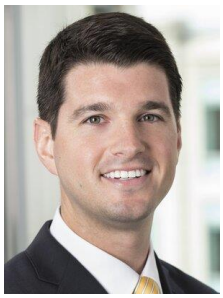
SEC, FINRA Actions Signal Increased AML Enforcement

By **Kevin Toomey, Kathleen Reilly and Daniel Hawke** (August 29, 2023)



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Emboldened by a yearslong battle in the courts, the U.S. Securities and Exchange Commission and the Financial Industry Regulatory Authority continue to beat the drum on the importance of Bank Secrecy Act and anti-money laundering, or AML, compliance for broker-dealers and the significant enforcement consequences for participants who fall short.

On July 31, after having made AML programs an examination priority for the past several years, the SEC's Division of Examinations issued a second risk alert on deficiencies examiners identified in past examinations of broker-dealers' AML programs, this time with a spotlight on the firms' testing of their programs, training of personnel, and identification of customers and their beneficial owners.[1]

The SEC's prior risk alert in 2021 focused on compliance issues in the suspicious activity monitoring and reporting components of broker-dealers' AML programs.[2]

That risk alert highlighted certain areas that had tripped up examined firms — inadequate policies and procedures, failure to implement existing procedures, failure to respond to suspicious activity, and filing inaccurate or incomplete suspicious activity reports, or SARs.

The new risk alert comes as the SEC and FINRA have pursued numerous enforcement actions against broker-dealers for AML program deficiencies in recent years that have resulted in significant fines.

Filing Obligations Imposed on Registered Broker-Dealers

Section 17(a) of the Securities Exchange Act of 1934 and Rule 17a-8 thereunder require registered broker-dealers to "comply with the reporting, recordkeeping, and record retention requirements" promulgated by the Financial Crimes Enforcement Network.

As part of their AML compliance program, among other things, broker-dealers must develop risk-based procedures that allow for the identification of suspicious activity attempted or conducted by, at, or through the broker-dealer and, when such transaction meets certain dollar thresholds, reporting of that activity, through the filing of SARs, to FinCEN.

FINRA imposes similar AML compliance program and reporting obligations on member firms under its Rule 3310.

These AML program requirements also require broker-dealers to establish and maintain other program components applicable to traditional banks and other financial institutions.

AML Compliance Remains An Examination Priority

AML is an examination priority for both the SEC and FINRA.[3]

Both the 2021 and 2023 risk alerts highlight common issues examiners have identified, and broker-dealers should take steps to confirm that these areas of interest are designed and operating effectively in anticipation of further examinations.

In the most recent risk alert, the examinations division generally restated the various AML obligations for broker-dealers and presented a spectrum of observations from recent examinations, including that some broker-dealers were deficient in the independent testing of AML programs, ongoing training of personnel, design of customer identification programs and implementation of FinCEN's new customer due diligence rule.

With respect to the customer due diligence rule, the examinations division noted that some broker-dealers were using outdated AML compliance programs that were never revised to include the new customer due diligence obligations created in 2018 or were not using appropriate forms to collect beneficial ownership information.

The examinations division also specifically highlighted findings of insufficiently resourced and trained AML compliance departments, which they noted can be exacerbated by the U.S. Department of the Treasury's increasing sanctions tied to Russia's invasion of Ukraine, as well as broker-dealers who rely on the same staff to manage AML and sanctions risks.

Although the securities regulators have not specifically incorporated sanctions program elements into their recent AML enforcement actions, the examinations division is clearly telling the industry that these compliance functions are related and will be examined accordingly.

Indeed, federal and state banking regulators routinely examine and enforce AML and sanctions compliance in parallel, and the SEC may soon follow suit.

FINRA likewise issued Regulatory Notice 19-18 in 2019 and Regulatory Notice 21-03 in 2021, providing guidance to member firms on suspicious activity monitoring and reporting and fraud prevention involving low-priced securities.[4]

In 2022, FINRA issued Regulatory Notice 22-06 alerting firms to the Treasury Department's sanctions actions related to the Russian financial services sector and encouraged member firms to continue to monitor the Treasury Department's website for relevant information.[5]

Firms would do well to study these releases, as the risk alerts and regulatory notices indicate the type of issues the regulators look for based on their prior supervisory experience.

