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Subcommittee on Investigations,
Committee on Governmental Affairs,
U.S. Senate

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ANTI-MONEY LAUNDERING

Efforts in the Securities Industry



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Abbreviations

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| BSA | Bank Secrecy Act |
| CFATF | Caribbean Financial Action Task Force |
| FATF | Financial Action Task Force |
| FinCEN | Financial Crimes Enforcement Network |
| GLBA | Gramm-Leach Bliley Act |
| NASD | National Association of Securities Dealers |
| NASDR | National Association of Securities Dealers Regulation |
| NYSE | New York Stock Exchange |
| SAR | suspicious activity report |
| SEC | Securities and Exchange Commission |
| SRO | self-regulatory organization |



United States General Accounting Office
Washington, D.C. 20548

October 10, 2001

The Honorable Carl Levin
Chairman, Permanent Subcommittee on Investigations
Committee on Governmental Affairs
United States Senate

Dear Mr. Chairman:

This report is in response to your request that we conduct a review of money laundering issues related to the securities industry. Money laundering is criminal activity that occurs when individuals or organizations seek to disguise or place illegally obtained funds in the stream of legitimate commerce and finance. Money launderers have traditionally targeted banks, which accept cash and facilitate domestic and international funds transfers. However, the U.S. securities markets, which are the largest and most liquid in the world, may also be targeted by criminals seeking to hide and obscure illicit funds. In response to one of the matters raised in your request, we reported in March 2001 on the status of regulatory efforts to oversee the anti-money laundering activities of certain broker-dealers affiliated with banks after the passage of the Gramm-Leach-Bliley Act (GLBA).¹

To address the remaining matters contained in your request, this report describes (1) government and industry views on the potential for money laundering in the securities industry, (2) current legal and regulatory requirements relating to anti-money laundering in the securities industry and the actions regulators have taken to oversee these requirements, (3) the efforts that broker-dealers and mutual funds have undertaken to detect and prevent money laundering, and (4) international anti-money laundering efforts relating to securities activities and the effectiveness of these efforts.

¹See *Money Laundering: Oversight of Suspicious Activity Reporting of Bank-Affiliated Broker-Dealers Ceased* (GAO-01-474, Mar. 22, 2001).

In completing our work, we interviewed U.S. and foreign officials from law enforcement and regulatory agencies, broker-dealers, mutual fund groups,² industry associations, and international bodies formed to combat money laundering. We also reviewed available documents, including domestic and foreign reports on anti-money laundering initiatives, pertinent U.S. laws and examination procedures, and proposed drafts of a suspicious activity report (SAR) rule for the U.S. securities industry. In addition, we surveyed randomly selected samples of the industry and used this information to estimate the extent to which firms in 2 key populations—3,015 broker-dealers and 310 direct-marketed, no-load mutual fund groups—had implemented measures to detect and prevent money laundering.³ We did not, however, verify the information that firms reported on their anti-money laundering measures nor did we evaluate the effectiveness of these measures, which depends on various factors such as the level of management commitment to the area. Appendix I provides more detailed information on the scope and methodology of our review, and appendix II contains an example of one of the survey instruments we administered.

We conducted our work between May 2000 and May 2001 in accordance with generally accepted government auditing standards.

Results in Brief

Although they acknowledged that the number of documented cases in which broker-dealer or mutual fund accounts have been used to launder money was limited, law enforcement agencies were concerned that criminals may increasingly attempt to use the securities industry to launder money. The agencies explained that the securities industry would more likely be used in the later stages of money laundering to obscure the origin of illegal proceeds rather than in the initial stage when cash is first placed into the financial system. Law enforcement officials believed that the large, active, and liquid nature of the U.S. securities markets, along with the

²Mutual fund groups are firms that operate one or more mutual funds.

³Our survey population of broker-dealers included firms registered as broker-dealers doing business with the public and excluded firms that conduct only proprietary trading. Our survey population of mutual fund groups predominantly market no-load mutual fund shares directly to investors, and, as such, their transactions would be subject to some anti-money laundering requirements. Our broker-dealer and mutual fund group survey populations excluded firms that were found to be subsidiaries of depository institutions or financial holding companies; survey responses of any firm indicating such an affiliation were included in our analysis of a separate survey administered to broker-dealer subsidiaries of bank holding companies.

ability to quickly move funds through wire transfers among accounts and to other financial institutions worldwide, make the securities industry attractive to money launderers. Industry regulators and representatives also acknowledged that money launderers may target the securities industry. However, the extent to which broker-dealers and mutual funds are actually used for money laundering is not clear. In addition, the industry's overall vulnerability is impacted by the extent to which it is covered by anti-money laundering requirements, overseen by regulators, and mitigated by the anti-money laundering measures implemented by broker-dealer and mutual fund firms.

Currently, most broker-dealers or firms that process customer payments for mutual fund groups⁴ are subject to all U.S anti-money laundering requirements. They are required to adhere to the reporting and recordkeeping requirements relating to currency and other transactions arising under the Bank Secrecy Act (BSA) that are designed to detect illegal financial activity, including the requirement to report cash deposits exceeding \$10,000. But unlike banks and other depository institutions, most of these firms are currently not required to report suspicious activities that could be evidence of money laundering. Most of these firms are also not subject to related requirements such as developing written policies and procedures for monitoring suspicious activities and providing formal training to help employees identify suspicious activities. The Department of the Treasury is in the process of developing a rule requiring broker-dealers to report suspicious activities related to money laundering and anticipates that such a rule will be issued for public comment by the end of 2001. To develop this rule, Treasury is working closely with the Securities and Exchange Commission (SEC) to resolve several issues, including the appropriate dollar threshold for reporting suspicious activities and the types of activities that should be reported. SEC and self-regulatory organizations (SRO), such as the New York Stock Exchange (NYSE) and the National Association of Securities Dealers Regulation (NASDR), conduct periodic examinations to ensure that the broker-dealers that they oversee adhere to these BSA reporting and recordkeeping requirements related to currency and other transactions that currently apply to broker-dealers.

⁴Firms that process customer payments for mutual fund groups include transfer agents that maintain records of fund shareholders and distributors that sell mutual fund shares to investors.

On the basis of the responses to our survey, some of the 3,015 broker-dealers and the 310 direct-marketed mutual fund groups (including the firms that process their customer payments)⁵ in our survey populations reported undertaking voluntary anti-money laundering efforts that go beyond applicable BSA reporting and recordkeeping requirements. Our survey results showed that more than 90 percent⁶ of broker-dealers or mutual fund firms never accept cash, thereby reducing their vulnerability to the initial stage of money laundering when illicit funds are first placed into the financial system.⁷ Many direct-marketed mutual fund groups and some broker-dealers accept monetary instruments, such as money orders and traveler's checks. These monetary instruments can be used by money launderers as part of attempts to structure deposits to avoid BSA currency-reporting requirements.⁸ Beyond currency-related restrictions, we found that most firms have yet to implement other types of voluntary anti-money laundering measures, including written policies and procedures to identify and report suspicious activities. Overall, 17 percent of broker-dealers and 40 percent⁹ of direct-marketed mutual fund groups in our survey populations did report implementing such voluntary anti-money laundering measures. Larger firms, which hold most of the industry's assets and accounts were more active as an estimated 70 percent of the 111 large broker-dealers and the 15 large mutual fund groups¹⁰ in our survey

⁵Our survey instructed mutual fund groups to include the anti-money laundering policies and procedures of transfer agents or principal underwriters that processed payments for fund share purchases or redemptions. These entities, not the mutual funds, are subject to BSA reporting and recordkeeping requirements because many are either banks or broker-dealers. Transfer agents that are not either banks or brokers are subject to similar currency reporting requirements under the Internal Revenue Code. According to our survey results, 95 percent of the mutual fund respondents used transfer agents to process payments. Thus, the information presented in this report on mutual fund groups and their anti-money laundering efforts includes the efforts of their transfer agents as well as their own.

⁶All such estimates are subject to sampling errors, which are less than ± 10 percentage points unless otherwise noted. See appendix I for further explanation of sampling errors.

⁷Unless otherwise stated, survey results presented in this report have been projected to the survey population on the basis of firms' responses.

⁸Structuring involves an individual who makes multiple deposits of cash, each of which is below the \$10,000 threshold that must be reported to regulators but that together total more than \$10,000. Structuring can also involve multiple deposits in a financial institution consisting of monetary instruments, such as money orders, traveler's checks, or cashier's checks purchased at other financial institutions in increments less than the \$10,000 threshold.

⁹The sampling error for this estimate is ± 11 percentage points.

populations reported implementing such voluntary procedures. The largest broker-dealers—those with assets exceeding \$10 billion—had been even more active; specifically, eight of the nine largest broker-dealer respondents reported implementing nine or more voluntary anti-money laundering measures. However, our survey results also indicated that far fewer of the remaining 3,200 small and medium-sized broker-dealer and mutual fund firms¹¹ had implemented measures that go beyond the BSA requirements applicable to the securities industry or other applicable cash transaction reporting requirements.

Various intergovernmental bodies, such as the Financial Action Task Force (FATF), have worked internationally to develop recommendations that pertain to financial institutions, including securities firms. These recommendations call for member countries to take a number of actions to combat money laundering through their financial institutions, including requiring securities firms to report suspicious activities. Although many member countries reported that they have issued all or many of these recommended requirements and applied them to their securities firms, ascertaining how well the measures are being implemented and enforced is difficult. Little information related to anti-money laundering initiatives is available from foreign countries—for example, the number of SARs that securities firms have filed and the number of money laundering cases involving the securities industry. Some countries have issued their anti-money laundering requirements only recently, and it may be too early to assess how fully these requirements have been implemented. FATF also reported that limited law enforcement tools and resources in certain countries may hinder efforts to effectively implement anti-money laundering requirements.

We make no recommendations in this report. We asked Treasury, SEC, and the Department of Justice to comment on this report. In general, these agencies agreed with the information presented, and we incorporated their technical comments as appropriate.

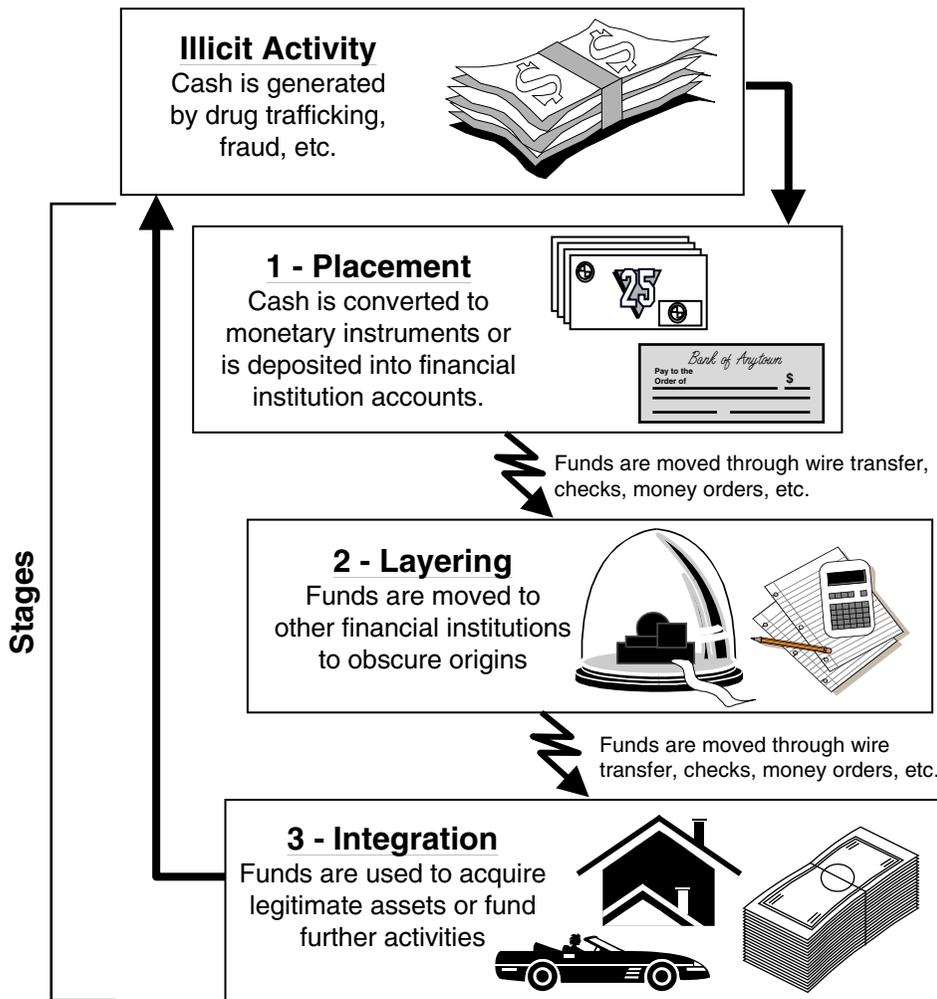
¹⁰For sampling purposes, we defined large broker-dealers as those with assets equal to or greater than \$230 million and larger mutual fund groups as those whose fund assets exceeded \$10 billion.

¹¹For sampling purposes, small broker-dealers were defined as having assets equal to or less than \$1 million. The population of direct-marketed mutual fund groups was divided into large and “other” mutual fund groups. The latter represented medium-sized and small fund groups with fund assets equal to or less than \$10 billion.

Background

Illicit activities, such as drug trafficking, robbery, fraud, or racketeering, produce cash. Money laundering is the process used to transform the monetary proceeds derived from such criminal activities into funds and assets that appear to have come from legitimate sources. Money laundering generally occurs in three stages. As shown in figure 1, in the placement stage, cash is converted into monetary instruments, such as money orders or traveler's checks, or deposited into financial institution accounts. In the layering stage, these funds are transferred or moved into other accounts or other financial institutions to further obscure their illicit origin. In the integration stage, the funds are used to purchase assets in the legitimate economy or to fund further activities.

Figure 1: Money Laundering Stages



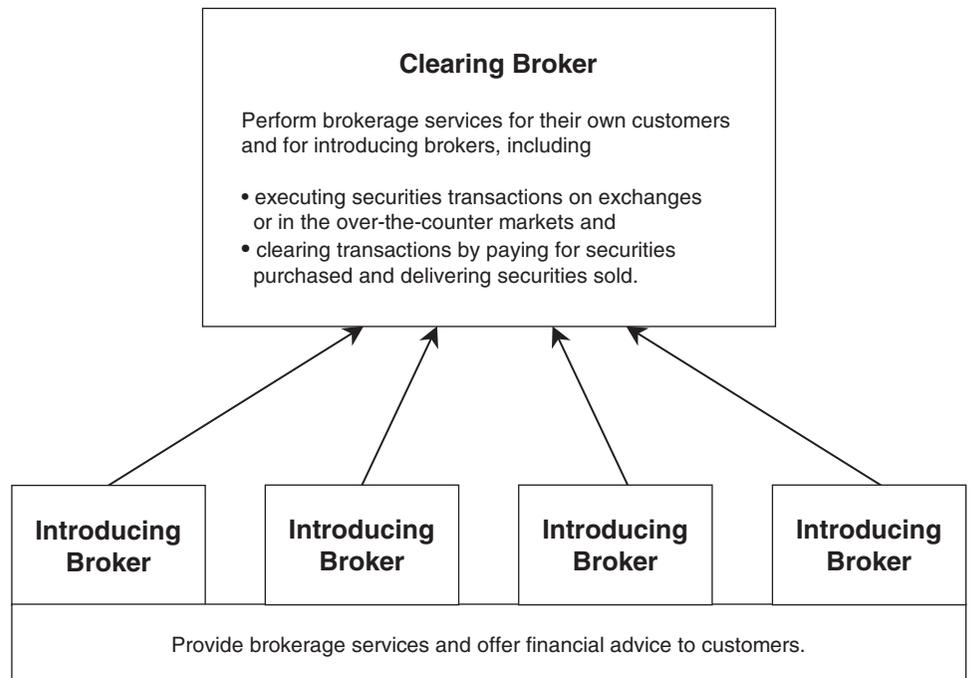
Source: *FinCEN Reference Series: An Assessment of Narcotics Related Money Laundering*, FinCEN, July 1992.

There is no way to determine the actual amount of money that is being laundered in general, let alone through a single industry such as the securities industry. However, experts have estimated that money laundering in the global financial system is between 2 to 5 percent of the world's gross domestic product. Estimates of the amount of money laundered in the United States have been as high as \$100 billion.

The Securities Industry Has Various Participants

Money launderers can target any of the various types of businesses that participate in the U.S. securities industry. Broker-dealers, for instance, provide a variety of products and services to retail (usually individual) and institutional investors—buying and selling stocks, bonds, and mutual fund shares. As shown in figure 2, two types of broker-dealers—introducing brokers and clearing brokers—perform different roles that can affect the extent of their anti-money laundering responsibilities.

Figure 2: Introducing Broker and Clearing Broker Services



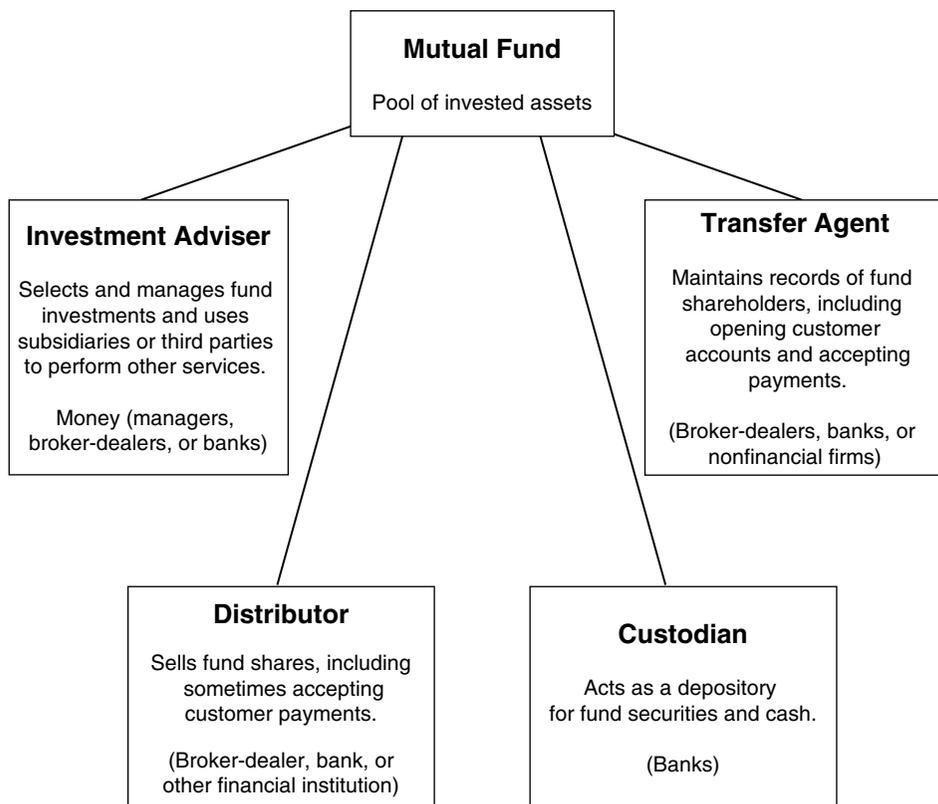
Source: Henry F. Minnerop, *The Role and Regulation of Clearing Brokers*, Henry F. Minnerop 48 Bus. Law. 841 (1993).

Some broker-dealers regulated as clearing firms may clear only their own firms' transactions and not those of other firms. These firms are known as a self-clearing firms.

Mutual funds are another major participant in the securities markets. Mutual funds are investment companies that pool the money of many investors and use it to purchase diversified portfolios of securities. The administrator of a mutual fund, which in most cases is the fund's

investment adviser, contracts with other entities to provide the various services needed to operate the fund. Figure 3 shows some of these entities, the services they perform, and some of the institutions that usually perform them. Depending on the extent to which these entities interact with the fund's customers or accept customer payments, their responsibilities for conducting anti-money laundering activities may also vary.

