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# Anti-Money Laundering Issues for Securities Transfer Agents

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# Caveat

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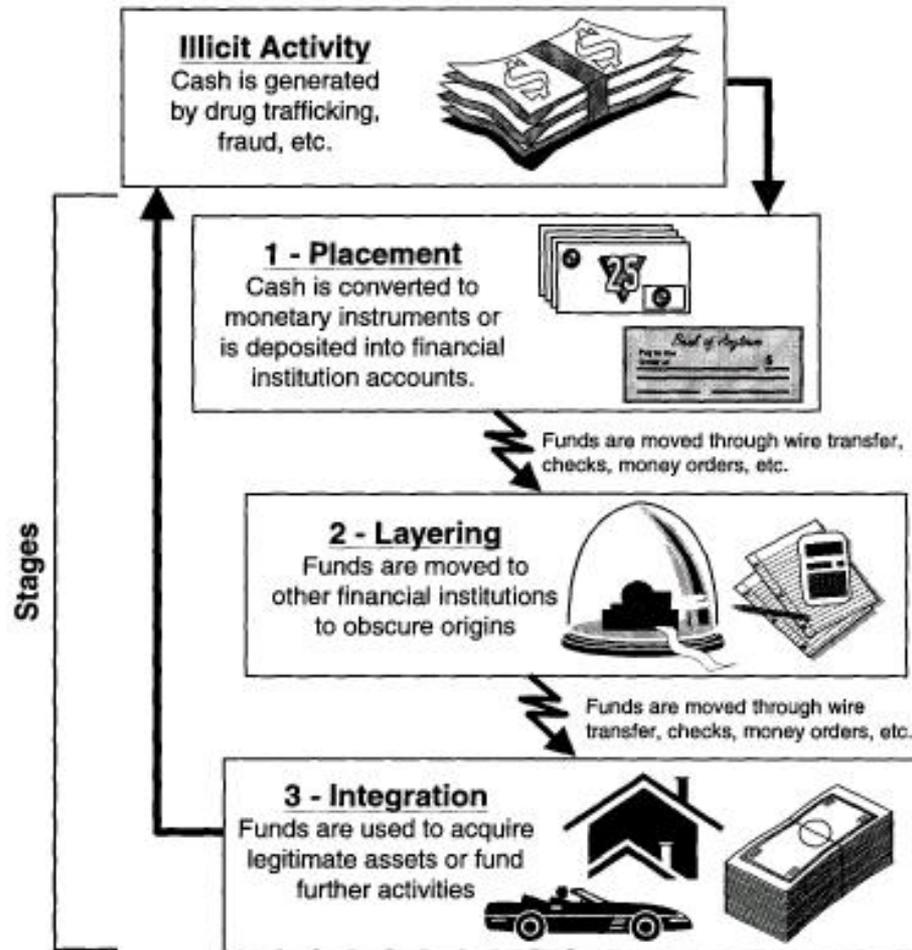
- This outline and the oral presentation that accompanies it are for informational purposes only and are neither intended to nor should be construed as legal advice or a legal opinion applicable to any particular set of facts or to any individual's or entity's general or special circumstances.

