

# Anti-Money Laundering Compliance Programs: Time to Reevaluate Risks

by Anne C. Flannery, Christian J. Mixter, Steven W. Stone,  
Monica L. Parry, and Beth D. Kiesewetter

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**J**ust as most mutual funds' Chief Compliance Officers have gotten their funds' annual compliance reviews under control, recent actions by the Financial Crimes Enforcement Network (FinCEN) and the Securities and Exchange Commission (SEC) will cause these Chief Compliance Officers to reevaluate the anti-money laundering compliance risks and duties of fund complexes, including their advisers, principal underwriters, administrators, and transfer agents (collectively, service providers). FinCEN recently enacted final regulations that require mutual funds and their service providers to report suspicious activity and perform additional due diligence for foreign accounts. Of even greater concern to a fund complex for risk assessment purposes, however, is the SEC's first-ever enforcement action under the USA PATRIOT Act of 2001 (PATRIOT Act) against broker-dealer *Crowell, Weedon & Co.* for failing to adequately document its customer identification program.<sup>1</sup> This article explores how these recent regulatory actions will impact the anti-money laundering compliance risks and obligations of mutual fund complexes in the coming year and highlights important considerations for a mutual fund's next compliance review. For some Chief Compliance Officers, however, these recent actions may prompt more immediate conversations with counsel to determine whether an *interim internal review* is necessary.

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Anne C. Flannery is a partner in the Investment Management and Securities Industry practice groups of Morgan, Lewis & Bockius LLP in New York, NY. Christian J. Mixter and Steven W. Stone are partners, Monica L. Parry is an of counsel, and Beth D. Kiesewetter is an associate in the Investment Management and Securities Industry practice groups of Morgan, Lewis & Bockius LLP in Washington, DC. Copyright © 2006 Morgan, Lewis & Bockius LLP. All rights reserved.

## Mutual Fund Compliance Reviews under SEC Rule 38a-1

Stemming, in part, from the discovery by state securities authorities and the SEC of inappropriate market timing and late trading by mutual fund service providers, the SEC adopted Rule 38a-1<sup>2</sup> under the Investment Company Act of 1940<sup>3</sup> in December 2003.<sup>4</sup>

Rule 38a-1 requires mutual funds to adopt,

and their respective board of directors to approve, written policies and procedures that are reasonably designed to prevent violations of the federal securities laws by the fund and provide oversight of the compliance efforts of the fund's service providers through which the fund conducts its business.<sup>5</sup> One of the *critical* areas of compliance oversight for funds and their service providers is anti-money laundering compliance, given the reputational risks associated with, and severe monetary penalties and/or asset forfeiture for, noncompliance.<sup>6</sup>

Acknowledging that Rule 38a-1 increases the workload and responsibilities of mutual fund boards, the adopting release indicates that directors may satisfy their obligations under the rule with respect to the fund and its affiliated service providers by reviewing summaries of compliance programs prepared by a chief compliance officer, legal counsel, or other persons familiar with such programs and, with respect to unaffiliated service providers, states that directors are permitted to rely on a third-party's report on the "adequacy of the service provider's compliance controls."<sup>7</sup> In this regard, the adopting release emphasizes that the review and approval process by the mutual fund's board, should provide directors with an understanding of the relevant features of the compliance programs of the fund and its service providers, especially with respect to those policies and procedures that address "significant compliance risks."<sup>8</sup>

Further, Rule 38a-1 requires mutual funds to designate a chief compliance officer who is charged with the administration of the fund's written compliance policies and procedures.<sup>9</sup> The designated chief compliance officer must furnish the fund's board members with an annual report addressing (1) the operation of the policies and procedures of the fund and its service providers and any material changes to such policies and procedures made since the date of the last report; (2) any recommendations for material changes to the fund complex's policies and procedures resulting from the annual review; and (3) any material compliance matters that have arisen since the date of the last report.<sup>10</sup> Although the rule states that an annual review is required, the adopting release clarifies that funds should undertake "*interim reviews*" as a result of "significant compliance events, changes in business arrangements and new regulatory developments."<sup>11</sup>

### **Significant Mutual Fund Anti-Money Laundering Developments in 2006**

Although mutual fund boards have become

all too familiar over the last few years with the anti-money laundering regulatory framework, *significant regulatory developments* during 2006 present new compliance risks that merit consideration and may well require reevaluation of the adequacy of anti-money laundering programs of funds and their service providers, as well as the business arrangements (*e.g.*, transfer agent agreements, distribution agreements, dealer agreements, etc.) established between funds and their service providers that memorialize the delegation of anti-money laundering responsibilities.