Figure 3: Activities of Entities Involved in Providing Mutual Fund Services



Note: In most cases, the distributor for a direct-marketed mutual fund is a broker-dealer affiliate of the fund's administrator.

Source: *Mutual Fund Fact Book 2001*, Investment Company Institute.

SEC Is the Primary Regulator of Securities Activities, but Other Organizations Also Provide Oversight

SEC has primary responsibility for overseeing the various participants in the U.S. securities industry, including broker-dealer and mutual fund firms. It promulgates regulations, performs examinations, and initiates enforcement actions against alleged violators of the securities laws. Before conducting business with the public, broker-dealers are required to register with SEC and must also join and submit to oversight by an SRO. These SROs, which include NASDR and NYSE, oversee members' compliance with their own rules, rules enacted by SEC, and the securities laws. Federal regulators of depository institutions have oversight responsibilities for banks, thrifts, and their holding companies.¹² Prior to the passage of GLBA in 1999, banks conducting securities activities directly were subject to regulation and supervision by their respective banking regulators rather than SEC. After GLBA is fully implemented, banks and thrifts conducting certain securities activities will have to do so in entities registered as broker-dealers subject to oversight by SEC and securities industry SROs.¹³ The role of the depository institution regulators, with regard to the securities activities of the entities that they regulate, now involves sharing information with SEC, although under certain circumstances these regulators may conduct examinations of the subsidiaries.¹⁴

Under current legislation governing money laundering, the Secretary of the Treasury has a variety of responsibilities. These include issuing anti-money laundering regulations applicable to financial institutions and other organizations, such as banks, broker-dealers, casinos, and money transmitters. Within Treasury, the authority to issue and administer these regulations has been delegated to the Director of the Financial Crimes Enforcement Network (FinCEN). FinCEN was established in 1990 to

¹²The Federal Reserve has supervisory responsibility for state-chartered banks that are members of the Federal Reserve System and bank holding companies. The Office of the Comptroller of the Currency is the primary regulator for nationally chartered banks (national banks). The Office of Thrift Supervision is the primary regulator of all federal and many state-chartered thrift institutions, including savings banks, savings and loan associations, and thrift holding companies. The Federal Deposit Insurance Corporation is the primary federal regulator of state-chartered banks that have federally insured deposits and are not members of the Federal Reserve System.

¹³The effective date under GLBA for depository institutions to conduct securities activities within a registered broker-dealer was May 12, 2001, but an SEC order extended this date to May 12, 2002. SEC's order will also require thrifts conducting certain securities activities to conduct such activities in a registered broker-dealer.

¹⁴See GAO-01-474.

support law enforcement agencies by collecting, analyzing, and coordinating financial intelligence information to combat money laundering.

The Securities Industry Is Viewed as a Potential Target, but the Extent of Actual Money Laundering Is Unknown

Although the extent to which broker-dealers and mutual funds are being used to launder money is not known, law enforcement officials were concerned that the securities industry would increasingly be a target for potential money launderers. All financial sectors, and even commercial businesses, could be targeted by money launderers. The securities industry has characteristics similar to other financial sectors but also has some significant differences. Criminals seeking to convert their illegal proceeds to legitimate assets have targeted banks, which take cash for deposit, as a means to initially introduce illicit income into the financial system.

Law enforcement and securities industry officials said that because securities activities generally do not involve cash, broker-dealers and mutual funds are not as vulnerable as banks during the initial placement stage of the money laundering process. However, some structuring schemes used in the placement stage involve monetary instruments such as money orders, and money launderers could attempt to use broker-dealers and mutual funds that accept these forms of payment.

According to law enforcement officials, money launderers would more likely attempt to use brokerage or mutual fund accounts in the layering and integration stages of money laundering, rather than for the placement stage. Similar to their use of banks, money launderers could use brokerage or mutual fund accounts to layer their funds by, for example, sending and receiving money and wiring it quickly through several accounts and multiple institutions. The securities industry could also be targeted for integrating illicit income into legitimate assets. In one case, illicit proceeds from food stamp fraud were used to open brokerage accounts and invest in stocks through an ongoing stream of deposits that ranged from less than \$1,000 to almost \$10,000.

Law enforcement officials were concerned that various characteristics of the securities industry and securities transactions were particularly attractive to money launderers. For example, the U.S. national money laundering strategy for 2000,¹⁵ issued by the Secretary of the Treasury and the U.S. Attorney General, notes that the general nature of the securities industry provides criminals with opportunities to move and thus obscure funds. The report suggests that money launderers may target the industry because funds can be efficiently transferred among accounts and to other financial institutions, both domestically and internationally. For example, like some banking organizations, several large broker-dealers have offices located throughout the United States and in many foreign countries. Some law enforcement officials noted that wire transfers, specifically those that involve offshore accounts, can be particularly vulnerable to money laundering. The national strategy report also suggests that money launderers may be attracted to the industry because of the high degree of liquidity in securities products, which can be readily bought and sold.

Some law enforcement officials pointed to the high volume, large-dollar amounts, and potentially profitable nature of securities transactions. On a typical day, for example, an estimated 3 billion shares of stock worth over \$85 billion are traded on the main U.S. markets—a dramatic increase from about \$20 billion in 1995. (Appendix III provides additional information on the size and growth of the U.S. securities industry.) Officials noted that the rapid growth of the securities markets and increasing popularity of investing in stocks and mutual funds may also have raised the industry's profile with money launderers, who are becoming increasingly sophisticated and are attempting to find as many avenues as possible to launder funds.

Law enforcement and securities industry officials also identified several specific financial activities that securities firms conduct and that they viewed to be more at risk for potential money laundering. For example, law enforcement officials expressed concern that on-line brokerage accounts were vulnerable to use by money launderers, and such accounts have grown substantially in the last few years, jumping from an estimated 7 million in 1998 to almost 20 million in 2000. On-line brokerage services provide little opportunity for face-to-face contact with customers or for verifying the identity of those logging into accounts—a safeguard that is

¹⁵*The National Money Laundering Strategy for 2000* issued by the Secretary of the Treasury and the U.S. Attorney General, Mar. 2000.

important to anti-fraud as well as anti-money laundering initiatives. Although the industry already conducts much of its customer contacts solely by telephone, securities regulators and industry officials acknowledged that on-line activities pose particular challenges from a money laundering perspective. Law enforcement officials also noted that some large broker-dealers are offering private banking services (broadly defined as financial and related services provided to wealthy clients) that are deemed vulnerable to money laundering. These services generally attempt to offer considerable confidentiality as part of the client relationship, routinely involve large-dollar transactions, and sometimes offer the use of offshore accounts.

Some law enforcement officials maintained that the securities industry lacks adequate anti-money laundering requirements and thus represents a weak link in the U.S. regulatory regime that can be exploited by money launderers in their search for new ways to hide their funds. These officials described the securities sector as a “money laundering loophole” within the financial services industry that should be closed, particularly as other financial sectors are being required to improve their defenses against money laundering. For example, Treasury issued rules for banks in 1996 and for money services businesses in 2000 requiring these firms to report suspicious activities, including potential money laundering. However, similar requirements do not yet apply to all broker-dealers and mutual fund firms, and law enforcement officials saw this fact as a reason that criminals may seek to use such firms to facilitate money laundering. Some law enforcement officials also suggested that as financial institutions continue to merge in response to GLBA,¹⁶ the need for consistent and adequate anti-money laundering requirements in all financial sectors is becoming even more pronounced.

Securities industry officials acknowledged that money launderers could potentially target their industry. SEC staff have noted that the large volume of money generated by illegal activities creates a risk for broker-dealers as well as other financial institutions. In a May 2001 speech, an SEC official stated that firms in the securities industry face great risks if they allow themselves to be used for money laundering. The official noted that

¹⁶Among other things, GLBA permits eligible bank holding companies to form affiliations that engage in securities and insurance activities through a financial holding company. 12 U.S.C. § 1843 (Supp. 2000).

trillions of dollars flow through the industry each year, and criminal activity within the industry could taint important U.S. capital markets.

The Number of Identified Cases in Which Money Has Been Laundered Through Securities Accounts Is Limited

Despite concerns regarding potential money laundering in the securities industry, the extent to which money launderers are actually using broker-dealers and mutual fund firms is not known. According to law enforcement officials, no organization currently collects information in a way that lends itself to readily identifying cases in which funds generated by illegal activity outside of the securities industry were laundered through brokerage or mutual fund accounts. Legal searches of cases primarily identify money laundering cases in which broker-dealers or others committed securities law violations, such as insider trading, market manipulation, or the sale of fraudulent securities, and then laundered the proceeds from their illegal activities through banks or other financial institutions.

Law enforcement and securities industry officials acknowledged that a limited number of cases involving money laundering through broker-dealer or mutual fund accounts could be readily identified to date. At our request, the Internal Revenue Service and the Executive Office for U.S. Attorneys collected information from some of their field staff that identified about 15 criminal or civil forfeiture cases¹⁷ since 1997 involving money laundering through brokerage and mutual fund accounts. The laundered funds in these cases came from a number of activities, including drug trafficking, illegal gambling, and food stamp fraud, and the estimated amounts of laundered funds varied widely, ranging from \$25,000 to \$25 million per case.¹⁸ In contrast, during 1999 alone, the United States reported having 996 money laundering convictions, most of which involved funds that were laundered through banks or other means. SEC and industry officials also pointed out that the industry has not had a history of money laundering cases.

¹⁷A civil forfeiture case involves civil proceedings for the seizure of personal property, including money, negotiable instruments, securities, or other things of value that have been used or were intended to be used to facilitate any violation of the law or that have resulted from such illegal activity.

¹⁸Appendix IV provides a summary of cases that included allegations of money laundering through brokerage and mutual fund accounts.

Law enforcement officials suggested that several factors could have contributed to the limited number of known cases involving money laundered through brokerage or mutual fund accounts. These factors include the difficulty of detecting money laundering at the layering and integration stages and the lack of adequate systems to detect money laundering activities in the securities industry. Specifically, they noted that the absence of a SAR rule may be limiting the identification of money laundering through broker-dealer and mutual fund accounts.¹⁹ A few officials also explained that some investigators faced with time constraints and multiple leads may choose to trace illegal funds through bank rather than brokerage or mutual fund accounts because banks are subject to SAR rules and thus are expected to have SAR-related procedures and documentation needed for investigations.

Law enforcement officials anticipated that more cases may surface in the future as criminals continue to search for new ways to launder their funds and turn to the securities industry. One U.S. attorney stated that although, historically, money laundering through the securities industry has not been an apparent problem, some pending investigations involving the movement of Russian funds through various types of financial accounts, including brokerage accounts, indicate that activity in the area may be increasing. Other law enforcement agencies were also attempting to identify and develop additional cases in which brokerage and mutual funds accounts were used to launder money. For example, staff at one agency was in the process of analyzing whether money orders made payable to broker-dealers, mutual funds, and other financial institutions were being used for money laundering.

¹⁹The extent to which broker-dealer and mutual fund transactions are covered by anti-money laundering requirements is discussed in the next section of this report.

Broker-Dealer and Mutual Fund Firms Are Not Subject to All Anti-Money Laundering Regulatory Requirements

Broker-dealers and the firms that receive and process customer payments on behalf of mutual fund groups (hereinafter referred to as mutual fund service providers)²⁰ can be held criminally liable if they are found to be involved in money laundering. They are also subject to certain reporting and recordkeeping requirements. However, unless a broker-dealer is a subsidiary of a depository institution or of a depository institution's holding company, or a mutual fund service provider is itself a depository institution (as are some transfer agents), it is not subject to regulations requiring it to file SARs for transaction that could involve money laundering. SEC and the SROs monitor the industry's compliance with the currency and related reporting and recordkeeping requirements during examinations and, according to SEC officials, are planning to conduct more extensive reviews of firms' anti-money laundering efforts starting in the fall of 2001.

Broker-Dealer and Mutual Fund Firms Can Be Prosecuted for Aiding Money Launderers and Are Subject to Certain BSA Requirements

Broker-dealers and mutual fund service providers that accept customer funds are subject to the Money Laundering Control Act of 1986,²¹ which is a statute that applies broadly to all U.S. citizens. This act makes knowingly engaging in financial transactions that involve profits from certain illegal activities a criminal offense. As a result, individuals and companies conducting financial transactions on behalf of customers can be prosecuted if they are found to have conducted transactions involving money from illegal activities. Broker-dealers and mutual fund service providers can also be prosecuted if they knew or were willfully blind to the fact that a transaction involved illegal profits. Penalties under the Money Laundering Control Act include imprisonment, fines, and forfeiture.²²

²⁰Various entities may be involved with opening customer accounts or accepting and processing customer payments. Most funds use transfer agents or their distributor (which are usually broker-dealers) to perform these services, but the fund's principal underwriter could also be involved in interacting with fund customers. In addition, the fund group or its transfer agent may use a bank to perform cash management services, which would be subject to any currency and other related anti-money laundering requirements.

²¹18 U.S.C. §§ 1956 & 1957 (1994 & Supp. 2000).

²²The maximum criminal penalty for a violation under 18 U.S.C. § 1956 is imprisonment for 20 years; a fine of \$500,000 or twice the value of the funds laundered, whichever is greater; or both penalties. Under section 1957, the maximum criminal penalty can be 10 years in prison and a fine of twice the value of the criminally derived property. Section 1957 contains no civil penalty provision.

Like other financial institutions, broker-dealers and those mutual fund service providers that accept customer funds²³ are required to comply with various BSA or similar reporting and recordkeeping requirements. Such requirements are designed to be useful in tax, regulatory, or criminal investigations, including those relating to money laundering. As shown in table 1, firms subject to these requirements are to identify and report currency transactions exceeding \$10,000 with FinCEN, file reports on foreign bank and financial institution accounts with FinCEN, and report the transportation of currency or monetary instruments into or out of the United States with the U.S. Customs Service.

Table 1: BSA Reporting Requirements for Broker-Dealers and Mutual Fund Service Providers That Accept Customer Payments

| Type of report | Reporting responsibilities | Report to be filed with: |
|---|---|--------------------------|
| Currency Transaction Report | Must report all receipts or transfers of U.S. currency over \$10,000. Must report all known receipts or transfers by one entity that exceed \$10,000 in 1 day. | FinCEN ^a |
| Report of International Transportation of Currency or Monetary Instruments ^b | Must report transactions involving the movement of currency or monetary instruments over \$10,000 into or out of the United States. | Commissioner of Customs |
| Report on Foreign Bank and Financial Accounts | Must report a financial interest in or signature authority over financial accounts in a foreign country if the aggregate value of the accounts exceeds \$10,000. | FinCEN ^a |

^aThese reports are to be sent to the Internal Revenue Service's Detroit Computing Center, which processes them for FinCEN.

^bBSA regulations define monetary instruments as including checks, promissory notes, traveler's checks, money orders, or securities in bearer form or otherwise when title passes on delivery. 31 CFR 103.11(u).

Source: BSA regulations.

²³Firms that accept customer payments for mutual funds are usually either the distributing broker-dealer or the fund's transfer agent. Many mutual fund transfer agents are banks or broker-dealers that are also subject to BSA recordkeeping and reporting requirements. Transfer agents that are not financial institutions must comply with similar currency reporting requirements contained in the Internal Revenue Code.

In addition to imposing reporting requirements, the BSA requires broker-dealers and mutual fund service providers to maintain certain records. For example, broker-dealers and other financial institutions conducting transmittals of funds of \$3,000 or more (including wire transfers) are required to obtain and keep information on both the sender and recipient and to record such information on the transmittal order. Broker-dealers also are required to have compliance programs in place for ensuring adherence to the federal securities laws, including the applicable BSA requirements.

Regulations under the BSA also require that banks report suspicious transactions of \$5,000 or more relating to possible violations of law, but these requirements do not currently apply to all broker-dealers and mutual fund service providers. Amendments to the BSA adopted in 1992 gave Treasury the authority to require financial institutions to report any suspicious transaction relevant to a possible violation of a law. In 1996, Treasury issued a rule requiring banks to report suspicious activities involving possible money laundering to FinCEN using a SAR form.²⁴ In 1996, the depository institution regulators promulgated regulations that require broker-dealer subsidiaries of bank holding companies, national banks, and federal thrifts to file SARs if the subsidiaries identify potential money laundering or violations of the BSA involving transactions of \$5,000 or more. Until Treasury promulgates SAR rules for broker-dealers, only broker-dealers that are subsidiaries of depository institutions or of their holding companies are subject to SAR requirements. Depository institution regulators have also issued regulations that require banks to have BSA compliance programs in place, including (1) developing internal policies, procedures, and controls; (2) independently testing for compliance; (3) designating an individual responsible for coordinating and monitoring compliance; and (4) conducting training for personnel.

Efforts to Develop a Securities SAR Rule Renewed

Treasury is engaged in renewed efforts to develop a SAR rule for the securities industry and anticipates that a proposed rule will be issued for public comment before the end of 2001. Working with SEC, Treasury

²⁴Banks must report transactions involving \$5,000 or more that they suspect (1) involve funds derived from illegal activity or an attempt to hide or disguise funds or assets derived from illegal activity, (2) are designed to evade the requirements of the BSA, or (3) have no apparent lawful or business purpose or vary substantially from normal practice. 31 C.F.R. § 103.18(2000).

initially attempted to develop a SAR rule for the securities industry in 1997. Treasury officials explained that this effort was set aside so that the Department could focus first on cash-intensive businesses, such as the money services businesses and casinos, that are viewed as more vulnerable to money laundering at the placement stage. During 2001, Treasury resumed working with SEC to develop a SAR rule for the securities industry. Key issues being discussed include determining the appropriate threshold for reporting suspicious activities, ensuring that the SAR rule will not interfere with existing procedures for reporting securities law violations that apply to broker-dealers, and providing for compliance program requirements.

One question being debated is whether the \$5,000 threshold for reporting suspicious activities that applies to banks should also apply to the securities industry. Securities industry and regulatory officials explained that this reporting threshold reflects the cash-intensive nature of the banking industry and its vulnerability to money laundering at the placement stage and, as such, should not be applied to securities firms. They also noted that the banking threshold does not reflect the typically high-dollar amount of securities transactions. Instead, these officials have proposed thresholds ranging from \$25,000 to \$100,000. Officials from a few large firms stated that they currently use thresholds ranging from \$250,000 to \$1 million in their proprietary systems for monitoring suspicious transactions. They explained that \$5,000 transactions would be too difficult to identify in the accounts of several million customers and too burdensome for processing and review purposes. In responding to our survey, five broker-dealer subsidiaries of bank holding companies, which are required by bank regulators to file SARs, suggested that the threshold for the securities SAR rule needed to be raised.²⁵ A few broker-dealer subsidiaries said that the thresholds should be the same for both the banking and securities industry rules, and the remaining 18 respondents did not offer any comment on tailoring the SAR threshold to the securities industry.

Results from our surveys did suggest that the average securities transaction tends to be much larger than \$5,000. For example, broker-dealers reported that the average size of an individual transaction processed for retail

²⁵Broker-dealer subsidiaries of bank holding companies, subject to the banking SAR rule, were asked how a similar rule for the securities industry should be tailored to the business of broker-dealers.

customers was about \$22,000,²⁶ although the size of these transactions ranged anywhere from \$200 to \$150,000. Appendix V provides additional survey information on the size of average transaction amounts.

Securities industry representatives also pointed out that a low SAR threshold could result in an inordinate number of SAR filings from the industry, undermining the ability of law enforcement agencies to use the reports effectively. Federal Reserve officials supported a higher SAR threshold for the securities industry, in part because they thought it could help justify a higher reporting threshold for the banking industry as well. Finally, some law enforcement officials also viewed the reporting threshold as too low for the securities industry but did not propose an alternative amount. Although they acknowledged that the securities industry appears to be engaged in larger dollar transactions than other types of financial institutions, a few officials expressed concerns about having different reporting thresholds for the banking and securities financial sectors.

