Department of the Treasury
Financial Crimes Enforcement Network

**Guidance**

**FIN-2006-G009**
**Issued: May 10, 2006**
**Subject: Application of the Regulations Requiring Special Due Diligence Programs for Certain Foreign Accounts to the Securities and Futures Industries**

The Financial Crimes Enforcement Network is issuing this guidance to clarify the due diligence obligations of broker-dealers, futures commission merchants, and introducing brokers in commodities (collectively, "securities and futures firms") under the final rules implementing section 312 of the USA PATRIOT Act (the "section 312 rules").[1] Specifically, this guidance addresses: (1) whether all five of the risk factors enumerated in the final due diligence rule for correspondent accounts established or maintained for foreign financial institutions[2] (the "correspondent account rule") must be applied in every instance in which securities and futures firms establish, maintain, administer, or manage such accounts; (2) how certain intermediated relationships should be treated for purposes of the correspondent account rule; (3) how the due diligence rule for private banking accounts[3] (the "private banking rule") applies to clearing firms; (4) how firms should determine whether a foreign entity is a "foreign financial institution" under the section 312 rules; and (5) how securities and futures firms should evaluate the purpose and anticipated activity of a correspondent account.

## 1. Application of the Due Diligence Requirements of the Final Rules

The correspondent account rule provides that securities and futures firms must "[assess] the money laundering risk presented by such correspondent account, based on a consideration of all relevant factors, which shall include, as appropriate [five enumerated factors]."[4] We have been asked to clarify whether the five risk factors must be applied to all correspondent accounts established or maintained for foreign financial institutions under the rule, or whether, as part of a risk-based approach, the evaluation may include an analysis of which, if any, of the five risk factors must be applied.

We do not expect that securities and futures firms will need to apply each of the five risk factors to every correspondent account relationship they establish, maintain, administer,

[1] Anti-Money Laundering Programs; Special Due Diligence Programs for Certain Foreign Accounts, 71 Fed. Reg. 496 (Jan. 4, 2006) (the "Final Rules").

[2] 31 C.F.R. § 103.176.

[3] 31 C.F.R. § 103.178.

[4] 31 C.F.R. § 103.176(a)(2).

or manage for a foreign financial institution. Rather, securities and futures firms may apply some subset of the five enumerated factors when conducting due diligence on a foreign financial institution, depending upon their determination of the nature of the foreign financial institution they are assessing and the relative money laundering risk posed by such institution.[5] We do expect that securities and futures firms will consider the factors that are relevant to the particular risk profile of the foreign financial institution being assessed and we note, moreover, that the five risk factors enumerated in the rule were not meant to be exhaustive. The due diligence programs of securities and futures firms should provide, as appropriate, for the consideration of additional factors that have not been enumerated in the rule when assessing foreign financial institutions with a unique risk profile or those that pose high risk.[6]

## 2. Intermediated Relationships under the Correspondent Account Rule

We also have been asked to address how securities and futures firms should treat certain intermediaries and intermediated relationships for the purpose of complying with the due diligence provisions of the correspondent account rule. Whether a securities or futures firm has established or maintained a correspondent account with a foreign financial institution will depend on whether the securities or futures firm has a "formal relationship" with the foreign financial institution.[7]

With respect to omnibus accounts established or maintained for an intermediary financial institution, a securities or futures firm will have a formal relationship with the intermediary financial institution holding the omnibus account. Under the correspondent account rule, a securities or futures firm is required to perform due diligence on a foreign financial institution for which an omnibus account is established or maintained.[8] The securities or futures firm generally is not required to look through an omnibus account to perform due diligence on any foreign financial institutions that may be underlying accountholders. However, due diligence conducted on a foreign financial institution for which an omnibus account is established or maintained should include conducting a risk-

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[5] *See* Final Rules, 71 Fed. Reg. at 502 ("we agree that this provision should be modified to incorporate a risk-based approach to the entire rule . . . [T]his . . . will permit covered financial institutions to assess the risks posed by their various non-U.S. customers and accounts and to direct their resources most appropriately at those accounts that pose a more significant money laundering risk").

[6] *See id.* at 503 ("[s]ection 103.176(a) does not prescribe the elements of increased due diligence that should be associated with specific risk factors, but a covered financial institution's general due diligence program should identify risk factors that would warrant the institution conducting additional scrutiny of a particular account").