On an annual basis since July 2002, directors have been required to review and evidence their approval of funds' anti-money laundering programs in compliance with rules implementing Section 352 of the PATRIOT Act.<sup>12</sup> Such anti-money laundering programs must provide for:<sup>13</sup>

1. The development of internal controls, policies and procedures that are reasonably designed to detect activities indicative of money laundering;
2. The designation of a fund officer to act as the anti-money laundering compliance officer with responsibility and authority to develop and enforce appropriate policies and procedures throughout the fund complex;
3. An ongoing employee training program to provide general awareness of anti-money laundering requirements and job-specific responsibilities; and
4. An independent audit function to test such programs.

In addition, since October 2003, fund directors' reviews of such anti-money laundering programs have included an assessment of the fund's customer identification program consistent with Section 326 of the PATRIOT Act, which must incorporate policies and procedures to:<sup>14</sup>

1. Verify the identity of any person seeking to open an account;
2. Maintain records of information used to verify the person's identity;
3. Determine whether the person appears on any lists of known or suspected terrorists or terrorist organizations provided by a government agency (*e.g.*, the List of Specially Designated Nationals and Blocked Persons maintained by the US Office of Foreign Assets Control (OFAC's SDN List)); and
4. Provide shareholders with adequate notice that the fund is requesting information to verify their identities.

Recognizing that mutual funds typically conduct their operations through their service providers, the adopting releases for the rules requiring mutual funds to implement anti-money laundering programs and customer identification programs also provide guidance on the circumstances under which it is permissible for a mutual fund contractually to delegate the implementation of such programs to its affiliated or unaffiliated service provider.<sup>15</sup> In particular, a mutual fund may delegate responsibility for certain aspects of its anti-money laundering program or customer identification program to a service provider by entering into a written contract that (1) specifies which program obligations the service provider will perform, (2) provides for *active oversight* by the fund of the service providers' implementation of the programs (e.g., periodic reports on the operation of the programs and any compliance matters that arise), and (3) authorizes federal examiners to obtain information and records from the service provider relating to the programs.<sup>16</sup> In order to *rely* on a service provider to perform aspects of a fund's anti-money laundering program, however, (1) reliance on the service provider's implementation of the program must be *reasonable*, (2) the service provider must be a "financial institution" subject to an anti-money laundering program requirement and regulated by a "federal functional regulator" (e.g., a broker-dealer), and (3) the delegation contract must require the service provider to certify annually that it has implemented an anti-money laundering program and will perform the specified requirements of the fund's customer identification program.<sup>17</sup> Many mutual funds, however, have delegated anti-money laundering program or customer identification program responsibilities to service providers that do not meet the criteria for "reliance;" therefore, fund directors must ensure that the fund is *actively overseeing* the performance of delegated responsibilities, including determining that reliance remains *reasonable* in light of new regulatory requirements.

### Mutual Fund Suspicious Activity Reporting

The regulatory framework for mutual funds significantly changed this year when FinCEN issued a final rule that *requires* mutual funds to file suspicious activity reports on Form SAR-SF for transactions occurring on or after November 1, 2006.<sup>18</sup>

The requirement to file a suspicious activity report is limited to those transactions conducted

or attempted by, at, or through a mutual fund that involve or aggregate to at least \$5,000 in funds or other assets, that fall within one of the following four categories:<sup>19</sup>

1. Involves funds derived from illegal activity or is intended or conducted in order to hide or disguise funds or assets derived from illegal activity as part of a plan to violate or evade federal laws or regulations;
2. Is designed, whether through structuring or other means, to evade the requirements of the Bank Secrecy Act;
3. Has no business or apparent lawful purpose, is an unusual transaction for the particular customer and the mutual fund knows of no reasonable explanation for the transaction; *or*
4. Involves the use of the mutual fund to facilitate criminal activity.