Another issue being discussed is the scope of suspicious activities that should be reported to FinCEN on the SAR form. Financial regulators, industry, and law enforcement officials agree that any rule requiring the securities industry to report suspicious activities involving money laundering should not replace existing procedures that require broker-dealers to report suspected violations of securities laws. Currently broker-dealers are to report possible securities law violations to SEC, SROs, or a U.S. attorney's office. In turn, SEC and the SROs are to refer criminal money laundering offenses that are reported along with suspected securities law violations to the appropriate U.S. attorney's office. To minimize any potential confusion on the part of the industry, officials emphasized that the language of the SAR rule should be written to ensure that firms understand that they are to continue to report potential securities violations to the appropriate securities regulators.

²⁶This average is based on the actual amounts reported in the survey responses. We could not develop meaningful estimates for the entire industry because of the low number of firms that provided information on the average size of transactions and the wide range of responses.

Both securities industry and law enforcement officials recognize the value of requiring compliance programs for reporting suspicious activities and are discussing whether the SAR rule is the most appropriate mechanism for imposing such requirements. Law enforcement officials said that industry participants cannot fully implement a suspicious activity reporting regime unless they are also required to set up systems to monitor their customers' activities to prevent and detect transactions involving money laundering. In addition, securities industry officials said that the SAR rule should provide that broker-dealers with systems for reasonably detecting suspicious transactions, appropriate procedures for filing SARs, and no basis for believing that these procedures are not being followed, have a defense against being cited for violating the SAR reporting requirement.²⁷ Such a provision would be an effective incentive for broker-dealers to develop and maintain up-to-date programs designed to monitor and report suspicious activities that may involve money laundering.

In addition to issues relating to the SAR rule itself, some unique characteristics of the securities industry, including the variety of business structures and processes, product lines, and client bases among broker-dealers and mutual funds, will make implementing the rule more challenging. Not all firms in the industry perform similar activities and thus may have to work with other firms to fulfill their SAR-related responsibilities. For example, determining whether particular transactions are suspicious may require information from an introducing broker on a customer's identity and business activities or investment patterns and information from a clearing broker on the customer's payment and transaction histories. Regulators and others have also noted that addressing anti-money laundering considerations will be more challenging within the securities industry because firms may not collect the same type of information about customers as banks. Broker-dealers are expected to collect enough information about their customers to ensure that any recommended investments are suitable. However, for some accounts this may not include all information, such as the customer's source of the wealth or income, that can be important for assessing whether this customer's activities are suspicious. Further, with the securities industry, there is a greater need to focus on the layering and integration stages of money laundering.

²⁷This defense would be modeled after section 15(b)4(E) of the Securities Exchange Act of 1934.

Securities Regulators Examine Broker-Dealers and Mutual Fund Firms for Compliance With Applicable Requirements and Plan for Broader Reviews

SEC and the securities industry SROs oversee broker-dealers' compliance with BSA reporting and recordkeeping requirements involving currency and other related transactions. After Treasury granted SEC the authority to examine broker-dealers for compliance with these BSA requirements, SEC adopted Rule 17a-8 under the Exchange Act, incorporating these requirements into its own rules. As a result, SEC and the SROs have the authority to both examine broker-dealers for compliance with these requirements and bring action against firms that violate them.

Along with SEC, the SROs are to perform examinations of broker-dealers, including reviews to assess compliance with anti-money laundering reporting and recordkeeping requirements. These examinations do not routinely include assessing compliance with BSA SAR requirements that do not yet apply to the industry. During 2000, NASDR reported that it conducted 1,808 broker-dealer examinations, and NYSE reported that it conducted 319 examinations. Both SROs found that some broker-dealers had deficiencies in supervisory procedures pertaining to the currency reporting and recordkeeping requirements under SEC Rule 17a-8.

Although most broker-dealers are not subject to SAR requirements, National Association of Securities Dealers (NASD) and NYSE representatives noted that they have reviewed broker-dealers' procedures relating to suspicious activities. In 1989, NASD and NYSE issued guidance advising their members that reporting suspicious activities could prevent firms from being prosecuted under the Money Laundering Control Act. In its issuance, NASD specifically warned its members that failure to report suspicious transactions could be construed as aiding and abetting violations of the act and could subject the broker to civil and criminal charges.²⁸ In its guidance, NYSE cautioned its members to establish procedures to detect transactions by money launderers and others who seek to hide profits obtained from illegal activity.²⁹ In conducting reviews of their members' procedures relative to such guidance, these SROs cited a few firms for deficiencies such as failing to maintain written supervisory procedures to identify and record suspicious transactions.

²⁸*Reporting Suspicious Currency and Other Questionable Transactions to the IRS/Customs Hotline*, NASD Notice to Members 89-12 (1989).

²⁹*Reporting of Suspicious Transactions Under the Money Laundering Control Act of 1986*, NYSE Information Memo 89-5 (July 20, 1989).

Although the SROs conduct most examinations of broker-dealers, SEC staff also perform them and examinations of certain transfer agents. For instance, SEC staff conduct oversight examinations of broker-dealers that are designed to test both the firms' compliance with securities laws and SEC rules (such as SEC Rule 17a-8) and the quality of SRO examinations. SEC staff also perform "cause examinations" that are initiated in response to special concerns related to a firm. These examinations can sometimes cover compliance with Rule 17a-8, even though BSA compliance may not have been the initial reason for the examination. During 2000, SEC completed 422 oversight examinations and 283 cause examinations but found no violations of anti-money laundering requirements that had not already been identified by the SROs.

SEC also conducts examinations of mutual funds and their transfer agents that address some money laundering issues. Among the firms that act as transfer agents for mutual funds are broker-dealers, banks, and nonfinancial firms that provide other services to mutual funds. Although Rule 17a-8 does not apply to transfer agents that are not broker-dealers, SEC staff explained that the examiners also inquire about these firms' policies for detecting transactions that may involve money laundering. Most mutual fund shares, however, are sold by broker-dealers or other financial intermediaries that have primary responsibility for complying with the BSA or other currency reporting requirements (such as those contained in the Internal Revenue Code).³⁰

Recognizing the need to strengthen the securities industry's efforts to combat money laundering, and anticipating a SAR rule for the industry, SEC and the SROs are in the process of developing a "refocused" approach to anti-money laundering examinations. According to SEC officials, this enhanced approach will result in a broader review of securities firms than the current approach, which focuses on compliance with Rule 17a-8. The new approach is intended to assess firms' overall anti-money laundering strategies to determine whether they include policies, procedures, and internal control systems for monitoring suspicious activities. SEC officials anticipated that the expanded procedures would be used during examinations starting in the fall of 2001. They also indicated that once

³⁰According to research by the Investment Company Institute, which is the primary industry organization for mutual funds, 82 percent of new mutual fund share sales were made through a third party or intermediary in 1999. These third parties included banks, insurance companies, broker-dealers, financial planners, and retirement plans.

Treasury adopts a SAR rule for the securities industry, SEC and the SROs plan to develop additional examination procedures to review firms for compliance with this rule.

Some Firms Reported Implementing Anti-Money Laundering Measures That Go Beyond Existing Requirements

In responding to our survey, broker-dealers and direct-marketed mutual fund groups reported taking steps to combat money laundering that go beyond the BSA requirements applicable to the securities industry at large. Many firms have gone beyond currency reporting requirements by restricting the acceptance of cash and other forms of payment that may be used to launder money in the placement stage. Survey results also showed that some broker-dealers and direct-marketed mutual fund groups had implemented voluntary anti-money laundering measures designed to identify and report suspicious activities that may involve money laundering, but most have yet to take such steps. Clearing brokers were more actively engaged in such voluntary anti-money laundering efforts than introducing brokers.³¹ In some cases, introducing brokers relied on their clearing brokers to conduct anti-money laundering activities for them, but not all clearing firms performed such activities or subjected introducing broker transactions to such measures. The largest broker-dealers and direct-marketed mutual fund groups, which represent the majority of assets and accounts in the securities industry, were reportedly much more actively engaged in such voluntary anti-money laundering efforts than small and medium-sized firms, although these represent the majority of industry participants.

³¹For purposes of our survey analysis, references to clearing firms include those broker-dealers that clear only for their own firms' transactions (i.e., self-clearing firms), perform clearing services for other broker-dealers, or do both.

Most Broker-Dealers and Mutual Fund Groups Restricted Cash Transactions and the Use of Some Monetary Instruments

A vast majority of the broker-dealers and direct-marketed mutual fund groups surveyed reported having policies that prohibit the acceptance of cash. By prohibiting cash transactions, firms reduce their vulnerability to money laundering at the placement stage and the number of instances in which they must report certain currency transactions. Our survey showed that 95 percent³² of a projected 2,979 broker-dealers among our survey population³³ and 92 percent of the 310 mutual fund groups never accept cash in the normal course of business. The remaining firms accept cash only as an exception. For example, these firms might accept small amounts (less than \$1,000) or conduct cash transactions approved by a legal or compliance department. Industry officials explained that most securities firms and mutual funds are not set up to handle cash. Conducting securities business in cash is generally viewed as too burdensome, and many firms have chosen not to develop the needed infrastructure, including policies and procedures, storage facilities, and internal controls. Furthermore, industry officials note that prohibiting the use of cash is a prudent business practice that helps to reduce risks, other than money laundering, commonly associated with handling cash, including theft and embezzlement.

Although most broker-dealers and direct-marketed mutual fund groups have reduced their vulnerability to money laundering that involves cash transactions, many may still be vulnerable to money laundering using other forms of payment or deposit, such as traveler's checks, money orders, and cashier's checks. As shown in figure 4, over 55 percent of direct-marketed mutual fund groups reported always accepting money orders. According to law enforcement officials, such forms of payment or deposit can be used as part of structuring schemes in which cash is converted into monetary instruments and deposited in increments of less than the \$10,000 reporting threshold.³⁴ In addition, a large portion of mutual fund groups and broker-

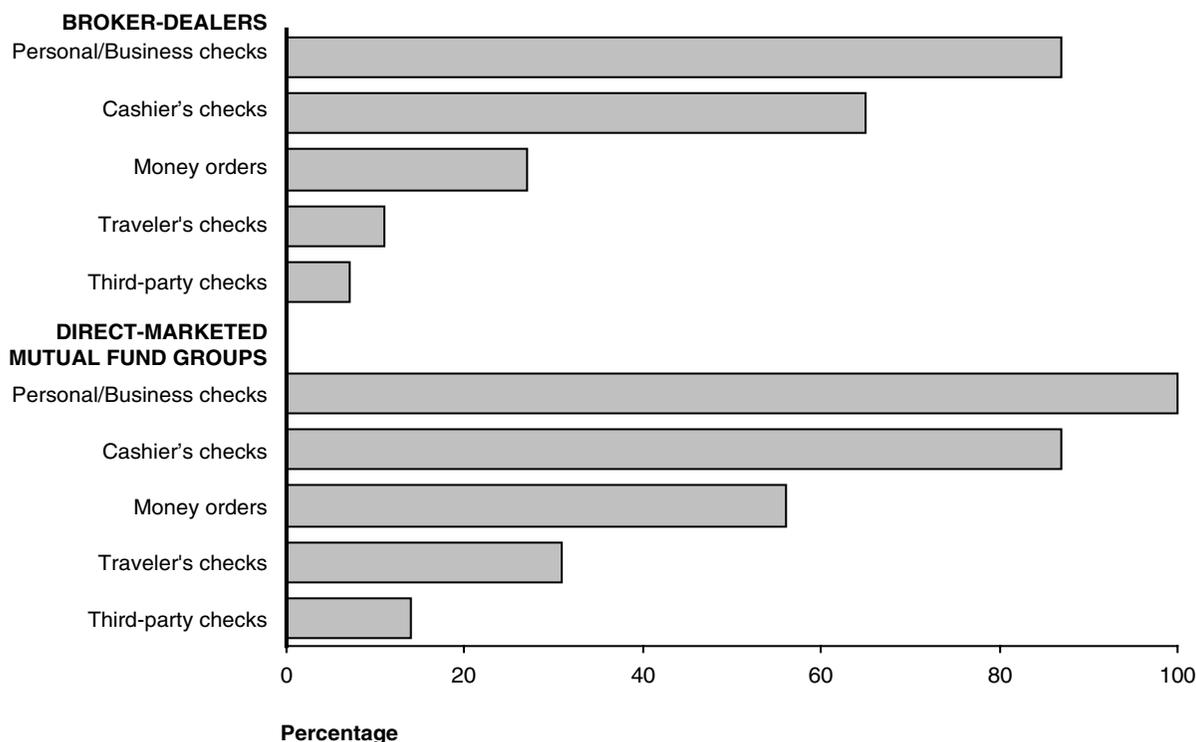
³²This estimate has a sampling error of ± 4 percentage points. All other estimates projected to a larger survey population are also subject to sampling errors, which are less than ± 10 percentage points unless otherwise noted. See appendix I for further explanation of sampling errors.

³³About 1 percent of our broker-dealer sample did not respond to the specific survey question on accepting cash. For this reason, our estimate of this characteristic for the population does not reflect the entire 3,015 in our total survey population.

³⁴In the absence of a mandated obligation to report potential structuring using such monetary instruments, SEC encourages broker-dealers to be cognizant of and report these types of suspicious transactions.

dealers also reported accepting cashier's checks, which can also be used in money laundering schemes. A securities industry official pointed out that cashier's checks are a common form of payment that firms tend to monitor rather than restrict for money laundering purposes. Personal checks are the most widely accepted form of payment but, according to industry officials, are viewed with less concern since they can usually be traced to accounts at depository institutions that have their own anti-money laundering requirements.

Figure 4: Kinds of Payments That Broker-Dealers and Direct-Marketed Mutual Fund Groups Accept (percentage of survey population)



Note 1: This figure reflects firms that reported always accepting the noted forms of payment. In a few cases, we have included firms whose survey responses indicated that they accepted these forms of payment if certain obvious criteria were met, such as taking only personal checks drawn on the bank account of their customer.

Note 2: This figure excludes respondents that reported never accepting any of the forms of payment listed on our survey.

Note 3: The sampling errors for the estimates of broker-dealers that accept cashier's checks, broker-dealers that accept money orders, direct-marketed mutual fund groups that accept traveler's checks,

and direct-marketed mutual fund groups that accept money orders are ± 11 , ± 10 , ± 11 , and ± 12 percentage points, respectively.

Source: Analysis of responses to GAO survey.

Industry representatives also pointed out that although the survey responses reflect the proportion of firms that accept certain forms of payment, these figures do not likely correspond with the extent to which the cited forms of payment are actually used to deposit funds into broker-dealer or mutual fund accounts. For example, officials from a mutual fund industry association said that considerable amounts of money are deposited into mutual funds through electronic fund transfers from bank accounts or through payroll deposits.

Some Broker-Dealers and Direct-Marketed Mutual Fund Groups Reported Implementing Additional Voluntary Anti-Money Laundering Measures

Although not subject to SAR requirements, some broker-dealers and direct-marketed mutual fund groups reported having implemented anti-money laundering measures designed to identify and report suspicious activities. According to our survey, 17 percent of broker-dealers, or an estimated 513 of 3,015 firms, reported implementing anti-money laundering measures that go beyond BSA provisions for the securities industry at large. In our survey, we asked firms to identify the type of voluntary anti-money laundering measures, if any, they have implemented. We divided these types of measures into four broad categories:³⁵

- written policies and procedures, such as those requiring staff to learn more about customers and the nature of the customers' businesses;
- internal controls, including supervisory reviews to ensure that anti-money laundering policies and procedures are being followed;
- tools and processes, such as an automated transaction monitoring program to facilitate the detection of potential money laundering; and
- formal training programs for staff, such as those that provide guidance on how to identify suspicious activities that may involve money laundering.

Information presented in this report that is based on our surveys was self-reported by the respondent firms. Although in some cases we attempted to obtain additional information or clarification on certain responses, we did not systematically verify all responses provided by firms or the extent to

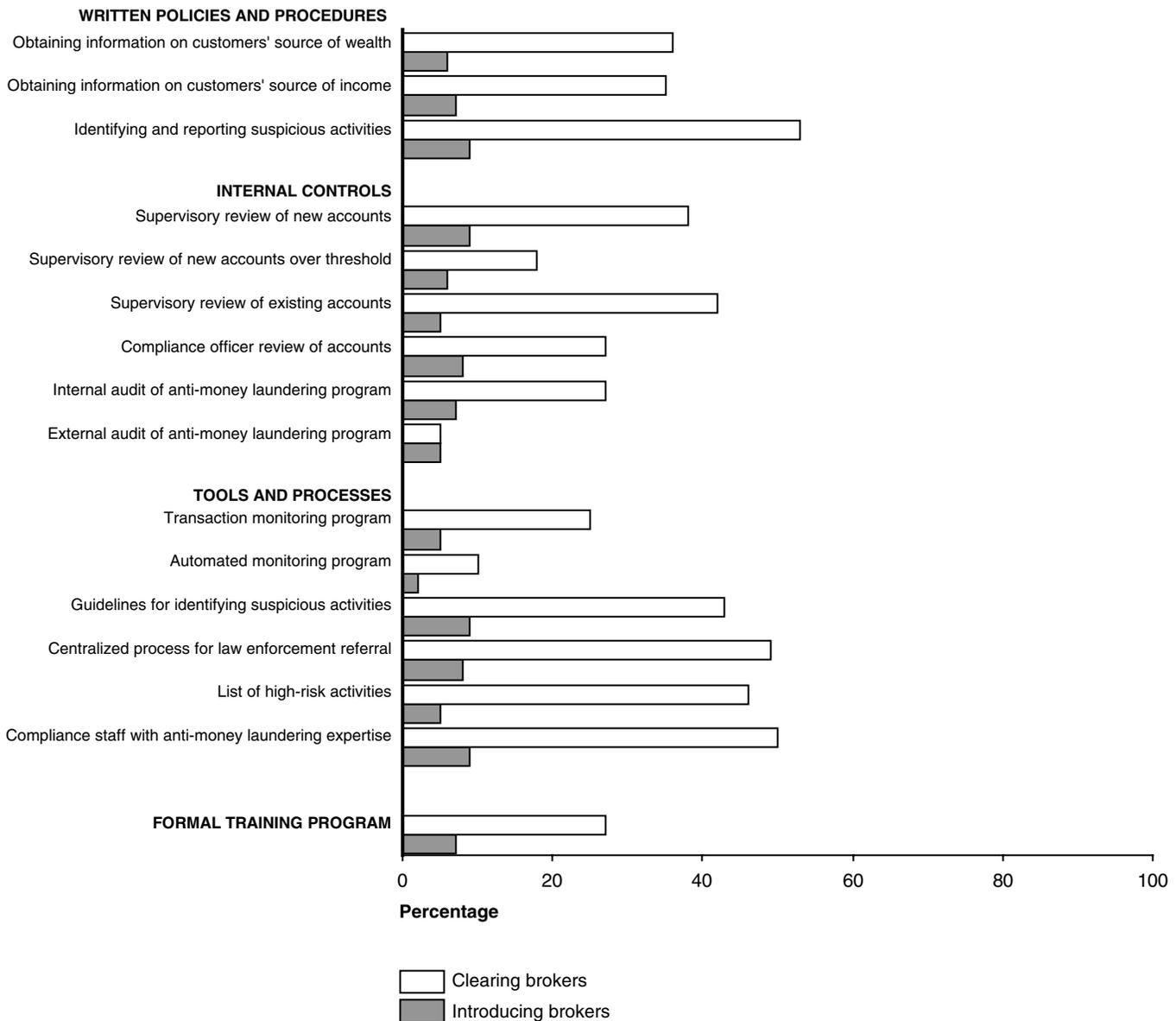
³⁵These categories were used to determine the general nature of industry efforts and do not represent a comprehensive list of anti-money laundering efforts.

which firms that reported implementing anti-money laundering measures were actually adhering to them. In addition, the effectiveness of these measures at any firm would depend on various factors, including the level of a firm's management commitment to detecting and preventing money laundering and the degree to which the employees responsible for following anti-money laundering policies and procedures are being supervised and held accountable.

