customer.

Verification may occur through two methods: through documents and through non-documentary means. The means of verification may vary based on the type of customer and the method of opening an account. A CIP must discuss both methods and provide guidance on when it is appropriate to use either one or a combination of both.

Documents

CIPs must provide guidance concerning when it is appropriate to use documents to verify a customer's identity. The proposed regulation lists some suitable documents.

They include:

- ▶ For natural persons, an unexpired government-issued identification evidencing nationality or residence and bearing a photograph or similar safeguard.
- ▶ For entities, documents showing existence such as registered articles of incorporation, a government-issued business license, a partnership agreement, or a trust instrument.

Non-Documentary Means

A CIP must describe non-documentary verification methods and when these methods will be used in addition to, or instead of relying on, documents. The regulation provides for the exclusive use of non-documentary means (if necessary) due to the number of accounts opened over the Internet, the telephone, and the mail. Suitable non-documentary methods of verification include:

- ▶ contacting a customer after the account is opened (particularly, if the account is opened online or by mail);
- ▶ obtaining a financial statement;
- ▶ comparing the identifying information provided by the customer against fraud and bad check databases to determine whether any of the information is associated with known incidents of fraudulent behavior (negative verification);

- ♦ comparing the identifying information with information available from a trusted third-party source, such as a credit report from a consumer reporting agency (positive verification);²¹ and
- ♦ checking references with other financial institutions.

Other factors to consider include checking whether there is a logical consistency between the identifying information provided such as the customer's name; street address; zip code; telephone number, if provided; the customer's date of birth; and Social Security number.

Non-documentary methods should be used in certain situations, particularly when a firm cannot examine original documents. The following are examples of situations when non-documentary methods should be used:

- ♦ a person is unable to provide an unexpired government-issued identification document with a photograph or similar safeguard;
- ♦ the firm is presented with unfamiliar documents to verify an identity;
- ♦ the firm does not meet the customer face-to-face; or
- ♦ there is a risk that the documents will not enable the firm to verify the customer's identity.

Also, in light of the increase in identity fraud, firms are encouraged to use non-documentary methods, even when a customer has provided documents.

Use of Government Lists

The proposed regulation also requires reasonable procedures for determining whether a customer appears on any list of known or suspected terrorists or terrorist organizations provided by any government agency. This requirement applies only with respect to lists circulated by the federal government such as the list found on Treasury's Office of Foreign Assets Control (OFAC) Web Site (www.treas.gov/fac) and available on www.nasdr.com/money.asp under "OFAC List." Broker/dealers must have procedures for responding to circumstances when a customer is named on a list.²²

Customer Notice

The proposed regulation states that firms must give their customers notice of their identity verification procedures.²³ The CIP must include procedures for providing customers with adequate notice that the broker/dealer is requesting information to verify their identity. This requirement may be satisfied generally by notifying customers about the procedures a firm must comply with to verify their identities. The release also cites, as an example, posting a sign in a firm's lobby or providing customers with any form of written, electronic, or oral notice. Notice must be given before an account is opened or trading authority is granted.

Lack of Verification

As stated above, a broker/dealer should maintain an account for a customer only when it can form a reasonable belief that it knows the customer's true identity. However, a CIP must have procedures for responding to circumstances when a firm cannot form a reasonable belief.²⁴ There

should also be guidelines for when an account will not be opened. Furthermore, a CIP should specify when an account should be closed after attempts have been made to verify a customer's identity. There should also be procedures for determining when a suspicious activity report (SAR) should be filed.²⁵

Recordkeeping

The proposed regulation requires procedures for maintaining records of information used to verify a person's identity, including name, address, and other identifying information.²⁶ Information that must be maintained includes all identifying information provided by a customer. A firm must make a record of each customer's name, date of birth (if applicable), addresses, and tax identification number or other number. Firms also must maintain copies of any documents that were relied on, evidencing the type of document and any identification number it may contain. Firms must make and maintain records of the methods and results of measures undertaken to verify the identity of a customer. These records must be maintained for five years after the date the account is closed or the grant of authority to effect transactions with respect to the account is revoked.

Exemptions

The proposed regulation provides that the Commission, with the concurrence of the Secretary of the Treasury, may exempt any broker/dealer that registers with the Commission from this requirement. Excluded from this exemptive authority are firms that register as broker/dealers solely because they deal in security futures products. In issuing such exemptions,

the Commission and the Secretary will consider whether the exemption is consistent with the purposes of the BSA and in the public interest and may consider other necessary and appropriate factors.²⁷

Comments

Treasury and the SEC seek comment on all aspects of the proposed regulation, and specifically seek comment on the following issues:

1. Whether the proposed definition of "account" (which includes all types of securities accounts maintained by brokers or dealers) is appropriate and whether other examples of accounts should be added to the text of the regulation.
2. How broker/dealers can comply with the requirement to obtain both the address of a person's residence, and, if different, the person's mailing address in situations involving natural persons who lack a permanent address.
3. Whether non-U.S. persons that are not natural persons will be able to provide a broker/dealer with the identifying information required in 31 CFR 103.122(c)(4),²⁸ or whether other categories of identifying information should be added to this section.
4. The extent to which the verification procedures required by the proposed regulation makes use of the information that broker/dealers currently obtain in the account opening process.