# I. What is Money Laundering?

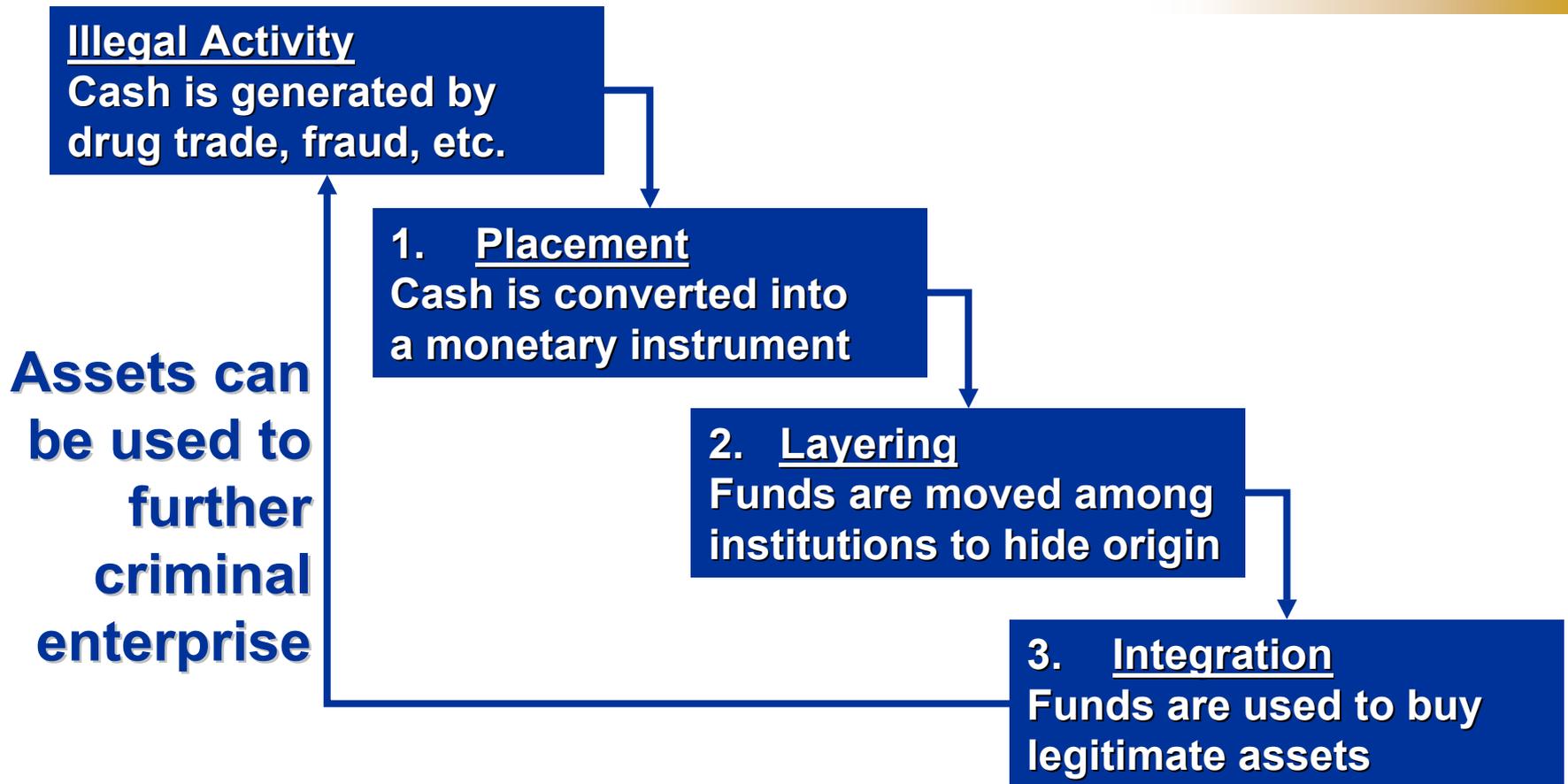
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- The process by which monetary proceeds of illegal activity are transformed into those that appear to have come from legitimate sources.
- “Reverse money laundering”
  - Legally derived funds are channeled through circuitous routes to fund terrorism, *e.g.*, through charitable organizations.