Although 17 percent of broker-dealers overall reported implementing at least one voluntary anti-money laundering measure, broker-dealers that clear trades for themselves and other firms reported being more active in the area. According to our survey analysis, 15 percent of introducing brokers and 63 percent of clearing brokers reported implementing voluntary anti-money laundering measures.³⁶ As shown in figure 5, the extent to which introducing brokers reported implementing the various voluntary measures identified in our survey ranged from 2 to 10 percent. The extent to which clearing brokers reported implementing the various voluntary measures identified in our survey ranged from 5 to 53 percent.

³⁶For purposes of our survey analysis, references to clearing firms include those broker-dealers that clear only for their own firms' transactions (i.e., self-clearing firms), perform clearing services for other broker-dealers, or do both.

Figure 5: Voluntary Anti-Money Laundering Measures Implemented by Introducing Brokers and Clearing Brokers



Note 1: This figure reflects measures implemented or used specifically for anti-money laundering purposes. Some firms may have in place similar measures that were implemented and used for purposes other than anti-money laundering considerations, and these were not intended to be included in this figure.

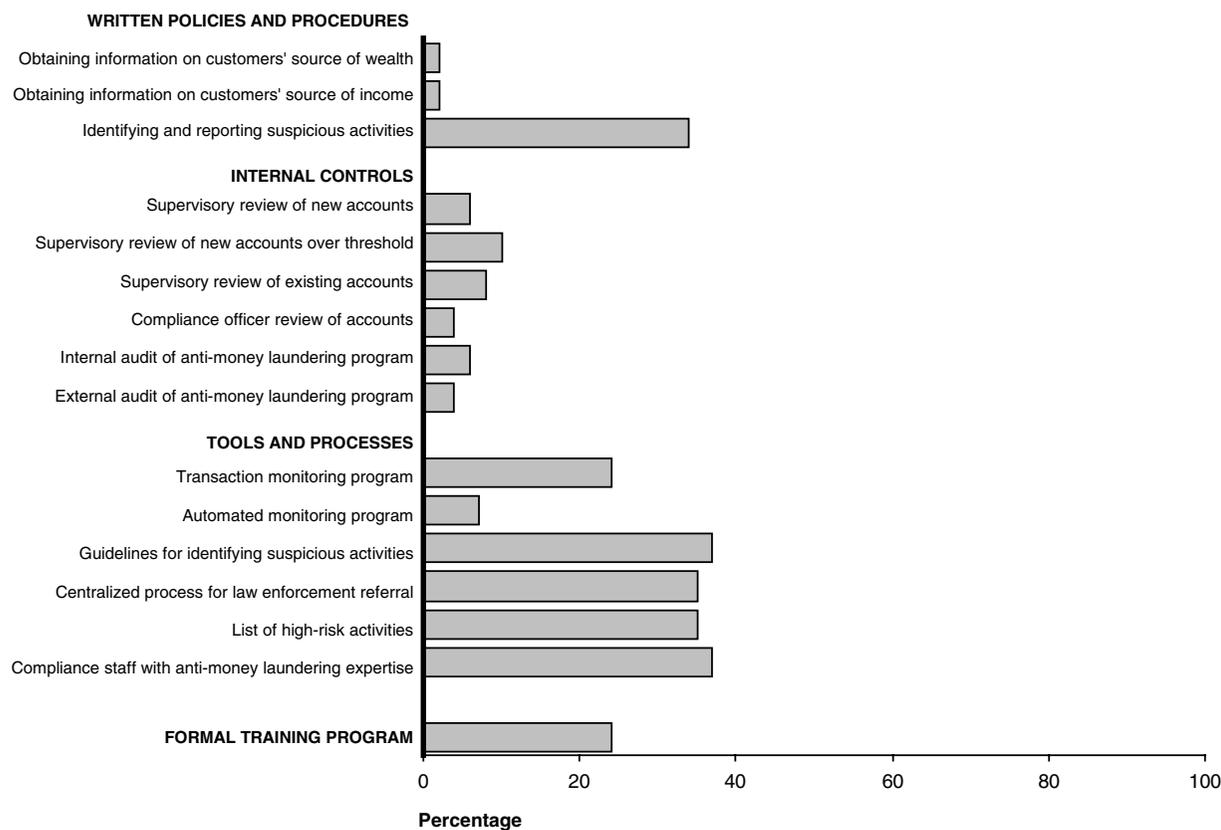
Note 2: This figure does not include institutional broker-dealers, of which approximately 3 percent reported implementing voluntary anti-money laundering measures.

Note 3: Sampling errors of estimates made for the clearing brokers range from ± 6 to ± 25 percentage points. Sampling errors of estimates for the introducing brokers are under ± 7 percentage points.

Source: Analysis of responses to GAO survey.

Our survey results also showed that the transactions processed by 40 percent³⁷ of direct-marketed mutual fund groups were subject to some type of voluntary anti-money laundering measures. Over 30 percent of these groups reported that they or their transfer agents had put in place policies and many of the tools and processes for identifying and monitoring suspicious activities (fig. 6).

Figure 6: Voluntary Anti-Money Laundering Measures Implemented by Direct-Marketed Mutual Fund Groups and Their Transfer Agents



³⁷The sampling error for this estimate is +11 percentage points.

Note 1: This figure reflects measures implemented or used specifically for anti-money laundering purposes. Some firms may have in place similar measures implemented and used for purposes other than anti-money laundering considerations, and these were not intended to be included in this figure.

Note 2: This figure excludes one mutual fund group that described its business as exclusively institutional and indicated it had not implemented any voluntary anti-money laundering measures.

Note 3: Sampling errors for estimates in this figure are all ± 11 percentage points or less.

Source: Analysis of responses to GAO survey.

The extent to which firms had implemented multiple anti-money laundering measures varied. For example, for broker-dealers that reported having implemented voluntary anti-money laundering measures, almost 20 percent³⁸ indicated they had three or fewer of these measures in place. Almost 30 percent³⁹ of these broker-dealers reported having implemented more than 10 measures.

Even when firms reported implementing the same measures, the scope of their efforts differed. For example, officials at one firm explained that its transaction monitoring system, although still in the process of being implemented, was specifically designed for anti-money laundering purposes and focused on the overall financial activities of its customers, including deposits, wire transfers, and transactions involving cash equivalents. This firm's system will eventually use customer profiling techniques to identify unusual spikes in account activity and will have the ability to make links among related customers to identify any suspicious patterns of activity that may involve money laundering. In contrast, officials at another firm that reported having a transaction monitoring system told us that that their system involved the manual review of transactions identified by a reporting system designed to identify fraud to determine if the transactions might also involve money laundering. Similarly, some firms described having ongoing training programs specifically tailored to money laundering issues, including guidance on how to identify suspicious activities. A few firms addressed money laundering issues only as part of the orientation training provided to new employees.

Industry officials noted that, in general, a firm's vulnerability to money laundering will vary, depending upon such factors as its type of business activities, customer base, and company size. They suggested that this

³⁸The sampling error for this estimate is ± 18 percentage points.

³⁹The sampling error for this estimate is ± 18 percentage points.

variance in vulnerability among firms may account for some of the observed differences in the extent and scope of voluntary anti-money laundering measures implemented by broker-dealers and mutual fund groups.

Our survey results also disclosed that a relatively small number of broker-dealers and direct-marketed mutual fund groups filed SARs during calendar year 2000, although they were not legally required to do so. Specifically, 12 of 152 broker-dealer respondents and 6 of 65 mutual fund group respondents indicated that they had filed SARs.⁴⁰ Almost all were larger firms. Most indicated that they had submitted 25 or fewer SARs during 2000, but 1 reported submitting over 200 reports during the year.⁴¹ An industry association official noted that, rather than filing SARs, some firms informally refer suspicious activities that may involve money laundering informally to appropriate regulatory or law enforcement authorities.

Industry officials explained that firms have generally chosen to adopt voluntary anti-money laundering measures to protect themselves from becoming unwitting participants in money laundering activities. The firms hope that implementing such measures will also help to reduce the likelihood of prosecution or civil enforcement actions for violations of money laundering laws and mitigate sanctions in the event that a violation does occur. Industry trade associations encourage voluntary efforts, noting that firms are less likely to be subject to a regulatory penalty (or may have a penalty reduced) if a violation occurs when an effective compliance program is in place. Firms also believe that being associated with criminal elements or activities such as money laundering can threaten their reputation and have a tremendous impact in terms of lost business and costly legal fees. Lastly, firms note that they are taking voluntary actions in anticipation of a SAR rule for broker-dealers.

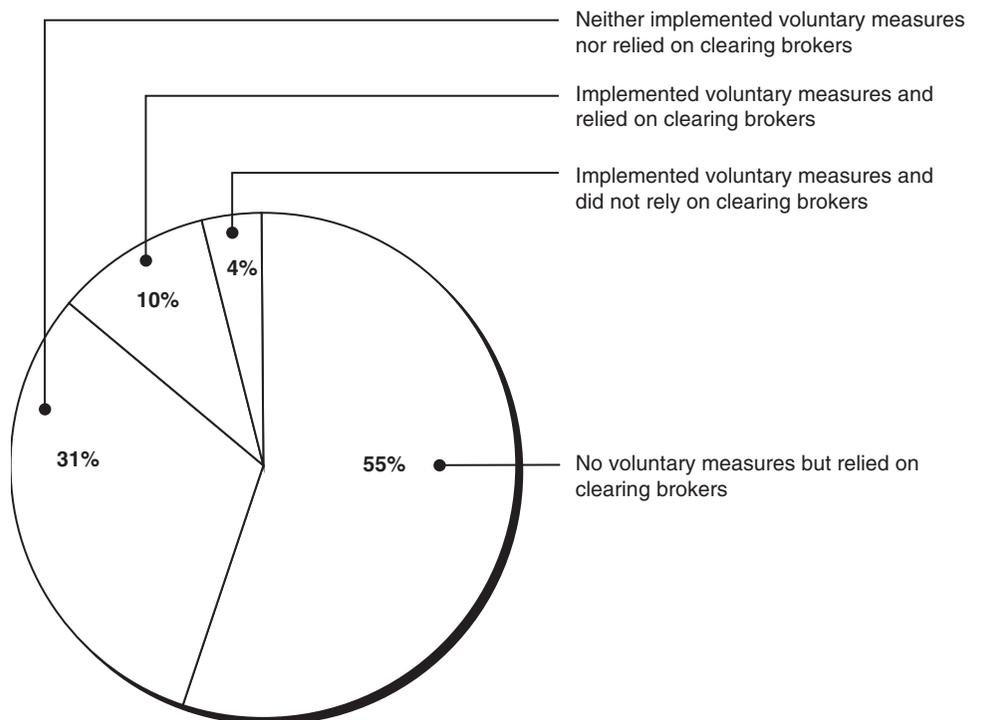
⁴⁰Because the number of respondents indicating that they had filed SARs was so low and a meaningful estimate of the number of firms these respondents might represent in the entire industry could not be developed, we cite only the actual number of responses.

⁴¹Survey responses on SAR filings were corroborated to the extent possible with available information from FinCEN.

Extent to Which Introducing Brokers' Transactions Were Covered by Anti-Money Laundering Activities Is Unclear

Although a relatively small portion of introducing brokers reported having implemented voluntary anti-money laundering measures, many other introducing brokers reported relying on their clearing brokers to conduct anti-money laundering activities on their behalf. According to our survey, more than half of the introducing brokers indicated that they had not undertaken such efforts, relying instead on their clearing brokers (fig. 7). Almost another third reported that they had no voluntary measures of their own and did not rely on their clearing brokers to undertake such measures for them.

Figure 7: Extent to Which Introducing Brokers Conducted or Relied on Their Clearing Brokers to Conduct Voluntary Anti-Money Laundering Activities



Note 1: A few introducing brokers did not indicate whether they relied on their clearing brokers to conduct voluntary anti-money laundering measures and are not included in this figure.

Note 2: Estimates for introducing brokers that had no voluntary measures but relied on clearing brokers and for those that neither implemented voluntary measures nor relied on clearing brokers have sampling errors of ± 11 and ± 10 percentage points, respectively.

Source: Analysis of responses to GAO survey.

We found that the allocation of anti-money laundering responsibilities between introducing and clearing brokers was not always clear. Of the many introducing brokers that reported relying on clearing brokers to conduct anti-money laundering activities, most did not know exactly what types of anti-money laundering activities the clearing brokers performed. Several introducing brokers indicated that they thought their clearing brokers monitored customer accounts to identify suspicious activities that could involve money laundering and would report such activities to them. Few of the introducing brokers indicated that they received regular transaction reports from their clearing brokers for anti-money laundering purposes.

In addition, many of the clearing brokers responding to our survey reported that they either did not engage in voluntary anti-money laundering activities or performed them only for their own firms' transactions, not for those of introducing brokers. As a result, some introducing brokers may have been mistaken in assuming that their clearing brokers performed anti-money laundering activities on their behalf. We were not able to determine whether any of the introducing brokers in our survey population used the clearing brokers that reported performing anti-money laundering activities.⁴² Six of the 29 clearing broker respondents that provided clearing services for other broker-dealers reported that they did not engage in any type of voluntary anti-money laundering measures.⁴³ While the remaining 23 clearing broker respondents reported having voluntary anti-money laundering measures for their own trades, only about half of these firms indicated they applied the same measures to their introducing brokers' transactions. Only a few of the clearing brokers reported that they provided other broker-dealers with transaction exception reports for anti-money laundering purposes. SEC officials explained that existing NYSE and NASD rules, which require introducing and clearing brokers to clearly delineate their respective responsibilities in a written agreement, will require them to include any expanded anti-money laundering responsibilities that will result from the issuance of a securities SAR rule in such agreements.

⁴²Our sample of broker-dealers was randomly selected, and we did not link introducing brokers to their respective clearing brokers.

⁴³Because the number of respondents indicating that they provided clearing services for other broker-dealers was so low, only the actual number of responses is cited here.

Large Firms Were More Actively Engaged in Voluntary Anti-Money Laundering Efforts

Although most broker-dealers and direct-marketed mutual fund groups have yet to implement voluntary anti-money laundering measures, larger firms reported having done so to a greater degree than had medium-sized or small firms. Larger firms also reported having implemented anti-money laundering programs that included a broader range of measures. Specifically, from the results of our survey, we estimated that 66 percent of the 111 large broker-dealers had implemented measures that go beyond those required by applicable BSA regulations compared with 14 percent of the 1,738 small firms (table 2). An estimated 77 percent of the large direct-marketed mutual fund groups had implemented measures beyond those required, compared with 38 percent of the other mutual fund groups. Appendix VI provides information on the types of voluntary anti-money laundering measures implemented by broker-dealers and mutual fund groups, by size.

Table 2: Extent of Voluntary Anti-Money Laundering Measures Implemented by Broker-Dealers and Direct-Marketed Mutual Fund Groups

| Type and size of firms | Survey population for which our estimates are made | Firms with voluntary anti-money laundering measures | |
|-------------------------------------|--|---|----------------------|
| | | Estimated number | Estimated percentage |
| Broker-dealers: | | | |
| Large | 111 | 73 | 66 |
| Medium | 1,166 | 202 | 17 |
| Small | 1,738 | 238 | 14 |
| Total | 3,015 | 513 | 17 |
| Direct-marketed mutual fund groups: | | | |
| Large | 15 | 11 | 77 |
| Medium/Small | 295 | 114 | 38 |
| Total | 310 | 125 | 40 |

Note: Estimates for large broker-dealers, medium-sized broker-dealers, medium-sized and small direct-marketed mutual fund groups, and total direct-marketed mutual fund groups have sampling errors of ± 10 , ± 10 , ± 12 , and ± 11 percentage points, respectively.

Source: Analysis of responses to GAO survey.

The largest firms have also been the most active in implementing anti-money laundering measures. For example, 18 firms in our broker-dealer

population had assets exceeding \$10 billion; together, these firms held about 80 percent of the industry's total assets as of year-end 1999. We received responses from the nine firms we surveyed in this population. According to their responses, eight of these firms had implemented voluntary anti-money laundering measures, with each reporting to have nine or more measures in place. SEC officials told us that having such measures in place at firms like these was particularly important because money launderers would likely attempt to blend their activities with those of the vast numbers of customers and transactions handled by large broker-dealers.

However, SEC officials as well as industry officials representing some of the major broker-dealers and mutual fund groups acknowledged that no firms in the industry, including small and medium-sized firms, are immune to money laundering schemes. They suggested that small and medium-sized firms also need to protect themselves from being inadvertently drawn into charges of assisting with money laundering. But the officials stressed that these firms should be allowed to develop anti-money laundering programs that are commensurate with their size, available resources, and—most importantly—any identified risks of vulnerability to money laundering. For example, some small firms with an established and limited client base may know their customers well enough to be able to monitor their business transactions with little need for expensive tracking systems or formal training programs.

Certain Bank-Affiliated Respondents Also Reported Implementing Measures to Identify and Report Suspicious Activities

All 25 respondents to our survey of securities subsidiaries of bank holding companies,⁴⁴ along with an additional 14 firms identified as securities subsidiaries of depository institutions during our other industry surveys,⁴⁵ reported having implemented anti-money laundering efforts to comply with the SAR rules to which they were subject. For example, at least 85 percent of these bank-affiliated respondents reported having written procedures for identifying and reporting suspicious activities, a formal training

⁴⁴Our survey sample for firms subject to the banking SAR requirements was randomly selected from a Federal Reserve list of 53 securities subsidiaries of bank holding companies, formerly referred to as section 20 subsidiaries.

⁴⁵In administering our survey to the overall population of broker-dealers and direct-marketed mutual fund groups, we asked firms if they were affiliated with depository institutions and subject to the banking SAR requirements. An additional 12 broker-dealers and 2 mutual fund groups indicated that they were subject to the banking SAR requirements.

program, and internal audit reviews to ensure compliance with anti-money laundering policies and procedures. Most of these firms had also hired compliance staff with knowledge of and expertise in money laundering. In addition, 12 of 25 respondents that were securities subsidiaries of bank holding companies and 3 of 14 respondents that were subsidiaries of depository institutions reported having filed SARs during 2000.

Most Foreign Countries Have Anti-Money Laundering Rules for Securities Firms, but the Effectiveness of These Rules Is Unclear

U.S. and foreign officials from law enforcement and financial regulatory agencies have been working together within various international forums to develop anti-money laundering standards. These standards call for participating countries to require their financial institutions, including securities firms, to take steps to prevent money laundering. Among other things, the recommended standards call for firms to identify their customers, report suspicious activities, and implement anti-money laundering programs. Many foreign countries reported having issued most or all of the recommended requirements for their financial institutions, including their securities industry, whereas efforts in the United States are still under way. However, assessing the effectiveness of the measures other countries have taken is difficult because many requirements have only recently been issued. In addition, most countries have also yet to report many cases involving financial institutions, including securities firms.

International Forums Have Developed Anti-Money Laundering Standards

Money laundering issues are the focus of several internationally active forums, including FATF, which is the largest and the most influential intergovernmental body seeking to combat money laundering. Established in 1989, FATF has 31 members, including the United States.⁴⁶ Its activities include monitoring members' progress in implementing anti-money laundering measures, identifying current trends and techniques in money laundering, and promoting the adoption of the organization's standards. Many of these activities are conducted during plenary meetings attended by delegations from each member country. Smaller international groups that address money laundering issues are also able to attend FATF plenary

⁴⁶The members of FATF are Australia, Austria, Belgium, Canada, Denmark, Finland, France, Germany, Greece, Hong Kong, Iceland, Ireland, Italy, Japan, Luxembourg, the Netherlands, New Zealand, Norway, Portugal, Singapore, Spain, Sweden, Switzerland, Turkey, the United Kingdom, and the United States. Argentina, Brazil, and Mexico became members on June 21, 2000. Two regional organizations, the European Commission and the Gulf Cooperation Council, are also members.

meetings. These groups are often regional, like the Caribbean Financial Action Task Force (CFATF), which includes 25 countries from the Caribbean, Central America, and South America.⁴⁷ Other regional forums include the Asia Pacific Group on Money Laundering and the Financial Action Task Force on Money Laundering in South America.

