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## AML in the Spotlight: Compliance Risks for Broker-Dealers and Investment Advisers

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# AML IN THE SPOTLIGHT: COMPLIANCE RISKS FOR BROKER-DEALERS AND INVESTMENT ADVISERS

BY: JOHN H WALSH & CECILIA BAUTE MAVICO\*

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## I. INTRODUCTION

In the first days of 2014, financial regulators have made Anti-Money Laundering (“AML”) a compliance priority. On January 2, 2014, the Financial Industry Regulatory Authority (“FINRA”) announced that its examiners would focus on AML compliance.<sup>1</sup> Just a week later, on January 9, 2014, the Securities and Exchange Commission (“SEC”) announced that its examiners would also focus on AML compliance.<sup>2</sup> In addition, the Department of the Treasury’s Financial Crimes Enforcement Network (“FinCEN”) appears to be moving forward with a previously announced initiative to extend AML compliance requirements to investment advisers.<sup>3</sup> For broker-dealers and

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<sup>1</sup> Press Release, FINRA Releases 2014 Regulatory & Exam Priorities, (Jan. 2, 2014), *available at* <http://www.finra.org/web/groups/industry/@ip/@reg/@guide/documents/industry/p419710.pdf>.

<sup>2</sup> Press Release, SEC, SEC Announces 2014 Examination Priorities (Jan. 9, 2014), *available at* <http://www.sec.gov/about/offices/ocie/national-examination-program-priorities-2014.pdf>.

<sup>3</sup> See Jennifer Shasky Calvery, Remarks at the Securities Industry and Financial Markets Association Anti-Money Laundering and Financial Crimes Conference (Feb. 27, 2013), *available at* [http://www.fincen.gov/news\\_room/speech/html/20130227.html](http://www.fincen.gov/news_room/speech/html/20130227.html). See also Emily Flitter, *New Rule Could Turn U.S. Hedge Funds into Informers*, REUTERS, Jan. 4, 2013, *available at* <http://www.reuters.com/article/2013/01/04/us-usa-hedgefunds-informers-idUSBRE9030NL20130104>. The initiative was announced by FinCEN’s then Director in late 2011.

investment advisers alike, this places AML compliance in the spotlight.

Certainly, much of regulators' attention is due to a largest-ever BSA related settlement involving JPMorgan Chase Bank, N.A. ("JPMorgan").<sup>4</sup> In January 2014, the Department of Justice filed a two-count criminal information that charged JPMorgan with failing to maintain an effective AML program and failing to file a suspicious activity report in connection with the Bernard Madoff's Ponzi scheme.<sup>5</sup> In the settlement, JPMorgan agreed to forfeit \$1.7 billion and entered into a deferred prosecution agreement.<sup>6</sup> This case drew considerable interest in the media, and understandably, appears to have captured other regulators' attention as well.

In light of regulators' renewed attention, this article discusses recent events, reviews AML enforcement actions against securities firms, and identifies the compliance risks they suggest. The article concludes that the time has come for broker-dealers and advisers alike to take a holistic view of compliance and their AML risks, and to prepare for enhanced oversight and regulation.

## II. RECENT DEVELOPMENTS

Early each year, FINRA publishes an annual list of regulatory and examination priorities.<sup>7</sup> This year, AML is on the list and examiners will focus on AML issues associated with institutional business with a particular focus on DVP/RVP customers. As part of its annual pronouncement of priorities, also FINRA reminded firms to develop risk-based AML programs that address the risks specific to their firm and tailor programs around these risks.<sup>8</sup> The idea that AML is an issue of continuing interest is consistent with other public statements about FINRA's program. For example, in 2011, an official of the Securities and Exchange Commission ("SEC") stated that in 2010, the SEC and FINRA had conducted 1,900 broker-dealer examinations that included an AML review.<sup>9</sup> In

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James H. Freis, Jr., Remarks at the Am. Bankers Ass'n/Am. Bar Ass'n Money Laundering Enforcement Conference (Nov. 15, 2011), *available at* [http://www.fincen.gov/news\\_room/speech/pdf/20111115.pdf](http://www.fincen.gov/news_room/speech/pdf/20111115.pdf).

<sup>4</sup> Press Release, DOJ, JPMorgan Criminally Charged with Two Violations of the Bank Secrecy Act (Jan. 7, 2014), *available at* <http://www.justice.gov/usao/nys/pressreleases/January14/JPMCD PAPR.php>.

<sup>5</sup> *Id.*

<sup>6</sup> *Id.*

<sup>7</sup> See, FINRA, Annual Regulatory and Priorities Letters *available at* <http://www.finra.org/Industry/Regulation/Guidance/CommunicationstoFirms/P122861>.

<sup>8</sup> FINRA, *supra* note 1.

