

BDQUARTERLY

“Suspicious Activity Reports provide law enforcement with information that is critical for investigating and prosecuting money laundering, terrorist financing and other financial crimes.”

— Susan Merrill

FINRA Executive Vice President and Chief of Enforcement

AML Independent Testing – The Environment is Changing

FINRA has recently taken a number of steps in the implementation and enforcement of the requirements of NASD 3011 (the “Rule”), “Anti-Money Laundering Compliance Programs”

USA PATRIOT Act Requirements

On October 26, 2001, President Bush signed into law the USA PATRIOT Act (“Patriot Act”). Title III of the Patriot Act, entitled the “International Money Laundering Abatement and Anti-Terrorist Financing Act of 2001,” added new provisions to the Bank Secrecy Act (“BSA”) designed to ensure that all appropriate components of the financial services industry are required to report potential money laundering transactions. In reaction to the newly enacted law, the Financial Industry Regulatory Authority (“FINRA”), formerly NASD Regulation established the Rule, which requires financial institutions, including broker-dealers to establish and implement anti-money laundering compliance programs designed to ensure ongoing compliance with the requirements of the BSA and the regulations promulgated thereunder. Specifically, the Rule requires firms to develop and implement written

anti-money laundering compliance programs (“AMLCPs”) that are approved in writing by a member of senior management and, at a minimum:

- Establish and implement policies and procedures that can be reasonably expected to detect and cause the reporting of transactions that raise a suspicion of money laundering;
- Establish and implement policies, procedures, and internal controls reasonably designed to achieve compliance with the BSA and regulations thereunder;
- Provide for independent compliance testing of the AMLCP to be conducted by qualified member personnel or by an outside party;
- Designate an individual or individuals responsible for implementing and monitoring the day-to-day operations and internal controls of the AMLCP; and
- Provide ongoing training for appropriate personnel.

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FINRA Examination Program

The Rule's enactment marked uncharted territory for many broker-dealers, since other than adhering to the reporting requirement of the BSA, the securities industry had limited experience with anti-money laundering regulations and the scope of FINRA's focus and expectation related to their examination program. FINRA's examination program requires that all routine cycle examinations focus, in part, on each member firm's AMLCP and its ability to address the requirements of the Rule, including the firm's independent testing results. FINRA continues to place the most emphasis on a broker-dealer's ability to adequately establish and implement effective monitoring procedures that identify potential suspicious activity. This emphasis has seen FINRA requiring firms to go beyond standard procedures that merely outline and define suspicious activity. Examination staff continues to analyze each firm's overall risk assessment of its business activity in relation to suspicious activity (e.g., market making firms' analyses of trading activity).

One of the often overlooked aspects or misconceptions related to suspicious activity monitoring is that the activity primarily must involve the movement of funds. The frequent movement of funds without a responsible business purpose can be an indication of potential suspicious activity, but is not the key component that triggers the obligation to file a suspicious activity report ("SAR"). The purpose of the SAR is to report known or suspected violations of law or suspicious activity observed by any financial institutions subject to the regulations of the BSA. Information provided in SAR forms provides FinCEN with a method of identifying emerging trends and patterns associated with financial crimes. The information about those trends and patterns is vital to law enforcement agencies and provides valuable feedback to financial institutions. There are a number of activities that may be deemed suspicious including computer intrusions

and client reluctance to provide standard documentation in accordance with a firm's customer identification program. Broker-dealers should remain cautious and file a SAR for all instances where potential suspicious activity is detected.

FinCEN has set up a system specifically for the electronic submission of SARs, which allows the incorporation of information the SAR contains into the FinCEN database much sooner than it could be included if the information on the SAR were filed manually.¹ The BSA prohibits the filer of a SAR from notifying any person involved in the suspicious transaction that the transaction has been reported. Implementing regulations issued by the FinCEN has construed this confidentiality provision as generally prohibiting a securities broker-dealer, futures commission merchant, or introducing broker in commodities from disclosing the existence of a SAR, except where such disclosure is requested by appropriate law enforcement agencies, securities and futures industry regulatory agencies or self-regulatory organizations, or the FinCEN.

Six years removed from the initial approval of the rule, FINRA has continued to issue regulatory guidance aimed at assisting firms in understanding their AML monitoring requirements. Now that the brokerage industry has had several years to digest the increased regulatory requirements established by the Rule, broker-dealers are facing a higher probability of receiving formal action for repeated AML deficiencies, up to and including expulsion.