# How is Money Laundered?



# Easy as One, Two, Three



# Common Money Laundering Methods and Schemes

- Use of cash-equivalents – money orders, travelers checks, cashier’s checks, foreign bank drafts and bearer securities
- Use of smurfs and “structuring” schemes
- Use of front businesses and fictitious entities
- Use of offshore legal structures and shell banks
- Use of offshore wire transfers
- Credit/debit cards
- Trade-based money laundering schemes
- Use of mutual funds

# Structuring

- Many money laundering schemes involve structuring.
- Structuring involves the breaking down of cash in amounts less than \$10,000 or \$3,000 to avoid the recordkeeping and reporting requirements applicable to financial institutions. It can occur on one or more days at one or more financial institutions.
- “Financial institutions” engaging in funds transfers must identify customers sending \$3,000 or more and sellers of money orders and travelers checks must identify customers who purchase cash equivalents with cash<sup>7</sup> i.e. money orders



# How Large is The Problem?

- The IMF has estimated that worldwide money laundering accounts for between 2 and 5% of the world's annual gross national product -- \$800 billion to \$2 trillion each year.
- Increasing globalization and increasing facility to transact business over the internet without regard for political boundaries will make money laundering an even greater problem for both governments and legitimate businesses in the 21<sup>st</sup> century.
- The focus of Government efforts to combat money laundering shifted after the September 11, 2001 attacks to also preventing terrorist activity.

## II. Why Do All Financial Services Industry Players Including Securities Transfer Agents Need to be Concerned about Money Laundering?

The Risk Exposure from Money Laundering is Significant

- Since September 11, 2001, money laundering has become a front burner issue for everyone in the United States. The policy in the United States to crack down on illegal money laundering through anti-money laundering (AML) efforts strong, clear and expanding.
- **Compliance Risk.** All businesses providing financial services face increased compliance risk for money laundering for violation of:

- USA Patriot/Bank Secrecy Acts and Regulations (31 USC 5311-5355; 31 CFR 103)



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- **Legal Risk.** Financial services businesses and professionals have serious potential “Aiding and Abetting” criminal liability under 18 USC 1956-1957 (federal anti money laundering statutes) and U.S. Department of Justice Prosecution Manual and U.S. Sentencing Commission Guidelines
  - **Operational Risks.** There are a number of other operational risks a financial services business like a transfer agent can suffer if it does not pay attention to money laundering:

- Violation of contractual relationships with principal
- Diminished ability to obtain new servicing contracts



- Falling behind other competitors
- Jeopardize operating licenses/charters
- Inability to respond quickly to money laundering issues when they do arise
- Compliance with AML customer identification rules on data collection not dissimilar to SEC Rule 17A(d) for transfer agents

➤ **Reputational Risk.** Getting ensnared in an antimoney laundering imbroglio can result in serious reputational risk exposure

- No valid excuse for participation (even unwitting) in money laundering for terrorists or other threats to national security
- Programs for compliance with SEC record-keeping



### III. How Does Someone in the Financial Services Industry Minimize Risk Exposure to Money Laundering Activity?

Let's talk common sense – not legal requirements or consultant recommendations. In 1998, the Financial Action Task Force (FATF) suggested four “best practices” for AML prevention by financial services businesses

#### 1. Adopt an Antimoney Laundering Compliance Program

- Develop internal policies, procedures and controls
- Designate a compliance officer at the management level
- Develop an ongoing employee training program
- Use an audit function to test the system

#### 2. Implement Customer Identification and



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### 3. **Suspicious Activity Reporting**

- Monitor large transactions with no apparent purpose
- Investigate and report suspicious transactions to regulatory or law enforcement authorities

### 4. **High Risk Transaction Monitoring**

- Use special or “enhanced” due diligence and monitoring of transactions from “bad boy” (FATF noncompliant countries which do not have adequate AML requirements).

All four of these “best practices” were incorporated into U.S. law upon the adoption of the USA Patriot Act in 2001.

### III. What Are the Basic AML Statutes in the U.S. And Who Enforces Them

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1. Basic US AML statutes
  - a. Bank Secrecy Act (“BSA”)
    - Enacted in 1970 as “The Currency and Foreign Transactions Reporting Act”
    - Has nothing to do with secrecy
    - Required “financial institutions” (banks and securities brokers) to keep records of customer accounts and transactions and report certain cash transaction to the U.S. government

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- b. USA PATRIOT Act (“Patriot Act”) (Public Law No. 107-56)
- Enacted in 2001 following September 11
  - Title III of Patriot Act (The International Money Laundering Abatement and Anti-Terrorist Financing Act of 2001) deals with control international money laundering and financing of terrorism
  - Required most financial institutions to implement written AML compliance programs (although this requirement has been deferred for insurance companies and other classes of financial institutions which do not regularly deal in cash and currency).