SEC Actions Follow in the Wake of the Alpine Decision

Similarly, the heightened enforcement activity in this area provides clues as to what the regulators will be expecting from AML programs, especially in the wake of the U.S. Court of Appeals for the Second Circuit's 2020 SEC v. Alpine Securities Corp., which affirmed the SEC's authority as the primary federal regulator of broker-dealers to enforce BSA recordkeeping requirements.[6]

After the SEC brought suit against Alpine, a penny stockbroker, for failing to comply with

the reporting requirements for filing SARs,[7] Alpine argued during summary judgment that the agency lacked authority to bring claims because the Treasury Department has the sole authority to enforce the BSA.[8]

The U.S. District Court for the District of Nevada denied Alpine's argument and held, among other things, that the SEC had the requisite authority.[9]

On appeal, the Second Circuit affirmed the district court's ruling, agreeing that the SEC had authority under Exchange Act Section 17(a) and Rule 17a-8 to enforce compliance with BSA standards imposed by FinCEN.[10]

In rejecting Alpine's argument that the SEC was enforcing the BSA, not the Exchange Act, when it brought claims relating to late or missing SAR filings, the Second Circuit stated:

The fact that Rule 17a-8 requires broker-dealers to adhere to the dictates of the BSA in order to comply with the recordkeeping and reporting provisions of the Exchange Act does not constitute SEC enforcement of the BSA.[11]

In November 2021, the U.S. Supreme Court denied Alpine's petition for certiorari, leaving in place the SEC's authority under Section 17(a) and Rule 17a-8 to enforce BSA recordkeeping requirements, including suspicious activity reporting, on broker-dealers.

Recent SEC and FINRA Enforcement of SAR-Related Violations

After the SEC's victory at the Second Circuit in Alpine, the SEC and FINRA continued their supervisory attention on broker-dealer AML compliance through enforcement actions.

In July, the SEC and FINRA each fined a registered broker-dealer and its parent company $6 million for allegedly failing to file hundreds of SARs over a 10-year period.

The parent company had assumed responsibility for creating and implementing the broker-dealer's SAR policies and procedures, which incorrectly included the bank $25,000 threshold instead of the required $5,000 threshold at the broker-dealer level for reporting suspicious transactions where a suspect for the suspected criminal activity could not be identified, which resulted in the broker-dealer not reporting suspicious activity above $5,000 but below $25,000.

The SEC and FINRA credited the broker-dealer and the parent company's actions to remediate the issues, which included updating policies, procedures and automated surveillance systems to properly account for:

- The $5,000 threshold and training the personnel responsible for filing SARs;
- Reporting the issue to the SEC, FINRA and FinCEN;
- Conducting a look-back review to the earliest date for which the broker-dealer retained records and then filing 865 SARs; and
- Conducting and reporting the results of an internal investigation to the SEC, FINRA and FinCEN.[12]

In March, the SEC fined Cambria Capital LLC $100,000 for failing to file SARs on suspicious

activity that raised red flags identified in the firm's AML policies and procedures.

Cambria Capital specialized in helping its customers liquidate microcap securities, and, in numerous transactions, the SEC found that the pattern of liquidations often occurred in combination with other red flags noted in Cambria's policies and procedures.

Cambria failed to investigate its customers' suspicious trading and similarly failed to file SARs for many of the transactions even though Cambria's written supervisory procedures identified such activity as red flags of suspicious activity and required further investigation for the possible filing of a SAR.[13]

In February, FINRA fined SageTrader LLC $100,000 for failing to tailor its AML program to reasonably monitor for and report suspicious activity.

SageTrader's AML program directed all alerts generated by its automated third-party surveillance system to one individual compliance officer at the firm who had no prior AML supervisory experience or training.