Even if a transaction does not technically fall within the reporting requirements, the rule *encourages* funds to report suspicious transactions if they appear relevant to violations of law or regulation.<sup>20</sup> For example, if a transaction appears relevant to a possible violation of law but does not aggregate to at least \$5,000 in funds, the mutual fund *may voluntarily* file a SAR-SF.<sup>21</sup>

The standard established by the rule for identifying suspicious transactions is that a mutual fund "*knows, suspects or has reason to suspect*" that the transaction or pattern of transactions falls into one of the four reportable categories. As certain commenters to the proposed rule noted, mutual funds and their service providers are likely to have difficulty in complying with the "*knows, suspects or has reason to suspect*" standard.<sup>22</sup> Typically, the fund, its transfer agent, and principal underwriter do not have in-person interactions with shareholders. Instead, the information gathered regarding shareholders is most often only that information required on the mutual fund account application.<sup>23</sup> Further, unlike other financial institutions subject to suspicious activity reporting requirements, such as retail broker-dealers, funds, and their service providers do not generally make recommendations to shareholders that would trigger a suitability analysis and review of comprehensive information regarding the shareholder's investment goals and objectives, risk profile, investment history, and financial resources.<sup>24</sup> Nevertheless, a fund and its service providers must establish internal controls, policies, and procedures to monitor for transactions or patterns of transactions that *could* indicate money laundering.<sup>25</sup> This should

include establishing a list of “red flags” for the fund and its service provider to determine whether or not to file a suspicious activity report. In this regard, the proposing release provides examples of “red flag” activity including:<sup>26</sup>

- Shareholder refusal to provide information necessary for the fund to make reports or keep records required by regulation;
- Shareholder information that the fund determines to be false; or
- Shareholders that seek to cancel transactions after they have been notified that the fund must verify their identity.

Once a fund has identified a suspicious transaction based on a review of all the facts and circumstances relating to the transaction and the shareholder, the fund has 30 calendar days to file the form SAR-SF.<sup>27</sup> However, under circumstances in which the fund is not able to identify a suspect on the date of the initial detection, it may delay filing a Form SAR-SF for an additional 30 calendar days, but not to exceed more than 60 calendar days after the date of the initial identification of the suspicious transaction.<sup>28</sup> Although the fund and its service providers must collect and maintain supporting documentation obtained during their due diligence review process, that documentation should not be submitted with the Form SAR-SF to FinCEN. Recognizing that the activity of a particular shareholder may involve more than one fund in a mutual fund complex, the final rule permits all of the funds involved in a particular suspicious transaction to file a single joint report.<sup>29</sup> Funds must maintain Forms SAR-SF and all supporting documentation for a period of five years from the date of filing<sup>30</sup> and must treat such records as confidential.<sup>31</sup> Importantly, the rule reiterates that whether or not a Form SAR-SF is *required* to be filed or is *voluntarily* filed, the statutory safe harbor protects funds and their service providers from liability for making such reports and also for failure to disclose the fact of such reporting.<sup>32</sup>

As with other anti-money laundering requirements, the adopting release clarifies that although a mutual fund may contract with an affiliated or unaffiliated service provider to perform the reporting obligation as the fund’s agent, the mutual fund remains responsible for assuring compliance with the rule and, therefore, must maintain an *active working* relationship with the service provider’s

compliance personnel to oversee the performance of its reporting obligations.<sup>33</sup> Although the adopting release did not provide interpretive gloss as to what an *active working relationship* means, from a practical perspective it is not unreasonable to assume that a written contract between the fund and its service provider would set forth the types of information sharing and periodic reports that would be provided to the fund by the service provider relating to due diligence of transactions performed, any “red flag” activities identified, and any Forms SAR-SF filed with FinCEN.

### **Know Your Customer—Special Due Diligence for Foreign Accounts**

Separately, FinCEN adopted a final rule implementing certain portions of Section 312 of the PATRIOT Act in January 2006 that requires mutual funds to establish due diligence procedures that are reasonably designed to detect and report money laundering through “correspondent accounts”<sup>34</sup> and “private banking accounts”<sup>35</sup> that they maintain for non-US persons.<sup>36</sup> Subsequent to the adoption of the final rule, and based on comments from the industry regarding the difficulty of complying with the requirements, FinCEN extended the date on which mutual funds must begin to apply the due diligence provisions to new correspondent accounts and new private banking accounts to July 5, 2006.<sup>37</sup>