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c. U.S. Code

- The Patriot Act effectively amended the BSA
- Major provisions of both acts are codified at 31 U.S.C. 5311-5355
- These codified statutes are frequently referred to as the Bank Secrecy Act

d. Money Laundering Control Act of 1986 (Public Law No. 99-570, §1351-52)

- Codified at 18 USC 1956-1957
- Made money laundering a criminal offense



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e. Internal Revenue Code Section 6050I and 31 U.S.C. 5331(a)

- Requires persons engaged in non-financial trades or businesses who do qualify as “financial institutions” under the BSA to report to IRS and FinCEN the receipt of \$10,000 or more in cash and monetary instruments in a trade or business transaction

- “Financial institutions” subject to BSA regulations make the filings with FinCEN only and are not required to report to IRS. 31 CFR 103.22



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## f. OFAC Laws

- Eight laws passed by Congress imposing economic sanctions on various countries
  - Generally called “OFAC laws”
  - Assets of those governments, its citizens, drug traffickers and suspected terrorists can be frozen or “blocked”
  - Administered by Treasury Department Office of Foreign Asset Controls
  - OFAC laws have nothing to do with money laundering

## 2. Who Regulates AML in the United States?

### ➤ U.S. Treasury Department

- Financial Crimes Enforcement Network (FinCEN)
- Office of Foreign Asset Control (OFAC)
- Internal Revenue Service (IRS)

### ➤ U.S. Government Functional Regulators

- Federal Reserve System (bank holding companies)
- Office of Comptroller of Currency (OCC – national banks)
- Office of Thrift Supervision (OTS – federal thrifts)
- Federal Deposit Insurance Corp. (FDIC - state banks)
- National Credit Union Administration (NCUA-federally insured credit unions)
- Securities Exchange Commission (SEC – public markets)
- Commodity Futures Trading Commission (CFTC – futures markets)

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- U.S. Department of Justice
  - Securities Industry Self Regulatory Organizations
    - National Association of Securities Dealers
    - Stock Exchanges

# IV. Transfer Agents and AML

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## 1. Introduction

- Transfer agents have differing compliance burdens for AML issues depending upon their charter, owner and customer base

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- There are three conceptual models of securities transfer agent (TA) for AML analysis are
    - A. **Financial Institution TA.** TAs which are “financial institutions” for purposes of the Bank Secrecy Act. This means:
      - Banks (including trust companies)
      - Bank owned subsidiaries
      - Bank holding company owned subsidiaries/affiliates

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- B. Financial Institution Servicer TA.** TAs which do not themselves directly qualify as “financial institutions” for purposes of the Bank Secrecy Act but serve as agents for companies which are “financial institutions”
- TAs providing services to mutual funds which are covered as financial institutions under BSA
- c. Private TA.** TAs which neither are nor serve as agent for a financial institution for purposes of the Bank Secrecy Act
- TA which is not a bank or bank owned and which serves no companies qualifying as financial institutions

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- The AML compliance responsibilities a TA has depend to a significant extent on the conceptual model which its operations most closely resemble
    - Financial Institution TA** – greatest responsibility
    - Financial Institution Servicer** – intermediate responsibility
    - Private TA** – limited responsibility (at present)

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- AML compliance obligations fall most heavily on “financial institutions”, as that term is defined in BSA
  - The BSA, at 31 USC 5312(a)(2), defines “financial institution” to include inter alia
    - A bank insured by FDIC
    - A trust company
    - A private banker
    - The US branch of a foreign bank
    - A broker-dealer

