BDWEEK

Regulatory news and compliance best practices.

INSIDE...

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Enforcement Alert

Settlement shows need to focus on anti-money laundering basics

A recent **FINRA** settlement with one firm's former CCO/AML compliance officer shows that if individuals in that position don't follow the dictates of the firm's own written AML program, they can be cited for rule violations.

That was the case with **Zulina Visram**, a former CCO/AML compliance officer with **Biremis Corporation**, based in British Columbia, who recently agreed to pay FINRA a $30,000 settlement. She also was suspended from associating with any firm in any capacity for six months. The regulator found that Visram failed to implement the firm's written AML policies and procedures in a way reasonably designed to detect suspicious transactions, and to cause them to be reported.

"She had an AML program she didn't follow," stressed **L. Burke Files**, president of the consulting

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OCIE report notes BD compliance problems on structured products

If your firm sells structured products to retail customers, make sure your supervisory procedures detect attempts by reps to market them to conservative investors as suitable if, in fact, they aren't.

That's one of the recommendations the **SEC** made last week, when it unveiled findings stemming from a sweep exam in 2008 and 2009 of 11 broker-dealers that dealt in structured products. The firms represented a cross-section of the industry: three were large and affiliated with bank holding companies that issue structured products; one was a wholesaler; and seven were smaller retail firms.

(Structured products, continued on page 2)

Firms dealing with large traders need to gear up for new reporting requirement

You will need to decide whether any of your customers are potentially what the **SEC** defined as a "large trader," under a final rule the Commission issued last week. Large traders are those whose transactions in exchange-listed securities are at least two million shares or $20 million during any calendar day, or 20 million shares or $200 million during any calendar month. BDs trading their own securities for such amounts would be considered large traders, too.

If it appears a customer does fit that category based on their business at your firm, you're supposed to tell the customer he is supposed to identify himself as a large trader by filing orm 13H, which won't be reviewable by the public, the Commission said.

The customer would then get a large trader identification number (LTID) from the Commission,

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Structured products *(cont. from pg. 1)*

A report summarizing the examiners' findings was released to show firms some of the pitfalls to avoid, and some practices to consider, if they want to sell structured products.

"Sales of structured products to retail investors have increased over recent years and may continue to increase as they are marketed as a higher return investment alternative," said **Carlo di Florio**, director of the Commission's Office of Compliance Inspections and Examinations, which released the report. "This report could help companies strengthen their compliance programs to better address the issues we observed during our sweep and in subsequent exams."

Commission staff stressed the need for firms of all sizes to have adequate procedures and controls to review suitability for these products, and said small firms in particular need to also bolster their training of reps who sell the products, and training for their supervisors.

Among some of the areas big firms need to focus on are: training, detecting abuses in the secondary market, disclosing material facts, and reviewing concentrations of structured products in customer accounts.

Here's a rundown of some of the SEC staff's more-specific findings and recommendations:

✔ **Reverse convertible notes** — The biggest observation involved the sale of reverse convertible notes, which is perhaps the riskiest kind of structured product available to retail investors, the report said. There were lots of instances when sales of RCNs didn't seem to jibe with investors' stated investment objectives and profiles. Lots of customers didn't understand the products. Various firms violated **FINRA's** suitability rule. Some firms' WSPs didn't ensure RCNs were recommended only to customers able to stand the product's risk. Some WSPs also didn't ensure that all the product's promotional materials were balanced.

✔ **Monitoring concentration** — Keeping an eye on customer concentrations in structured products "may be a beneficial practice," the staff says. It noted that two of the three originating firms in the sweep have monthly exception reports to review customers' concentrations in structured products.

✔ **Disclosure** — One firm's prospectus for "principal-protected" notes didn't disclose the risk that customers might receive less on the principal investment if the notes were redeemed before maturity. The firm marketed the notes as "100% principal protected." All the other structured product prospectuses reviewed for that firm had a disclosure that principal protection applied only if the product was held to maturity.

