Dechert LLP

Financial Services

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New SEC Staff Guidance on Customer Identification Programs

In a February 12, 2004 no-action letter to the Securities Industry Association ("SIA"), the SEC's Division of Market Regulation stated that it would not recommend enforcement action against a broker-dealer that relies on a registered investment adviser ("Adviser") to perform elements of the broker-dealer's customer identification program ("CIP").[1] In addition to permitting broker-dealers to rely on Advisers for CIP purposes, the no-action relief provides significant guidance on the CIP responsibilities of broker-dealers that execute portfolio transactions for the benefit of an Adviser's clients. This Financial Services Update summarizes the no-action letter and its implications for broker-dealers and Advisers.

Background: The CIP Rules and Reliance on Other Financial Institutions

Last year, the U.S. Department of the Treasury and seven other regulators, including the SEC, issued rules requiring banks, broker-dealers, mutual funds and certain other financial institutions to implement comprehensive CIPs by October 1, 2003.[2] Under the rules, each financial institution must obtain certain minimal identifying information from each "customer" that opens a new account, verify the customer's identity, check the customer's identity against a list of known or suspected terrorists and terrorist organizations, and provide the customer with notice that information is being collected to verify the customer's identity.[3]

The rules also permit one financial institution to rely on another financial institution to perform these identification and verification responsibilities in cases where the customer "is opening, or has opened, an account or has established a similar relationship with the other financial institution to provide or engage in services, dealings or other financial transactions." Under the rules, reliance is permitted if:

- reliance is "reasonable under the circumstances";

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1 Securities Industry Association, SEC No-Action Letter (Feb. 12, 2004).

2 *See, e.g.*, 31 C.F.R. 103.122 ("broker-dealer CIP rule"); Customer Identification Programs for Broker-Dealers, 68 Fed. Reg. 25,113 (May 9, 2003) ("Preamble"). Although the regulators issued separate CIP rules for each financial institution, the provisions in the rules are substantially similar.

3 The broker-dealer CIP rule defines a "customer" generally as "a person that opens a new account," *i.e.*, a person that opens "a formal relationship with a broker-dealer established to effect transactions in securities…." 31 C.F.R. § 103.22(a)(1).

- the other financial institution is subject to a rule under the U.S. Bank Secrecy Act ("BSA") requiring it to implement an anti-money laundering ("AML") compliance program and is regulated by a federal functional regulator; and

- the other financial institution enters into a contract requiring it to certify annually to the financial institution that it has implemented its AML compliance program, and that it (or its agent) will perform the requirements of the financial institution's CIP.[4]

Importantly, a financial institution that properly relies on another financial institution to perform its CIP responsibilities will not be responsible for the failure of the other financial institution to do so.

The No-Action Relief

Advisers use broker-dealers to execute portfolio transactions for client accounts. As a result, some broker-dealers have concluded that they have "customer" relationships with the Adviser's clients, and thus must perform the identification and verification checks required by the broker-dealer CIP rule. An Adviser, however, may not wish to provide personal identifying information about its clients to broker-dealers who may be competitors. Moreover, some Advisers have questioned whether a broker-dealer in fact has a "customer" relationship with the Adviser's clients, especially in cases where the account at the broker-dealer is maintained in the name of the Adviser, rather than the client.

Because Advisers may resist providing broker-dealers with information needed to verify the identity of their clients, on January 6, 2004, the SIA asked the SEC staff to confirm that it would not recommend enforcement action against a broker-dealer that relies on an Adviser to perform the broker-dealer's CIP responsibilities. Advisers currently are not required to implement AML compliance programs under the BSA, although the Treasury Department recently proposed a rule that would subject certain Advisers to AML program requirements, and many Advisers already have implemented AML compliance programs on a voluntary basis.[5] Currently, however, under the reliance provisions of the CIP rules a broker-dealer is not permitted to rely on an Adviser to perform the broker-dealer's CIP responsibilities because Advisers are not yet *required* to implement AML compliance programs under the BSA.

