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Legal Update

SEC Division of Examinations Publishes Risk Alert on Broker-Dealer AML Practices

On March 29, 2021, the staff of the Division of Examinations ("EXAMS") of the US Securities and Exchange Commission ("SEC") published a Risk Alert regarding the anti-money laundering ("AML") obligations of broker-dealers.[1] The Risk Alert highlights compliance issues related to suspicious activity monitoring and reporting observed by EXAMS over the course of its examinations of broker-dealers.

For the past several years, AML compliance has been top-of-mind for the SEC (as well as other financial industry regulators) on an agency-wide basis. The US Department of Justice brought the first criminal charges against a broker-dealer for violations of the Bank Secrecy Act ("BSA") in 2018, and just last year, the SEC, in cooperation with the Financial Industry Regulatory Authority ("FINRA") and the US Commodity Futures Trading Commission, assessed a total of $38 million in penalties to one broker-dealer for AML violations, including violations relating to suspicious activity monitoring and reporting. FINRA has also been active in its enforcement of AML compliance, issuing fines into the multimillion-dollar range for AML compliance failures.

In this Legal Update, we highlight key observations relating to suspicious activity monitoring and reporting made by EXAMS staff.

Background on AML Framework for Broker-Dealers

The BSA and its implementing regulations establish the basic framework for AML obligations imposed on financial institutions. The Financial Crimes Enforcement Network ("FinCEN"), a bureau of the Department of the Treasury, adopted requirements that financial institutions, including broker-dealers, establish and implement AML programs that include suspicious activity monitoring and reporting policies and procedures.[2]

A broker-dealer is required to establish and implement a risk-based AML program that includes policies, procedures and internal controls reasonably designed to, among other things, identify and report suspicious transactions, as required by the BSA and its implementing regulations. A broker-dealer should tailor its AML program to address the risks facing its particular business in order to identify "red flags" for suspicious activity and should adopt and implement policies and procedures to appropriately manage those red flags.[3]

As a part of its AML program, a broker-dealer is required to file reports with FinCEN of suspicious transactions (a "suspicious activity report" or "SAR") that may relate to potential violations of law or that have no apparent business purpose.[4] Broker-dealers are further instructed by FinCEN to identify five "essential elements" (*i.e.*, who? what? when? where? why?) regarding the suspicious activity in their SARs.

EXAMS Key Observations

The Risk Alert articulates several key observations by EXAMS staff that primarily address the adoption of adequate AML policies, procedures and internal controls or their implementation. The risks posed by low-priced securities or "penny stocks," which can be susceptible to market manipulation, are also heavily featured in the Risk Alert as a type of security producing an outsized number of AML compliance failures.

The Risk Alert divides EXAMS staff observations into two parts: (1) AML Policies and Procedures and Internal Controls and (2) Suspicious Activity Monitoring and Reporting.

AML POLICIES AND PROCEDURES AND INTERNAL CONTROLS

Inadequate policies and procedures. EXAMS observed that some broker-dealers did not establish reasonably designed policies and procedures and internal controls to adequately identify and report suspicious activity as required under the BSA. Examples included:

- Failure to include red flags in their policies and procedures to assist with identifying suspicious activity for further due diligence or failure to tailor the red flags in their policies and procedures to address risks associated with the type of activity in which their customers regularly engaged.
- Some firms with large volumes of daily trading failed to establish and implement automated systems to monitor and report suspicious activity associated with trading in large volumes.
- Where firms incorporated penny stock transactions into their automated monitoring, some firms set the threshold for generating an alert at securities worth less than $1 per share, failing to monitor penny stocks priced between $1 and $5 per share.
- Setting the SAR reporting thresholds at amounts significantly higher than the $5,000 threshold specified in the SAR Rule.
- Inappropriately deferring to clearing firms to identify and report suspicious transactions in customer accounts and failing to adopt procedures that take into account the high-risk nature of certain customers' activity (*e.g.*, penny stock transactions).

Failure to implement procedures. EXAMs also noted that some firms that had reasonably designed written policies and procedures did not implement their procedures adequately and did not conduct adequate due diligence on or report suspicious activity that, per their own procedures, appeared to trigger a SAR filing requirement. Examples included firms' failure to:

- File SARs on transactions that appeared identical in nature to transactions for which the firm had routinely filed SARs without distinguishing such transactions.
- Reasonably use available transaction reports and systems to monitor for suspicious activity.
- Follow up on red flags identified in their procedures, such as prearranged or non-competitive trading, including wash or cross trades or potential insider trading.
- Comply with firm prohibitions on accepting trades for securities priced at less than one penny per share and conduct due diligence to determine whether to file SARs on those transactions.