OCIE further pointed out that one underwriting firm corrected a deficient disclosure for a fixed income structured product, but failed to correct the final pricing supplement.

✔ **Customer account statements** — Two of the large firms incorrectly listed structured products as "Preferred Securities" on customer account statements.

(Structured products, continued on page 3)

Structured products *(cont. from pg. 2)*

✔ **Secondary market pricing** — At most of the firms, trading desk prices were reviewed by an internal control group that was independent of the business. One firm that didn't follow that course, and that traded a structured product, was cited for having an internal control weakness because it lacked an independent review of traders' prices.

✔ **Training** — Some of the firms failed to have specific training on structured products for their reps or for those reps' supervisors. Two of the firms were cited as having an internal control weakness due to the lack of training.

✔ **Secondary market activity** — Many weaknesses were found in this area, including firms not reviewing customer transactions soon after the securities were issued, firms not reviewing customer sell transactions near maturity, firms not reviewing secondary activity in structured products for possible switching, and commission charges on secondary activity greatly exceeding the firm's guidelines. ■

Industry expresses worry over OSJ language in proposed supervision rule

Language in **FINRA's** proposed new supervision rules will make it more burdensome for broker-dealers to supervise Offices of Supervisory Jurisdiction, say industry members who submitted comments to the **SEC** about the proposal.

The proposal, an update as part of FINRA's rule-consolidation process, would require that a producing OSJ supervisor would have to be under close supervision and control of another appropriately registered principal who would have to perform on-site supervision of the OSJ supervisor on a regular periodic schedule determined by the member, noted **Stephanie Brown**, managing director and general counsel of **LPL Financial**.

The requirement for regular periodic onsite inspection appears to "ignore the nature of the business in today's high technology environment where nearly all of the supervisory responsibilities of the OSJ may be conducted from remote locations that take into account the economic circumstances of each member firm," Brown said.

A similar sentiment was expressed by others. Also on the topic of OSJs, the **Financial Services Institute** criticized the proposal's call for the designated principal for each OSJ to have a physical presence, on a regular and routine basis at each OSJ for which the principal has supervisory responsibilities. And it criticized language in the proposal that said FINRA will presume that a principal won't be designated and assigned to be the on-site supervisor of more than one OSJ.

Each BD and its registered principals should determine the needed number of offices assigned to each OSJ manager because they're best able to judge the effectiveness to the supervisory system, said the letter from FSI General Counsel and Director of Government Affairs **David Bellaire**. And **SIFMA** called this standard "unreasonable" because it doesn't defer enough to the firm's judgment, said **Joel Polanin** and **Claire Santaniello**, who are co-chairs of SIFMA's Compliance and Regulatory Policy Committee.

Among some of the other points commenters raised:

✔ Continued questions about whether FINRA is trying to exceed its authority by proposing a requirement that firms establish supervision systems for *all* their business lines. The commenters worry whether this would conflict with requirements from other regulators, such as states regulating insurance; and

✔ Criticism of FINRA's call to have a principal supervise internal communications, and that this be documented in writing. ■

Large traders *(cont. from pg. 1)*

and the customer is supposed to give you that number.

After that, you need to maintain a record of that customer's transactions in an expanded version of the Commission's Electronic Blue Sheets (EBS) system, which will require you to modify your program to add two fields: one for the LTID number and another for transaction time.

Upon the Commission's request, you would then be required to electronically send requested transaction information about large traders. The Commission usually will want this information no

(Large traders, continued on page 4)

Large traders *(cont. from pg. 3)*

later than the morning following the day of the request, the rule says. In certain circumstances, however, the Commission might want that information the same day, the rule says.

Monitoring 'big players'

The rule is an attempt by the Commission to improve its ability to monitor transactions in the market, and to keep an eye on big players. SEC Chairman **Mary Schapiro** says the information will help her staff reconstruct market events, conduct investigations, and bring enforcement actions as appropriate.