Some international bodies have recommended countermeasures against money laundering to their members. These recommendations cover criminal justice and enforcement systems, financial systems, and mechanisms for international cooperation. Some recommendations apply specifically to financial institutions, including securities firms (table 3).

Table 3: Examples of International Anti-Money Laundering Recommendations for Financial Institutions

| Area | Specific recommendations |
|---|---|
| Customer identification and recordkeeping | <ul style="list-style-type: none"> --Avoid anonymous accounts. --Record customers' identities. --Obtain proof of incorporation. --Ensure that individuals acting on behalf of others are authorized to do so. --Keep records on customer transactions. |
| Suspicious transactions | <ul style="list-style-type: none"> --Pay special attention to unusually large transactions that have no apparent economic purpose. --Examine the background and purpose of such transactions. --Establish findings in writing. --Report suspicions of transactions involving funds stemming from possible criminal activities to competent authorities. |
| Anti-money laundering programs | <ul style="list-style-type: none"> --Develop internal policies, procedures, and controls. --Designate compliance officers at management level. --Develop adequate screening procedures to ensure high standards when hiring employees. --Develop an ongoing employee training program. --Use an audit function to test the system. |
| High-risk transactions | <ul style="list-style-type: none"> --Give special attention to transactions with persons, companies, and financial institutions from countries without adequate anti-money laundering requirements. |

Source: *The Forty Recommendations of the Financial Action Task Force, FATF*, June 28, 1998.

⁴⁷Additional information about CFATF and its member countries is presented in appendix VII.

Many Countries Reported Complying With FATF Recommendations for Financial Institutions

Many of the countries participating in international forums reported being in compliance with the FATF recommendations relating to their financial institutions, including the securities industry. For example, 24 of the 26 FATF member countries that participated in a recent self-assessment reported having in place most of the key FATF recommendations that apply to stockbrokers.⁴⁸ These included three FATF recommendations suggesting that stockbrokers record customers' identity, pay attention to unusually large transactions that have no apparent economic purpose, and report suspicious activities to authorities. A fourth recommendation suggested that guidelines be issued to assist stockbrokers in detecting suspicious activities. Canada, one of the two member countries that had not implemented the specific recommendation that stockbrokers be required to report suspicious activities to competent authorities at the time of the self-assessment, has since published suspicious activity reporting regulations that cover the securities industry and are expected to come into force in November 2001. In a recent report on the anti-money laundering systems of its members,⁴⁹ FATF observed that countries such as Canada and the United States, which have federal systems of government and a division of responsibilities for financial institutions sectors, generally take longer to implement controls for institutions regulated at the state or provincial level. CFATF officials also observed that 8 of the 11 CFATF members with organized securities exchanges had enacted legislation or adopted regulations requiring their securities firms to report suspicious transactions.

The United States has applied some of the FATF recommendations to its securities industry. For example, U.S. requirements for currency reporting and funds transfers that apply to the securities industry already comply with international recommendations. According to U.S. officials, many of the existing customer identification requirements for broker-dealers in the

⁴⁸Member countries report on their efforts to comply with the FATF recommendations through annual self-assessment surveys. These surveys collect, among other things, compliance information that applies to nonbank financial institutions, including broker-dealers. In some cases, the reporting country provides aggregated information for its nonbank financial institutions and does not provide separate information for its broker-dealers. FATF's two regional organization members and three newest country members did not participate in the 1998-99 self-assessment survey referred to above. To the extent possible, the number of countries reporting to be in compliance with the noted recommendations was updated on the basis of FATF's annual report for 2000-01.

⁴⁹*Review of FATF Anti-Money Laundering Systems and Mutual Evaluation Procedures 1992-99*, FATF XII Plenary, Feb. 16, 2001.

United States also are consistent with FATF recommendations. However, the United States has not issued requirements on suspicious activity reporting and related anti-money laundering programs for the securities industry but, as previously discussed, is in the process of developing a SAR rule.

The Effectiveness of Implementing Anti-Money Laundering Standards in Many Countries Is Unclear

Determining how well international anti-money laundering standards have been implemented around the world is difficult because of the limited amount of information available. Some countries have only recently issued anti-money laundering requirements for their financial institutions, including securities firms, and have had little time to fully implement and enforce them. In addition, FATF reports that limited law enforcement tools and resources in some countries may hinder the effective implementation and enforcement of anti-money laundering requirements.

Most FATF countries have only a few years of statistics on suspicious activity reporting by banks, and few countries have data on suspicious activity reporting by other financial institutions. Only six countries provided information to FATF on SARs filed by their securities firms, and all six countries showed limited activity in the area. Specifically, securities firms filed a relatively small portion of the total SARs filed in these countries—from nearly 0 percent to just over 4 percent (table 4).

Table 4: SARs Filed by Securities Firms in FATF Countries

| Country | Total SARs filed | SARs filed by securities firms | Percentage of total SARs |
|----------------|------------------|--------------------------------|--------------------------|
| Belgium | 8,030 | 335 | 4.17 |
| Finland | 271 | 10 | 3.69 |
| Netherlands | 3,995 | 1 | 0.03 |
| Norway | 788 | 2 | 0.25 |
| Switzerland | 160 | 1 | 0.63 |
| United Kingdom | 14,500 | 81 | 0.56 |

Note: All data are for 1999, except for the Netherlands, which reported 1998 data.

Source: Review of FATF Anti-Money Laundering Systems and Mutual Evaluation Procedures 1992-99, FATF XII Plenary, Feb. 16, 2001.

In some countries, suspicious activity reporting requirements for financial institutions are relatively new, and it may be too early to judge the

effectiveness of implementing these measures. As previously noted, 8 of 11 CFATF members with organized securities exchanges had implemented legislation or regulations requiring firms to report suspicious activities, but 7 did not enact these laws until 1998 or later. Similarly, FATF's three newest members issued their anti-money laundering laws covering suspicious activity reporting requirements in 1997, 1998, and 2000.

Some countries may not have the necessary enforcement tools and resources to implement anti-money laundering measures properly. FATF reported that while some member countries have sanctions in place for firms that fail to report suspicious activities indicative of money laundering, other countries do not. In the United Kingdom, for example, we were told that officers of firms that do not report suspicious activities can be sentenced to up to 15 years in jail. In general, however, FATF reports that few members have applied such sanctions. In some member countries where the regulatory framework and mechanisms for monitoring suspicious activities are in place, the resources fall short of what is needed to make full use of these systems. FATF identified limited staff resources as a particular problem that has resulted in a backlog of SARs that have not been investigated. However, these countries are planning to allocate more resources to the units responsible for collecting, analyzing, and disseminating suspicious transaction information.

Most countries had not reported many money laundering cases involving nonbank financial institutions, and data on securities-specific cases are generally not available. Overall, other countries reported having much lower rates of enforcement activity related to money laundering than the United States. FATF reported that law enforcement statistics showed marked differences in the anti-money laundering activities of its member countries and in some cases indicated that members had undertaken few prosecutions or confiscations of funds. Law enforcement statistics for CFATF members also showed limited activity in the area, including few money laundering prosecutions and convictions. In contrast, the United States has reported relatively large numbers of prosecutions, convictions, confiscations, and seizure rates involving money laundering. During 1999, for example, the United States had 996 money laundering convictions, the highest number reported by any of the FATF member countries.

Conclusions

The extent to which money laundering is occurring in the securities industry is not known, although law enforcement officials believe that various characteristics of the industry may make it a target like other

financial industries. An assessment of the industry's vulnerability must also consider the extent to which the industry is covered by anti-money laundering regulatory requirements and the actions broker-dealers and mutual fund firms themselves have taken to prevent their use by money launderers. Although firms in the securities industry are subject to criminal prosecution for facilitating money laundering and must comply with certain BSA reporting and recordkeeping requirements, all broker-dealer and mutual fund firms are not yet required to report suspicious activities that could be evidence of potential money laundering. As a result, the extent to which firms in the industry have taken steps to detect and prevent money laundering also varied. We found that many of the larger firms, which hold the majority of accounts and assets in the industry, had implemented voluntary anti-money laundering measures, but most of the small and medium-sized firms that represent the majority of broker-dealer and mutual fund firms in the industry had not. Although efforts by regulators to develop a SAR rule applicable to the securities industry are under way, they are not yet complete. As a result, regulators, broker-dealers, and mutual fund firms have more to do to further reduce the securities industry's overall vulnerability to money laundering.

Agency Comments and Our Evaluation

We received written comments on a draft of this report from Treasury's FinCEN and SEC. FinCEN, whose written comments appear in appendix VIII, generally agreed with the draft report. FinCEN noted that the report provides information that will be useful in identifying and evaluating the operational effects of any future anti-money laundering regulatory requirements pertaining to the securities industry. This includes FinCEN's current efforts to promulgate a draft rule that would require registered broker-dealers to establish programs to identify and report suspicious activities. FinCEN also provided technical comments, which we incorporated in this report as appropriate.

SEC, whose written comments appear in appendix IX, similarly agreed with the observations contained in the draft report and noted that the draft provided a helpful overview of issues facing the securities industry, securities regulators, and law enforcement agencies as they continue their efforts to block money laundering. In its view, SEC said that our draft report identified two insights that would be particularly helpful to the government's continued fight against money laundering. First, because more than 90 percent of broker-dealer and mutual fund firms reported never accepting cash, SEC noted that placement of physical currency into the financial system is not a significant risk for the securities industry.

Secondly, SEC's letter highlighted that our survey results indicated that the firms responsible for most of the U.S. securities industry's accounts, transactions, and assets have implemented a broad range of voluntary anti-money laundering measures. We agree that the larger firms were more likely to report having implemented a variety of anti-money laundering measures. We note, however, that we did not attempt to verify the information provided by firms responding to our survey. In addition, the effectiveness of firms' anti-money laundering programs also depends on such factors as the extent of management support and the level of supervision over employees and customer activity. In its letter, SEC also noted that the implementation of an effective SAR requirement for broker-dealers—one focused on layering and integration—should help all regulators and law enforcement officials address money laundering. SEC also provided technical comments, which we incorporated in this report as appropriate.

Justice provided us with informal comments in which it generally concurred with the substance of the draft report and offered a few additional observations. Justice noted, for example, that most of its enforcement efforts have focused on the large broker-dealers, leaving a significant segment of the securities industry unaddressed. It also emphasized that the opportunities for laundering illegal proceeds through on-line brokerage accounts require further scrutiny.

As agreed with your office, unless you publicly release its contents earlier, we plan no further distribution of this report until 14 days from its issuance date. At that time, we will send copies of this report to interested congressional committees and members. We will also send copies to the Secretary of the Treasury, the U.S. Attorney General, and the Chairman of SEC. Copies will also be made available to others upon request.

Key contributors to this report are listed in appendix X. If you have any questions, please call me at (202) 512-5431 or Cody Goebel, Assistant Director, at (202) 512-7329.

Sincerely yours,

A handwritten signature in black ink, appearing to read "Davi M. D'Agostino". The signature is fluid and cursive, with the first name "Davi" being the most prominent.

Davi M. D'Agostino
Director, Financial Markets
and Community Investment

Scope and Methodology

Determining Potential for Money Laundering and the Extent to Which Existing Regulations and Oversight Apply to the Securities Industry

To develop information on the potential for money laundering in the U.S. securities industry, we obtained the views of securities industry representatives and regulatory officials as well as the perspectives of several law enforcement agencies. At the Department of the Treasury, we spoke with officials from the Financial Crimes Enforcement Network (FinCEN), U.S. Customs Service, Internal Revenue Service, U.S. Secret Service, Office of Foreign Assets Control, and Office of Enforcement. At the Department of Justice, we spoke with officials from the Drug Enforcement Administration, Federal Bureau of Investigation, and Executive Office for U.S. Attorneys. We reviewed relevant reports, including *the National Money Laundering Strategy for 2000* issued by Treasury and the U.S. Attorney General, *International Narcotics Control Strategy Report* issued by the U.S. Department of State, and *Report on Money Laundering* by the International Organization of Securities Commissions. We also conducted an independent legal search of cases involving money laundering through the securities industry and reviewed indictments, news articles, and other supporting documentation (provided primarily by the Internal Revenue Service and the Executive Office for U.S. Attorneys) to identify relevant cases.

To describe the anti-money laundering legal framework applicable to the U.S. securities industry and related regulatory oversight, we interviewed officials at the Securities and Exchange Commission (SEC), New York Stock Exchange (NYSE), National Association of Securities Dealers (NASD), Federal Reserve Board, Office of the Comptroller of the Currency, and Office of Thrift Supervision. We also reviewed U.S. anti-money laundering laws, rules, and regulations; accompanying congressional records; SEC and self-regulatory organization (SRO) examination procedures covering compliance with Bank Secrecy Act (BSA) requirements and related anti-money laundering guidance; semiannual reports to Treasury summarizing SEC and SRO examination findings pertaining to BSA, SEC correspondence on anti-money laundering issues, and other relevant documentation.

Determining the Extent to Which Broker-Dealers and Mutual Funds Have Implemented Anti-Money Laundering Activities

To determine the nature of the anti-money laundering efforts of broker-dealers and mutual funds, we interviewed industry officials at their respective companies and held roundtable discussions with panels of industry officials representing some of the nation's major broker-dealer and mutual fund firms. We also spoke with representatives of industry trade associations, such as the Securities Industry Association and Investment Company Institute, and reviewed available reports and other documents covering money laundering issues relative to the securities industry.

To determine the extent to which firms were undertaking anti-money laundering activities, we also surveyed representative probability samples of broker-dealers and mutual funds. For our survey of broker-dealers, our target population was all broker-dealers conducting a public business, including firms that carry customer accounts, clear trades, or serve as introducing brokers. These firms were selected because their activities may expose them to potential money laundering, unlike brokers who do not conduct transactions for customers. For our survey of mutual fund firms, our target population was direct-marketed, no-load mutual fund families that sell shares directly to investors and would have some anti-money laundering responsibilities because of their direct contact with customers. The majority of other mutual funds are sold by other financial institutions, such as broker-dealers, banks, and insurance companies, and these entities would have the contact with customers potentially seeking to launder money.

Our representative probability samples included three groupings: (1) broker-dealers, (2) securities subsidiaries of bank holding companies and foreign banking organizations, and (3) mutual funds. For each grouping, we used survey data to estimate what types of monetary instruments are accepted and what anti-money laundering activities are conducted, including voluntary measures such as implementing written anti-money laundering procedures to identify noncash suspicious activities, establishing related internal controls, providing personnel training, and filing suspicious activity reports (SAR). Appendix II is an example of one of our survey instruments.

Sample Design

Our three statistically valid random samples were drawn so that each sampled firm had a known, nonzero probability of being included in our survey. In the broker-dealer and mutual fund surveys, the samples were allocated across several categories, or strata, defined by the size of the

firm, so that proportionally more of the sample was allocated to the strata with larger firms. This makes our estimates of anti-money laundering activity, which tends to vary by size of firm, more precise. To produce the estimates from this survey, answers from each responding firm were weighted in the analysis to account for the different probabilities of selection by stratum and to make our results representative of all the members of the population, including those that were not selected or did not respond to the survey.

For our survey of broker-dealers, our target population was all broker-dealers conducting a public business, including firms that carry customer accounts, clear trades, or serve as introducing brokers. Using these specifications, we requested year-end 1999 financial and operational reports filed with SEC by 5,460 firms. From this list, we eliminated 1,626 NASD-member firms not conducting a public business and carrying or clearing trades, such as those that act as floor brokers on the various exchanges or that sell mutual funds, direct participation plans, or units of mutual funds, but that nevertheless file broker-dealer reports with SEC. We also removed the 53 section 20 subsidiary firms identifiable in the dataset at that time, resulting in a population of 3,781 broker-dealers for sampling purposes. Table 5 provides additional information on the selected characteristics of this broker-dealer population.

Table 5: Selected Characteristics of the Broker-Dealer Population

| Selected characteristics | Number of broker-dealers |
|--|---------------------------------|
| Total assets: | |
| \$10 billion and over | 18 |
| \$230 million and under \$10 billion | 148 |
| \$1 million and under \$230 million | 1,472 |
| Under \$1 million | 2,143 |
| Average total assets: \$395 million | |
| Type of firm: | |
| Introducing brokers | 3,147 |
| Clearing brokers | 634 |
| Designated examining authority: | |
| NASD | 3,538 |
| NYSE | 231 |
| Chicago Board Options Exchange | 6 |
| Midwest Securities Exchange | 6 |

Source: GAO analysis of year-end 1999 financial and operational reports filed with SEC.

From these 3,781 firms, we drew a random probability sample of 231 broker-dealers. We distributed that sample over three size strata defined by total assets of the firms.

For our survey of mutual funds, our target population was direct-marketed funds whose shares are sold directly to retail or institutional customers. We developed a list of 363 of these direct-marketed mutual fund groups from lists of no-load mutual fund families (those fund complexes most likely to distribute shares of their funds themselves) from publications widely available at the time of our survey.¹ We drew a random sample of 92 fund families across two strata defined by the year-end 1998 asset size of firms.

¹Loads are sales charges paid by purchasers of mutual fund shares used to compensate the financial institution sales personnel for marketing those funds. No-load funds do not charge such fees because they market their funds themselves.

Some broker-dealers and mutual fund groups have been subject to additional money laundering regulation because of their affiliation with banks or other depository institutions—specifically, as subsidiaries of depository institutions or of their holding companies. As a result, we attempted to remove this group from our overall survey population of broker-dealers and administered a separate survey for such bank-affiliated brokers. However, we were unable to develop a survey population that included all securities subsidiaries of depository institutions or of their holding companies because comprehensive data on the extent and the identities of all such subsidiaries were not available. However, the Federal Reserve maintained data on the securities subsidiaries of the bank holding companies and foreign banking organizations that it oversees.² These bank-affiliated broker-dealers were subject to banking SAR requirements.³ As of December 31, 1999, the Federal Reserve oversaw 53 of these firms, and we randomly selected 37 of them for our survey.

Administration of the Surveys

We contacted all sampled firms by telephone to determine their eligibility for the survey and to determine who in each firm should receive the questionnaire. We sent questionnaires primarily by fax to firms beginning in December 2000. We made telephone follow-up contacts to some of the firms that did not respond within several weeks, to encourage them to return a completed questionnaire or to answer our questions by telephone. We stopped collecting completed questionnaires in April 2001. We used several variants of the questionnaires tailored to each industry and to whether the firm was subject to the banking SAR requirements. Although we conducted follow-up work with some of the respondents to clarify their responses and obtain additional information, we did not systematically verify the accuracy of survey responses or the extent to which firms were adhering to reported policies and procedures.

²At the time of our survey, a list of securities subsidiaries of bank holding companies compiled by the Federal Reserve was the only readily available listing of bank-affiliated broker-dealers. Information on the securities subsidiaries of national banks and federal thrifts was not available, but efforts have since been made to compile such information. See *Money Laundering: Oversight of Suspicious Activity Reporting of Bank-Affiliated Broker-Dealers Ceased* (GAO-01-474, Mar. 22, 2001).

³These securities subsidiaries had previously been referred to as section 20 subsidiaries, but the passage of the Gramm-Leach-Bliley Act of 1999 repealed sections 20 and 32 of the Glass-Steagall Act that had applied to the operations of these securities subsidiaries.

Disposition of Samples

We received 164 usable broker-dealer responses, 67 mutual fund responses, and 25 responses from securities subsidiaries of bank holding companies. After adjusting for those sampled firms that were discovered to be ineligible for our survey because they were no longer independent entities in their respective industries, the number of usable responses resulted in final response rates of 87 percent, 83 percent, and 69 percent, respectively (tables 6 to 8). Because not all respondents provided an answer to each question that they were eligible to answer, the item response rate varies and is generally lower than the unit response rate for each industry.

