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NEW TREASURY REGULATIONS WILL REQUIRE JEWELERS TO ADOPT COMPREHENSIVE ANTI-MONEY LAUNDERING PROGRAMS

INTRODUCTION

On June 9, 2005, the U.S. Department of Treasury (Treasury) issued regulations implementing Section 352(c) of the USA PATRIOT Act of 2001 (Patriot Act)[1] adding jewelers to the list of financial institutions required to establish anti-money laundering ("AML") programs.[2] As a result, every jewelry and precious metal wholesaler in the United States will be required to put into place risk-based AML policies and procedures and will be subject to examination for compliance by the IRS. To date, few such businesses have experience with this kind of federal mandate. In practice, given the need to develop comprehensive systems applicable to both their inventory and their customers, most jewelry and precious metal dealers will need to initiate a process for AML promptly in order to meet the Treasury deadline for implementation of January 1, 2006.

This advisory describes the final interim rule's regulations on anti-money laundering, discusses the potential impact on affected dealers, and suggests steps dealers can take to prepare for these changes. In practice, jewelers generally will need to appoint a compliance officer, develop comprehensive, risk-based AML policies and procedures, put together and implement employee training programs, and ensure that each of these have the express approval of the company's board of directors under a formal resolution.

INTERIM FINAL REGULATIONS ON ANTI-MONEY LAUNDERING

History

Prior to 2002, jewelry dealers had been listed under the Bank Secrecy Act (BSA) as a category of financial institution, but the Treasury's Financial Crimes Enforcement Network (FinCEN) had not defined the term or issued regulations for them.[3] On April 29, 2002, FinCEN undertook a study of how to apply AML programs to jewelry dealers, and on February 21, 2003, the Treasury issued a notice of proposed rule making that would require dealers in jewels, precious metals, and precious stones "to develop

[1] Patriot Act, Pub. L. No. 107-56 (2001).
[2] Anti-Money Laundering Programs for Dealers in Precious Metals, Stones, or Jewels, 70 Fed. Reg. 33,702 (issued June 9, 2005).
[3] Anti-Money Laundering Programs for Dealers in Precious Metals, Stones, or Jewels, 68 Fed. Reg. 8,481 (proposed Feb. 21, 2003).

and implement written anti-money laundering programs tailored to the risk of money laundering of terrorism financing presented by their businesses."[4] Following a comment period, Treasury issued the interim final rule on June 9, 2005.

The interim final rule differs slightly from the earlier proposed regulations, but in general retains its requirements that each dealer "develop and implement an anti-money laundering program" that is "reasonably designed to prevent the dealer from being used to facilitate money laundering or the financing of terrorist activities."[5]

General Provisions

The interim final rule imposes five basic requirements on dealers: (1) dealers must develop in writing an anti-money laundering program and obtain approval by senior management; (2) dealers must incorporate into the program policies, procedures, and internal controls based on the dealer's assessment of the money laundering and terrorist financing risks associated with its line(s) of business; (3) dealers must designate a compliance officer to administer the money-laundering program; (4) dealers must provide training and education for appropriate persons; and (5) dealers must periodically test their anti-money laundering programs.[6] The final interim rule gives dealers until January 1, 2006, or no later than six months after the date a person becomes subject to the rule's provisions to develop an anti-money laundering program.

What is the Definition of a Dealer?

The original proposed rule would have defined "dealer" as "a person engaged in the business of purchasing and selling of jewels, precious metals, precious stones, or jewelry composed of jewels, precious metals, or precious stones."[7] It also established a minimum dollar threshold of $50,000 or more in sales or proceeds from covered goods. The new definition of dealer is similar to the proposed rule, but includes three changes.