In November 2007, FINRA expelled Franklin Ross, Inc. ("FRI") of Princeton, New Jersey from FINRA membership for repeatedly violating anti-money laundering rules. FINRA also imposed fines and suspensions against two of the firm's principals, including its former President, Mark G. Ross, Jr., and its current President, Kevin K. Herridge. FRI was cited for repeatedly violating anti-money laundering rules by: (1) failing to investigate (CONTINUED)

1- See, <http://bsaefiling.fincen.treas.gov/index.jsp>

and report numerous suspicious transactions; (2) failing to obtain adequate background information on new customer accounts; (3) failing to conduct an independent test of its AML program; and (4) failing to provide AML training.² FINRA specifically noted FRI's failures to investigate red flags, which allowed the firm to serve as a 'safe haven' for individuals seeking to capitalize on highly suspicious or illegal stock transactions without detection.

It is essential that broker-dealers conduct thorough independent testing of their AMLCP. FINRA

2- See, Franklin Ross, Inc., FINRA News Release (Nov. 5, 2007).

Interpretive Material 3011-1 defines the term "independent" and further clarifies that the person conducting the independent testing must maintain a working knowledge of applicable requirements under the BSA and experience implementing its regulations.³ Given the enforcement proceedings against FRI, the brokerage community likely will continue to receive regulatory scrutiny related to AML programs and it is also likely that FINRA will continue to pursue formal action against firms that repeatedly fail to implement and adequately assess their AMLCP.

3- See, NASD NTM 06-07

Unexpected Capital Deficiencies

FINOP Alternatives

A very common practice utilized by small to mid-sized broker-dealers involves the outsourcing of financial responsibilities to qualified third party financial operations principals ("FINOPs"), often referred to as a "Rent-a-FINOP". This is a perfectly acceptable business practice, which often provides a cost effective solution to many broker-dealers that lack the necessary expertise, time, and/or personnel to prepare the firm's financials and FOCUS filings. In most instances an outsourced FINOP has limited interaction with the broker-dealer and essentially relies on the Firm to provide the required documentation utilized to prepare the firm's FOCUS filing. Outsourced FINOPs often have multiple broker-dealer relationships ranging in size and complexity. Among the challenges outsourced FINOPs face are inaccurate or omitted information supplied to the FINOP, unfamiliarity with the broker-dealer's overall business operations and expenses, and misinterpretation of regulations.

Material Oversight – Scenario

By way of an example, suppose your outsourced FINOP has just informed you that he or she just realized the most recent FOCUS filing was inaccurate due to a grossly underestimated legal invoice (approximately \$100,000). Discussions with your FINOP disclosed the actual legal invoice was greater than anticipated as verbally communicated by the law firm and has caused an adjustment to your firm's excess net capital from \$9,000 to (\$91,000). Although you may not be familiar with financial regulatory requirements, you realize the firm is not permitted to conduct a securities activity with negative excess net capital. Additionally, the firm has already exhausted the contingency source of backup capital due to negative market conditions. Your firm faces the following questions:

- What are the requirements to continue its operations?
- Does the most recent FOCUS have to be re-filed for the period?
- Does the firm need to self report this oversight to FINRA and/or the SEC?

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Course of Action

Pursuant to Exchange Act Rule 17a-11(c)(3), if a broker-dealer's net capital is less than 120 percent of required minimum dollar amount, the firm is required to file an "early warning" with FINRA. In the previous scenario, your firm exceeded the early warning parameter when alerted to the oversight by the FINOP. Therefore, the firm is required to file net capital deficiency notification pursuant to Exchange Act Rule 17a-11(b). FINRA's recent Regulatory Notice 08-11, published in March 2008 established "electronic filing requirements" for member firms, which includes both early warning and net capital deficiencies. This notice also outlines the previous hardcopy requirement contained in Exchange Act Rule 17a-11 requiring prompt notification to the designated examining authority whenever a firm experiences:

- Net capital deficiency;
- Aggregate Indebtedness exceeds net capital by 120 percent;
- Net capital decreases to less than five percent of aggregate debit items; or
- Net capital decreases to less than 120 percent of required minimum net capital.

Firms are expected to file electronic notification with FINRA within 24 hours of realizing any of these four events.