Table 6: Disposition of Broker-Dealer Sample

| Stratum, by total assets | Original population size | Sample size | Disposition | | | Usable response | Response rate |
|--|--------------------------|-------------|-------------|-----------|------------------------|-----------------|---------------|
| | | | Nonresponse | | | | |
| | | | Ineligible | Refusal | All other nonresponses | | |
| Large: \$230 million or more | 166 | 81 | 19 | 4 | 2 | 56 | 90% |
| Medium: 1 million up to \$230 million | 1,472 | 75 | 11 | 4 | 4 | 56 | 88 |
| Small: Up to \$1 million | 2,143 | 75 | 13 | 7 | 3 | 52 | 84 |
| Total | 3,781 | 231 | 43 | 15 | 9 | 164 | 87% |

Table 7: Disposition of Mutual Fund Sample

| Stratum, by total assets | Original population size | Sample size | Disposition | | | Usable response | Response rate |
|---|--------------------------|-------------|-------------|----------|------------------------|-----------------|---------------|
| | | | Nonresponse | | | | |
| | | | Ineligible | Refusal | All other nonresponses | | |
| Large: Over \$10 billion | 17 | 17 | 0 | 1 | 1 | 15 | 88% |
| Other (medium and small): \$10 billion and under | 346 | 75 | 11 | 6 | 6 | 52 | 81 |
| Total | 363 | 92 | 11 | 7 | 7 | 67 | 83% |

Table 8: Disposition of Sample of Securities Subsidiaries of Bank Holding Companies

| Original population size | Sample size | Disposition | | | | Usable response | Response rate |
|--------------------------|-------------|-------------|-------------|----|------------------------|-----------------|---------------|
| | | Ineligible | Nonresponse | | All other nonresponses | | |
| | | | Refusal | | | | |
| 53 | 37 | 1 | 0 | 11 | 25 | 69% | |

During the course of administering the surveys of broker-dealers and mutual fund groups, we identified 12 broker-dealers and 2 mutual fund groups that indicated that they were subject to the banking SAR requirements. Responses of these 14 firms were analyzed in conjunction with responses of the securities subsidiaries of institutions overseen by the Federal Reserve.

Survey Error and Data Quality

Point estimates from sample surveys are subject to a number of sources of error, which can be grouped into the following categories: sampling error, coverage error, nonresponse error, measurement error, and processing error. We took a number of steps to limit these errors.

Sampling error exists because our random sample is only one of a large number of samples that we might have drawn. Since each sample could have produced a different estimate, we express the precision of our particular sample's results as a 95-percent confidence interval. This is the interval (e.g., ± 7 percentage points on either side of the percentage estimate) that would contain the actual population value for 95 percent of the samples we could have drawn. As a result, we are 95-percent confident that each of the confidence intervals cited in this report will include the true values in the study population.

Surveys may also be subject to coverage error, which occurs when the sampling frame does not fully represent the target population of interest. We used the most up-to-date lists that were available to us, and we attempted to remove firms that were no longer in the industry of interest. For the mutual fund survey, our results are representative only of those mutual fund groups that are direct marketed and that offer predominantly no-load funds, which we believe is closest to the target population of mutual funds that are self-distributing. Also, we discovered a small number

of firms in our broker-dealer sample that was affiliated with depository institutions and subject to banking SAR requirements. These firms would have been excluded from our overall broker-dealer sample frame had we known this before conducting our survey; their responses were analyzed with those from our sample frame for bank-affiliated securities subsidiaries, which represented broker-dealers subject to banking SAR requirements.

Measurement errors are defined as differences between the reported and true values. Such errors can arise from the way that questions are worded, differences in how questions are interpreted by respondents, deficiencies in the sources of information available to respondents, or intentional misreporting by respondents. To minimize such errors, we asked subject matter experts to review our questionnaires before the survey, and pretested the questionnaires by telephone with respondents at several firms of various sizes and levels of anti-money laundering activity.

Nonresponse error arises when surveys are unsuccessful in obtaining any information from eligible sample elements or fail to get valid answers to individual questions on returned questionnaires. To the extent that those not providing information would have provided significantly different information from those that did respond, bias from nonresponse can also result. Because the seriousness of this type of error is often proportional to the level of missing data, response rates are commonly used as indirect measures of nonresponse error and bias. We took steps to maximize response rates, such as sending multiple faxes of the questionnaires and making several telephone follow-ups to convert nonrespondents.

Finally, surveys may be subject to processing error in data entry, processing, and analysis. We verified the accuracy of a small sample of keypunched records by comparing them with their corresponding questionnaires, and we corrected any errors found. Less than 1 percent of the data items we checked had random keypunch errors that would not have been corrected during data processing. Analysis programs were also independently verified.

We conducted follow-up work with many of the respondent firms to obtain additional information on or clarification of their survey responses. We also worked with FinCEN to corroborate survey responses on the extent that securities firms have filed SARs using procedures that attempted to maintain the confidentiality of the identities of our survey respondents.

International Anti-Money Laundering Efforts

To obtain information on international efforts aimed at addressing money laundering in the securities industry, we interviewed members of the U.S. delegation to the Financial Activities Task Force (FATF), officials of the Caribbean Financial Activities Task Force (CFATF), and representatives of the U.S. Department of State. We also spoke with foreign officials representing the financial supervising authorities, law enforcement or financial intelligence units, prosecuting offices, and securities industries in Barbados, Germany, Trinidad and Tobago, and the United Kingdom. In addition, we interviewed knowledgeable representatives at the U.S. embassies located in these jurisdictions. We reviewed FATF and CFATF annual reports; summaries of mutual evaluations, self-assessments, and the results of plenary meetings; documents provided by countries we visited on their anti-money laundering oversight and law enforcement efforts; and relevant reports issued by various international working groups and committees. Lastly, we researched the Web sites of selected foreign financial regulators and reviewed available documentation on their anti-money laundering regulations, policies, and industry guidelines. Information on foreign anti-money laundering laws or regulations is based on interviews and secondary sources and does not reflect our independent legal analysis.

We conducted our work between May 2000 and May 2001 in accordance with generally accepted government auditing standards.

Example of a Data Collection Instrument Used to Survey the Securities Industry

U.S. General Accounting Office

GAO

**Survey Of Anti-Money Laundering Programs
In the Securities Industry**

Background

We have been requested by the Senate's Permanent Subcommittee on Investigations to conduct a review of money laundering issues in the securities industry. One of several questions posed by the subcommittee involves the nature and extent to which securities firms are engaged in anti-money laundering efforts. Industry representatives have told us that, although existing anti-money laundering laws and requirements that pertain to the securities industry at-large focus primarily on reporting currency transactions and documenting transmittal of funds (as in 31 USC 5313 and 31 CFR Part 103, commonly referred to as the Bank Secrecy Act, and SEC Rule 17a-8), some broker-dealers firms have developed formal anti-money laundering programs that go beyond these two areas of activity. They have also noted that although a suspicious activity report rule for the securities industry has not yet been issued, some broker-dealers are already filing suspicious activity reports. This survey attempts to capture information on the nature and extent to which securities firms are engaged in such anti-money laundering efforts, especially those that go beyond current requirements for the industry.

Privacy

GAO will take steps to safeguard the privacy of your responses. The number and identifying information on this questionnaire are included only to aid us in our followup efforts, and GAO will break the link between the identity of respondents and their answers before our report is issued. Furthermore, survey results will be reported in an aggregated, summary form, and any discussion of individual answers or comments will omit any information that could identify the respondent.

Who Should Respond

It is very important that each firm that we have randomly selected to be in this study respond, even if money laundering issues have little or no relevance. Your response is necessary to ensure that we obtain a complete, unbiased description of this industry.

Please answer the questions for only the institution as addressed, and not any holding companies, subsidiaries, or affiliates that have their own securities operations or separate policies and procedures.

This questionnaire should be filled out by the person(s) most familiar with any policies and procedures regarding money laundering.

Instructions

Please fax your completed questionnaire to the attention of Evelyn Aquino at (415) 904-2111.

We would appreciate receiving your response to the survey within two weeks of receipt. Please attach additional sheets if the space provided is not adequate for your responses.

Please do not hesitate to call Evelyn Aquino at (415) 904-2253 if you have any questions or need more time to prepare your responses. Thank you for your time and attention to this matter.

Page 1 of 7

Appendix II
Example of a Data Collection Instrument
Used to Survey the Securities Industry

Please provide the following information in the event we need to clarify a response:

Name of Primary Respondent: _____

Title: _____

Institution: _____

E-mail Address: _____

Phone Number: _____ Fax Number: _____

1. Which of the following best describe your company's broker/dealer business?

Mark all boxes that apply and specify any others.

- Introducing
- Clearing
- Retail
- Institutional
- Discount
- Full service
- Online broker
- Other(s): _____

2. Which one of the following best describes the geographic scope of your company's operations? *Mark only one box.*

- Regional
- National
- International
- Other: _____

3. What is the average dollar size of an individual transaction processed by your company for its retail customers? *Enter best estimate of average transaction size below or N/A if your company has no retail customers.*

\$ _____

**Appendix II
Example of a Data Collection Instrument
Used to Survey the Securities Industry**

4. **Does your company accept any of the following monetary instruments?** *Mark one box in each row and, if "sometimes" is marked, please explain exceptions.*

| | Yes, in all cases | No, never | Some- times | IF "SOMETIMES": please explain exceptions: |
|-----------------------------|-------------------------|--------------|----------------|---|
| Currency (cash and coin) | | | | |
| Personal or business checks | | | | |
| Third party checks | | | | |
| Cashier's checks | | | | |
| Official bank checks | | | | |
| Travelers checks | | | | |
| Money orders | | | | |
| Promissory notes | | | | |

5. **Does your company facilitate transfers or transmittal of funds for its customers?** *Mark only one box.*

- Yes, in all cases**
 Sometimes, on an exception basis -- Briefly describe under what circumstances transfers or transmittal of funds are made:

- No, never**

6. **Does your company perform clearing services for other broker/dealers (e.g., introducing firms)?**

- Yes** ➔ *Please CONTINUE with question 7.*
 No ➔ *Please SKIP to question 8.*

Appendix II
Example of a Data Collection Instrument
Used to Survey the Securities Industry

7. For transactions forwarded by other broker/dealers, does your company conduct any of the following anti-money laundering functions?

Mark either "Yes" or "No" box in each row

Yes No

- Monitors and reports forwarded currency transactions over \$10,000
- Monitors and reports forwarded transactions involving cash equivalents (e.g., checks, money order, or promissory notes) exceeding \$10,000
- Documents forwarded requests for transfers or transmittal of funds over \$3,000

If any of the above is done on an exception basis only, please briefly explain below:

8. Although not currently required by law for the industry at-large, some firms might have implemented anti-money laundering measures (e.g., written policies and procedures, internal controls, tools or internal processes, or employee training) that go beyond monitoring and reporting currency transactions or documenting wire transfers. Specifically, this could entail various efforts to monitor and report suspicious transactions potentially involving money laundering. **Has your company implemented such voluntary anti-money laundering measures?**

- Yes** ➔ *Please CONTINUE with question 9.*
- No** ➔ *STOP here, you have completed the survey.*

9. Does your company currently have written anti-money laundering policies and procedures that cover any of the following areas? Mark either "Yes" or "No" box in each row and specify any others.

Yes No

- Obtaining and using information on new customers' sources of wealth or net worth for anti-money laundering purposes
- Obtaining and using information on new customers' sources of income for anti-money laundering purposes
- Identifying and reporting suspicious activities for anti-money laundering purposes, other than in currency transaction reports
- Limiting and monitoring the use of anonymous accounts for anti-money laundering purposes
- Other anti-money laundering-related policies and procedures:

Appendix II
Example of a Data Collection Instrument
Used to Survey the Securities Industry

10. **Does your company currently have any of the following internal controls (e.g., review procedures) to ensure that personnel handling customer accounts follow anti-money laundering policies and procedures identified in question 9?** *Mark either "Yes" or "No" box in each row and specify any others.*

Yes No

- Supervisor /manager review of all new accounts to ensure compliance with anti-money laundering policies and procedures
- Supervisor/manager review of new accounts over a certain dollar threshold to ensure compliance with anti-money laundering policies and procedures
- Supervisor/manager review of selected existing accounts to ensure compliance with anti-money laundering policies and procedures
- Compliance officer review of accounts to ensure compliance with anti-money laundering policies and procedures
- Internal audit review of compliance with anti-money laundering policies and procedures
- External audit review of compliance with anti-money laundering policies and procedures
- Other types of anti-money laundering-related internal controls:

11. **Does your company currently have any other tools or internal processes to help identify, review, and report suspicious activities that may involve money laundering?** *Mark either "Yes" or "No" box in each row and specify any others.*

Yes No

- A transaction monitoring program to identify suspicious activities that may involve money laundering
- A transaction monitoring program with computer surveillance capabilities for identifying suspicious activities that may involve money laundering
- Guidelines for identifying suspicious activities that may involve money laundering
- Centralized decision-making process to determine which suspicious activities should be externally reported to law enforcement for anti-money laundering purposes
- Identified list of high risk activities, clients, and/or transactions that warrant greater employee scrutiny for anti-money laundering purposes
- Compliance staff with knowledge and expertise in the money laundering area
- Other types of anti-money laundering-related tools or internal processes:

Appendix II
Example of a Data Collection Instrument
Used to Survey the Securities Industry

12. Does your company provide formal training to its employees to raise awareness about the potential for money laundering through the firm (including the identification of suspicious activities involving non-cash transactions)?

- Yes ➔ Please CONTINUE with question 13.
 No ➔ Please SKIP to question 15.

13. Which of the following employees currently receive such formal anti-money laundering training? Mark either "Yes" or "No" box in each row and specify any others.

Yes No

- | | | |
|--------------------------|--------------------------|---|
| <input type="checkbox"/> | <input type="checkbox"/> | Personnel who handle new customer accounts |
| <input type="checkbox"/> | <input type="checkbox"/> | Registered personnel and sales assistants who handle trades |
| <input type="checkbox"/> | <input type="checkbox"/> | Compliance staff |
| <input type="checkbox"/> | <input type="checkbox"/> | Management |
| <input type="checkbox"/> | <input type="checkbox"/> | New employees |
| <input type="checkbox"/> | <input type="checkbox"/> | Other types of employees: _____ |

14. Please briefly describe your company's anti-money laundering training program, including key topics covered and how often it is provided to employees, below:

15. Other than any measures already described above, does your company have specific anti-money laundering procedures that apply specifically to financial services provided to high net worth clients? Mark only one box.

- No additional procedures specifically for high net worth clients
 Yes ➔ Please briefly describe those procedures:

Appendix II
Example of a Data Collection Instrument
Used to Survey the Securities Industry

16. **Other than any measures already described above, does your company have specific anti-money laundering procedures that apply specifically to any online brokerage services you may provide?** *Mark only one box.*

- Not applicable - No online brokerage services offered
- No additional procedures specifically for online brokerage
- Yes ➔ Please briefly describe those procedures: _____

17. **If your company provides clearing services for other broker/dealers, what type of anti-money laundering measures does your company apply to clearing services that it performs for these broker/dealers?** *Mark all that apply and specify any others.*

- Not applicable - No clearing services for other firms offered
- Provides firms with transaction exception reports for anti-money laundering purposes
- Monitors transactions to identify suspicious activities that may involve money laundering
- Reports identified suspicious activities to broker/dealers
- Reports identified suspicious activities directly to law enforcement
- Applies same procedures used for its own trades to clearing services performed for other broker/dealers
- Other, please specify: _____

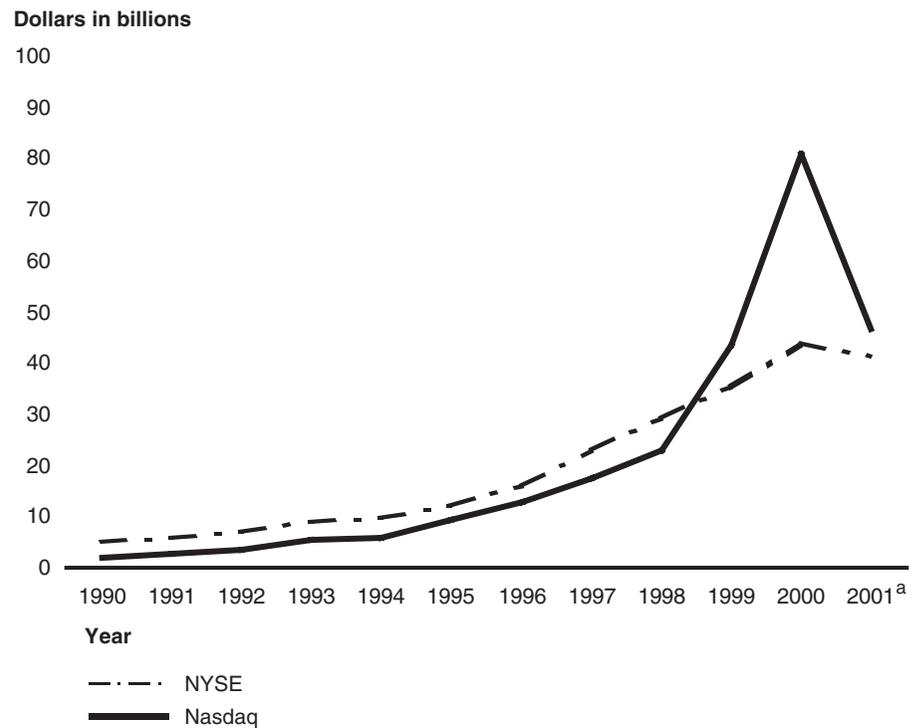
18. **How many suspicious activity reports, if any, has your company filed in calendar year 2000?** *Mark only one box.*

- Over 200
- 101-200
- 76-100
- 51-75
- 26-50
- 11-25
- 1-10
- None

Demographic Information on the U.S. Securities Industry

One of the reasons that the U.S. securities industry is seen as potentially attractive to money launderers is the rapid growth in securities activities in the United States. As shown in figure 8, the value of securities traded on the NYSE and the Nasdaq markets has grown significantly since 1990.

Figure 8: Average Daily Value of Securities Traded on Major U.S. Markets From January 1990 to June 1, 2001

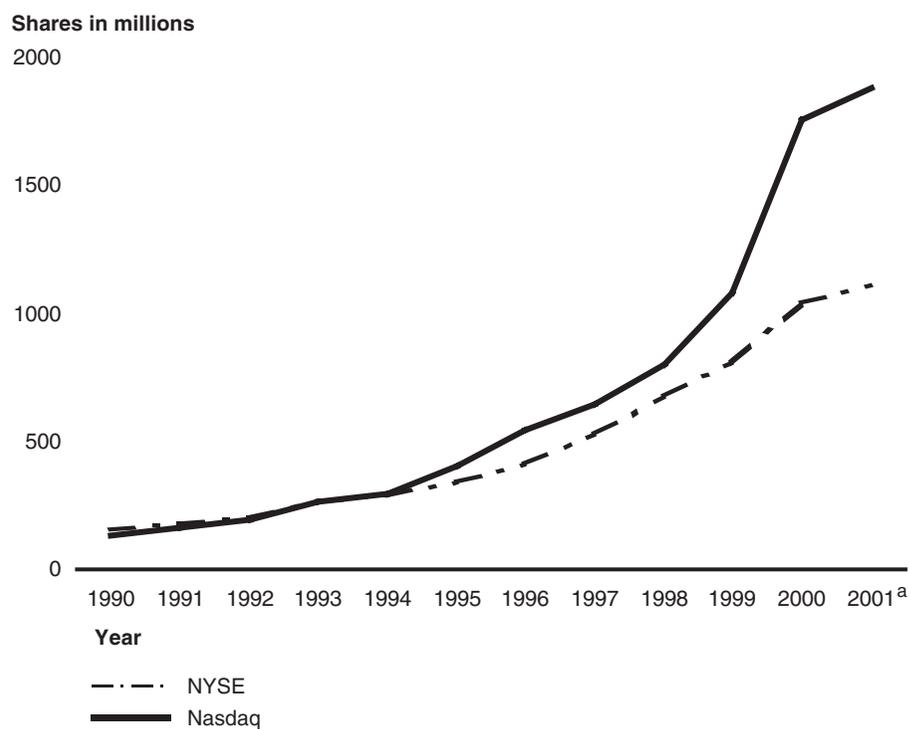


^aValue for 2001 reflects data through June 1.