<sup>9</sup> Carlo V. di Florio, Speech by SEC Staff: Keynote Address at the SIFMA Anti-Money Laundering Seminar (Mar. 3, 2011), *available at* <http://www.sec.gov/news/speech/2011/spch030311cvd.htm>.

these examinations, 46% of the broker-dealers were cited for deficiencies.<sup>10</sup> In other words, FINRA's renewed interest builds on a significant regulatory foundation—874 broker-dealers cited for AML deficiencies in 2010.<sup>11</sup>

FINRA's examination priorities continue to focus on fundamentals as well as esoteric issues. One specific example related to the usage of executing firms to effectuate large liquidations of low-priced securities for DVP/RVP customers.<sup>12</sup> FINRA stated that given the nature of a DVP/RVP customer relationship, the source of these low-priced securities may be "masked" and identified the application of the Customer Identification Program requirements to DVP/RVP customers as an area of focus.<sup>13</sup>

In early 2013, for the first time, the SEC's examination program, the Office of Compliance Inspections and Examinations ("OCIE") published a list of priorities similar to FINRA's annual list.<sup>14</sup> When OCIE published its second list, for 2014, much like FINRA, it indicated that its focus with AML would be on broker-dealers, both introducing and clearing firms.<sup>15</sup> In its annual list, it said, it would also examine "AML programs of proprietary trading firms that allow customers direct access to the markets from higher risk jurisdictions."<sup>16</sup> In 2013, OCIE was focused on firms that appeared to have weak programs, especially in regards to the firms' programs for customer identification, the identification of suspicious activity and filing of Suspicious Activity Reports, weak due diligence regarding "certain accounts," and taking on the accounts of firms that have failed or been expelled from membership in FINRA.<sup>17</sup> Finally, OCIE said, it will focus on firms' assessments of the risks arising from their business practices and implementation of the AML program for those risks<sup>18</sup>.

FinCEN's recent attention to investment advisers is based on a lengthy period of continuing interest. In 2003 it published a notice of proposed rulemaking that would have required investment advisers, both registered and unregistered, to establish AML compliance programs.<sup>19</sup> The year before, in

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<sup>10</sup> *Id.*

<sup>11</sup> *Id.* 1,900 examinations x 46% with deficiencies = 874.

<sup>12</sup> FINRA, *supra* note 1, at 5.

<sup>13</sup> FINRA, *supra* note 1, at 6.

<sup>14</sup> Press Release, SEC, SEC Announces 2013 Examination Priorities (Feb. 21, 2013), available at <http://www.sec.gov/news/press/2013/2013-26.htm>.

<sup>15</sup> SEC, *supra* note 2, at 8.

<sup>16</sup> *Id.*

<sup>17</sup> SEC, *supra* note 18.

<sup>18</sup> *Id.*

<sup>19</sup> Anti-Money Laundering Programs for Investment Advisers, 68 Fed. Reg 86 (proposed May 5, 2003) (to be codified at 31 C.F.R. pt. 103).

2002, it had published a similar proposal for unregistered investment companies.<sup>20</sup> Both proposals were withdrawn in 2008.<sup>21</sup> Then, in late 2011, FinCEN's Director indicated that it was working on a regulatory proposal to require investment advisers to establish an AML compliance program and report suspicious activity.<sup>22</sup> Broker-dealers have been subject to both requirements—an AML compliance program and reporting suspicious activity—since 2002.<sup>23</sup> In 2013, both FinCEN's Director, and press reports have suggested that FinCEN is moving forward with both elements of its proposal for investment advisers.<sup>24</sup>

In light of these developments, broker-dealers and investment advisers could well believe the regulators are raising the stakes in this area. Indeed, regulators have stated as much. In 2012, the Chief Counsel of the SEC's Division of Trading and Markets stated that the regulators' "expectations have changed, and frankly have increased."<sup>25</sup> He went on to note that this is typically the case when a rule has been on the books for a while.<sup>26</sup> Of course, that may be true for broker-dealers, but not investment advisers. In any event, securities firms have been forewarned.

### III. AML COMPLIANCE RISKS

As regulators increase their focus on AML, what compliance risks are likely to have their attention? One means of identifying higher priority compliance risks is to consider the problems that the regulators have deemed sufficiently serious to warrant a public enforcement or disciplinary action.<sup>27</sup> Over the last few years, the SEC and FINRA have brought a number of enforcement actions alleging AML problems. In general, these cases fall into four types: problems with an AML program; failure to self-report one's own

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<sup>20</sup> Anti-Money Laundering Programs for Unregistered Investment Companies, 67 Fed. Reg. 187 (proposed Sept. 26, 2002) (to be codified at 31 C.F.R. pt. 103).

<sup>21</sup> Press Release, *FinCEN Withdraws dated AML Rule Proposals for Unregistered Investment Companies, Commodity Trading Advisors, and Investment Advisers*, FIN. CRIMES ENFORCEMENT NETWORK (Oct. 30, 2008), available at [http://www.fincen.gov/news\\_room/nr/html/20081030.html](http://www.fincen.gov/news_room/nr/html/20081030.html).

<sup>22</sup> Freis,, *supra* note 3.

<sup>23</sup> Amendments to the Bank Secrecy Act Regulations – Requirement that Brokers or Dealers in Securities Report Suspicious Transactions, 66 Fed. Reg. 250 (proposed July 1, 2002) (to be codified at 31 C.F.R. pt. 103).

<sup>24</sup> See *supra* note 3 and accompanying text.

<sup>25</sup> David W. Blass, *Broker-Dealer Anti-Money Laundering Compliance – Learning Lessons from the Past and Looking to the Future* (Feb. 29, 2012), available at <http://www.sec.gov/news/speech/2012/spch022912dwb.htm>.

<sup>26</sup> *Id.*

<sup>27</sup> While the SEC refers to its actions as enforcement and FINRA refers to its actions as disciplinary, for ease of reference in this article, both will be called enforcement.

suspicious activity; failure to report a third party's suspicious activity; and liability for compliance professionals. Each is discussed below.