5. Whether any of the exemptions from the customer identification requirements contained currently in 31 CFR 103.35(a)(3) should be continued in the proposed regulation. Commenters should address the standards set forth in paragraph (j) of the proposed regulation as well as any other appropriate factors.²⁹

Written comments may be mailed to FinCEN, Section 326 Broker-Dealer Rule Comments, P.O. Box 39, Vienna, Virginia 22183, or sent to e-mail address regcomments@fincen.treas.gov with the caption "Attention: Section 326 Broker/Dealer Rule Comments" in the body of the text.

Written comments should be submitted in triplicate to the Secretary, Securities and Exchange Commission, 450 Fifth Street, NW, Washington, DC 20549-0609. All submissions should refer to the File No. S7-25-02. Comments may also be submitted electronically at the following e-mail address: rulecomments@sec.gov. The file number should be included on the subject line if e-mail is used.

Written comments must be submitted to Treasury and the SEC on or before September 6, 2002.

Conclusion

NASD will update members when the proposed regulation becomes final. In the interim, NASD reminds members to comply with the provisions of the PATRIOT Act that currently apply to broker/dealers.

Endnotes

- 1 67 Fed. Reg. 48,306 (July 23, 2002).
- 2 Treasury, jointly with other federal financial regulators, also separately issued customer identification requirements for banks and trust companies, savings associations, credit unions, mutual funds, futures commission merchants, and futures introducing brokers.
- 3 67 Fed. Reg. 48,306 at 48,307.
- 4 *Id.*
- 5 *Id.*
- 6 The release notes that there may be times when a broker/dealer may need to verify the identity of customers associated with accounts it is acquiring. Procedures for the transfer of accounts are expected to be part of a firm's AML compliance program required under Section 352 of the PATRIOT Act.
- 7 67 Fed. Reg. 48,306 at 48,307. Broker/dealers that register solely because they effect transactions in security futures products will be subject to separate customer identification regulations issued jointly by Treasury and the Commodity Futures Trading Commission.
- 8 *Id.*
- 9 *Id.*
- 10 *Id.* See also 26 U.S.C. 6109 (2002), which states that, generally speaking, the identifying number of an individual is his or her Social Security account number or employer identification number.
- 11 67 Fed. Reg. 48,306 at 48,307- 48,308.
- 12 31 U.S.C. 5318(h).
- 13 67 Fed. Reg. 48,306 at 48,311.
- 14 Firms located in certain known money laundering areas, for example, may pose a greater risk than firms located in other areas. See 67 Fed. Reg. 48,306 at 48,308.
- 15 This refers to whether the account was opened in person or whether it was opened online, for example. See 67 Fed. Reg. 48,306 at 48,308.

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- 16 A firm must determine if the account is a cash, margin, or prime brokerage account, for example. See 67 Fed. Reg. 48,306 at 48,308.
- 17 This could be short sales, block trades, repurchases, and reverse repurchase agreements, for example. See 67 Fed. Reg. 48,306 at 48,308.
- 18 67 Fed. Reg. 48,306 at 48,308.
- 19 NASD Rule 3230 governs clearing agreements. It states, among other things, that all clearing or carrying agreements entered into by a member, except where any party to the agreement is also subject to a comparable rule of a national securities exchange, shall specify the respective functions and responsibilities of each party to the agreement. NYSE 382 also addresses carrying agreements and states, in part, that each carrying agreement shall identify and allocate the respective functions and responsibilities of the introducing and carrying organizations.
- 20 A "similar safeguard" is included in the definition to permit for the use of any biometric identifier that may be used in addition to, or instead of, photographs.
- 21 See *NASD Notice to Members 02-21* at 6, which discusses the use of databases such as Equifax, Exertion and Lexis/Nexis. Please note that NASD is not endorsing any particular product, but offering the names as references.
- 22 67 Fed. Reg. 48,306 at 48,310. See also *NASD Notice to Members 02-21* at 6.
- 23 67 Fed. Reg. 48,306 at 48,310.
- 24 *Id.*
- 25 67 Fed. Reg. 40448 (July, 1, 2002).
- 26 *Id.*
- 27 67 Fed. Reg. 48,306 at 48,311.
- 28 See 67 Fed. Reg. 48,306 at 48,308. Section 103.122(c)(4) requires that a broker/dealer obtain from a customer before an account is opened or trading authority is granted a "documentary number."
- 29 31 CFR 103.35(a)(3) currently provides that a broker/dealer need not obtain a taxpayer identification number with respect to specified categories of persons opening accounts, such as (i) agencies and instrumentalities of Federal, State, local, or foreign governments; (ii) aliens who are ambassadors; ministers, career diplomatic or consular officers; naval, military or other attaches of foreign embassies and legations; and members of their immediate families; (iii) aliens who are accredited representatives of certain international organizations, and their immediate families; (iv) aliens temporarily residing in the United States for a period not to exceed 180 days; (v) aliens not engaged in a trade or business in the United States who are attending a recognized college or university, or any training program supervised or conducted by an agency of the Federal Government; and (vi) unincorporated subordinate units of a tax exempt central organization that are covered by a group exemption letter. The proposed regulation does not contain any exemptions from the Customer Identification Program requirements.
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