[7] With respect to broker-dealers, we have defined the term "account" to mean "any *formal relationship* established with a broker or dealer in securities to provide regular services to effect transactions in securities." 31 C.F.R. § 103.175(d)(2)(ii) (emphasis added). The term "account" is defined similarly in 31 C.F.R. § 103.175(d)(2)(iii) with respect to futures commission merchants and introducing brokers in commodities.

[8] *See* Final Rules, 71 Fed. Reg. at 503 ("the due diligence requirement . . . generally requires an assessment of the money laundering risks presented by the foreign financial institution for which the correspondent account is maintained").

based assessment into the "nature of the foreign financial institution's business and the markets it serves,"[9] including the nature of the foreign firm's account base. Moreover, we expect that a securities or futures firm will conduct increased due diligence on the intermediary institution's account base in the highest risk situations.[10]

With respect to accounts introduced on a fully disclosed basis to clearing firms in the securities industry,[11] a clearing firm will have a formal relationship with any financial institution with which it has executed a clearing or carrying agreement pursuant to New York Stock Exchange or NASD rules.[12] Thus, a clearing firm is required to perform due diligence pursuant to the correspondent account rule with respect to its carrying agreements with a foreign financial institution.[13] However, a clearing firm will not have a formal relationship, and thus will not have an "account" subject to the due diligence provisions of the correspondent account rule, with a foreign financial institution introduced under a clearing or carrying agreement unless the clearing firm engages in activities that obligate it to make a suitability determination with respect to securities transactions conducted through the introduced accounts.[14]

We caution that this interpretation should not be construed as limiting the anti-money laundering obligations of clearing firms under our rules.[15] The risks of money laundering and terrorist financing do not stop at an introducing firm's back door. In a relationship

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[9] 31 C.F.R. § 103.176(a)(2)(i)

[10] *See infra* note 6 and accompanying text.

[11] We have limited this interpretation of the responsibilities of introducing and clearing firms to those in the securities industry. We will address the application of the correspondent account rule to introduced business in the futures industry separately.

[12] *See* NYSE Rule 382 and NASD Rule 3230.

[13] *See* NYSE Rule 382.

[14] In a typical relationship between a clearing firm and an introducing firm, the introducing firm and not the clearing firm will recommend securities transactions or strategies to the accountholder of an introduced account, requiring it to inquire, for example, into the financial status, the investment objectives, and the risk tolerance of the account holder. *See* NASD Rule 2310 ("[in recommending to a customer the purchase, sale or exchange of any security, a member shall have reasonable grounds for believing that the recommendation is suitable for such customer upon the basis of facts, if any, disclosed by such customer as to his other security holdings and as to his financial situation and needs"). *See also* NASD IM-2310-3 ("[m]embers' responsibilities include having a reasonable basis for recommending a particular security or strategy, as well as having reasonable grounds for believing the recommendation is suitable for the customer to whom it is made"). In circumstances where a clearing firm establishes the type of relationship that would cause it to recommend securities or strategies to an introduced accountholder, which would subject it to compliance with the suitability rule, the clearing firm would be establishing a formal relationship with the introduced accountholder that would subject it to the due diligence requirements of the correspondent account rule.

[15] *See* 31 C.F.R. § 103.120(c) (anti-money laundering program requirements for registered securities broker-dealers). Additionally, this interpretation of the section 312 rules does not supersede prior guidance regarding the application of the Customer Identification Program rules that we jointly issued with the Securities and Exchange Commission and the Commodity Futures Trading Commission. *See* Customer Identification Programs for Broker-Dealers, 68 Fed. Reg. 25113 (May 9, 2003); Customer Identification Programs for Futures Commission Merchants and Introducing Brokers, 68 Fed. Reg. 25149 (May 9, 2003).

with an introducing firm, a clearing firm must consider the money laundering risks posed by the introducing firm, including any information the clearing firm acquires about the account base of the introducing firm in the ordinary course of its business and through the application of its anti-money laundering policies, procedures, and controls.

