BD WEEK

Regulatory news and compliance best practices.

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March 28, 2011

Enforcement Alert
Clearing firm is fined $400,000 in settlement over AML program

Introducing broker-dealers and the clearing firms they rely on to perform certain anti-money laundering functions should make sure the clearing firms are adequately reviewing and analyzing the exception reports they generate.

Otherwise the introducing BDs might not learn about suspicious trends in some of their accounts, and the clearing firm could face a fate similar to the one that befell **First Clearing, LLC,** of St. Louis (formerly **First Clearing Corporation**). **FINRA** recently fined the firm $400,000 fine in a settlement after determining that the firm's AML program was in violation of FINRA Rule 3011. The rule calls for firms to have a Suspicious Activity Reporting program that's reasonably expected to detect, and cause the reporting of, suspicious transactions.

"This is a shot across everyone's bow that FINRA

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SEC, FINRA examiners to look closer at your risk-management programs

Risk management was a major talking point last week in messages delivered by the top regulators delivering speeches to attendees of **SIFMA's** Compliance and Legal Society Annual Seminar.

SEC and **FINRA** examiners will be zooming in on to see how involved firms' leaders are with their firms' risk management and compliance programs, said SEC Chairman **Mary Schapiro** and FINRA CEO **Richard Ketchum**, who addressed the conference separately.

"Investors deserve — and we will be looking for — a commitment by boards and executives to make enterprise risk management part of a firm or

(Risk management, continued on page 2)

FINRA's revisions to sanctions guidelines could cut both ways

If you find yourself before a **FINRA** panel that's pondering what sanction to mete out, don't expect to get an automatic break just because you have no disciplinary history. *Having* a disciplinary history will be considered an "aggravating" factor that could get you a stiffer penalty, but the absence of one isn't a mitigating factor that can buffer the blow, the regulator says in Regulatory Notice 11-13 💻.

The change is among a handful of new revisions in FINRA's "Sanction Guidelines," the roadmap that FINRA's National Adjudicatory Counsel and Hearing Panels use when they determine the severity of a sanction they're handing down.

The other revisions instruct adjudicators to:

✔ consider the penalties the firm received from other regulators for the same misconduct;

✔ not order restitution unless the injured party's loss was in large part caused by the respondent's

(Sanctions guidelines, continued on page 4)

Risk management *(cont. from pg. 1)*

corporation's culture," said Schapiro, who delivered her remarks via teleconference because the Commission cut back on travel due to its current budget restraints.

SEC Examiners will look for how senior management is involved in business process and decision-making at a number of levels, Schapiro said. adding that you should be prepared for questions such as "How are the business units of an entity ensuring they are taking and managing risk effectively at the product and asset class level?" and "How is the internal audit process independently verifying and providing the board and senior management with assurance about the operating effectiveness of the risk management, compliance and control functions?"

She added that SEC examiners will be "paying particular attention to" consolidation of disparate IT, the familiarity of new business units with risk management, internal audit and compliance functions, and business continuity planning.

FINRA plans more risk-based exams

Within the next couple of years, **FINRA's** exams will be more risk-oriented, with the SRO doing more pre-exam prep, demanding more risk-related information from you, and increasing its questioning of key firm personnel, Ketchum said.

The SRO is hoping to learn more about your business model, and to structure the exam you undergo accordingly, he said.

In the next two or three years, FINRA hopes to better identify high-risk firms, as well as high-risk branch offices, brokers, activities, and products. It plans to ask firms for more information about the firm's business model, business activities, product mix, and customer base, Ketchum said.

FINRA will seek industry feedback on data delivery specs it develops to collect this information, he continued. Where "appropriate," the SRO will seek firms' data from clearing organizations, clearing firms, carriers, or service bureaus, he said.

Among other exam-related points Ketchum made:

✔ FINRA will take a careful look at firms' controls in discrete areas, and controls related to bigger risks;

✔ There will be "thematic reviews" to collect information around a specific theme such as new-product development. The results will provide a reference point that FINRA will use to assess firms.