With respect to “*correspondent accounts*,” the rule requires a fund to establish as part of its anti-money laundering program a due diligence program that includes policies, procedures, and controls that are reasonably designed to enable the fund to detect and report any known or suspected money laundering conducted through or involving correspondent accounts established, maintained, administered, or managed by a fund in the United States for a foreign financial institution.<sup>38</sup> The fund must incorporate such due diligence procedures into its anti-money laundering program and include an appropriate, specific, and *ongoing* evaluation of the anti-money laundering risks posed by the correspondent accounts it maintains for foreign financial institutions.<sup>39</sup> The adopting release suggests that the starting point for funds should be a “stratification of their money laundering risk” based on a review of relevant risk factors to determine which accounts may require enhanced due diligence.<sup>40</sup> In this regard, relevant risk factors include:<sup>41</sup>

- The nature of the foreign financial institution’s business and the markets it serves;

- The nature of the correspondent account, including the types of services to be provided and the purpose and anticipated activity of the account;
- The nature and duration of the fund's and/or its affiliates' relationship with the foreign financial institution;
- The anti-money laundering and supervisory regime of the jurisdiction that issued the foreign financial institution's charter or license, as well as that of the foreign financial institution's owner; and
- Any information known or available to the fund regarding the foreign financial institution's anti-money laundering record.

Although the adopting release acknowledged that mutual funds may not currently offer accounts that would fall within the definition of “*private banking account*,” the rule nonetheless requires funds to maintain a due diligence program that includes policies, procedures, and controls that are reasonably designed to detect and report any known or suspected money laundering conducted through or involving any private banking account that the financial institution maintains for or on behalf of a non-US person.<sup>42</sup> Such policies, procedures, and controls must be incorporated into the fund's anti-money laundering program.<sup>43</sup> The rule includes *minimum* due diligence requirements for private banking accounts, such as ascertaining the identity of nominal and beneficial account owners, determining the source of funds deposited into the account and the expected use of the account, and determining if any owner may be a senior foreign political figure.<sup>44</sup> The financial institution's procedures also must include enhanced scrutiny of private banking accounts owned by senior foreign political figures that are reasonably designed to detect and report transactions that may involve the “proceeds of foreign corruption.”<sup>45</sup>

Moreover, with respect to due diligence programs for both “correspondent accounts” and “private banking accounts,” the rule requires the adoption and implementation of special procedures under circumstances in which due diligence cannot be performed.<sup>46</sup> In this regard, funds must establish protocols to follow when they cannot obtain adequate information to perform appropriate due diligence on such accounts, including identification of the circumstances under which

the fund should “refuse to open the account, suspend transaction activity, file a suspicious activity report, or close the account.”<sup>47</sup>

As described, such due diligence programs must be incorporated into a fund's anti-money laundering program, portions of which may be delegated to the funds service providers as long as the arrangement is memorialized in a written contract that (1) specifies which program obligations the service provider will perform, (2) provides for *active oversight* by the fund of the service providers' implementation of the programs (e.g., periodic reports on the operation of the programs and any compliance matters that arise), and (3) authorizes federal examiners to obtain information and records from the service provider relating to the programs.<sup>48</sup>

### **SEC Has Stepped into the Anti-Money Laundering Enforcement Arena**

Just as FinCEN added substantial new obligations to the anti-money laundering regulatory regime for mutual funds, the SEC has brought its first anti-money laundering enforcement action, which significantly alters the risk profile for compliance failures. On May 22, 2006, the SEC settled an enforcement action brought against Crowell, Weedon & Co. (Crowell) with respect to violations of Section 17(a) of the Securities Exchange Act of 1934 (Exchange Act) and Rule 17a-8 thereunder, which require a broker-dealer to comply with the reporting, recordkeeping, and record retention requirements implemented under the Bank Secrecy Act, including the requirements of the customer identification program rule.<sup>49</sup>

The SEC found that from October 2003 until at least late April 2004, Crowell's written customer identification program failed to accurately describe the process it used to verify customers' identities. The SEC found that it used procedures that were materially different from and weaker than those procedures identified in Crowell's customer identification program. The written customer identification program stated that Crowell would use certain documentary and non-documentary methods to verify the identity of each customer. Crowell instead relied on its registered representatives' attestations indicating that they had personal knowledge of the customer's identity. During the period in question, Crowell opened approximately 2,900 new accounts and did not follow the verification and documentation process set forth in the customer identification program. In anticipation of the proceedings and without admitting or denying the findings therein, Crowell consented to the

issuance of an order requiring it to cease and desist from committing or causing any violations and any future violations of Section 17 of the Exchange Act and Rule 17a-8 thereunder.