Failure to File Notification

If your firm fails to promptly file an electronic notification, the result can be severe regulatory and reputational damage. FINRA does not provide a timeframe for issuing a cease and desist order, although such action is typically taken within 24 hours of receipt of notification. FINRA's immediate concern will be to determine if your firm has the ability to infuse additional capital to render the firm back in net capital compliance. If your firm is unable to obtain additional funding, FINRA will

likely issue an immediate "cease and desist" letter. A broker-dealer receiving a cease and desist order is only permitted to conduct liquidation transactions until the firm is rendered back within net capital compliance.¹ The firm should be cautious to ensure that it does not conduct any securities activity while out of net capital compliance. Often a determining factor FINRA considers when deciding whether to take enforcement action against a firm is whether the firm knowingly continued to engage in a securities business while in net capital deficiency. Unfortunately, many firms often attempt to conceal such deficiencies or inaccuracies by masking certain inventory positions at the end of the month with a counterparty or by inflating mark-to-market calculations. As with many regulatory enforcement actions, these improper activities are typically detected when FINRA examiners review either the broker-dealer's electronic communications or other financial books and records.

For failing to promptly file notifications, FINRA has historically suspended member firms from conducting any securities business for up to 30 business days and/or the FINOP from all capacities for up to 30 business days. In some egregious cases, FINOPs have experienced lengthier suspensions of up to two years or have been barred from associating with another member firm.

Summary

Outsourced FINOPs provide viable, alternative financial solutions to many firms, but as with most brokerage activities, this is not without risks. It is imperative that firms that maintain such arrangements continuously communicate with their FINOP to ensure the most accurate and up to date information is processed and sent to the FINOP. Additionally, it is a sound business prac-

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¹– In order to be rendered back within net capital compliance, a broker-dealer would be required to substantiate the firm's financials (allowable assets) and sourcing of all capital utilized to fund the broker-dealer's operation.

tice for member firms to have additional principals review monthly/quarterly financial documentation to provide a “reality check” when compared to the actual business activities. Unfortunately, even with the proper checks and balances in place, firms will

experience oversights and errors, which can be expected. The most critical component is that the broker-dealer does not expand on this oversight by failing to follow the proper notification procedures and necessary steps to take corrective action.

In Case You Missed It!

Delegation of CIP Responsibilities

FIN-2008-G002

On March 4, 2008, FinCEN issued guidance concerning its *Customer Identification Program Rule No-Action Position Respecting Broker-Dealers Operating under Fully Disclosed Clearing Agreements According to Certain Functional Allocations*.¹

The FinCEN guidance highlights FinCEN’s current position that it deems appropriate to require “only” the introducing broker-dealer to comply with the requirements of the CIP rule with respect to customers introduced to a clearing firm pursuant to a clearing agreement. Additionally, FinCEN notes it will take no action against a clearing firm for not complying with the CIP rule with respect to an introduced customer under the specific circumstances discussed in the guidance. The guidance further notes FinCEN’s position is aimed at ensuring consistency with the application of the CIP rules to intermediated relationships in other industries.

FinCEN’s guidance suggests that a clearing firm’s ALMP should contain risk-based policies, procedures, and controls for assessing the money laundering risk posed by its fully disclosed clearing arrangements, for monitoring and mitigating that risk, and for detecting and reporting suspicious activity. Introducing firms should continue to establish anti-money laundering programs that contain risk-based policies, procedures, and controls that include both the introducing broker-dealers direct

customers and any customers that may be introduced to the firm through a piggyback clearing arrangement.

The guidance also notes that broker-dealers are permitted to contract with another financial institution for the performance of any or all of the broker-dealer’s CIP functions. However, pursuant to Notice to Members 03-34, broker-dealers would continue to be responsible for ensuring contractual delegations are properly performed by the delegate.

Amendments to Recordkeeping Requirements

An **Information Notice** was issued by FINRA on February 21, 2008 that states that a firm is no longer required to maintain a hard copy or electronic images of the following forms:

- Form U4 amendments that do not require the registered person’s signature
- Form U5 filings (both initial Forms U5 and any amendments) that do not require the registered person’s signature; and
- Form BR Filings (both initial Form BR and any amendments).²

Please keep in mind that the initial Form U4 and any amendments (that provide disclosure information and must be signed by the registered person) and the initial Form BD and amendments are not covered by the no-action relief issued by the SEC’s Division of Trading and Markets.

1– See, FinCEN, Regulatory/Guidance, March 4, 2008.

2– See, FINRA Information Notice, February 21, 2008.

Regulatory Notices, Updates, and Rule Changes

FINANCIAL INDUSTRY REGULATORY AUTHORITY – REGULATORY NOTICES/ NOTICES TO MEMBERS

MARCH

Regulatory Notice 08-14 FINRA Implements New Electronic Form NMA Filing Requirement; *Effective Date: February 29, 2008.*

Regulatory Notice 08-13 FINRA Consolidates the Collection of Short Interest Data; *Effective Date: May 15, 2008.*

Regulatory Notice 08-12 SEC Approves Amendment to NASD Rule 2210 to Create an Exception to the Principal Approval Requirements for Certain Filed Sales Material; *Effective Date: March 26, 2008.*

Regulatory Notice 08-11 Q&A on Electronic Filing Requirements of NASD Rule 3170.