Although the Commission signed off on the rule last week, the compliance deadline for large traders to self-identify is about four months away, and the compliance deadline for broker-dealers to comply with the record maintenance and reporting requirements is about nine months away.

Another provision in the rule calls for you to keep transaction information for "unidentified large traders" — those whom you know or have "reason to know" are large traders but that haven't identified themselves as such. But the rule doesn't prohibit you from continuing to do business with those individuals or entities, the Commission notes.

Covered BDs

The rule's recordkeeping, reporting and monitoring is applicable for:

✔ registered BDs that are large traders; and

✔ registered BDs that carry accounts for large traders or unidentified large traders or, with respect to accounts carried by a non-BD, broker-dealers that execute transactions for large traders or unidentified large traders.

Safe harbor

There's a safe harbor from the rule's monitoring requirement if you conclude, based on your knowledge of your customers and their trading activity at your firm, that there's no reason to expect any of their transactions to approach the safe harbor threshold.

You also can use the safe harbor if you have no actual knowledge that a customer is a large trader and if you have policies and procedures in place to identify customers whose transactions in an account or a group of accounts at your firm exceed the threshold. Those procedures also would have to call for treating people that appear to be large traders as unidentified large traders and notifying them of their reporting obligations. The policies and procedures should consider account name, tax identification number, or other identifying information available in the books and records of your firm. There's no need to seek out information about accounts outside your firm, the SEC said.

Among other points made in the rule:

✔ Some SEC requests for information might require your firm to send it on a Saturday or a Sunday, depending on how urgently Commission staff need the information;

✔ There's no mechanism in the rule for a non-trader to be informed of the status of another trader with whom it jointly exercised investment discretion;

✔ There's no requirement for a BD to maintain records of transactions by an inactive large trader after getting notice from the large trader that the trader filed for inactive status with the Commission on Form 13H;

✔ The Commission might periodically request information from BDs on all customers they may be treating as unidentified large traders;

✔ The BD would have to keep the transaction data on the large traders and unidentified large traders for at least three years, and two years' worth of information must be kept in a readily available place;

✔ A large trader may voluntarily register as one with the Commission if it hasn't met the threshold yet but expects to do so;

✔ EBS-related requests for information usually calls for it to be delivered to the Commission within 10 business days, as opposed to this rule's next-day basis. But the Commission believes that once the electronic recordkeeping system is in place, the collection of such information will result in "minimal additional burden" on firms.

✔ The Commission expects to send about 100 requests for large trader data per year to each affected BD.

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Large traders *(cont. from pg. 4)*

SIFMA noted in a statement that it has previously recommended to the SEC to forego the idea of expanding the EBS, and coordinating this effort more with plans to build a consolidated audit trail system.■

AML *(cont. from pg. 1)*

firm **Financial Examinations & Evaluation Inc.** based in Tempe, Arizona. He estimated that maybe 50% of broker-dealers follow their AML program to the letter.

Between April 2005 and May 29, 2009, Visram was the AML compliance officer of the firm, and the violations occurred within that time period, FINRA said. The firm's written AML program required her to identify red flag-triggering events in exception reports, spur internal investigations of suspicious activity and document her findings. At the end of such internal investigations, FINRA said, she was required to report findings to senior management and determine whether any SARs should be filed, and if so, to file them, the settlement says.

But Visram didn't review the trading activity for AML purposes, according to the settlement.

"During her tenure as AML compliance officer, Respondent didn't adequately understand SARs or the type of activity that may be considered suspicious and require the filing of SARs," the settlement says. "Further, Respondent did not consider whether SARs should be filed in her reviews, despite the presence of red flags described in the AML Program."

During 2008 and 2009, the firm handled a large number of orders from day traders who were outside the United States, and the firm executed most of those orders on U.S. markets. **Example**: From January 2009 through June 2010, the firm received, on average, more than a million orders a day and executed, on average, more than 400,000 transactions. These transactions, altogether, involved more than 310 million shares.