Although the SEC has brought numerous enforcement actions against firms subject to its jurisdiction for recordkeeping violations, this action is an important indication that the SEC is willing to wield its enforcement authority to pursue violations of the PATRIOT Act. This is especially significant for a mutual fund's assessments of risks associated with anti-money laundering program compliance failures. Prior to this action, violations of anti-money laundering requirements have been brought against financial institutions only by FinCEN, the NASD or the NYSE. In contrast to broker-dealers that can expect the SEC to defer in the first instance to the NASD and NYSE examination programs, mutual funds should expect the SEC to make the evaluation of fund compliance an examination priority in view of the absence of any alternative examination authority such as that to which broker-dealers are subject. Juxtaposed against the new regulatory requirements imposed on funds by FinCEN, the SEC's recent venture into the anti-money laundering enforcement arena creates incentives for mutual funds to reevaluate the adequacy of not only the substance of their anti-money laundering compliance program and those of their service providers, but also how well such programs are documented.

### **Reevaluating Risks—An Internal Review Checklist**

However tempting it may be simply to rely on the annual compliance review as a means to achieve compliance with Rule 38a-1, the recent changes in the regulatory landscape may necessitate an interim internal review. In this regard, mutual fund boards should confer with counsel to determine whether an internal review should be performed in order to, among other things:

- Determine whether previously prepared compliance risk assessments remain accurate for each subcomponent of the fund's overall anti-money laundering program;
- Assess whether the anti-money laundering programs of the fund and its service providers reflect existing and new regulatory requirements, including suspicious activity reporting procedures and due diligence procedures;

- Interview employees involved in implementing the fund's anti-money laundering program to determine whether the procedures are documented correctly and whether such employee's understanding of his or her role and responsibilities is consistent with what is set forth in the written policies and procedures;
- Observe how anti-money laundering obligations are actually performed by the fund and its service providers to determine how routine and non-routine matters are handled as they arise, and whether issues are resolved in accordance with guidance provided in the written policies and procedures and the terms of the delegation agreement between the fund and its service providers;
- Understand how records and reports required to be established and maintained pursuant to the anti-money laundering program are generated, used, and maintained;
- Test the establishment of new accounts and processing of transactions to determine whether existing policies and procedures are consistent with the requirements of the PATRIOT Act and its implementing regulations;
- Review the adequacy of written delegation agreements between the fund and its service providers relating to the delegation of duties and also mechanisms for active oversight of the performance by services providers of delegated functions; and
- Consider the scope and adequacy of information contained in reports prepared for management relating to the fund's anti-money laundering program.

By undertaking this type of interim assessment, subject to the benefits of attorney-client privilege, funds can better determine what, if any, enhancements should be made to their anti-money laundering program well in advance of the next required annual compliance review. It also will better prepare funds for the eventuality that several SEC examiners may very well show up on the front doorstep.