Among other deficiencies, FINRA said the firm's written AML procedures and training materials did not provide reasonable guidance for determining whether the alerts required follow-up, could be disregarded or required the filing of a SAR.[14]

In May 2022, the SEC fined a dually registered broker-dealer and investment adviser $7 million for failing to file at least 34 SARs in a timely manner.

First, after transitioning to a new AML transaction monitoring system, the new system did not properly cross-reference certain country codes when monitoring wire transfers made to foreign countries, which resulted in missed alerts.

Second, on dates when there was a public holiday, but not a brokerage holiday, the system would not generate alerts for wire transfers with high- or moderate-risk countries for further review.

The SEC credited the firm's remedial measures, including:

- Promptly reviewing its AML transaction monitoring system when issues were raised;
- Identifying and notifying the SEC about additional failure of its AML transaction monitoring system;
- Correcting the issues;
- Retaining an outside consulting firm to review its transaction monitoring system and procedures and to recommend enhancements; and
- Conducting and reporting the results of an internal investigation to the SEC.[15]

In 2021, the SEC fined GWFS Equities Inc. $1.5 million, finding that GWFS personnel, including its BSA officer, identified fraudulent transactions related to cyberattacks that required SAR filings, yet GWFS failed to file approximately 130 SARs.

The SEC also determined that, for the 297 SARs that GWFS actually filed, the broker-dealer

did not include the five essential elements of information that it knew and was required to report, including persons, phone numbers, bank accounts, URL addresses and IP addresses.[16]

That same year, FINRA fined Score Priority Corp. $250,000 for failing to establish and implement a reasonably designed AML program and a risk-based customer identification program. Among other program deficiencies, FINRA cited a lack of reasonable written AML procedures and an almost exclusive reliance on manual reviews of daily trade blotter activity.[17]

In August 2020, the SEC, FINRA and the Commodities Futures Trading Commission fined Interactive Brokers a total of $38 million for failing to file over a one-year period more than 150 SARs to flag potential manipulation of microcap securities in its customers' account.[18]

Takeaways

As stated in the SEC's risk alerts and FINRA's regulatory notices, and as demonstrated by the recent enforcement actions, financial regulators beyond the traditional banking regulators are closely scrutinizing AML-related issues, of which broker-dealers and other financial institutions should be mindful.

Broker-dealers, just like other financial institutions under the BSA, need to design, implement and maintain an AML program and written policies and procedures tailored to the specific risks and regulatory obligations of their financial institution.

The written policies and procedures need to meet current expectations and be reasonably designed to identify and detect potentially suspicious activity based on the institution's customer base, type of securities business and relationships with affiliated entities.

All institutions should regularly review and test the program in light of the existing business model and the evolving AML regulatory landscape.

Furthermore, the regulatory pronouncements and actions emphasize the importance of not just having written policies and procedures, but following them. Recent enforcement actions highlight the issues that arise when a financial institution fails to appropriately implement its written policies and procedures to escalate transactions that triggered red flags.

If transactions are flagged, any analysis involving questionable activity or customer should be clearly documented, and, where necessary, follow the firm's standards for deciding whether to file a SAR.

Financial institutions should also adequately invest in their AML programs and compliance teams. Common finding in AML enforcement actions taken by the SEC and FINRA, and banking regulators more generally, are the failure to maintain a transaction monitoring program designed to fit the specific business operations of the organization and the failure to match operations with an appropriately sized and trained compliance staff.

Outdated systems or manual reviews of transactions often signal that a firm's AML systems may not have kept pace with the firm's operations. To avoid drawing the attention of examiners, firms should continually evaluate whether their compliance departments are trained and staffed commensurate with the firm's risk profile.

And, as established by Alpine, if a SAR is filed, firms should assure that the content of the

report is sufficient to meet regulatory expectations.

Firms should also assure that they have appropriate processes in place to facilitate coordinated responses when filing a SAR, such as continuing to monitor the customer relationship, addressing related sanctions issues, responding to grand jury or other government subpoenas, and evaluating whether to discontinue customer relationships.