A clearing firm's anti-money laundering program should contain risk-based policies, procedures, and controls for monitoring introduced business, which includes knowing whether the introducing firm may establish or maintain correspondent accounts for foreign financial institutions and the nature and scope of that business, including the nature of the introducing firm's account base. The program additionally should address circumstances that may warrant gathering any necessary and appropriate information about specific accounts of the introducing firm in high-risk situations. The clearing firm also should have established risk-based policies, procedures, and controls to monitor and mitigate the money laundering risk of the business introduced to it and to detect and report suspicious activity attempted at or conducted through the clearing firm.[16]

### 3. Obligations of Clearing Firms under the Private Banking Account Rule

In the preamble to the Final Rules, we describe how introducing and clearing firms in the securities and futures industries may apportion due diligence functions for the purposes of complying with the private banking rule.[17] We have been asked to clarify whether we meant to impose obligations on clearing firms in the securities industry to perform due diligence on introduced private banking accounts pursuant to the private banking rule.[18]

We did not intend to impose such an obligation on clearing firms in all instances. When a clearing firm does not impose aggregate minimum account requirements of not less than $1,000,000 on an introduced account for a non-U.S. person and does not assign an officer, employee, or agent to act as a liaison between the clearing firm and such an account, the introduced account will not be considered a private banking account of the clearing firm.[19]

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[16] *See* 31 C.F.R. § 103.19(a)(2).

[17] In the preamble at footnote 68, we wrote "where [introducing and clearing firms in the securities and futures industries] maintain a private banking account for a customer . . . [a]ny apportionment of [due diligence] functions between such 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." Final Rules, 71 Fed. Reg. at 508.

[18] We have limited this interpretation to clearing and introducing firms in the securities industry. We will address the application of the private banking rule to introduced business in the futures industry separately.

[19] A "private banking account" is defined in the Final Rules as "an account (or . . . combination of accounts) . . . maintained at a covered financial institution that . . . [r]equires a minimum aggregate deposit of funds or other assets of not less than $1,000,000 . . . [i]s established on behalf of or for the benefit of one or more non-U.S. persons who are direct or beneficial owners of the account [and is] assigned to, or is administered or managed by, in whole or in part, an officer, employee, or agent of a covered financial institution acting as a liaison between the covered financial institution and the direct or beneficial owner of the account." 31 C.F.R. § 103.175(o).

We caution that this clarification should not be interpreted as limiting the anti-money laundering program obligations of clearing firms under our rules.[20] In a relationship with an introducing firm, a clearing firm must consider the money laundering risks posed by the introducing firm, including any information the clearing firm acquires about the account base of the introducing firm in the ordinary course of its business and through the application of its anti-money laundering policies, procedures, and controls.

A clearing firm's anti-money laundering program should contain risk-based policies, procedures, and controls for monitoring introduced business, which includes knowing whether the introducing firm may offer or maintain private banking accounts to non-U.S. persons and the nature and scope of that business. The program additionally should address circumstances that may warrant gathering any necessary and appropriate information about specific accounts of the introducing firm in apparently high-risk situations. The clearing firm also should have established policies, procedures, and controls to monitor and mitigate the money laundering risk of such introduced business and to detect and report suspicious activity attempted at or conducted through the clearing firm.[21]

**4. <u>Determining Whether a Foreign Entity is a "Foreign Financial Institution"</u>**

We have additionally been asked to clarify the term "foreign financial institution" as it has been defined for the purposes of applying the correspondent account rule. It has been suggested that that the legal analysis required to determine which foreign entities would be broker-dealers, futures commission merchants, or mutual funds "if [they] were located in the United States"[22] will be extremely difficult. With respect to mutual funds, it has been further suggested that applying the definition of "investment company" under the Investment Company Act of 1940[23] is a complex matter, often requiring the advice of specialized legal counsel.

We recognize the difficulty in determining whether a foreign person would be required to register in the United States as a broker-dealer, futures commission merchant, or mutual fund, which would result in such entity falling within the definition of "foreign financial institution" under the correspondent account rule.[24] We did not intend that compliance with the correspondent account rule would require covered financial institutions to undergo complex and exhaustive legal analyses to determine which foreign entities would be foreign financial institutions under the rule, and we did not expect that a

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[20] *See supra* note 15.

[21] 31 C.F.R. § 103.19(a)(2).

[22] 31 C.F.R. § 103.175(h)(1)(iii).

[23] 15 U.S.C. 80a–1 et seq.