*A. Problems with the AML Program*

The most straightforward compliance risk in this area is the failure to establish and maintain an appropriate AML compliance program. Regulations under the Bank Secrecy Act require broker-dealers to establish an AML compliance program,<sup>28</sup> including a Customer Identification Program,<sup>29</sup> and Rule 17a-8 under the Securities Exchange Act gives the SEC authority to enforce those requirements.<sup>30</sup> As set forth in greater detail below, the SEC has brought administrative enforcement proceedings against broker dealers alleging this type of failure. The specific problems alleged by the SEC have generally involved either gaps in a firm's policies and procedures, or deviations from them.

As examples of gaps in firms' policies and procedures, in one case, the SEC alleged that a broker-dealer failed to verify the identities of subaccount holders in corporate omnibus accounts.<sup>31</sup> The SEC noted that an omnibus account could itself be deemed the broker-dealer's customer where the omnibus account holder fully intermediated the transactions.<sup>32</sup> In the case, however, the SEC alleged that the subaccount holders directly effected transactions through their subaccounts with the broker-dealer's direct market access software, making the subaccount holders customers, and subject to verification.<sup>33</sup> In another case, the SEC alleged that a broker-dealer's Customer Identification Program had indicated that it would verify customers' identities, yet, it failed to verify the identities of secondary account holders in joint accounts.<sup>34</sup>

As an example of a deviation from policies and procedures, in one case the SEC alleged that a broker-dealer established a written Customer Identification Program, but then used informal procedures not set forth in the written program

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<sup>28</sup> See 31 C.F.R. §§ 1023.200, 1023.210 (2013) (establishing broker-dealers' obligation to establish an AML compliance program as set out in 31 C.F.R. § 5318(h) or self-regulatory rules); *see also*, FINRA Rule 3310 (governing AML compliance).

<sup>29</sup> See 31 C.F.R. § 1023.220 (establishing minimum requirements for broker-dealers' Customer Identification Programs).

<sup>30</sup> See 17 C.F.R. § 240.17a-8 (a rule issued under the Securities Exchange Act, and therefore within the enforcement authority of the SEC, that requires broker-dealers to comply with the reporting, recordkeeping, and record retention requirements of the Bank Secrecy Act).

<sup>31</sup> Pinnacle Capital Mkts LLC, Exchange Act Release No. 34-62811 (Sept. 1, 2010), *available at* <http://www.sec.gov/litigation/admin/2010/34-62811.pdf>.

<sup>32</sup> *Id.*

<sup>33</sup> *Id.*

<sup>34</sup> E\*Trade Clearing LLC, Exchange Act Release No. 34-58250 (July 30, 2008), *available at* <http://www.sec.gov/litigation/admin/2008/34-58250.pdf>.

to verify customers' identities.<sup>35</sup> Specifically, while the firm's policies and procedures required the use of photo identifications or specific non-documentary methods, in practice, it simply relied on its registered representatives' personal knowledge of the customer.

Similar to the SEC cases discussed above, FINRA also has focused on AML program weaknesses. FINRA Rule 3310 requires member firms to establish a written AML program reasonably designed to *achieve* and *monitor* for compliance with the requirements of the Bank Secrecy Act and the regulations promulgated thereunder.<sup>36</sup> In recent years, FINRA has reached settlements in a number of disciplinary matters involving AML program deficiencies.<sup>37</sup> As set forth below these matters highlight two common problem areas: (i) firms not tailoring AML programs to their business activities and AML risks; and (ii) firms relying on inadequate surveillance reports and/or manual reviews to detect potentially suspicious activities.

Fundamental to the success of an AML program is the extent to which the program is tailored to a firm's business activities, customer base, and identified AML risks. In a number of cases, FINRA found that firms implemented policies based on FINRA's AML Template for Small Firms,<sup>38</sup> and failed to sufficiently customize these policies to address their business activities and relevant red flags. By way of example, FINRA found that a firm engaged in market-making activities failed to address this business activity in its AML program, such as by including relevant red flags that would alert it to market manipulation, prearranged or other non-competitive trading practices, and wash sales or other fictitious trading.<sup>39</sup> In another case, FINRA found that a firm's AML program was inadequate because, among other things, the firm maintained clearing agreements with four institutions yet only reviewed and had access to AML exception reports for one of the four clearing platforms.<sup>40</sup> This omission resulted in approximately 40 percent of the firm's business escaping review.<sup>41</sup>

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<sup>35</sup> Crowell, Weedon & Co., Exchange Act Release No. 34-53847 (May 22, 2006), *available at* <http://www.sec.gov/litigation/admin/2006/34-53847.pdf>.

<sup>36</sup> FINRA Rule 3110.

<sup>37</sup> *See e.g.*, FINRA Press Release: FINRA Fines Three Firms \$900,000 for Inadequate AML Programs *available at* <https://www.finra.org/Newsroom/NewsReleases/2013/P256514>; FINRA Press Release: FINRA Fines Banorte-Ixe Securities \$475,000 for Inadequate Anti-Money Laundering Program and for Failing to Register Foreign Finders *available at* <http://www.finra.org/Newsroom/NewsReleases/2014/P440108>.

<sup>38</sup> *Anti-Money Laundering Template for Small Firms*, FINRA, <http://www.finra.org/Industry/Issues/AML/p006340> (last updated June 25, 2010).

<sup>39</sup> Seton Sec. Group, Inc., FINRA Letter of Acceptance Waiver and Consent No. 2009017333701 (Nov. 16, 2011).

<sup>40</sup> Sanders Morris Harris, Inc., FINRA Letter of Acceptance Waiver and Consent No. 2008015360002 (Aug. 7, 2012).