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[1] Observations From Anti-Money Laundering Compliance Examinations of Broker-Dealers, Risk Alert, SEC Division of Examinations (July 31, 2023), https://www.sec.gov/files/risk-alert-aml-compliance-examinations-bd-073123.pdf.

[2] Compliance Issues Related to Suspicious Activity Monitoring and Reporting at Broker-Dealers, Risk Alert, SEC Division of Examinations (Mar. 29, 2021), https://www.sec.gov/files/aml-risk-alert.pdf.

[3] See 2023 Examination Priorities, SEC Division of Examinations, https://www.sec.gov/files/2023-exam-priorities.pdf; 2023 Report on FINRA's Examination and Risk Monitoring Program, Financial Industry Regulatory Authority (Jan. 2023), https://www.finra.org/sites/default/files/2023-01/2023-report-finras-examination-risk-monitoring-program.pdf.

[4] Fraud Prevention, Regulatory Notice 21-03, Financial Industrial Regulatory Authority (Feb. 10, 2021), https://www.finra.org/sites/default/files/2021-02/Regulatory-Notice-21-03.pdf.

[5] U.S. Imposes Sanctions on Russian Entities and Individuals, Regulatory Notice 22-06, Financial Industrial Regulatory Authority (Feb. 25, 2022), https://www.finra.org/sites/default/files/2022-02/Regulatory-Notice-22-06.pdf.

[6] See United States Sec. & Exch. Comm'n v. Alpine Sec. Corp., 982 F.3d 68, 76 (2d Cir. 2020), cert. denied, 142 S. Ct. 461 (2021).

[7] Alpine Sec. Corp., 308 F. Supp. 3d 775, 787 (S.D.N.Y. 2018).

[8] Id. at 781.

[9] Id. at 797.

[10] Alpine Sec. Corp., 982 F.3d at 76.

[11] Id.

[12] In re Merrill Lynch, Pierce, Fenner & Smith Inc. and BAC North America Holding Co., Exchange Act Release No. 97872, SEC File No. 3-21524 (July 11, 2023); In re Merrill Lynch, Pierce, Fenner & Smith Inc., FINRA Letter of Acceptance, Waiver and Consent, No. 2020066667001 (July 11, 2023); see SEC and FINRA Actions Emphasis Continued Focus on Broker-Dealer AML Compliance, Arnold & Porter (July 18, 2023), https://www.arnoldporter.com/en/perspectives/advisories/2023/07/sec-and-finra-actions-emphasize-continued-focus.

[13] In re Cambria Capital LLC, Exchange Act Release No. 97020, SEC File No. 3-21319 (Mar. 2, 2023).

[14] In re SageTrader LLC, FINRA Letter of Acceptance, Waiver and Consent, No. 2022073705601 (Feb. 7, 2023).

[15] In re Wells Fargo Clearing Services LLC, Exchange Act Release No. 94955, SEC File No. 3-20866 (May 20, 2022); see SEC Enforcement Sends Clear Message That "AML Obligations Are Sacrosanct," Arnold & Porter (May 26, 2022), https://www.arnoldporter.com/en/perspectives/advisories/2022/05/sec-enforcement-sends-clear-message.

[16] In re GWFS Equities Inc., Exchange Act Release No. 91853, SEC File No. 3-20298 (May 12, 2021); see SEC Settles Charges Against Broker-Dealer For SAR-Related Deficiencies, Arnold & Porter (May 26, 2021), https://www.arnoldporter.com/en/perspectives/advisories/2021/05/sec-settles-charges-against-broker-dealer.

[17] In re Score Priority Corp., formerly known as Just2Trade Inc., FINRA Letter of Acceptance, Waiver and Consent, No. 2020067466901 (April 14, 2021).

[18] See In re Interactive Brokers LLC, Exchange Act Release No. 89510, SEC File No. 3-19907 (Aug. 10, 2020); In re Interactive Brokers LLC, FINRA Letter of Acceptance, Waiver and Consent, No. 2015047770301 (Aug. 10, 2021); In re Interactive Brokers LLC, Order Instituting Proceedings, CFTC Docket No. 21-19 (Aug. 10, 2021).