FINRA as SRO overseeing investment advisers

On the hot topic of FINRA's desire to regulate investment advisers, Ketchum spoke of the need to "eliminate artificial and jurisdictional restrictions across one customer-facing financial advisory business," referring to what he sees as restrictions FINRA currently faces when trying to examine the investment adviser side of a dually registered firm.

FINRA could fill the role of an SRO for investment advisers, Ketchum indicated, stressing that it's unlikely Congress will give the SEC enough

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Risk management *(cont. from pg. 2)*

money to adequately examine IAs.

"I don't think it takes a political pundit to recognize that the reality of that happening is unlikely. In fact, Congress is talking about cutting, not increasing, the SEC funding," he said.

If FINRA became the SRO of IAs, it wouldn't "force the full suite of specific broker-dealer requirements on investment advisers," Ketchum said. "That would not be appropriate or in the public interest." He said regulators' main concern regarding IAs is the lack of exam resources. Ketchum added that he didn't see the need for extensive SRO rulemaking for investment advisers.

As for IA representation on FINRA's governing body, Ketchum said that if FINRA became the SRO for investment advisers, it would establish a separate affiliate that would have a board made up mostly of public representatives, but the IA industry would be given the remaining seats. ■

Proposed SEC rule lays out timeline for trying to locate 'lost security holders'

Broker-dealers would have to take certain steps to try to locate customers with whom they lose contact, under a recently proposed **SEC** rule mandated by the Dodd-Frank Act. The proposed rule extends to broker-dealers some of the provisions that apply to transfer agents under Exchange Act rule 17Ad-17.

The change will put into law certain minimal efforts BDs would have to take to look for 'lost security holders.' They're defined as security holders to whom the firm sent correspondence at the address contained in customer account records only to have it returned twice as "undeliverable" after sending it twice in the course of a month – and there's no new address.

"They're already doing this," said **David Thetford**, securities compliance principal analyst at **Wolters Kluwer Financial Services**, speaking of the actions firms take when they lose touch with a customer. But the difference would be the firms would have a formal requirement to do it, and to document what they're doing, Thetford adds.

Most of the BDs that would be covered by this provision are clearing firms, the SEC says, saying there are 503 of them registered with the Commission. The SEC says the rule likely wouldn't cover introducing firms, although Thetford notes they would still need to be involved in tracking down a lost client because the rep is the closest to the client.

The rule would require firms that hold customer accounts to conduct two database searches using at least one information database service. The firm would have to search by taxpayer ID number or by name if a search by taxpayer ID number isn't likely to locate the client.

The searches would have to be conducted without charge to the client and be performed between three and 12 months of the client becoming 'lost', and between six and 12 months after the firm's first search for the lost client. The client is considered lost as of the day the resent correspondence is returned.

Much of the information the new rule will require BDs to collect is collected anyway, such as taxpayer identification numbers, the SEC says.

John McGovern, managing director at **Ascendant Compliance Management** in New York, notes that some firms use software linked to the U.S. Postal Service, or even AML customer ID information to research the validity of addresses.

The two most frequent reasons for lost contact are: 1) the client neglected to notify the firm of his or her correct address, especially after moving; and 2) the estate of a deceased security holder failed to notify the firm of the death and the name and address of the trustee for the estate, the Commission said.

Non-negotiated checks

The proposal also directs firms to send written notification to clients when a firm sends the client a check but it isn't negotiated either 1) within six months of being sent, or 2) before the next regularly scheduled check is sent, whichever comes first. Under the rule, those clients are called "missing security holders." The notification would have to be sent within seven months of the non-negotiated check being sent. (The notification package could contain other correspondence, including another check.)

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Lost security holders *(cont. from pg. 3)*

This provision applies to "any issuer, transfer agent, broker, dealer, investment adviser, indenture trustee, custodian, or any other person that accepts payments from the issuer of a security and distributes the payments to the holders of the security," the proposal says.

The notification proposal wouldn't cover checks less than $25, and the provision would have no effect on state escheatment laws, the SEC says.