<sup>41</sup> *Id.*

Another AML program deficiency noted in FINRA cases involves the reasonableness of systems and processes used to monitor for suspicious activities.<sup>42</sup> Introducing firms commonly use clearing firm exception reports and blotters to monitor for potentially suspicious activities.<sup>43</sup> In recent cases described below, however, FINRA has found the use of certain surveillance and transaction reports to be unreasonable for the purposes of detecting potentially suspicious activities because of the unlikelihood that such reports would effectively identify potential issues. For example, in one case FINRA found that manual reviews of blotters or other voluminous reports to detect potentially suspicious money movements and transactions were inadequate.<sup>44</sup> Along the same lines, in another case, FINRA found reviews of voluminous transaction reports to be an unreasonable approach to detect potentially suspicious activities where a single client traded on average up to three billion shares per month.<sup>45</sup> Further, FINRA found that this same firm unreasonably relied upon its clearing firm to detect potentially suspicious activities.<sup>46</sup> FINRA also has alleged deficiencies in AML programs where introducing firms failed to review and respond to information about potential suspicious activities provided by the clearing firm.<sup>47</sup> FINRA also has determined AML programs were deficient where systems used to monitor for suspicious activities were unable to capture patterns of suspicious trading across accounts or by security, and/or involved manual reviews impossible to capture suspicious activities or inflows and outflows.<sup>48</sup>

Finally, FINRA also has focused on clearing firm AML programs and the

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<sup>42</sup> See, e.g., Lincoln Fin. Sec. Corp., FINRA Letter of Acceptance Waiver and Consent No. 20090163025 (Dec. 10, 2012).

<sup>43</sup> See e.g., NASD Notice to Members 99-57, SEC Approves Rule Amendments Governing Clearing Firms and Their Introducing Firm Clients' Relationship (Jul. 1999).

<sup>44</sup> See, e.g., Success Trade Sec., Inc., FINRA Letter of Acceptance, Waiver and Consent No. 2009016309801 (Feb. 22, 2012); Newport Coast Securities, Inc., FINRA Letter of Acceptance, Waiver and Consent No. 2009017333501 (May 22, 2012).

<sup>45</sup> Title Sec., Inc., FINRA Letter of Acceptance, Waiver and Consent No. 2010022913901 (Sept. 26, 2012).

<sup>46</sup> *Id.* See also OC Sec., Inc., FINRA Letter of Acceptance, Waiver and Consent No. 2010021779801 (July 18, 2011) (finding that the firm improperly relied on its clearing firm to conduct due diligence inquiries with regard to stock certificates presented for deposit into the firm's customer accounts).

<sup>47</sup> See, e.g., Tradespot Mkts Inc., FINRA Disciplinary Proceeding No. 2009017590801 (Aug. 4, 2011); Euro Pac. Capital, Inc., FINRA Letter of Acceptance, Waiver and Consent No. 2009016300801 (Sept. 19, 2011) (finding that the firm did not consistently utilize exception reports made available by its then clearing firm, and did not promptly respond to clearing firm's inquiries regarding potentially suspicious activities); Ferrara, FINRA Disciplinary Proceeding No. 2009016640701 (July 30, 2012) (finding that the AML Compliance Officer failed to obtain exception reports from the clearing firm which would have assisted him in detecting suspicious trading in penny stocks by his firm's online customers).

<sup>48</sup> See FINRA Letter of Acceptance, *supra* note 36.



extent to which they sufficiently monitor for suspicious transactions. As communicated in regulatory guidance, both clearing and introducing firms are obligated to monitor for suspicious activities.<sup>49</sup> In one case, FINRA found that a clearing firm failed to sufficiently monitor for suspicious activities because the clearing firm did not consistently review transactions or AML surveillance reports that it routinely made available to its correspondents.<sup>50</sup> FINRA determined that the clearing firm reviewed such limited information that it failed to establish and implement a transaction monitoring program reasonably designed to achieve compliance with the SAR reporting requirements.<sup>51</sup>

### *B. Reporting Oneself*

Perhaps the most sensitive compliance obligation under the AML rules is self-reporting. Broker-dealers are required to report suspicious activity on Form SAR (“SAR”).<sup>52</sup> Specifically, they must file a SAR if a transaction is attempted by, at, or through the broker-dealer; it involves or aggregates funds or other assets of at least \$5,000; and the broker-dealer knows, suspects, or has reason to suspect that the transaction involves funds derived from illegal activity, is intended to hide or disguise such funds, is designed to evade the AML regulations, has no business or apparent lawful purpose, and the broker-dealer “knows of no reasonable explanation for the transaction after examining the available facts,” or involves the use of the broker-dealer to facilitate criminal activity.<sup>53</sup> By its terms, the requirement applies both to outsiders seeking to transact “at” or “through” the firm, as well as to transactions “by” the firm itself. Recent enforcement cases by the SEC have focused on the latter self-reporting aspect of the rule.

Perhaps the most detailed description of the compliance risk posed by this requirement can be found in an administrative enforcement proceeding against Ferris, Baker Watts, Inc.<sup>54</sup> A registered representative of the firm purchased 960,000 shares of a security over two days, allocated 20,000 to his personal

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<sup>49</sup> Special NASD Notice to Members 02-21 (Apr. 2002) (emphasizing cooperation among introducing and clearing firms to achieve compliance with the Money Laundering Abatement Act and reminding firms that any allocation of responsibility among an introducing and clearing firm would not relieve either party from its independent obligation to comply with AML laws).

<sup>50</sup> First Clearing LLC, FINRA Letter of Acceptance, Waiver and Consent No. 2008012791101 (July 26, 2011).