In the new regulation, a "dealer" is defined as:

> "a person engaged within the United States as a business in the purchase and sale of covered goods and who, during the prior calendar or tax year:
>
> (A) Purchased more than $50,000.00 in covered goods; and
>
> (B) Received more than $50,000.00 in gross proceeds from the sale of covered goods.[8]

The first change is the use of the terms "purchase and sale" rather than "purchasing and selling."[9] This was done for consistency because "purchase and sale" is used

[4] 70 Fed. Reg. at 33,704.
[5] 70 Fed. Reg. at 33,704.
[6] *Id*. at 3317.
[7] 68 Fed. Reg. at 8,482.
[8] *Id*.
[9] 70 Fed. Reg. at 33,704.

throughout the regulation. The second change is a new minimum dollar threshold of $50,000 in the purchase *and* sale, rather than purchase *or* sale, of covered goods because money launders must be able to sell as well as purchase goods to abuse the system. The third change is the addition of the phrase "engaged within the United States" to modify dealers, which restricts the regulations to dealers with a physical presence in the United States.[10]

The regulation exempts retailers ("retailer exception") and licensed or state-authorized pawn-brokers from the definition of a dealer because the two groups do not represent a significant percentage of money-laundering occurrences.[11] A retailer will only be defined as a dealer if, during the prior calendar or tax year, he "purchased more than $50,000.00 in covered goods from persons other than dealers or other retailers."[12]

What is the Definition of a Retailer?

The proposed rule would have defined "retailer" as "a person engaged in the business of sales to the public of jewels, precious metals, or precious stones, or jewelry composed thereof."[13] In the interim final rule the scope of the definition of "retailer" has been clarified to state, "a retailer is a U.S. person engaged in the business of sales *primarily* to the public of the covered goods."[14] The use of the phrase "*primarily* to the public" was done to distinguish retailers from dealers, who sell mainly to retailers and dealers, and to include within the "retailer exception" dealers who sell primarily to the public.[15] This distinction was made because dealers who behave like retailers do not occupy a significant sector of money laundering occurrences. By employing the new definition, the Treasury avoids regulating dealers who, like retailers, primarily sell to the public but only occasionally sell to dealers or retailers.

What are Covered Goods?

The interim final rule introduces the term "covered good," which is defined to include jewels, precious metals, precious stones, and finished goods deriving 50 percent or more of their values from jewels, precious metals, or precious stones attached to them.[16] Finished goods include jewelry, numismatic items, and antiques. The "covered good" term was added to replace "jewelry," an undefined term in the proposed rule.[17] The term is also used to clarify and broaden the scope of the "value-added fabricated goods" exception for transactions in jewels, precious metals, and precious stones attached to finished goods, which do not attribute significant value to or possess "minor amounts of jewels, precious metals, and precious stone."[18]

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[10] 70 Fed. Reg. at 33,707.
[11] *Id*. at 33,708-09.
[12] *Id*. at 33,708.
[13] 68 Fed. Reg. at 8,482.
[14] 70 Fed. Reg. at 33,709.
[15] *Id*.
[16] *Id*. at 33,706.
[17] *Id*.
[18] *Id*.

What is the Definition of a Person?

The final interim rule maintains the 13 CFR §103.11(z) definition of a "person," which is: "An individual, a corporation, a partnership, a trust or estate, a joint stock company, an association, a syndicate, joint venture, or other unincorporated organization or group, an Indian Tribe (as that term is defined in the Indian Gaming Regulatory Act), and all entities cognizable as legal personalities."[19]

Other Definitions (Jewel, Precious Metal, Precious Stone)

The interim final rule maintains earlier definitions for the terms "jewel," "precious metal," and "precious stone."[20] A "jewel" continues to be defined to include organic substances that have a market-recognized gem level of quality, beauty, and rarity.[21] A "precious metal" includes gold, silver, and the platinum group of metals at a level of purity of "500 parts per 1000 (50 percent or greater), singly or in any combination."[22] A "precious stone" is defined to include those substances that have "market-recognized gem level of quality, beauty, and rarity."[23]

Anti-Money Laundering Minimum Requirements

General Obligation: The interim final rule requires each dealer to develop and implement an anti-money laundering program "reasonably designed to prevent the dealer from being used to facilitate money laundering or the financing of terrorist activities."[24] The program will apply to the purchase and sale of covered goods by dealers. The dealer must commit the program to writing, including a detailed discussion of the responsibilities of the individuals and departments involved. The program will need to be approved by the dealer's senior management and be made available to the Treasury or its designee upon request. At all times, the dealer will be responsible for ensuring compliance with the program. Retailers that purchase more than $50,000 in covered goods also will be held to the dealers' obligation to develop an anti-money laundering program. However, the retailer's program need only address the risks associated with purchasing covered goods.