Regulatory Notice 08-10 FINRA Announces Amendments to Make Permanent the Pilot Program Increasing Positions and Exercise Limits for Stock Options; *Effective Date: February 28, 2008.*

FEBRUARY

Regulatory Notice 08-07 FINRA and NYSE Filed Rule Changes with the SEC to Amend FINRA's Gross Income Assessment and Eliminate Certain NYSE Fees; *Effective Date: Upon SEC Approval With an Implementation Date of January 1, 2008.*

JANUARY

Regulatory Notice 08-03 SEC Approves Technical Amendments to the Uniform Application for Securities Industry Registration or Transfer (Form U4), the Uniform Termination Notice for Securities Industry Registration (Form U5) and the Uniform Branch Office Registration Form (Form BR); *Effective Date: February 4, 2008.*

Regulatory Notice 08-02 Acceptability of Series 24 Examination under NYSE Rule 342.121.

SECURITIES AND EXCHANGE COMMISSION MARCH

Release No. 34-57526 Proposed Rule Changes of Self-Regulatory Organizations; *Effective Date: April 28, 2008.*

FEBRUARY

Release No. 33-8891 Electronic Filing and Revision of Form D Conforming Version; *Effective Date: September 15, 2008 (see effective date section of the release for exceptions).*

MUNICIPAL SECURITIES RULEMAKING BOARD MARCH

MSRB Notice 2008-17 Submission of Official Statements to the MSRB under Rule G-36 in Connection With Certain Remarks of Outstanding Issues.

MSRB Notice 2008-16 Request for Comment Regarding Group Orders under Rule G-11 and Notice of Technical Amendments to Rules G-11 and G-12.

MSRB Notice 2008-12 MSRB Responds to SEC Request for Review of Definition of "Issuer Official" under Rule G-37 on Political Contributions.

FEBRUARY

MSRB Notice 2008-10 Amendment to Rule G-8 Filed to Delete Requirement to Maintain Copies of Form G-40.

MSRB Notice 2008-07 Preliminary Agenda and Registration Form for MSRB 529 Compliance Seminars.

MSRB Notice 2008-06 Reminder: New Supervisory Requirements under Rule G-27. *Effective Date: February 29, 2008.*

JANUARY

MSRB Notice 2008-05 MSRB Begins Planning for Continuing Disclosure Component of the New Electronic Municipal Market Access System (EMMA).

FINANCIAL CRIMES ENFORCEMENT NETWORK FEBRUARY

FinCEN Releases Ninth Issue of SAR Activity Review – By The Numbers

JANUARY

Sigue Corp. and Sigue, LLC of California to pay \$15 million to U.S. Government for Anti-Money Laundering Program Deficiencies

Did You Know?

Continuing Education

Only registered persons who have client contact are required to complete the FINRA firm element continuing education requirement described in NASD Rule 1020(b).

Independent AML Testing

The following persons would be **prohibited** from conducting the AML independent test:

- The sole employee of a member firm.
- Employees who do not have a working knowledge of AML regulations.

- Employees who conduct any part of the process that constitutes the member firm's AML compliance program.
- Employees supervised by any person having a role within the member firm's AML compliance program.
- The AML Compliance Officer.¹

¹— See, FINRA Notice to Members 06-61, Anti-Money Laundering Compliance Programs.

Conferences/Roundtables/Webcasts

CONFERENCES —

FINRA

Advertising Regulation Conference

October 2-3, 2008 • Washington, DC

Small Firm Conference Series

June 19, 2008 • Dallas, TX

Securities Conferences—Spring and Fall

May 21–23, 2008 • Hollywood, FL

October 22–24, 2008 • Carlsbad, CA

ACA

Fall Conference

September 8-10, 2008 • Boston, MA

ROUNDTABLES—

ACA Chief Compliance Officer Free Roundtables

June 10-12, 2008 • Denver, CO

October 14-16, 2008 • Minneapolis, MN

WEBCASTS—

ACA – 2008

Broker-Dealer Branch Office Examinations

June 17, 2008

Wesley L. Ringo, CCO, J.J.B. Hilliard, L.L. Lyons, Inc.; **Leigh Vazquez**, Managing Director, ACA Compliance Group

Fundamentals of Broker-Dealer Compliance

September 9, 2008

Brian L. Rubin, Partner, Sutherland Asbil & Brennan, LLP; **Greg Deaver**, Senior Principal Consultant, ACA Compliance Group

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