<sup>51</sup> *Id.*

<sup>52</sup> See 31 C.F.R. § 1023.320(b)(1) (2013). Before April 1, 2013 the applicable form was called Form SAR-SF. A FinCEN briefing on the transition to the new form can be found at: <http://www.fincen.gov/whatsnew/pdf/TheNewFinCENSAR-RecordedPresentation.pdf>.

<sup>53</sup> *Id.* § 1023.320(a)(2)(i)–(iv).

<sup>54</sup> Ferris, Baker Watts, Inc., Exchange Act Release No. 34-59372 (Feb. 10, 2009), available at <http://www.sec.gov/litigation/admin/2009/34-59372.pdf>.

account, and the remainder to client accounts.<sup>55</sup> The purchases caused the price to rise, and the registered representative then sold his personal shares for a profit.<sup>56</sup> The broker-dealer's AML officer discovered the trades and asked a senior executive to request an explanation.<sup>57</sup> The senior executive did not.<sup>58</sup> A few weeks later, the AML officer sent the senior executive a follow-up e-mail, in which he asked if the trades were suspicious because, he said, if they were, he was obligated to file a SAR.<sup>59</sup> The senior executive again failed to respond.<sup>60</sup> The Compliance Director then sent an email, with the AML officer's two e-mails attached, and told the senior executive that they needed an explanation—the Compliance Director received no response.<sup>61</sup> Finally, the AML officer attempted several times to discuss the trades with the senior executive, until he stood in the executive's door and refused to leave until he received an answer.<sup>62</sup> He was told the firm would not be filing a SAR.<sup>63</sup> The SEC noted the AML officer's observation that the trades "could create an appearance of manipulative market practices," and sanctioned the firm for failing to file a SAR.<sup>64</sup>

The allegations against Ferris, Baker Watts highlight several important considerations. First, the trading was suspicious because it created an "appearance" of manipulation. That was enough to trigger the filing requirement. Second, the trading was identified internally, and both the AML officer and Compliance Director became involved in seeking a determination of the firm's filing obligation. Third, in describing the events surrounding the decision not to file—repeated e-mails, in person follow-up, standing in the executive's door—the SEC was evidently giving color to the internal process it found wanting.

While the order against Ferris, Baker Watts may be the SEC's most dramatic narrative of a failure to self-report in a SAR, this problem has been alleged in several recent cases. These cases have included an alleged failure to

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<sup>55</sup> *Id.*

<sup>56</sup> *Id.*

<sup>57</sup> *Id.*

<sup>58</sup> *Id.*

<sup>59</sup> *Id.*

<sup>60</sup> *Id.*

<sup>61</sup> *Id.*

<sup>62</sup> *Id.*

<sup>63</sup> *Id.*

<sup>64</sup> *Id.* There was trading in another security that was referenced in the enforcement order, but the SEC did not provide an equivalent narrative regarding the alleged failure to file a SAR in that regard. *Id.* In addition, allegations against certain individuals at the firm gave rise to extensive litigation. *Id.* The authors state no view on that litigation and limit their comments to the settled order against Ferris, Baker Watts, Inc. *Id.*

self-report suspicious wire transfers by a co-owner of a firm;<sup>65</sup> trading by a registered representative in low-priced, little known securities, which was suspiciously timed and corresponded with the issuance of spam e-mail and international wire activity;<sup>66</sup> and manipulative trading by foreign traders who, the SEC alleged, were under the broker-dealer's control and, therefore, associated persons of the firm.<sup>67</sup>

FINRA has also been active in this area. By way of example, FINRA found that a compliance officer failed to respond to multiple red flags that should have alerted him to monitor, analyze and investigate suspicious transactions to determine the need to file a SAR.<sup>68</sup> The red flags included the compliance officer learning that a foreign-based publicly traded company had intended to pay entities controlled by the operators of the branch office (who were in the process of becoming firm owners) \$350,000 for unspecified services.<sup>69</sup> Working under the direction of these branch office operators, registered persons solicited customers to purchase stock of this publicly traded company.<sup>70</sup> The compliance officer also approved the opening of accounts for customers of another foreign-based publicly traded company.<sup>71</sup> These customers deposited more than 3.8 million shares of the company during the AML Compliance Officer's registration with the firm and sold over \$23 million of the company's stock.<sup>72</sup> These were the only transactions effected in the customers' account and generated approximately seventy-five percent of all commissions earned while the AML Compliance Officer was registered with the firm.<sup>73</sup>

### *C. Reporting Third Parties*

A third area of compliance risk in AML programs is in the obligation to

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<sup>65</sup> SEC v. Ficeto, Litigation Release No. 21865 (Feb. 25, 2011), *available at* <http://www.sec.gov/litigation/litreleases/2011/lr21865.htm> (action against Hunter World Markets, Inc.).

<sup>66</sup> Gilford Sec., Inc., Exchange Act Release No. 33-9264 (Sept. 30, 2011), *available at* <http://www.sec.gov/litigation/admin/2011/33-9264.pdf>.

<sup>67</sup> Biremis Corp., Exchange Act Release No. 34-68456 (Dec. 18, 2012), *available at* <http://www.sec.gov/litigation/admin/2012/34-68456.pdf>; Hold Bros. On-Line Inv. Servs., LLC, Exchange Act Release No. 34-67924 (Sept. 25, 2012), *available at* <http://www.sec.gov/litigation/admin/2012/34-67924.pdf>.

<sup>68</sup> Altschul, FINRA Letter of Acceptance Waiver and Consent No. 2009019108904 (Jan. 31, 2012).