SUSPICIOUS ACTIVITY MONITORING AND REPORTING

Failure to respond to suspicious activity. EXAMS observed that weak policies, procedures, and internal controls, or the failure to implement existing policies and procedures, ultimately resulted in firms not conducting or documenting adequate due diligence in response to red flags. Examples of such red flags included:

- Large deposits of low-priced securities, followed by the near-immediate liquidations of those securities and then wiring out the proceeds.
- Patterns of trading activity common to several customers including, but not limited to, the sales of large quantities of low-priced securities of multiple issuers by the customers.
- Trading in thinly traded, low-priced securities that resulted in sudden spikes in price or that represented most, if not all, of the securities' daily trading volumes.
- Trading in stock of issuers that were shell companies, were subject to trading suspensions or who had affiliates, officers, or other insiders with a history of securities law violations.
- Questionable background of customers, including those subject to criminal, civil, or regulatory actions relating to, among other things, securities law violations.
- Trading in the stock of issuers for which over-the-counter stock quotation systems had published warnings because the issuers had ceased to comply with their SEC financial reporting obligations or for which the firms relied on a "freely tradeable" legal opinion that was inconsistent with publicly available information.

EXAMS also observed that firms often did not reasonably account for information that was publicly available or in the firms' possession when evaluating activity in customer accounts.

Filing inaccurate or incomplete SARs. EXAMS observed that some broker-dealers did not include details known to the firm of individual customer trades or issuers that were suspicious or did not make use of specific structured data fields on the SAR. Examples included:

- Not including or inaccurately capturing key information despite having such information available in the firm's own internal records.
- Reporting the deposit of low-priced securities but failing to report the liquidation of the same securities shortly thereafter and the disposition of the proceeds, or reporting that a customer deposit of low-priced securities was an "initial" deposit, despite firm records indicating one or more previous deposits of the same security.
- For cyber-intrusions, not including details known at the time of reporting regarding the method and manner of cyber-intrusions and schemes to "take over" customer accounts.

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Takeaways

The implementation and maintenance of an AML program is not a static exercise. Regulators, including the SEC, expect broker-dealers to identify, assess and understand their money laundering risk in terms of the products, customers and geographies they are exposed to, and to adapt their AML programs to align with their unique risk profiles.

Suspicious activity monitoring and reporting are critical components of an effective, risk-based AML program, and the failure to implement adequate suspicious activity monitoring and reporting has been a source of several high-profile regulatory enforcement actions, as well as a DOJ action. Monitoring systems that identify unusual or suspicious activity and support the filing of a SAR should be properly calibrated to a firm's risk profile. Typically, such monitoring systems include manual, transaction-based systems and/or automated surveillance systems. The sophistication of a broker-dealer's monitoring systems should reflect the firm's risk profile, with particular emphasis on higher-risk products, services, customers, entities, and geographies.

The Risk Alert also highlights penny stocks as a product that carries increased risk of money laundering. Broker-dealers that deal with such securities should expect that EXAMS staff will be attentive to the risks posed by penny stocks and the steps taken to guard against those risks. Any broker-dealer with exposure to penny stocks should ensure its AML program accounts for the heightened risks described in the Risk Alert through enhanced risk mitigation measures.

We expect AML requirements, including suspicious activity monitoring and reporting, to remain of significant interest to the SEC and other financial regulators. Given the abundance of recent guidance in this space and increased attention in both examinations and enforcement, particularly with respect to penny stock transactions, financial regulators are sending a clear message to the industry that they will be actively monitoring for AML compliance. Broker-dealers should therefore review the Risk Alert in order to assess their supervisory, compliance and/or other risk management systems related to these risks and make appropriate changes to address or strengthen their systems.

Endnotes

[1] AML compliance is frequently a stated examination priority for EXAMS (formerly, the Office of Compliance Inspections and Examinations) and continues to be an important focus for broker-dealer examinations. *See* SEC, Division of Examinations, *2021 Examination Priorities*, https://www.sec.gov/files/2021-exam-priorities.pdf.

[2] *See* 31 C.F.R. § 1023.210; 31 C.F.R. § 1023.320; *see also* 17 C.F.R. § 240.17a-8. Self-regulatory organizations' rules also contain AML requirements. *See, e.g.*, FINRA Rule 3310.

[3] *See* FINRA, Regulatory Notice 19-18, *FINRA Provides Guidance to Firms Regarding Suspicious Activity Monitoring and Reporting Obligations* (May 6, 2019), https://www.finra.org/rules-guidance/notices/19-18; *see also* SEC, *Anti-Money Laundering (AML) Source Tool for Broker-Dealers*, https://www.sec.gov/about/offices/ocie/amlsourcetool.htm (last updated Jan. 5, 2021).

[4] Generally, a broker-dealer must file a SAR for any transaction involving funds or other assets of at least $5,000 that are conducted or attempted by, at, or through the broker-dealer and for which the broker-dealer knows, suspects, or has reason to suspect that, among other things, the transaction (or pattern of transactions of which the transaction is a part): (1) involves funds derived from illegal activity or is intended or conducted to hide or disguise funds or assets derived from illegal activity as part of a plan to violate or evade any federal law or regulation; (2) is designed to evade any requirements set forth in regulations implementing the BSA; (3) has no business purpose or apparent lawful purpose or is not the sort in which the particular customer would normally be expected to engage, and the broker-dealer knows of no reasonable explanation for the transaction after examining the available facts, including the background and possible purpose of the transaction; or (4) involves use of the broker-dealer to facilitate criminal activity.

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