

Broker-Dealers Must Report Suspicious Activity

On June 28, 2002, as part of its anti-money laundering (“AML”) program, the Treasury Department issued rules under the USA Patriot Act to require broker-dealers to file suspicious activity reports (“SARs”) if customer activity suggests a possible violation of U.S. laws or regulations. Many firms had previously been filing SARs voluntarily. These broad rules require broker-dealers to report any suspicious transaction or series of transactions in excess of \$5,000 to the Treasury’s Financial Crimes Enforcement Network within 30 days after the broker-dealer becomes aware of the suspicious transaction. The purpose of these rules is to ensure that broker-dealers, as financial institutions, are not used by criminals as a medium for money-laundering. Examples of suspicious transactions that may warrant the filing of an SAR include, but are not limited to, those which:

- Possibly involve the proceeds of illegal activity;
- Involve funds that might be used to commit a crime;
- Are designed to evade the requirements of the Bank Secrecy Act;
- Appear to serve no business or apparent lawful purpose; and
- Cannot reasonably be explained based on the available facts.

The NASD warned of several situations that broker-dealers should pay close attention to and further investigate. These “red flags” include:

- A lack of concern exhibited by the customer regarding risks, commissions, or other transaction costs;
- The customer having difficulty describing the nature of his or her business or lacking general knowledge of his or her industry; and
- For no apparent reason, the customer has multiple accounts under a single name or multiple names, with a large amount of inter-account or third-party transfers.

If both an introducing and clearing broker are involved in a suspicious transaction, only one SAR need be filed, as long as the report includes all relevant facts concerning the transaction. In such a case, the parties’ clearing or carrying agreement should address this responsibility. Although a broker-dealer who is dually registered with the SEC and CFTC has an obligation to file an SAR in transactions involving securities futures products and any other products over which the SEC or another federal agency has jurisdiction, no obligation exists with regard to activities subject to the

exclusive jurisdiction of the CFTC. The rules do not apply to SEC registered broker-dealers located outside of the United States.

The new rules will be effective as of January 1, 2003.

D.C. Courts May Assert Personal Jurisdiction Over Online Brokerage Firms

On June 14, 2002, the U.S. Court of Appeals for the District of Columbia held that District of Columbia courts can assert personal jurisdiction over online securities brokerage firms if their websites enable them to form binding contracts with district residents. The basis for its ruling is that the district's long-arm statute permits its courts to assert personal jurisdiction over a foreign corporation if the corporation is "doing business" in the district in a manner which is "continuous and systematic." Online brokerage firms usually conduct business transactions with customers 24 hours a day and, therefore, their business with district residents will most likely be deemed continuous and systematic. As a result, all online brokerage firms may be subject to suit in the District of Columbia if a claim arises out of its dealings with online customers. *See Gorman d/b/a Cashbackrealty.com v. Ameritrade Holding Corp.*, D.C. Cir., No. 01-7085.

Mandatory Fingerprinting for All Securities Industry Employees in New York

On June 19, 2002, the New York State Assembly approved a bill that, if signed into law, will expand fingerprinting laws by mandating the fingerprinting of all employees of the NYSE, the Nasdaq Stock Market, the American Stock Exchange, and national securities associations registered with the SEC. Currently, New York only requires fingerprinting of stockbrokers and certain other members of brokerage houses, including partners, officers, directors and salespeople. The fingerprints would be sent to the FBI for a criminal history check. The purpose of this expanded law is to prevent attacks or sabotage that could wreak havoc on the nation's economy. The bill, which is supported by the NYSE, is expected to be signed into law by Governor Pataki in the near future.

Arbitration Clause Held Unenforceable Against Elderly Investor

On June 13, 2002, the Montana Supreme Court held that a pre-dispute arbitration clause in a customer account agreement was unenforceable against a 95 year-old customer. In this case, the elderly investor signed a typical customer agreement that incorporated an arbitration clause by reference. Citing the broker's failure to explain the arbitration clause, and the elderly investor's relative lack of sophistication in such matters, the court held that the terms of the clause exceeded the investor's reasonable expectations. This decision raises some potentially troubling issues. To ensure that an arbitration clause is enforceable, firms and their brokers should, at a minimum, inform their prospective customers of the existence of such clauses, especially when dealing with new customers that are elderly. *See Kloss v. Edward D. Jones & Co.*, No. 00-507, 2002 MT 129.

Number of Arbitration Filings on Pace to Break Record

Although the number of arbitration filings with NASD Dispute Resolution decreased in May 2002 (by 29) compared to May 2001, the first five months of 2002 saw an overall 11% increase in filings compared to the first five months of 2001. If this pace continues, it will represent a record year for filings. "Unsuitability" claims are up 70% from 2001 and "omission of facts" filings are up 72%. Mutual fund related dispute filings are over 100% compared to 2001.

Arbitration filings with the NYSE also increased dramatically during the first half of 2002. There were 625 filings as of the end of June, which represents an increase of 82% over the first six months of 2001.

Questions

If you have questions about anything in this advisory, or would like a copy of any of the cases discussed herein, please call any of the following Kelley Drye attorneys:

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