[24] For purposes of the correspondent account rule, a "foreign financial institution" includes a broad range of entities, including foreign banks, broker dealers, futures commission merchants, mutual funds, currency dealers or exchangers, and money transmitters. *See* 31 C.F.R. § 103.175(h).

covered financial institution would establish with legal certainty that a foreign entity is one that, if located in the United States, would require the kind of registration that would result in it being a "foreign financial institution" under the rule. Rather, we intended that covered financial institutions, as part of their overall risk-based due diligence effort, would conduct enough of an inquiry of a foreign entity for which it is establishing, maintaining, administering, or managing a correspondent account to draw a general conclusion as to whether that institution would be a broker dealer, futures commission merchant, or a mutual fund in the United States, and thus subject to the due diligence provisions of the correspondent account rule. For example:

- Whether a foreign entity would be a broker-dealer if located in the United States, as opposed to an investment adviser, for instance, may be determined from the responses to such questions as: (1) whether it is a member of a securities exchange, other organized securities markets, or a clearinghouse for securities in the jurisdictions in which it operates; (2) whether it underwrites securities or otherwise helps bring new issues to market; (3) whether it formally acts as a market maker on an exchange, trading system, or otherwise; (4) whether it holds itself out as promoting liquidity to the market or otherwise is looked to as a source of liquidity to market professionals or the public; (5) whether it provides services to investors, such as handling money and securities, extending credit, lending securities, or giving investment advice; (6) whether it advertises or otherwise lets others know that it is in the business of buying and selling securities; or (7) whether it manages accounts for customers or clients solely as a fiduciary;

- Whether a foreign entity would be a futures commission merchant if located in the United States can be determined from the responses to questions regarding: (1) whether it solicits or accepts orders to purchase or sell futures or commodity option contracts in the jurisdictions in which it operates; and (2) whether it accepts any money, securities, or other property to margin, guarantee, or secure solicited or accepted trades or contracts;[25] and

- Whether an offshore fund would be a mutual fund in the United States may be determined from the responses to questions in connection with: (1) whether its shares are continuously offered; (2) whether it has more than 100 beneficial shareholders; and (3) whether its shares are offered to the general public in its home jurisdiction, or whether they are offered exclusively to purchasers who qualify under certain minimum asset or sophistication requirements.[26]

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[25] 7 U.S.C. 1a(20).

[26] *See, e.g., Touche, Remnant & Co.*, 1984 SEC No-Act. LEXIS 2566 (Aug. 27, 1984) (analyzing section 3(c)(1) of the 1940 Act as it applies to foreign funds operating in the United States) and *Goodwin, Procter*

Additionally, it has been suggested that it would be "difficult to determine which foreign entities would be considered a U.S. currency dealer or exchanger or money transmitter covered by the rule." We do not believe that conducting a reasonable inquiry into the nature of a foreign entity's business for the purposes of identifying such institutions as currency dealers or exchangers or money transmitters is complex. Whether a foreign entity would be considered a "foreign financial institution" for the purposes of the correspondent account rule depends on whether it "is *readily identifiable* as . . . [a] currency dealer or exchanger[,] or [a] money transmitter."[27] Though we expressly noted that the definition of currency dealer or exchanger and money transmitter does not correspond to the definition of such institutions contained in our rules,[28] to determine whether a foreign entity is operating functionally as a currency dealer or exchanger or money transmitter we would encourage securities and futures firms to use our definitions as a starting point.[29]

Finally, we remind securities and futures firms that the correspondent account rule supplements their anti-money laundering obligations[30] – it does not supersede such obligations. A securities or futures firm's anti-money laundering program should contain policies, procedures, and controls for conducting appropriate, ongoing due diligence on foreign entities including, among other things, whether or not they are foreign financial institutions for the purposes of the correspondent account rule. Such policies, procedures, and controls should include, where appropriate, ascertaining the foreign entity's ownership and the nature of its business. In high-risk situations involving any account, an anti-money laundering program should include provisions for obtaining any necessary and appropriate information about the customers underlying such an account. The anti-money laundering program additionally should contain risk-based provisions for monitoring and mitigating the money laundering risk such entities may present, and for detecting and reporting suspicious activity in such accounts.

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*& Hoar*, 1997 Sec No-Act. LEXIS 375 (Feb. 28, 1997) (analyzing sections 3(c)(1) and 3(c)(7) as they apply to foreign funds operating in the United States).

[27] 31 C.F.R. § 103.175(h)(1)(iv) (emphasis added). We additionally have limited the definition to exclude those entities that may offer currency or money transmission services only incidentally. *Id*. *See also Final Rules*, 71 Fed. Reg. at 502.

[28] *See id.* at note 36.