Minimum Requirements: The interim final rule requires that each dealer incorporate policies, procedures, and internal controls to prevent money laundering and terrorist financing.[25] These procedures must be updated to continually comply with all BSA requirements and be rooted in the dealer's risk assessment of money laundering and terrorist financing associated with their line(s) of business. These policies, procedures, and internal controls are intended to be particularly useful in discerning

[19] Financial Record Keeping and Recording of Currency Transactions, 31 C.F.R.§ 103.11(z) (April 29, 2005).
[20] 70 Fed. Reg. at 33,708.
[21] *Id*.
[22] *Id*.
[23] *Id*.
[24] *Id*. at 33,709.
[25] *Id*.

money-laundering and terrorist financing activities associated with transactions in which customers attempt to maintain an "unusual" level of secrecy in light of the circumstances normal and customary for the industry.[26]

In determining the risk associated with their line(s) of business, dealers must consider "all relevant factors" mentioned in the rule.[27] These factors include: (1) the money laundering and terrorist financing risks associated with dealer products, customers, suppliers, distribution channels, and geographic location; (2) the extent to which the dealer engages in transactions with other than established customers, or sources of supply, or dealers subject to BSA regulations; and (3) the extent to which the dealer receives payment for transactions instead of reconciliation routed to or from accounts in jurisdictions identified by the U.S. Department of State as vulnerable to terrorism or money laundering.

The dealer's procedures will need to include "reasonable inquiries" into whether a transaction may involve money laundering or terrorist financing.[28] The program should provide the dealer with indicia, on which the dealer may rely, to determine whether a transaction may involve money-laundering or terrorist financing and procedures to confirm suspicions of money-laundering or terrorist financing. Finally, the program should include follow-up procedures for when suspicions of money-laundering or terrorist financing are confirmed. These steps should include refusing to enter into, or complete, a transaction that appears designed to further illegal activity.

Compliance Officer: The interim final rules further require that a dealer select a compliance officer to be "completely responsible" and authoritative in administering the dealer's anti-money laundering program.[29] The compliance officer should be an employee or officer of the dealer and his position should either completely or partially focus on BSA compliance, according to the complexity and size of the dealer's business. The compliance officer should ensure the anti-money laundering program is "effectively implemented, updated as necessary, and properly administered with respect to training the appropriate people."[30] The credentials of a compliance officer should include knowledge about BSA requirements and money-laundering risks and issues.

Education and Training: The interim final rule continues to require a dealer to provide training for appropriate persons.[31] This means employee training and periodic refreshers in BSA requirements for employee as it relates to their job functions. The required training should include tactics and information on recognizing possible signs of money laundering and terrorist financing. Details such as the level, frequency, and focus of the training should vary according to the responsibilities of the employees and the risk factors the dealer has identified.

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[26] *Id*. at 33,710.
[27] *Id*.
[28] *Id*.
[29] *Id*.
[30] *Id*.
[31] *Id*.

Independent Testing: The interim final rule also continues to require that a dealer perform periodic testing of its anti-money laundering program to ensure it functions properly.[32] Either dealer employees or a person knowledgeable in BSA requirements, such an unaffiliated service provider, should be responsible for conducting tests provided that the person(s) conducting tests are not involved in the program's operation or oversight. The dealer should determine the frequency of the tests based on relevant factors, including the company's size, complexity, and nature of business.

FREQUENTLY ASKED QUESTIONS

Is the purchase and sale of jewelry and other finished goods containing jewels, precious metals, or precious stones subject to the rule as well?

- Only if the jewelry or other finished goods derive 50 percent of their values from the jewels, precious metals, or precious stones they contain.