### **NOTES**

1. In re Crowell, Weedon & Co., SEC Admin. Proc. File No. 3-12300 (May 22, 2006).

2. 17 C.F.R. § 270.38a-1 (2000).
3. 15 U.S.C. § 80a (2000).
4. *Compliance Programs of Investment Companies and Investment Advisers*, SEC. Rel. No. IC-26299, 68 Fed. Reg. 74,714 (Dec. 24, 2003) [hereinafter *Compliance Programs Adopting Release*].
5. 17 C.F.R. § 270.38a-1(a)(1) (2000).
6. See 18 U.S.C. §§ 1956, 1957 (2000).
7. See *Compliance Programs Adopting Release*, supra n.4, at 74,716–74,717.
8. *Id.* at 74,717 (emphasis added).
9. 17 C.F.R. § 270.38a-1(a)(4) (2000).
10. *Id.*
11. See *Compliance Programs Adopting Release*, supra n.4, at 74,720 (emphasis added).
12. 31 C.F.R. § 103.130; see also *Financial Crimes Enforcement Network; Anti-Money Laundering Programs for Mutual Funds*, 67 Fed. Reg. 21,117, 21,119 (Apr. 29, 2002) [hereinafter *Anti-Money Laundering Program Adopting Release*].
13. See *Anti-Money Laundering Program Adopting Release* at 21,119–21,120.
14. See *Customer Identification Programs for Mutual Funds*, 68 Fed. Reg. 25,131 (May 9, 2003) [hereinafter *Customer Identification Program Adopting Release*].
15. See *Anti-Money Laundering Program Adopting Release*, supra n.12, at 21,119; *id.* at 25,140.
16. See *id.*
17. *Id.*
18. See *Financial Crimes Enforcement Network; Amendment to the Bank Secrecy Act Regulations—Requirements That Mutual Funds Report Suspicious Transactions*, 71 Fed. Reg. 26,213 (May 4, 2006) [hereinafter *Suspicious Transactions Adopting Release*].
19. 31 C.F.R. 103.15(b) (2000) (emphasis added).
20. 31 C.F.R. 103.15(a) (2000).
21. See *id.*
22. See, e.g., Letter from Craig S. Tyle, General Counsel, Investment Company Institute, to Judith R. Starr, Chief Counsel, FinCEN (Mar. 21, 2003); see also *Suspicious Transactions Adopting Release*, supra n.18, at 26,216, n.29.
23. See, e.g., Letter from Craig S. Tyle, General Counsel, Investment Company Institute, to Judith R. Starr, Chief Counsel, FinCEN (Mar. 21, 2003).
24. See *id.*
25. See *Suspicious Transactions Adopting Release*, supra n.18, at 26,216, n.29.
26. See *Financial Crimes Enforcement Network; Amendment to the Bank Secrecy Act Regulations—Requirement that Mutual Funds Report Suspicious Transactions*, 68 Fed. Reg. 2716 (Jan. 21, 2003).
27. 31 C.F.R. 103.15(b) (2000).
28. See *id.*
29. See *Suspicious Transactions Adopting Release*, supra n.18, at 26,217.
30. 31 C.F.R. 103.15(c) (2000).
31. 31 C.F.R. 103.15(d) (2000).
32. See *Suspicious Transactions Adopting Release*, supra n.18, at 26,218 (emphasis added).
33. See *id.* at 26,216.
34. 31 C.F.R. 103.175(d)(i) (2000) (defining “correspondent account” to mean “an account established for a foreign financial institution to receive deposits from, or to make payments or other disbursements on behalf of, the foreign financial institution, or to handle other financial transactions related to such foreign financial institution.”); see also *Financial Crimes Enforcement Network; Anti-Money Laundering Programs; Special Due Diligence Programs for Certain Foreign Accounts*, 71 Fed. Reg. 496, 499 (Jan. 4, 2006) (clarifying that accounts “maintained by mutual funds for foreign financial institutions . . . in which these foreign financial institutions may hold investments in such mutual funds as principals or for their customers, and which the foreign financial institution may use to make payments or to handle other financial transactions on the foreign institutions’ behalf have sufficient similarities to correspondent accounts of banks” to subject mutual funds to the requirements of the rule) [hereinafter *Special Due Diligence Programs Adopting Release*].
35. 31 C.F.R. 103.175(d)(o) (2000) (defining “private banking account” to mean “an account (or combination of accounts) maintained at a covered financial institution that: (1) requires a minimum aggregate deposit of funds or other assets of not less than \$1,000,000; (2) is established on behalf of or for the benefit of one or more non-US persons who are direct or beneficial owners of the account; and (3) is assigned to, or is administered or managed by, in whole or in part, an officer, employee, or agent of a [mutual fund] acting as a liaison between the [mutual fund] and the direct or beneficial owner of the account.”)
36. See *Special Due Diligence Programs Adopting Release*, supra n.34, at 496.
37. See *Financial Crimes Enforcement Network; Anti-Money Laundering Programs; Special Due Diligence Programs for Certain Foreign Accounts*, 71 Fed. Reg. 16,040 (Mar. 30, 2006).
38. 31 C.F.R. 103.176(a) (2000).
39. See *id.* (emphasis added).
40. See *Special Due Diligence Adopting Release*, supra n.34, at 502.
41. See *id.* at 503.
42. See 31 C.F.R. 103.178(a) (2000); see *id.* at 507–508.
43. See 31 C.F.R. 103.178(a) (2000).
44. See 31 C.F.R. 103.178(c) (2000).
45. *Id.*
46. 31 C.F.R. 103.178(d) (2000).
47. *Id.*
48. See *id.*
49. In re Crowell, Weedon & Co., SEC Admin. Proc. File No. 3-12300 (May 22, 2006).