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- An investment company
  - An insurance company
  - Any business \*\*\* which engages in any activity which the Secretary of the Treasury determines, by regulation, to be an activity which \*\*\* related to \*\*\* any activity in which any business described in this paragraph is authorized to engage”
  - “Financial institution”, as defined in 31 USC 5312(a)(2), is subject to varying AML compliance obligations in the BSA
  - The Treasury Department (FinCEN) defines “financial institution” in its regulations (31 CFR 103.11) more narrowly than the BSA. It has issued regulations temporarily deferring the obligations of certain types of BSA defined “financial institutions” to have AML



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- A securities transfer agent does not presently fall within the definition of “financial institution” under the BSA or its FinCEN regulations and, absent the presence of other factors, would not generally be subject to the AML compliance requirements of the BSA (although it is subject to OFAC and the filing for receipt of more than \$10,000 in cash under IRC 6050I and 31 USC 5331(a))
  - **Financial Institution TAs** are financial institutions subject to BSA because, as banks, they fit within the definition of a “financial institution” under 31 USC 5312(a)(2)

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- Financial Institution Servicer TAs do not directly fall under the definition of financial institution at the present time (unless they are banks). But Financial Institution Servicer TAs perform transfer agent services for mutual funds which are financial institutions. Since mutual funds are currently subject to many AML requirements of the BSA (except suspicious activity reporting), they normally delegate responsibility for the provision of these AML compliance services to the transfer agent in the transfer agency agreement. In other words, the source of the transfer agent's AML responsibilities is contractual, not regulatory.



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- In addition to mutual funds, transfer agents may provide securities transfer services to other types of client companies, which also qualify as financial institutions (and have AML compliance responsibilities some of which could be contractually delegated to a transfer agent). Among the types of transfer agent client companies that are treated as financial institutions under the BSA are
    - Insurance companies
    - Unaffiliated banks or bank holding companies
    - Operators of credit card systems
    - Dealers in precious metals

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- Travel agencies
  - Businesses engaged in vehicle sales
  - Casinos and gaming establishments
- Some of these financial institutions are currently obligated to have AML policies under the BSA and FinCEN regulations. Others, like insurance companies, are temporarily exempted from this requirement.
- Unlike mutual funds which do not have employees and therefore commonly delegate AML compliance issues to their transfer agents, a publicly held insurance company (for example) can be expected to have significant in-house AML

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- Private TAs are not financial institutions and neither are their client companies. As a result they will have minimal AML compliance duties. These are generally limited to OFAC and IRC 6050I/31 USC 5331(a) compliance.
  - While not probable at this time, it is conceivable that the U.S. Treasury Department could determine by regulation that all transfer agents should be treated as “financial institutions” under 31 USC 5312(a)(2)(Y) because transfer agency services are similar or related to services which other businesses described in 31 USC 5312(a)(2)(Y) (i.e., banks or trust companies) are



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## 2. Specific AML laws and their applicability to transfer agents

- As noted above, some AML laws apply to all three of the conceptual models of transfer agency outlined above (i.e., OFAC laws). Others apply only to some of the conceptual models. (i.e., IRC 6050I and BSA). This section of the presentation will outline which AML requirements apply to each conceptual model.

## A. OFAC

### What is OFAC?

The Office of Foreign Assets Control (OFAC) is an agency within the U.S. Treasury Department

### What does OFAC do?

OFAC has nothing to do with money laundering. It enforces U.S. foreign policy and national security objectives, not anti-money laundering laws.

OFAC administers economic and trade sanctions programs against certain countries, individuals or parties from sanctioned countries, terrorists and narcotics traffickers

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The “Trading with the Enemy Act” dates back to 1861. It is still the law and OFAC enforces it. OFAC also administers and enforces sanctions under seven other federal statutes and presidential declarations involving national emergency powers.

## **Who is subject to the OFAC laws?**

Every person or business in the U.S., including all securities transfer agents.