Source: GAO presentation of Securities Industry Association data.

The number of shares traded on these two major U.S. markets has also increased during the 1990s (fig. 9).

Figure 9: Average Daily Shares Traded on Major U.S. Markets From January 1990 to June 1, 2001

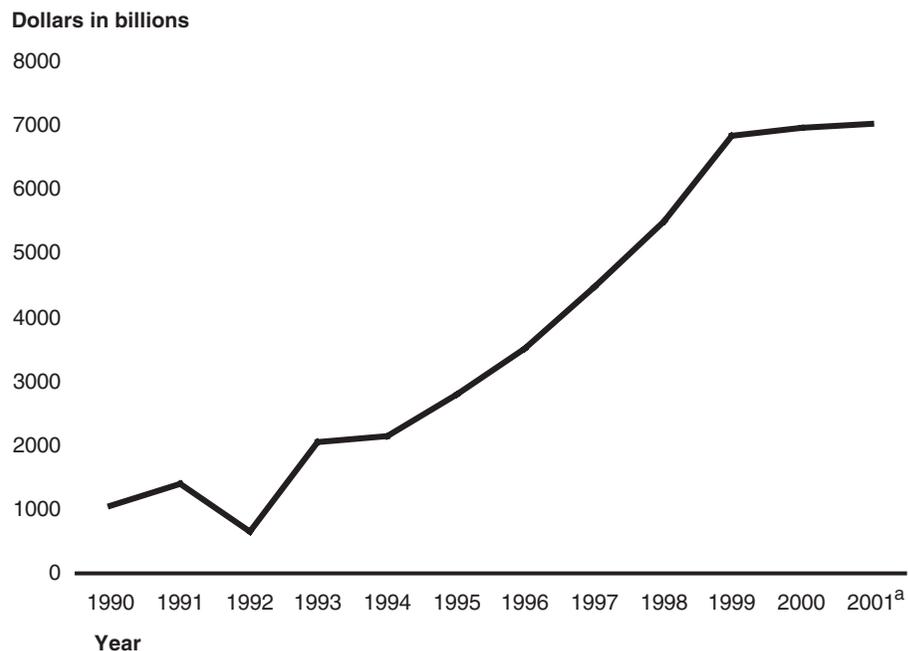


^aValue for 2001 reflects data through June 1.

Source: GAO presentation of Securities Industry Association data.

In addition to the increase in stock trading, mutual funds have also experienced considerable growth in the 1990s. As shown in figure 10, assets in mutual funds exceeded \$7 trillion in 2001.

Figure 10: Mutual Fund Assets From 1990 to June 1, 2001

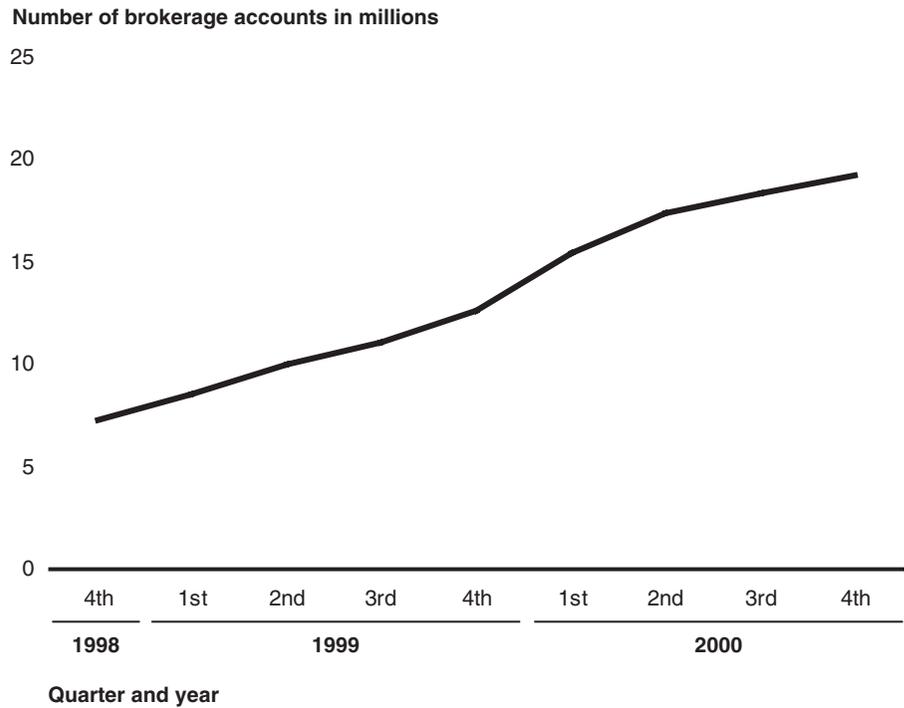


^aValue for 2001 reflects assets as of June 1.

Source: GAO presentation of Investment Company Institute and Securities Industry Association data.

Securities markets are now more accessible to investors with the advent of on-line trading accounts that allow investors to open accounts and send transaction instructions to broker-dealers using the Internet. As shown in figure 11, research staff for one broker-dealer reported that the number of on-line brokerage accounts was close to 20 million at the end of 2000.

Figure 11: Growth of On-line Brokerage Accounts From Fourth Quarter 1998 to Fourth Quarter 2000

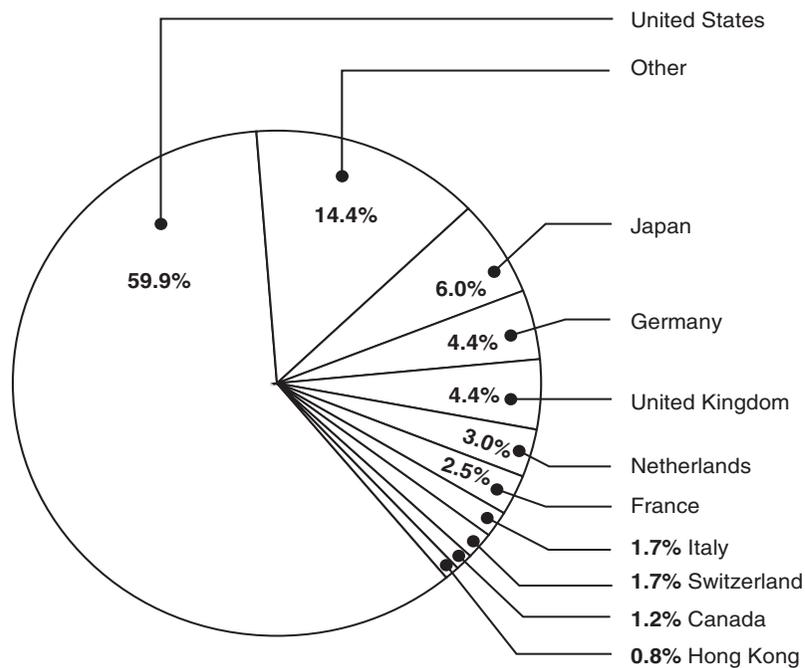


Source: GAO presentation of JP Morgan Securities, Inc., Equity Research data.

Although many countries have active securities markets, trading on markets in the United States continues to represent the majority of trading on all large markets (fig. 12).

**Appendix III
Demographic Information on the U.S.
Securities Industry**

Figure 12: Percentage Share of Trading for Markets in 10 Most Active Countries During 1999



Source: GAO presentation of Standard and Poor's data from the *2000 SIA Securities Industry Factbook*.

Identified Cases of Money Laundering Through the U.S. Securities Industry

To obtain information on the extent to which the U.S. securities industry was used to launder money as well as the vulnerability of the industry to money laundering, we contacted various U.S. law enforcement agencies. Within Treasury, we contacted the Customs Service, Internal Revenue Service's Criminal Investigation Division, Secret Service, FinCEN, Office of Foreign Assets Control, and Office of Enforcement. At Justice, we spoke with officials from the Drug Enforcement Administration, Federal Bureau of Investigation, and Executive Office for U.S. Attorneys.

Statistics on the number of cases in which money was laundered through brokerage firms and mutual funds were not readily available, but we compiled a listing of cases in which illegal funds were laundered through brokerage firms or mutual funds from information provided primarily by two of the law enforcement agencies we contacted. At our request, the Internal Revenue Service and Executive Office for U.S. Attorneys collected information from some of its field staff that identified about 15 criminal or civil forfeiture cases since 1997 that involved money laundering through brokerage and mutual fund accounts. Some cases in which money laundering is alleged involved securities fraud or crimes committed by securities industry employees who then moved their illegally earned proceeds to other institutions or used them to purchase other assets, thus violating the anti-money laundering statutes. However, we only included such cases if broker-dealer or mutual fund accounts were alleged to have been used to launder the money.

Table 9 provides a list of criminal cases in which proceeds from illegal activities were laundered through brokerage or mutual fund accounts. Table 10 provides a list of forfeiture cases in which property, including assets held in brokerage or mutual fund accounts, obtained from proceeds that were traceable to certain criminal offenses were taken by the United States to be distributed to the victims of such crimes as restitution. These lists contain examples of cases that involve charges of money laundering through brokerage or mutual fund accounts and do not represent an exhaustive compilation of all such known cases. For example, law enforcement officials indicated that they were unable to provide information on many relevant pending cases in the area and further emphasized that not all field offices and staff had been formally queried. Specific case information presented in the tables was extracted from public documents provided primarily by the Internal Revenue Service and Executive Office for U.S. Attorneys.

**Appendix IV
Identified Cases of Money Laundering
Through the U.S. Securities Industry**

Table 9: Identified Criminal Cases in Which Indictments Contained Charges of Money Laundering Through Brokerage or Mutual Fund Accounts

| Date of indictment or disposition | Case | U.S. District Court | Brief description, including source of illicit funds | Estimated amount of funds laundered | Case outcome or status |
|--|---|----------------------------------|--|--|-------------------------------|
| 2/15/01 Conviction | <i>United States v. Nigel Ramsay</i> | Southern District of Florida | Proceeds from narcotics (cocaine) trafficking activities were laundered through brokerage accounts. | \$290,000 ^a | Convicted at trial |
| 02/12/01 Judgment | <i>United States v. Edward Sirhan</i> | Eastern District of Tennessee | Proceeds from felony food stamp fraud were deposited into brokerage accounts. | \$460,000 ^a | Guilty plea |
| 2000 ^b Indictment | <i>United States v. Anthony C. Wong</i> | Southern District of New York | Proceeds from wire and mail fraud were laundered through securities accounts and transferred into Cayman Island bank accounts. | \$209,700 | Guilty plea |
| 11/06/00 Judgment | <i>United States v. Rudolph Keszthelyi</i> | Eastern District of Tennessee | Indictment charged narcotics proceeds were laundered through brokerage accounts. | \$60,000 ^a | Guilty plea |
| 05/18/00 Indictment | <i>United States v. Pavel Ivanovich Lazarenko</i> | Northern District of California | Defendant charged with extorting stolen property in the Ukraine and transferring proceeds into U.S. bank and brokerage accounts to disguise the origin and owner of the money. | \$114 million ^c | |
| 12/18/98 Indictment | <i>United States v. Wade Friday</i> | Eastern District of Pennsylvania | Proceeds from food stamp fraud were deposited into various money market and brokerage accounts. | \$55,000 ^a | Guilty plea |
| 10/19/98 Judgment | <i>United States v. David R. Hasler</i> | Southern District of Iowa | Funds embezzled from a securities firm were wire transferred into a personal trading account. | \$460,000 | Guilty plea |
| 08/17/98 Plea agreement | <i>United States v. Samuel R. Snider</i> | District of Alaska | Proceeds from the manufacture and sale of marijuana were deposited into investment accounts. | \$526,000 | Guilty plea |
| 08/18/97 Judgment | <i>United States v. Jerry Dixon</i> | Middle District of Tennessee | Proceeds from illegal gambling were deposited into brokerage accounts and other financial institutions. | \$100,000 | Guilty plea |

^aFunds noted as laundered specifically through brokerage or mutual fund accounts.

^bTime frame was estimated on the basis of available information.

^cInformation was not readily available or could not be determined from documentation at hand.

Source: Public documents provided primarily by the Internal Revenue Service and Executive Office for U.S. Attorneys.

**Appendix IV
Identified Cases of Money Laundering
Through the U.S. Securities Industry**

Table 10: Identified Forfeiture Cases That Involved Money Laundering Through Brokerage or Mutual Fund Accounts

| Date of complaint | Name of account under forfeiture | U.S. District Court | Brief description, including source of illicit funds | Estimated amount of funds laundered^a | Status of case |
|--------------------------|---|-------------------------------|---|--|-----------------------|
| 1999 ^b | Raoul M. Stetson, et al. | Southern District of New York | Proceeds from drug operations were deposited into a brokerage account and forfeited in connection with guilty plea. | \$25,000 | Closed |
| 11/23/99 (second amend.) | Proceeds of Drug Trafficking Transferred to Certain Domestic Bank Accounts | Southern District of Alabama | Proceeds from drug trafficking were placed into various bank and investment accounts. | \$139,000 ^a | Closed |
| 12/03/98 | Contents of Account Number 5061-578941 in the Name of Andrew D. Rhee, at Refco, Inc. | Southern District of New York | Proceeds from fraudulent purchases and sales of commodity futures contracts were ultimately deposited into a brokerage account. | \$750,000 ^a | Closed |
| 11/15/98 | Approximately \$25,829,681.80 in the Court Registry Investment System | Southern District of New York | Proceeds of a wire fraud scheme were deposited into brokerage accounts. Victims were induced to wire transfer investment funds into brokerage accounts to be traded. Defendants instead withdrew the money for their own use. | \$25 million | Pending ^c |
| 07/08/98 | Contents of Account No. 594-07N41 in the Name of Hamilton Farrar, L.L.C. at Merrill Lynch, Pierce, Fenner & Smith, Inc. | Southern District of New York | Proceeds from a "prime bank" scheme ^d were placed into a brokerage account. | \$3.7 million | Closed |
| 03/18/98 | All Funds Held by AMS, L.L.C., as Trustee Pursuant to Court Order in Dean Witter Account | Southern District of New York | Proceeds from a prime bank scheme were wired into banks across the United States, then transferred into various brokerage accounts. | \$3.46 million | Closed |
| 08/29/97 | Contents of Dean Witter Brokerage Account in the Name of Paul W. Eggers | Southern District of New York | Proceeds from a prime bank scheme were placed into a brokerage account and money market fund. Brokerage account was opened with a cashier's check and received subsequent deposits in wire transfers and additional cashier's checks. | \$8 million (approx.) | Pending ^c |

^aFunds noted as laundered specifically through brokerage or mutual fund accounts

^bTime frame was estimated on the basis of available information.

^cForfeiture or some aspect of the criminal case is still pending. Cases in which a defendant has been charged but not yet convicted have not been included.

^dPrime bank schemes involve fraudulent investment recommendations in which investors are induced to purchase and trade prime bank financial instruments on overseas markets to generate huge returns. However, neither these instruments, nor the markets on which they allegedly trade, exist.

Source: Public documents provided primarily by the Internal Revenue Service and Executive Office for U.S. Attorneys.

Survey Information on the Average Dollar Size of Transactions Processed for Retail Customers

The overall average dollar size of individual transactions processed for retail customers among firms responding to our survey was \$22,000 for broker-dealers and \$11,000 for mutual funds groups, as shown in table 11. The median, or middle value for the full range of responses, was substantially lower than the average for each of the two types of firms. The combined range of the average transactions varied widely—from \$200 to \$200,000.

Table 11: Information on the Average Size of Transactions Processed for Retail Customers, by Type and Size of Firm

| Firm, by type and size | N | Dollar size of average transaction processed for retail customers | | | |
|-------------------------------------|------------|---|-----------------|-----------------|--------------------------|
| | | Mean | Median | Mode | Range |
| Broker-dealers: | | | | | |
| Large | 29 | \$26,536 | \$15,000 | \$5,000 | \$500 - \$100,000 |
| Medium | 38 | 24,370 | 15,000 | 10,000 | 200 - 150,000 |
| Small | 42 | 17,517 | 10,000 | 5,000 | 500 - 100,000 |
| All broker-dealers | 109 | \$22,306 | \$12,000 | \$5,000 | \$200 - \$150,000 |
| Direct-marketed mutual fund groups: | | | | | |
| Large | 12 | \$6,689 | \$5,665 | \$15,000 | \$750 - \$15,000 |
| Medium/Small | 47 | 12,582 | 5,000 | 10,000 | 200 - 200,000 |
| All mutual fund groups | 59 | \$11,384 | \$5,000 | \$10,000 | \$200 - \$200,000 |

Legend

N = The total number of respondents.

Note: This table reflects only the actual amounts reported on the survey. We could not develop meaningful estimates for the entire industry because of the low number of firms that provided information on the average size of transactions and the wide range of responses.

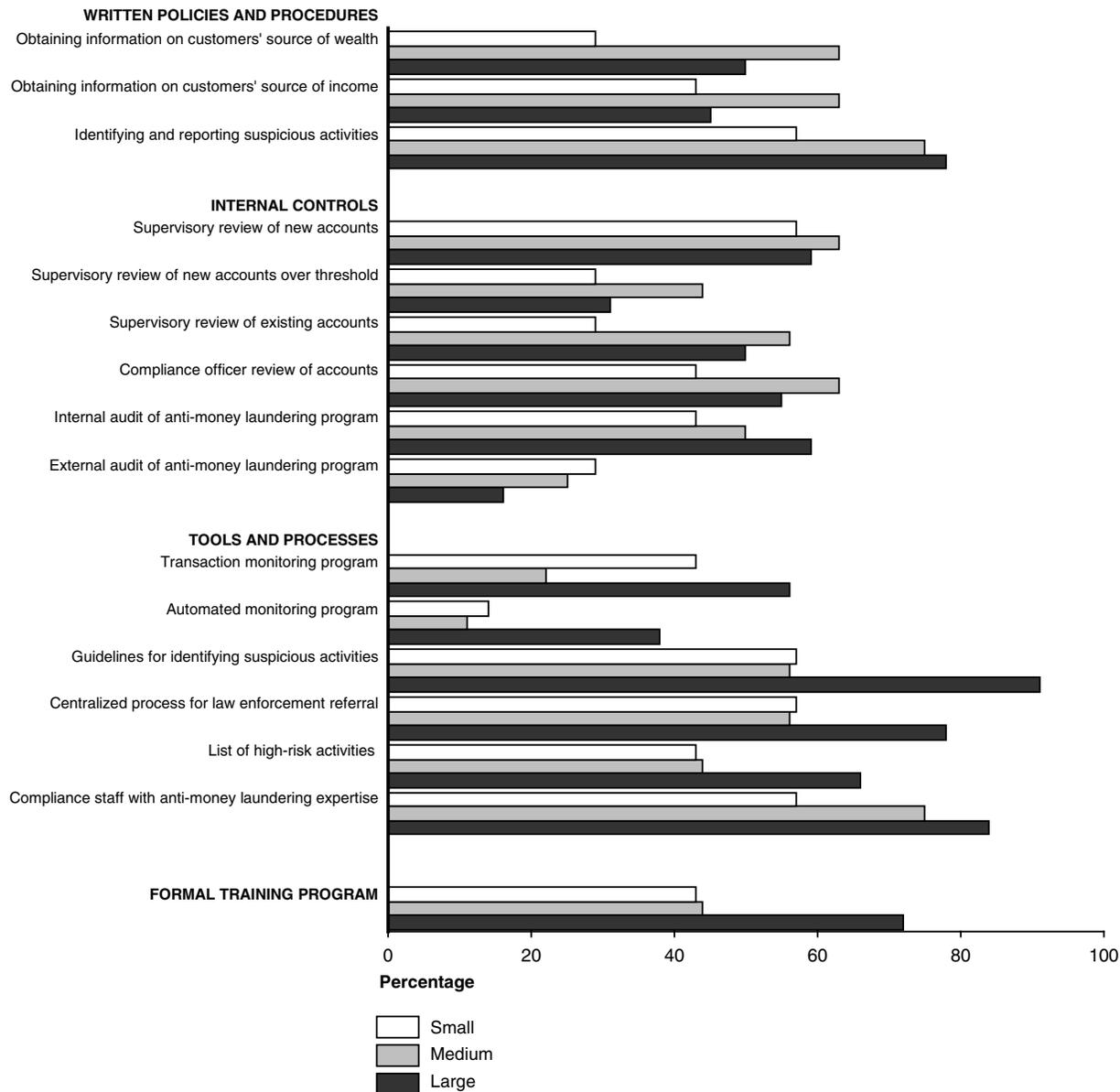
Source: Analysis of responses to GAO survey.