On February 12, 2004, the SEC staff confirmed that it would not recommend enforcement action against a broker-dealer that relies on an Adviser to perform the broker-dealer's CIP responsibilities. The no-action relief provides that the broker-dealer would have to satisfy the other elements of the broker-dealer CIP rule's reliance provisions, namely that:

- reliance on the Adviser is "reasonable under the circumstances";

- the Adviser is regulated by a federal functional regulator; and

- the Adviser enters into a contract requiring the Adviser to certify annually to the broker-dealer that the Adviser has implemented an AML compliance program, and that the Adviser (or its agent) will perform the specified requirements of the broker-dealer's CIP.[6]

In granting the requested relief, the SEC staff implied that a broker-dealer has a "customer" relationship with an Adviser's client with respect to "a securities account

4 *See, e.g.*, *id.* § 103.122(b)(6).

5 *See* FinCEN; AML Programs for Investment Advisers, 68 Fed. Reg. 23,646 (May 5, 2003).

6 The letter states that the no-action relief is withdrawn, without further action, on the earlier of: (1) the date upon which an AML Rule for Advisers becomes effective, or (2) February 12, 2005.

opened *in the name of the [client]* at the broker-dealer." In these cases, Advisers now should expect executing broker-dealers to:

- request certain identifying information from the Adviser about its client, so the broker-dealer may verify the client's identity in accordance with its CIP; *or*

- delegate the broker-dealer's CIP responsibilities to the Adviser, by requesting that the Adviser enter into a reliance agreement with the broker-dealer whereby the Adviser agrees to certify annually that it has implemented an AML compliance program, and that it will verify the client's identity in accordance with the broker-dealer CIP rule.

This delegation, if accepted by the Adviser, would require the Adviser to develop its own CIP, even though Advisers are not currently required to maintain CIPs. Advisers that do not wish to take on this increased burden could refuse to allow a requesting broker-dealer to rely upon the Adviser to discharge its identification and verification responsibilities. In this case, however, the broker-dealer still would be required to verify the identity of the Adviser's client, and the broker-dealer may request from Adviser certain identifying information about the client in order to fulfill the broker-dealer's CIP responsibilities.

It should be noted, however, that a broker-dealer that executes portfolio transactions for an Adviser may not always have a "customer" relationship with respect to the Adviser's clients. The no-action letter notes that Advisers "may open accounts in their own name at a broker-dealer to facilitate trading on behalf of their clients until transactions can be settled to their clients' individual securities accounts at another broker-dealer or bank." An Adviser also may open an omnibus account at a broker-dealer for the benefit of the Adviser's customers. In these cases, the no-action letter states that "the Adviser, rather than the beneficial owners, would be the broker-dealer's customer."[7] Accordingly, broker-dealers and Advisers should evaluate carefully whether a broker-dealer in fact has a "customer" relationship with the Adviser's client before considering entering into a CIP reliance agreement.

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Dechert will continue to monitor anti-money laundering developments and will issue Financial Services Updates when warranted. For more information, please contact one of the attorneys listed below or the Dechert LLP attorney with whom you are in regular contact.

Stuart J. Kaswell
+1.202.261.3314.....stuart.kaswell@dechert.com

Paul Schott Stevens
+1.202.261.3348.....paul.stevens@dechert.com

Elizabeth M. Knoblock
+1.202.261.3320..... elizabeth.knoblock@dechert.com

Thomas C. Bogle
+1.202.261.3360..... thomas.bogle@dechert.com

Michael L. Sherman
+1.202.261.3449..... michael.sherman@dechert.com

Please visit us at www.dechert.com/financialservices.

[7] *Id.* Last October, the SEC and Treasury Department staffs confirmed that a broker-dealer does not have CIP obligations with respect to omnibus accounts or sub-accounts established by financial intermediaries on behalf of beneficial owners. "Even if the broker-dealer has some information about a beneficial owner of assets in an omnibus account (*e.g.*, batch execution account) or a sub-account …the financial intermediary (not the beneficial owner) should be treated as the customer for purposes of the rule." Question and Answer About the Broker-Dealer Customer Identification Program Rule, *available at* http://www.sec.gov/divisions/marketreg/qa-bdidprogram.htm (Oct. 1, 2003).