## General Rule for OFAC Compliance

- All trade or financial dealings with the following blocked entities are generally treated as prohibited transactions:
  - Designated Foreign Countries (and in certain cases their nationals)
  - Specially Designated Nationals (SDN)
  - Blocked Persons
    - Securities dealings with these blocked entities are generally prohibited. Blocked securities may not be paid, withdrawn, transferred (even in book transfer), endorsed, guaranteed or otherwise dealt in.
  - Exemptions and licenses are sometimes available from OFAC

## Designated Foreign Countries

- Countries with which the United States has embargoes
    - Balkans
    - Burma (Myanmar)
    - Libya
    - North Korea
    - Sierra Leone
  - Sudan
  - Cuba
  - Iran
  - Iraq (all assets blocked as of 5/23/2003)
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- Embargoes generally apply only to the government of the embargoed country and any banks or entities it controls
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- In certain cases, the embargo extends to all

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## **Specially Designated Nationals (SDN)**

- Individuals, charities and commercial firms found to be “fronts” for Designated Foreign Countries
- For example, a French bank may be blocked if it is found to be a front for Libya

## **Blocked Persons**

- Individuals, charities or commercial firms blocked for other reasons
  - Terrorists
  - Drug “Kingpins”
  - Proliferators of weapons of mass destruction
  - Threats to democracy<sup>37</sup> (e.g. rebels in Zimbabwe)



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## The OFAC List

- OFAC maintains and regularly updates a list of approximately 3,500 SDNs and blocked persons. It is available at the OFAC website ([HTTP://www.treas.gov/ofac](http://www.treas.gov/ofac)).

## Rejected vs. Blocked Transactions

- Transactions with blocked countries and listed SDNs and blocked persons must not be processed or completed.
- Some transactions with citizens of most designated countries can be “rejected” without



- The embargo against most designated countries covers only the country government but not its citizens. (Cuba is one exception). If a foreign national is not on the OFAC SDN/Blocked Persons list (and there is no blocking of all citizens in the foreign country), there is no requirement to block a transfer to a national of that country. The transfer, however, is usually rejected because it cannot be completed without using or supporting the designated country's economic infrastructure—something generally prohibited by most embargoes. In that case, the foreign national

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## What Steps are Required for OFAC Compliance?

- Monitor transactions to ensure that prohibited transactions are “blocked”
- Block transactions to designated countries and nationals and anyone on the OFAC SDN/Blocked persons
- Notify OFAC within ten days of blocking the transaction

## The Reality

- Every transfer agent should have OFAC software in place to
  - Monitor transactions
  - Match information against OFAC list
- Matching names can be a problem – use a good software vendor
- Inquire into policies and procedures of brokers and clients that you deal with

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## Policies and Procedures

- Methods of monitoring transactions
  - Manual reviews
  - Use of interdiction software
  - Vendor procedures (if appropriate)
- How transfers are blocked and what happens to securities after block
- Affirmations from banks, broker-dealers and issuers that they have procedures in place to block property when required
- Cancellation of open orders on blocked



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- Notification to operating personnel of sanctioned countries for screening
  - Notification to OFAC within ten days of blocking a transfer

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## Responsible Persons

- Policies should set also forth:
  - Who is responsible within organization for oversight of OFAC procedures
  - Who is responsible for blocking transfers and filing reports
  - Who maintains records of any transfers that are blocked

## B. IRC 6050I and 31 USC 5331(a)

- Since 1985, Section 6050I of the Internal Revenue Code (26 USC 6050I) has required persons engaged in non-financial trades or businesses which did not qualify as “financial institutions” under BSA regulations to report receipt of cash in excess of \$10,000 in a single or related transactions to IRS on Form 8300. See also 26 CFR 1-6050I.

- This reporting requirement applies to all securities transfer agents unless they are “financial institutions” for purposes of BSA. 31 USC 5331(a) “Financial institutions” are required