Firms will have to maintain records showing they complied with the rule. Those records will need to be maintained for at least three years, with the first year's documentation kept in an easily accessible place.

Firms also would have to have written procedures that describe their methodology of compliance.

Compliance date – Dodd-Frank requires the SEC to put the revised rule in effect by July 21, 2011, at the latest, but the SEC said it will set a "compliance" date that's a year after the effective date.

McGovern said the SEC needs to try to avoid requiring redundant efforts of all the parties involved – such as transfer agents, banks, and broker-dealers – since they all would be making similar efforts with similar resources.■

Sanctions guidelines *(cont. from pg. 1)*

misconduct; and

✔ realize that disgorgement may be used toward restitution as opposed to the money going to FINRA.

Principal considerations

In new language on how adjudicators should view the "Principal Considerations" that are considered in determining punishment — factors such as disciplinary history, whether the firm accepted responsibility for its conduct, the sophistication of the injured party, and whether the respondent relied on competent legal advice — FINRA states that "not every enumerated factor has the potential to be aggravating and mitigating."

"It's giving more flexibility to panel members in terms of determining how to appropriately sanction. You know, when you have that increased discretion, it can go both ways," said **Deborah Meshulam**, a partner in the Washington office of **DLA Piper.** She defends firms.

Meshulam said she believes that in the past, adjudicators have looked at the enumerated factors in cases and weighed aggravating factors against mitigating ones.

"Now, they can point to the guidelines and say 'We don't have to do that. We don't have to engage in that type up balancing with respect to everything that's on the list, or everything that somebody's pointed out. We can look at the conduct, we can look at the totality of the circumstances, and exercise our discretion,'" Meshulam said.

"At least that's a concern that I have. Maybe it isn't going to play out that way. Maybe it's really just codifying what is already the practice. And to some extent I think that's probably right. But I think in some cases, for some panelists, it will lead to determinations that maybe they don't have to consider any of [the factors]. I don't know if that's an overstatement, but I think it's a risk."

Considering other regulators' sanctions

The directive to look at the sanctions that another regulator handed down is part of a trend among regulators, Meshulam said.

She added that it doesn't necessarily mean the respondent will get a break if it has been zapped by someone other than FINRA, although that *might* be the case. "It can go in different directions," she said. "It can avoid double sanctions, but it can also increase sanctions."

Adjudicators might look at another regulator's sanction of someone at face value and not necessarily look at the facts of the case, and hand out a similar sanction, Meshulam said.

FINRA does say in the Regulatory Notice, however, that adjudicators should consider whether the other sanction "was sufficiently remedial."

Restitution if misconduct was 'proximate' cause of loss

"Proximate causation" is the standard that must be met for adjudicators to order restitution. This means that a respondent may not have to pay

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Sanctions guidelines *(cont. from pg. 4)*

restitution if, for instance, he made an unsuitable recommendation but the stock was doing fine until the issuer loses a major contract and the stock price drops.

Meshulam said as a defense attorney she prefers that the standard be direct cause as opposed to the one that FINRA picked. But she said at least the standard that FINRA selected is one that can be argued over.

Disgorgement can be used toward restitution

Although the idea of disgorgement is to remove the ill-gotten gains from a wrongdoer, adjudicators can consider channeling that money toward restitution, instead of having it come to FINRA in the form of a fine, the SRO said. The NAC and the SEC have recognized that using disgorgement for the sake of restitution is "a valid secondary purpose."

An issue that can arise from this could be how to measure ill-gotten gains, Meshulam said. This could mean that defense counsel might have additional claims to address and more things to argue about. Although some of this might not be new, in practice, it is now explicit in the guidelines, she said.■

AML *(cont. from pg. 1)*

really means it, and these laws really are in place for a reason," said **L. Burke Files**, president of the consulting firm **Financial Examinations & Evaluation Inc.** "Now that the banking community is so sensitized to money laundering, the bad guys have been moving over to the broker-dealer area where they can move large sums of money in a variety of different ways. Honestly, a lot of the broker-dealers are not aware of all the different ways that you can launder money using the market or an account. It's not a slam [against broker-dealers]. The criminals are really, really creative."