How do I determine whether I have purchased and sold $50,000 worth of jewels, precious metals, or precious stones?

- The $50,000 threshold is based on the value of the jewels, precious metals, and precious stones that were purchased and sold during the prior calendar or tax year. A dealer should not include in the calculation the value of the jewelry in its entirety.

How do I determine whether the businesses from which I purchase my covered goods are "dealers" or other "retailers" for the purposes of the interim final rule?

- FinCEN only requires that a person take "reasonable steps" to determine whether a supplier is covered by this interim final rule or whether the supplier is an exempt retailer. "Reasonable steps" depend on "the nature of the relationship between the supplier and the person purchasing the items."

In 2005, I will purchase more than $50,000 in jewels, precious metals, and precious stones that I will use to manufacture inexpensive jewelry and sell to retail stores. Will I be required to have an anti-money laundering program?

- If a person plans to sell a retailer more than $50,000 in jewels, precious metals, and precious stones during a future calendar or tax year, the person will be required by Treasury to develop an anti-money laundering program.

I sell precious stones primarily to the public, but my supplier is a foreign company. Am I required to establish an anti-money laundering program?

- A person that sells primarily to the public is a retailer and only needs to develop an anti-money laundering program that addresses its purchase of covered goods.

[32] 70 Fed. Reg. at 33,711.

Are trade-in transactions "purchases" under this rule?

- No.

I am a retailer jeweler who sometimes buys jewelry from the general public, which I re-sell in my store. Am I required to have a money laundering program?

- Yes, if:

  (1) you sold jewelry containing more than $50,000 in jewels, precious metals, and precious stones and the value of the jewels, precious metals, and precious stones comprised 50 percent or more of the jewelry's selling price; and

  (2) you purchased from the general public jewelry containing more than $50,000 in jewels, precious metals and precious stones and the value of the jewels, precious metals, and precious stones compromised 50 percent or more of the jewelry's asking price.

I purchase jewels, precious stones, and precious metals for the purpose of making and selling decorative consumer goods. Do I have to establish an anti-money laundering program?

- If you sell your goods primarily to the public, then you are a retailer and only need an anti-laundering program if you meet the previous question's conditions.
- If you do not sell your goods primarily to the public, you must establish an anti-money laundering program if you meet the definition of a dealer.

What about the purchase of jewels, precious stones, or precious metals for use in machinery or equipment to be used for industrial purposes? If a business manufactures such equipment and sells it, is the business subject to the interim final rule?

- No.

When do I have to implement my anti-money laundering program?

- By January 1, 2006, or within six months after becoming subject to the anti-money laundering requirement.

I am required to have anti-money laundering program for 2006. How long must it last?

- If you are required to have a program by 2006, you must maintain it as long as you are a dealer, as defined by the rule. Once you no longer meet the definition of a dealer, you may discontinue the program in 2007.

Am I required to file a Suspicious Activity Report as part of my anti-money laundering program?

- No, but dealers are "strongly encouraged" to file the report when they suspect the transaction or funds involved have an illegal source or purpose or when the transaction has no apparent lawful purpose.

IMPLICATIONS

The jewelry industry, both wholesale and retail, contains huge variations in the size and scope of its activities and there is little history on which to build the newly mandated compliance programs. It is not yet clear when the IRS will initiate its examination process of jewelers. But it is likely that external auditors of publicly traded jewelers will soon require AML policies and procedures to be in place in connection with their certifications of company's meeting federal compliance requirements.

Initially, jewelers will need to undertake steps to create policies and procedures applicable to the way they actually do business. Over time, they will have to be tailored to risks, with particular attention given to cross-border purchases and sales, the treatment of cash, and the handling of suspicious transactions. While suspicious activity reporting is not mandated for jewelers, a failure to report a suspicious activity could leave the jeweler open to enforcement risk if the transaction resulted in the jeweler accepting funds or property from a person later found to have engaged in illicit activity. The development of a prudent approach to the treatment of suspicious activities will be among the most important elements of compliance programs for most dealers – and one where the Treasury regulations offer little guidance.

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