<sup>69</sup> *Id.*

<sup>70</sup> *Id.*

<sup>71</sup> *Id.*

<sup>72</sup> *Id.*

<sup>73</sup> *Id.*

file a SAR on a third party who engages in suspicious activity. While this is presumably less sensitive than reporting oneself, or one's employees, it is nonetheless a serious matter to report one's customers or counter-parties to federal law enforcement. This issue is highlighted in an SEC enforcement case that is still in litigation.<sup>74</sup>

The SEC staff alleged that several individuals associated with Leeb Brokerage Services, Inc. ("Leeb"), a now defunct broker-dealer, caused the firm to fail to file SARs.<sup>75</sup> In an initial decision<sup>76</sup> that has become final for one of the respondents,<sup>77</sup> and is under review by the Commission for others,<sup>78</sup> an Administrative Law Judge ("ALJ") found that over a period of several months, a large percentage of the clearing requests that originated in one of Leeb's offices raised red flags at its clearing firm.<sup>79</sup> Specifically, the ALJ noted, the clearing firm raised concerns about suspicious transactions (mostly, apparently, transactions in which large blocks of penny stocks were transferred into client accounts and then sold).<sup>80</sup> When Leeb did not respond, the clearing firm terminated the clearing relationship.<sup>81</sup> The red flags that alarmed the clearing firm, the ALJ concluded, showed multiple suspicious transactions that should have been reported by Leeb.<sup>82</sup>

The allegations in the Leeb case highlight the role played by red flags in AML compliance. The key step in the process is identifying that a transaction is suspicious, which often requires an awareness of the meaning of red flags. In the Leeb case, the red flags allegedly arose from the nature of the penny stock transactions.<sup>83</sup> In other cases, the SEC has identified additional red flags that should have been considered, such as a customer issuing trade orders to a broker-dealer for accounts in which he was not an authorized signatory.<sup>84</sup>

FINRA also has focused on firms' responsiveness to red flags relating to

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<sup>74</sup> See Bloomfield, Exchange Act Release No. 33-9334 (July 11, 2012), available at <http://www.sec.gov/litigation/opinions/2012/33-9334.pdf> (order directing additional briefing).

<sup>75</sup> Bloomfield, Initial Decision Release No. 416-A (Apr. 26, 2011), available at <http://www.sec.gov/litigation/aljdec/2011/id416a-bpm.pdf>.

<sup>76</sup> *Id.*

<sup>77</sup> See Labi, Exchange Act Release No. 33-9225 (Jun. 17, 2011), available at <http://www.sec.gov/litigation/aljdec/2011/33-9225.pdf> (Notice that initial decision has become the final decision of the Commission.).

<sup>78</sup> See Bloomfield, *supra* note 77.

<sup>79</sup> *Id.*

<sup>80</sup> *Id.*

<sup>81</sup> *Id.*

<sup>82</sup> *Id.*

<sup>83</sup> See Bloomfield, *supra* note 78.

<sup>84</sup> See, e.g., Park Fin. Group, Inc., Exchange Act Release No. 34-56902 (Dec. 5, 2007), available at <http://www.sec.gov/litigation/admin/2007/34-56902.pdf>.

customers. For example, FINRA expelled a firm for systematic AML violations, including a failure to identify, investigate and report suspicious penny stock activities.<sup>85</sup> A hearing panel found that the firm concealed suspicious activity from regulators, including that the firm allowed two customers to deposit and liquidate billions of shares of penny stocks, generating more than \$3 million in sales proceeds for the customers.<sup>86</sup> The hearing panel also found that the firm permitted five accounts, controlled by persons with disciplinary histories and criminal indictments for engaging in organized criminal activity and money laundering, to deposit and liquidate penny stocks in their accounts just two months after the SEC charged them with securities fraud.<sup>87</sup> Finally, the hearing panel found that the firm permitted approximately twenty customers to deposit and liquidate approximately sixty-five million shares of low-priced and thinly-traded stock.<sup>88</sup> FINRA found that the firm did not investigate apparent red flags or file warranted SARs.<sup>89</sup>

Another case involved a firm that permitted foreign corporate accounts, which coincidentally were controlled by one individual who deposited a total of approximately 279 million shares of low-priced securities and/or penny stocks into the accounts.<sup>90</sup> After the securities were deposited, they were promptly sold, and proceeds were transferred by wire to first party bank accounts maintained with a Scotland bank.<sup>91</sup> The firm did not maintain procedures to detect or prevent participation in unregistered distributions of securities and address the acceptance of securities in certificate or electronic form.<sup>92</sup> Further, the firm relied primarily on transfer agents to determine whether the securities were free trading.<sup>93</sup> FINRA found that the firm failed to detect the red flags and properly analyze them to determine if filing a SAR was warranted.<sup>94</sup>

Finally, in 2011 and 2012, several FINRA cases that primarily involved a firm's failure to establish an appropriate AML compliance program, see Section III.A above, also cited the firm's failure to file one or more SARs as a result of the program deficiencies. In these cases, FINRA noted that a firm's failure to monitor for relevant AML risks, and detect and investigate potential issues may

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<sup>85</sup> AIS Fin., Inc., FINRA Disciplinary Proceeding No. 2008012169101 (Mar. 3, 2011).

<sup>86</sup> *Id.*

<sup>87</sup> *Id.*

<sup>88</sup> *Id.*

<sup>89</sup> *Id.*

<sup>90</sup> Glendale Sec., Inc., FINRA Letter of Acceptance, Waiver and Consent No. 2009019747601 (Nov. 23, 2010).