[29] *See* 31 C.F.R. § 103.11(uu). The definitions of currency dealer or exchanger and money transmitter in 31 C.F.R. § 103.11(uu) cover a significant number of small financial institutions operating in the United States. See Definitions Relating to, and Registration of, Money Services Businesses, 64 Fed. Reg. 45438 (Aug. 20, 1999). The definitions in the section 312 rules were meant to capture larger foreign financial institutions located outside of the United States that engage in the business of dealing in or exchanging currency or transmitting money, which institutions would not be a foreign financial institution as the term is defined in 31 C.F.R. § 103.175(h)(1)(i)-(iii). Thus, we limited the definition of currency dealer or exchanger and money transmitter in the section 312 rules to those that are "readily identifiable" as such. *See supra* note 27.

[30] *See supra* note 15.

## 5. Evaluating the Purpose and Anticipated Activity of an Account

The correspondent account rule identifies "[t]he type, purpose, and anticipated activity of [a] correspondent account" as one of the relevant factors that should be considered, to the extent such is appropriate, in a securities or futures firm's risk assessment of a foreign financial institution for which it establishes, maintains, administers, or manages a correspondent account.[31] We have been asked whether securities and futures firms could limit their consideration to the "money movements" anticipated in accounts covered by the rules and not on the transactions in securities or futures or commodity option contracts through the account when considering the type, purpose, and activity of a securities or futures account.

We have determined they cannot. Correspondent accounts are used in the securities and futures industries, for example, when a market participant that does not have direct access to a market or membership in a clearinghouse may use the facilities of a market participant with such access or membership to execute and process trades on its own behalf or on behalf of its customers. Correspondents additionally may use such facilities to deliver funds or assets to a depository, custodial, or other carrying institution.

Illicit activity is not limited to the movement of funds. Money launderers may trade securities or futures or commodity option contracts as they layer transactions or integrate criminal proceeds with apparently legitimate proceeds. Thus, in considering the type, purpose, and anticipated activity of a correspondent account being established, maintained, administered, or managed for a foreign financial institution, securities and futures firms should consider the anticipated securities activities or futures and commodity options trading in a correspondent account as well as the use of the account for the purposes of moving funds when performing due diligence on or monitoring the activity of a correspondent account subject to the provisions of the correspondent account rule.[32]

For example, in situations where it is appropriate to consider the "type, purpose, and anticipated activity of [a] correspondent account,"[33] we expect that securities and futures firms will base their determinations of anticipated activity of a new correspondent account in part on the information they gather when they qualify the foreign financial institution as an account, as appropriate. Securities and futures firms additionally may base their determinations on experiences with like accounts for other similarly situated financial institutions, if appropriate.[34] For existing correspondent accounts, we expect

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[31] Similar provisions were contained in the private banking rule. *See* 31 C.F.R. § 103.178(b)(4) (requiring securities and futures firms to "[r]eview the activity of the account to ensure that it is consistent with the information obtained about the client's . . . stated purpose and expected use of the account").

[32] We would interpret similarly the "stated purpose and expected use" provision of the private banking rule. *See supra* note 31.

[33] 31 C.F.R. § 103.176(a)(2)(ii). *See also infra* note 5 and accompanying text.

[34] Types of correspondent accounts for which a securities or futures firm may determine that considering the account's purpose and anticipated activity are appropriate may include a new correspondent account

that securities and futures firms will base their initial consideration of purpose and anticipated activity on their past experiences with the foreign financial institution, to the extent that such relates to how the account is presently being used. In the event that a foreign financial institution begins to use an account for purposes and activities not previously considered or anticipated, securities and futures firms' due diligence programs should include provisions for reviewing the new use to ensure that it does not indicate suspicious activity and, when appropriate, for reevaluating the account in light of its new purpose.[35]

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with a foreign broker-dealer or futures commission merchant for the purpose of executing and clearing customer trades for such foreign financial institution, for which the information gathered during qualification of the financial institution may be relevant and applicable. Examples of types of accounts for which experiences with similarly situated financial institutions may be appropriate include a new correspondent account with a foreign broker-dealer or futures commission merchant for proprietary trading, or a new correspondent account with a foreign mutual fund seeking to trade securities in the U.S. markets or to protect its positions or portfolio.

[35] With respect to private banking accounts that may be established, maintained, administered, or managed by securities and futures firms, the purpose of the account and the expected use likely will correspond directly with a particular account program that a securities or futures firm has established with an aggregate account minimum of $1,000,000 and specialized liaison services. In the event that a private banking customer begins to use an account for new purposes the securities or futures firm should reevaluate the account and should commence monitoring the account for the anticipated activity associated with the new purpose, if necessary and appropriate in light of the circumstances.