Additional Information on Voluntary Anti-Money Laundering Measures From Surveys of Broker-Dealers and Mutual Fund Groups

For those broker-dealers that indicated that they had voluntary anti-money laundering measures in place, large broker-dealers tended to implement more of the anti-money laundering tools and processes than the medium-sized or small firms, as shown in figure 13. Implementation of the other types of voluntary anti-money laundering measures varied.

**Appendix VI
Additional Information on Voluntary Anti-
Money Laundering Measures From Surveys
of Broker-Dealers and Mutual Fund Groups**

Figure 13: Proportion of Broker-Dealers That Reported Implementing Various Types of Voluntary Anti-Money Laundering Measures



Note: Due to the small number of firms implementing voluntary measures in each size category, differences across size categories are not statistically significant.

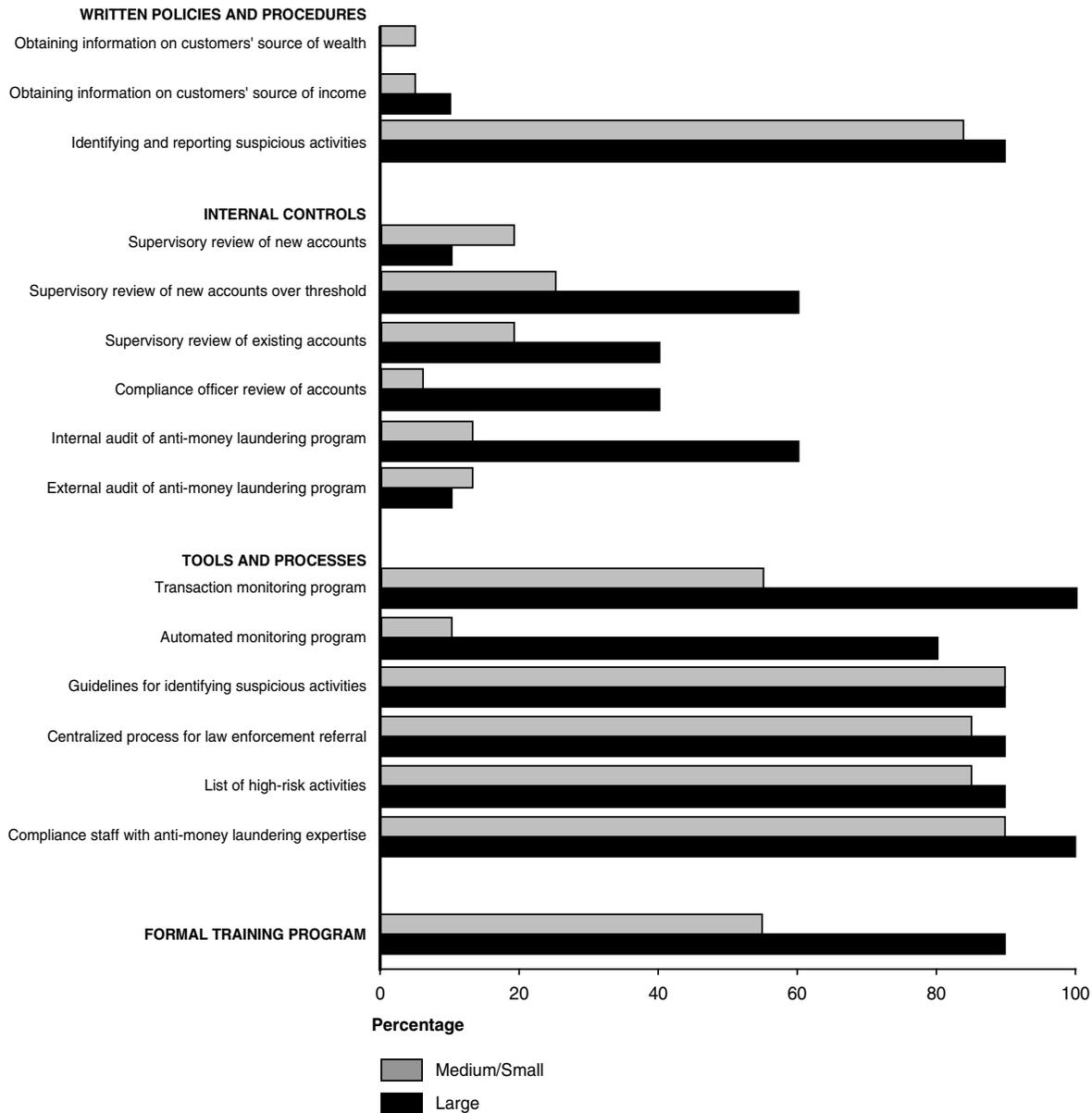
Source: Analysis of responses to GAO surveys.

**Appendix VI
Additional Information on Voluntary Anti-
Money Laundering Measures From Surveys
of Broker-Dealers and Mutual Fund Groups**

For those mutual fund groups that indicated they had voluntary anti-money laundering measures in place, large mutual funds reported implementing more of the various voluntary anti-money laundering measures, but medium-sized and small funds have also implemented many of the same measures (see fig. 14).

**Appendix VI
Additional Information on Voluntary Anti-
Money Laundering Measures From Surveys
of Broker-Dealers and Mutual Fund Groups**

Figure 14: Proportion of Mutual Fund Groups That Reported Implementing Various Types of Voluntary Anti-Money Laundering Measures



Note: Due to the small number of firms implementing voluntary measures in each size category, differences across size categories may not be statistically significant.

Source: Analysis of responses to GAO surveys.

Additional Information on the Caribbean Financial Action Task Force

CFATF is the Caribbean basin counterpart of FATF that works to assist member governments in implementing anti-money laundering mechanisms. Its 25 members are countries and territories from the Caribbean, Central America, and South America.¹ CFATF was created as the result of meetings held in the early 1990s by representatives of the Western Hemisphere countries to develop a common approach to combat the laundering of drug trafficking proceeds. In 1992, CFATF developed 19 recommendations on the basis of this common approach, which have specific relevance to the region and complement the 40 recommendations of FATF. Member governments have signed a memorandum of understanding, known as the Kingston Declaration on Money Laundering, which confirms their agreement to adopt and implement various internationally accepted standards and recommendations and CFATF's 19 regionally focused recommendations.² The CFATF Secretariat monitors members' implementation of the Kingston Declaration through various mechanisms, including self-assessment questionnaires, mutual evaluations of anti-money laundering regimes, training technical assistance programs, and plenary and Ministerial meetings.

Laws Requiring Securities Firms to Report Suspicious Transactions in Some CFATF Jurisdictions Were Recently Enacted

According to CFATF officials, most CFATF jurisdictions that have organized securities exchanges require their securities firms to report suspicious transactions; however, almost all of these requirements were enacted recently. CFATF officials noted that 11 member jurisdictions (i.e., the Bahamas, Barbados, Bermuda, the Cayman Islands, Costa Rica, the Dominican Republic, Jamaica, Nicaragua, Panama, Trinidad and Tobago, and Venezuela) have at least 1 organized securities exchange. Eight of these members have enacted legislation requiring their securities firms to report suspicious transactions to relevant authorities (fig. 15).

¹ CFATF members are Anguilla, Antigua and Barbuda, Aruba, the Bahamas, Barbados, Belize, Bermuda, the British Virgin Islands, the Cayman Islands, Costa Rica, Dominica, the Dominican Republic, Grenada, Jamaica, Montserrat, the Netherlands Antilles, Nicaragua, Panama, St. Kitts & Nevis, St. Lucia, St. Vincent and the Grenadines, Suriname, Trinidad and Tobago, the Turks and Caicos Islands, and Venezuela.

² Spanish-speaking member countries, with the exception of Panama, did not sign the declaration because a version was not available in Spanish.

**Appendix VII
Additional Information on the Caribbean
Financial Action Task Force**

Figure 15: CFATF Members Requiring Securities Firms to Report Suspicious Transactions



All named jurisdictions are CFATF members with one or more organized securities exchange.

- ★ Reporting required
- ☆ Reporting not required
- ☆ CFATF officials were unable to determine whether reporting requirements applied to securities firms.

Source: CFATF Secretariat.

CFATF officials noted that, with the exception of Panama, which has required its securities firms to report suspicious transactions since 1995, the remaining seven CFATF members with organized securities exchanges

enacted such requirements only since 1998. The Bahamas and Trinidad and Tobago, for example, enacted anti-money laundering legislation in 2000 requiring, among other things, securities firms to report suspicious transactions to relevant authorities; Jamaica enacted similar legislation in 1999.

Implementation Efforts in Other CFATF Jurisdictions Have Been Criticized

Although CFATF officials indicated that most CFATF jurisdictions require their financial institutions to report suspicious transactions, U.S. and international anti-money laundering authorities have criticized legislation and implementation in some CFATF jurisdictions. Treasury documents based on the mutual evaluations of CFATF members' activities indicate that anti-money laundering results in the region are very limited, noting that few cases of money laundering have actually been prosecuted or convicted. A June 2000 FATF report cited six CFATF jurisdictions as having significant deficiencies in their anti-money laundering systems and labeled them as "non-cooperative countries and territories."³ In addition, during 2000, FinCEN issued a series of advisories to U.S. businesses describing deficiencies in the anti-money laundering systems of six CFATF jurisdictions, including three jurisdictions with organized securities exchanges. FinCEN reported in a July 2000 advisory, for example, that the Bahamas did not require its financial institutions to report suspicious activities and that, although the Cayman Islands did have this reporting requirement, it lacked any sanctions for financial institutions that failed to comply. FinCEN also criticized the effectiveness of Panama's suspicious transaction reporting procedures that allowed the Office of the President of Panama to screen reports before referring them for investigation. However, in 2001, FATF removed the Bahamas, the Cayman Islands, and Panama from its list of noncooperative countries, noting that they had adequately addressed their deficiencies through legislative reforms and implementation efforts. FinCEN also retracted its advisories on the basis of the improvements made by these jurisdictions.⁴

³ The report also identified some non-CFATF jurisdictions as having significant deficiencies in their anti-money laundering systems and placed them on FATF's list of noncooperative countries.

⁴ In June 2001, FATF also removed non-CFATF jurisdiction from its list of noncooperative countries and territories and acknowledged the progress made to address deficiencies identified relative to the anti-money laundering systems in several other jurisdictions.

Securities Industry Viewed as Less Vulnerable Than Other Sectors of Caribbean Economies

Securities regulators with whom we spoke in Barbados and Trinidad and Tobago believed that the Caribbean securities markets would likely not be appealing to money launderers and other criminals because of their small size and low trading volumes. For example, compared with over 7,000 registered broker-dealers in the United States, regulatory officials stated that the Barbados stock exchange has only 17 member-brokers and the local securities market in Trinidad and Tobago has only 5 participating brokers. They also explained that trading activity in these markets is limited to 2 days a week in Barbados and 3 days a week in Trinidad and Tobago. Finally, regulatory officials believed that the small size of these markets would make it relatively easy to detect any unusual or suspicious activities.

Law enforcement officials and financial experts in the CFATF jurisdictions we visited considered other sectors of Caribbean economies more vulnerable to money laundering than the securities industry, citing, as an example, the increased use of local commercial businesses to launder money. Trinidad and Tobago law enforcement officials, for one, stated that they were aware of specific cases in which drug dealers invested in legitimate businesses such as supermarkets for the sole purpose of laundering illicit funds. Barbados authorities also stated that they were aware of money laundering through businesses engaged in the import or export of goods, sometimes involving high-volume, cash sales.

Comments From the Financial Crimes Enforcement Network



DEPARTMENT OF THE TREASURY
FINANCIAL CRIMES ENFORCEMENT NETWORK

SEP 19 2001

Davi M. D'Agostino
Director, Financial Markets and Community Investment
United States General Accounting Office
Washington, D.C. 20548

Dear Ms. Agostino:

The draft General Accounting Office (GAO) report entitled *Anti-Money Laundering: Efforts in the Securities Industry* has been referred to my office for comment. This report provides an informative and comprehensive account of the programs and activities undertaken by the securities industry to both detect and repel financial activity relating to money laundering.

We find that the statistical information set forth in the report is useful; including data about the volume and amounts of transactions that course through this industry each day. We are also heartened by the results of your survey of the industry which show that nearly one-fifth of registered broker-dealers have already begun to establish written policies and procedures calling for the identification and reporting to the government of suspected criminal activities. This information will also prove useful in helping to identify and evaluate the operational effects of any future anti-money laundering regulatory requirements pertaining to this industry including our efforts to promulgate a draft rule that would require registered broker-dealers to establish programs to identify and report suspicious activities.

We are attaching to this letter a list of technical and clarifying suggestions pertaining to the report. If you have any questions or comments, please contact me at (703) 905-3591 or Peter G. Djinis, Executive Assistant Director for Regulatory Policy at (703) 905-3930.

Sincerely,

A handwritten signature in cursive script, appearing to read "J. Sloan".

James F. Sloan
Director

Comments From the Securities and Exchange Commission



DIVISION OF
MARKET REGULATION

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549

September 21, 2001

Davi M. D'Agostino
Director, Financial Markets
and Community Investment
United States General Accounting Office
Washington, DC 20548

Dear Ms. D'Agostino:

Thank you for providing us with a copy of the General Accounting Office's (GAO) draft report titled *Anti-Money Laundering: Efforts in the Securities Industry*. GAO's draft is a helpful addition to the fight against money laundering. We join GAO, the Permanent Subcommittee on Investigations, which requested the report, and our other partners in government in the firm resolve to deny criminals the use of the nation's financial institutions to launder the proceeds of crime for profit, or for the furtherance of their criminal activities.

GAO's draft describes generally the different participants in the securities industry and provides a helpful overview of issues facing the securities industry, securities regulators, and law enforcement agencies as we continue our efforts to block money laundering. The report also provides two insights that will be helpful as we and our partners in the government continue the fight against money laundering.

The first insight involves the GAO's reporting that the first of three key stages of money laundering - the "placement" of physical currency into the financial system - is not a significant risk for the securities industry.¹ Instead, attention is directed at ways in which government or financial institutions might identify the second and third stages of money laundering - the "layering" and "integration" of illicit funds.² Previous suspicious activity rulemaking and related compliance efforts for depository institutions, money services businesses, and casinos have been heavily influenced by the placement risks in those industries. A clearer focus on the sophisticated activities that make up the layering and integration phases of money laundering will result in more effective government

¹ See also *The 2001 National Money Laundering Strategy*.

² As the GAO's draft report notes in its "background" section, in the "placement" stage cash is converted to monetary instruments, such as money orders or travelers checks, or deposited into financial institution accounts. In the "layering" stage, these funds are transferred or moved to other accounts to further obscure their illicit origin. In the "integration" phase, the funds are used to purchase assets in the legitimate economy or to fund further activities.

Appendix IX
Comments From the Securities and Exchange
Commission

Davi M. D'Agostino
September 21, 2001
Page 2

rulemaking, industry anti-money laundering efforts, and related government examinations and investigations. We look forward to the conclusion of the rulemaking process for broker-dealers. In our view, the implementation of an effective suspicious activity rule for broker-dealers – one focused on layering and integration – can only help all regulators and law enforcement officials who address money laundering. We believe these benefits clearly will extend to depository institutions, which must also confront the later stages of money laundering, in addition to the placement phase. As GAO has indicated in its report, the Commission staff has advised Treasury staff on how the suspicious activity reporting requirements for broker-dealers can be more effectively directed at the challenges those firms encounter.

The second insight provided by GAO's draft is that firms with most of the U.S. market's accounts, transactions, and assets have implemented a broad range of voluntary anti-money laundering measures. As you know, the securities industry includes thousands of small firms across the country that provide valued services to their clients. The industry is dominated by a relatively small number of large firms, however. These firms have most of the accounts, transactions, and assets. GAO's draft shows that virtually all of the firms with assets in excess of \$10 billion that responded to GAO's survey have implemented a broad range of voluntary anti-money laundering measures. We understand that in preparing its report, GAO has spoken with representatives of a working group comprised of senior compliance personnel that have responsibility for these major firms' anti-money laundering efforts. While these voluntary efforts are helpful, we look forward to completing the implementation of a suspicious activity reporting rule for broker-dealers to enhance the existing anti-money laundering efforts.

GAO's draft also fairly addresses actions industry and regulators will need to take once a suspicious activity reporting rule is in place. The SEC is committed to ongoing active participation in the fight against money laundering. As I reported to you in March 2001, in reply to the first in GAO's series of securities-related money laundering reports, we have been active in domestic and international forums that confront money laundering, and will continue to do so. Thank you for GAO's contribution to our efforts.

Very truly yours,



Annette L. Nazareth
Director

GAO Contacts and Staff Acknowledgments

GAO Contacts

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Acknowledgments

In addition to those named above, Evelyn E. Aquino, Emily R. Chalmers, Bradley D. Dubbs, Tonita W. Gillich, May M. Lee, Christine J. Kuduk, Carl M. Ramirez, and Sindy R. Udell made key contributions to this report.

Related GAO Products

Money Laundering: Oversight of Suspicious Activity Reporting at Bank-Affiliated Broker-Dealers Ceased (GAO-01-474), Mar. 22, 2001.

Suspicious Banking Activities: Possible Money Laundering by U.S. Corporations for Russian Entities (GAO-01-120), Oct. 31, 2000.

Money Laundering: Observations on Private Banking and Related Oversight of Selected Offshore Jurisdictions (GAO-T-GGD-00-32), Nov. 9, 1999.

Private Banking: Raul Salinas, Citibank, and Alleged Money Laundering (GAO/T-OSI-00-3), Nov. 9, 1999.

Private Banking: Raul Salinas, Citibank, and Alleged Money Laundering (GAO/OSI-99-1), Oct. 30, 1998.

Money Laundering: Regulatory Oversight of Offshore Private Banking Activities (GAO/GGD-98-154), June 29, 1998.

Money Laundering: FinCEN's Law Enforcement Support Role Is Evolving (GAO/GGD-98-117), June 19, 1998.

Money Laundering: FinCEN Needs to Better Manage Bank Secrecy Act Civil Penalties (GAO/GGD-98-108), June 15, 1998.

Money Laundering: FinCEN's Law Enforcement Support, Regulatory, and International Roles (GAO/GGD-98-83), Apr. 1, 1998.

Money Laundering: FinCEN Needs to Better Communicate Regulatory Priorities and Timelines (GAO/GGD-98-18), Feb. 6, 1998.

Private Banking: Information on Private Banking and Its Vulnerability to Money Laundering (GAO/GGD-98-19R), Oct. 30, 1997.

Money Laundering: A Framework for Understanding U.S. Efforts Overseas (GAO/GGD-96-105), May 24, 1996.

Money Laundering: U.S. Efforts to Combat Money Laundering Overseas (GAO/T-GGD-96-84), Feb. 28, 1996.

Money Laundering: Stakeholders View Recordkeeping Requirements for Cashier's Checks as Sufficient (GAO/GGD-95-189), July 25, 1995.

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