<sup>91</sup> *Id.*

<sup>92</sup> *Id.*

<sup>93</sup> *Id.*

<sup>94</sup> *Id.*

ultimately result in a failure to file a SAR. Specific program failures cited by FINRA in this context have included: failure to monitor disciplinary backgrounds, failure to respond to multiple red flags, and failure to monitor transactions involving journal transfers, penny stocks, or wire transfers.<sup>95</sup>

#### *D. Liability for Compliance Professionals*

A fourth and final area of compliance risk in AML programs is the extent to which compliance professionals are themselves at risk. Compliance programs mandated by the Bank Secrecy Act include an obligation to name an AML Compliance Officer.<sup>96</sup> In several of the enforcement cases brought by the SEC, compliance professionals have been named personally.

In many of these cases, the presentation by the SEC is fairly straightforward. Most often, the SEC alleges that the compliance official knew or should have known about red flags, and failed to file a SAR.<sup>97</sup> However, certain of the cases present interesting facts that warrant closer attention.

In one case, for example, a compliance officer refused to sign off on a \$4 million wire transfer from a customer account to a third party.<sup>98</sup> The transfer was against the firm's policy of disallowing wires from customer accounts to third parties.<sup>99</sup> In addition to refusing to sign off on the wire, the compliance officer required the funds to be returned.<sup>100</sup> Nonetheless, the SEC stated, she did not file a SAR.<sup>101</sup> In light of the red flags, and the potential that money was being laundered through the account, the SEC found, the compliance officer should have filed a SAR.<sup>102</sup> Compliance officers should take heed of the risk that liability can arise even from a transaction they have stopped and unwound.

In another case, a compliance officer hired a third-party to conduct two annual audits of the firm's AML procedures.<sup>103</sup> However, the ALJ simply

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<sup>95</sup> Scottsdale Capital Advisors Corp., FINRA Letter of Acceptance, Waiver and Consent No. 2008011593301 (Nov. 14, 2011); ACAP Fin. Inc., FINRA Letter of Acceptance, Waiver and Consent No. 2009017601901 (Mar. 26, 2012); Tradespot Mkts. Inc., FINRA Letter of Acceptance, Waiver and Consent No. 2009017590801 (Aug. 4, 2011).

<sup>96</sup> 31 C.F.R. § 5318(h)(1)(B) (2013).

<sup>97</sup> See, e.g., *Gilford Sec., Inc.*, *supra* note 48 (proceeding against compliance officer Richard Granahan).

<sup>98</sup> Pagliarini, Exchange Act Release No. 63964 (Feb. 24, 2011), available at <http://www.sec.gov/litigation/admin/2011/34-63964.pdf>.

<sup>99</sup> *Id.* at 5.

<sup>100</sup> *Id.*

<sup>101</sup> *Id.* at 4.

<sup>102</sup> *Id.* at 5.

<sup>103</sup> Bloomfield, Initial Decision Release, *supra* note 51 (proceeding against Robert Gorgia, compliance officer).

dismissed these audits by saying they “were shams that failed to note any AML issues.”<sup>104</sup> Unfortunately, however, the ALJ failed to state what made them shams and unreliable. Upon review by the Commission, some clarity was brought to this issue.<sup>105</sup> In its opinion the Commission noted that the compliance officer worked with the auditors and had input into their report. Notwithstanding the warning signs that had been brought to his attention up to that point, the report stated that the firm had “not identified any unusual or suspicious activity or patterns of activity that required further inquiry.”<sup>106</sup> Compliance officers should take heed of the risk that their interaction with third party auditors could be cited against them.

FINRA also has pursued disciplinary actions against compliance professionals for their role in AML related cases.<sup>107</sup> Similar to SEC cases, most of the related FINRA matters assert that the compliance officer failed to implement an effective, reasonably designed AML program, and should have known of potential red flags and/or adopted better procedures and processes to detect potentially suspicious activities. By way of example, a compliance officer and firm entered into an Offer of Settlement with FINRA for \$475,000 for allegedly failing to monitor, detect and report \$28 million activity in a customer account reportedly tied to a Mexican drug cartel.<sup>108</sup> FINRA found that the firm and compliance officer failed to adopt procedures tailored to the firm’s business, “relying instead on off-the-shelf procedures” which were inadequate for risks presented by transactions effected by the firm’s customers in Mexico or risks associated with the firm’s usage of foreign finders.<sup>109</sup> FINRA also alleged that the compliance officer along with the firm failed to “fully enforce” the AML program which resulted to lapses in the firm’s customer identification program and failures to detect suspicious activities.<sup>110</sup> As another example, a firm had an AML program in place, but FINRA alleged that the compliance officer shared responsibility with the firm for its limitations.<sup>111</sup> Among other things, the program was not tailored to the volume of business the firm conducted, it insufficiently monitored activity in high-risk penny stocks, and the

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<sup>104</sup> *Id.*

<sup>105</sup> Bloomfield, Opinion of the Commission, Securities Act Release No. 9553, Exchange Act Release No. 71632 (Feb. 27, 2014), *available at* <http://www.sec.gov/litigation/opinions/2014/33-9553.pdf>.

<sup>106</sup> *Id.* at 19.

<sup>107</sup> *See infra* cases cited in notes \_\_\_ to \_\_\_.

<sup>108</sup> Barnorte-Ixe Securities International, Ltd., and Brian Anthony Simmons, FINRA Letter of Acceptance Waiver and Consent No. 2010025241301 (Jan. 28, 2014).