But Visram "did not take any steps in connection with either the 2008 or 2009 review to test and verify that Biremis' supervisory procedures were reasonably designed to detect and prevent manipulative and fraudulent trading activity," the settlement says. She *did* conduct "limited" testing and verification in 2008 to assess compliance with an existing procedure about workers' outside brokerage accounts, FINRA said. And in 2009, she did some testing and verification on a process to review some deficiencies the firm's finance director identified regarding financial controls and record keeping.

"In both cases, the narrow scope of Respondent's testing and verification process did not comply with the more comprehensive, tailored analysis required by NASD Rule 3012," FINRA says.

In her reports to senior management under rule 3012 in 2008 and 2009, Visram didn't detail the firm's system of supervisory controls as the rule requires, the settlement asserts.

FINRA serious about AML

Although the settlement was about "some very basic stuff," it shows that FINRA is serious about AML infractions, says **Ross Delston**, founder of **GlobalAML.com**, an AML consulting firm based in Washington

Here are some pointers from Delston and Files:

✔ File SARs once in a while, Delston says. "In this case, the AML Compliance Officer presided over a four-year period in which not a single SAR is filed," he adds. "Too often, I encounter compliance folks at BDs who seem to think that SARs are a once-in-a-lifetime event!"

✔ Move to an automated suspicious activity monitoring system if you don't already have one, Delston says. "It's almost impossible to track repeat offenders, do instantaneous searches, look for addresses, stock buys and sells and patterns of activity using a manual system." And Files stresses the need to adjust your automated system so it doesn't generate too many false positives.

✔ When dealing with other countries, look at the U.S. State Department's International Narcotics Control Strategies Report to see high-risk countries. And don't forget to look at the Financial Action Task Force International Cooperation Review Group (FATF ICRG) to see the list of countries that don't fully comply with international standards in AML, Delston says.

✔ Make sure your AML auditor tests a broad

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AML *(cont. from pg. 5)*

range of transactions on a yearly basis as part of the independent AML test.

✔ AML compliance officers need a sufficient amount of internal training to keep abreast of updates in the AML policy. This is an area where many firms fall down, Files says.

✔ Brush up on the red flag examples that FINRA gives in Special NASD Notice to Members 02-21 (see related story, this page). ■

Some red flags to be on the lookout for

Keep in mind some of the following signs of suspicious activity that might warrant the filing of a Suspicious Activity Report as part of your AML program. These are just some of the examples that **FINRA** provides in Special NASD Notice to Members 02-21:

✔ Customer seeks transactions that lack business sense or are inconsistent with their stated business strategy;

✔ Customer or someone associated with him or her has questionable background, or is mentioned in news reports indicating possible criminal activity or regulatory violations;

✔ Lack of concern regarding risks, commissions, or transaction costs;

✔ Customer seems to be acting as an agent for an undisclosed principal, and is reluctant to identify that principal;

✔ Attempts to make frequent or large deposits of currency, insisting in dealing only in cash equivalents, or seeks exemptions from firm's policies regarding the deposit of cash or its equivalent;

✔ Transactions seem structured to avoid government reporting requirements;

✔ For seemingly no reason, customer has lots of accounts under a single name or multiple names, and there are many inter-account or third-party transfers;

✔ Unexplained or sudden extensive wire activity, especially for accounts where there had been little activity; and

✔ A deposit of funds immediately followed by requests that money be wired out to a third party, with seemingly no business purpose.■

Check with U.K. on its latest cold calling rules, FINRA says

If your firm wants to place cold calls to solicit business in the United Kingdom or advertise to people over there, make sure you check on the latest U.K. laws governing those activities. **FINRA** recently said you should disregard the guidance it provided firms on those topics in 1998 in NASD Notice to Members 98-91. Those U.K laws have since been changed, FINRA notes in new Regulatory Notice 11-34. ■

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