"The regulators are now looking not only at the [introducing] broker-dealer," when it comes to fulfilling AML obligations, said **Michael Clements**, president of Florida-based **Wall Street Consulting Services, LLC**. "They're looking at the liability of the clearing firm and their meeting their responsibilities on all levels, not just [looking out for] money laundering."

First Clearing's AML program reviewed transactions that covered only "a limited amount" of potentially suspicious activity, FINRA said in its Letter of Acceptance, Waiver, and Consent.

From the beginning of January 2007 through September 30, 2008, First Clearing served about 120 unaffiliated introducing BDs and six affiliated ones. During that period, it cleared about 735,000 accounts and roughly 60,500 daily transactions for unaffiliated introducing BDs, according to FINRA.

The firm didn't review or monitor the suspicious activity in most of the exception reports it prepared and sent to the introducing broker-dealers, FINRA said. Nor did it conduct sufficient risk-based monitoring of accounts introduced by unaffiliated BDs, it added.

Instead, First Clearing reviewed a limited amount of potentially suspicious money movements and penny stock activity beginning in 2007.

The firm *did* generate "many exception reports and alerts" dealing with potentially suspicious transactions and money movements, but the reports were what FINRA called "tools" the clearing firm provided to the introducing BDs to satisfy their AML obligations. But those reports weren't consistently reviewed by First Clearing for SAR reporting, FINRA said.

Review of patterns was lacking

The regulator said that since at least 2005, First Clearing conducted real-time review of outgoing international wires, but no patterns of wire activity. From April 2007 through September 2008, it started limited sampling of alerts dealing with potentially suspicious money movements, including domestic wire transfers. Also starting in April 2007, the firm used credit policy reports to pick certain accounts with penny stock activity for further review but had no systematic method to review them, FINRA said.

The firm said in a prepared statement: "First Clearing, LLC has reached an agreed resolution with FINRA and is pleased to put this matter behind us. Our firm has taken appropriate steps to review and modify procedures where appropriate."

What introducing BDs should look for in reports

Introducing firms might want to make sure their clearing firm sends exception reports that are

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comprehensive enough to detect patterns of wired money movement, and not simply movement in and out of accounts, Clements said, adding that introducing firms might have to pay extra for those reports.

"To just create a report that just shows money going out or money coming in through a wire doesn't necessarily mean that any kind of money laundering took place, nor is the report helpful in helping determine whether some type of laundering is taking place, [or] some type of structuring taking place," he said.

For instance, you need to get reports that indicate money being wired from Account A to Bank A, and then from Bank A back to Account A.

Or reports that say, for instance, that over the last 90 days a particular account sent money to a particular bank three times, and that bank, over the next six months, sent that money back to the customer, or a related account, such as one controlled by the customer's spouse or business, Clements explained.

And ask for AML reports that show structuring, he said.

Tip: Before signing with a clearing firm, introducing firms should get samples of the types of reports the clearing firm will provide related to AML and to all the areas key to the introducing firm's business.

AML pros also warn that the regulatory liability over an AML program can be shared by the introducing BD and the clearing firm that performs AML functions for it. ■

FINRA sweep targets communications about reverse convertibles

FINRA has launched a targeted sweep exam 💻 seeking information about firms' communications, sales literature, and advertising involving reverse convertibles. The sweep letter also asks firms to provide evidence that each communication involving reverse convertibles was approved by a registered principal. It also requests the portion of the firm's WSPs that deal with the production, approval, and distribution of communications about reverse convertibles.■

FBI warns about purported charities

The **FBI** has noted the need to perform due diligence on anyone soliciting donations for the earthquake victims of Japan (*BD Week*, March 21, 2011). You might want to pass on some of its advice to customers, such as: Beware of organizations with copy-cat names that are similar to but not exactly the same as those of reputable charities. Instead of following a purported link to a website, verify the legitimacy of a nonprofit organization by using various Internet-based resources that might help confirm the group's existence and non-profit status.■

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