<sup>109</sup> *Id.*

<sup>110</sup> *Id.*

<sup>111</sup> Brown Brothers Harriman & Co., and Harold A. Crawford, FINRA Letter of Acceptance Waiver and Consent No. 2013035821401 (Feb. 5, 2014).

AML staff did not receive adequate guidance on how to respond to red flags. The compliance officer entered into an Offer of Settlement with FINRA for a \$25,000 fine and a one-month suspension.

In another case, a compliance officer entered into an Offer of Settlement with FINRA based on findings that he failed to establish and implement a sufficiently tailored AML program and effective systems and tools to monitor for suspicious trading.<sup>112</sup> Specifically, the compliance officer failed to obtain exception reports made available through the firm's clearing firm, which would have assisted him in detecting suspicious trading activity effected in customer accounts, which FINRA described as consistent with pump and dump schemes.<sup>113</sup>

A compliance officer entered into an Offer of Settlement with FINRA based on findings that the firm and the compliance officer failed to monitor, detect and investigate suspicious activities.<sup>114</sup> Red flags included questionable backgrounds of customers, suspicious circumstances under which the accounts were opened, and subsequent account activities, including a pattern of selling millions of shares of volatile, low-priced securities and wiring more than \$3.7 million of proceeds to banks out of the country.<sup>115</sup> The compliance officer also failed to implement a reasonable customer identification program.<sup>116</sup>

Similarly, FINRA has pursued disciplinary actions for the role of compliance officers in procuring insufficient independent audits. Member firms must provide for independent testing of their AML programs on an annual basis or every two years depending on the member firm's business. The following FINRA disciplinary matters included deficiencies in independent audits and cited firms as well as AML Compliance Officers. FINRA found that certain independent audits lacked "independence" most often as a result of the AML Compliance Officer performing the testing. In one such case, a firm hired a consulting firm to conduct an overview of an AML Compliance Officer's self-test; FINRA determined that this independent overview did not remediate the violation.<sup>117</sup> Further, in this case and others, FINRA found the substance of the testing to be insufficient because the testing did not review whether personnel implemented the AML program, review account documentation, or test

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<sup>112</sup> Ferrara, *supra* note 39, at 33.

<sup>113</sup> *Id.* at 8–9.

<sup>114</sup> Vincent Michael Bruno, FINRA Disciplinary Proceeding No. 20090162301601, Order Accepting Offer of Settlement (Aug. 29, 2012).

<sup>115</sup> *Id.*

<sup>116</sup> *Id.*

<sup>117</sup> Stephen A. Kohn & Assocs., Ltd., FINRA Letter of Acceptance, Waiver and Consent No. 2011025501701 (Nov. 20, 2012).



transactions, money movements, and other business related activities.<sup>118</sup> In another case, FINRA staff described an independent audit as “patently inadequate” because, in part, the test failed to review for suspicious activity, high-risk accounts, red flags or customer account verification, and failed to indicate that the firm was not utilizing AML exception reports despite these reports being available through its clearing firm.<sup>119</sup> Similarly FINRA found that a firm’s independent consultants performed an inadequate independent audit because they limited their testing to a review of the firm’s AML procedures and interviews of individuals responsible for AML compliance which resulted in “superficial” findings presented in boilerplate language.<sup>120</sup>

#### IV. CONCLUSION

AML poses a variety of compliance risks. Both the SEC and FINRA have brought actions alleging problems in AML programs, including the failure to self-report the firm or an associated person, the failure to report third-parties, and failures by compliance professionals. In fact, the range of issues the cases cover has come to resemble the full panoply of compliance issues faced by broker-dealers. The regulators have noted this development.

In 2012, the Chief Counsel of the SEC’s Division of Trading and Markets stated that the regulators have become “increasingly focused on how AML obligations interact with a broker-dealer’s other obligations under the securities laws and SRO rules . . . .”<sup>121</sup> Firms, he said, should view their AML obligations as complementary and should consider how to leverage these corresponding requirements for a “more holistic view of their risks.”<sup>122</sup>

In sum, as broker-dealers prepare for enhanced oversight, and advisers for possible AML regulation, they should take a holistic view of their compliance risks. Instead of a separate area posing unique risks, AML should be integrated into their overall compliance system. The risks discussed above—gaps in and

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<sup>118</sup> *Id.*; see also First Ky. Sec. Corp., FINRA Letter of Acceptance, Waiver and Consent No. 2010021314101 (Apr. 23, 2012) (finding that the 2009 independent AML test was inadequate because, among other things, it did not include a review of the overall adequacy of the firm’s AML compliance program and did not test all of the firm’s business lines, AML training program, movement of funds, CIP and whether representatives were complying with CIP); Laidlaw & Co. (UK) Ltd., FINRA Letter of Acceptance, Waiver and Consent No. 2009016306101 (Feb. 7, 2012) (finding AML independent tests for two years were inadequate in that they consisted mainly of a summary of the AML written procedures without information regarding any testing of procedures).

<sup>119</sup> Success Trade Sec., Inc., FINRA Letter of Acceptance, Waiver and Consent No. 2009016309801 (Feb. 22, 2012).

<sup>120</sup> TradeStation Sec., Inc., FINRA Letter of Acceptance, Waiver and Consent No. 2010023934201 (Dec. 19, 2011).

<sup>121</sup> Blass, *supra* note 23.

<sup>122</sup> *Id.*

deviations from policies and procedures, red flags, reporting, and personal responsibility—are more than AML issues. They are compliance issues. Treating them holistically, across the compliance program, will help firms prepare for the intensified focus being placed on AML.