



## 2017: AML compliance retains high importance in FINRA and SEC exam priorities

Money laundering and terrorist financing continue to be a significant focus of securities regulators in 2017. The U.S. Securities and Exchange Commission (“SEC”) and the Financial Industry Regulatory Authority (“FINRA”) recently released letters announcing their respective examination priorities for 2017.<sup>1</sup> Within their respective 2017 priority letters, both the SEC and FINRA explicitly identified AML program deficiencies, among other issues, as an area of concern on which examinations will again focus.

The SEC and FINRA letters continue to emphasize examining whether an institution’s AML program is adequately designed to monitor for the particular risks posed by the institution’s specific business model. As the number of enforcement actions increases and fines for deficiencies continue to be levied, institutions should be on notice of the regulatory expectation that their AML programs be both up to date and tuned to their specific risks. The large fines for failures appear to be more numerous. Last year, FINRA imposed a \$17 million fine on one institution and a \$16.5 million fine on another for systemic AML program failures, and it finished 2016 by announcing a series of AML enforcement actions with significant fines and sanctions.

### **2017 SEC priorities letter**

The SEC’s January 12, 2017 priorities letter revealed that the SEC will continue its data analytics oriented approach to examinations. Consistent with previous years, the SEC again recognized money laundering and terrorist financing as a market-wide structural risk and identified that risk as an initiative for focus. Based on its letter, the SEC is concentrating on three areas of concern. Does the AML program reflect a risk based approach? Is the suspicious activity detection and reporting appropriately targeted and effectively carried out? Is the independent testing of the program sufficiently comprehensive?

<sup>1</sup> For SEC, see <https://www.sec.gov/about/offices/ocie/national-examination-program-priorities-2017.pdf>. For FINRA, see <http://www.finra.org/sites/default/files/2017-regulatory-and-examination-priorities-letter.pdf>

As to the risk-based approach, the SEC will examine a broker-dealer's AML program against the standard that it be tailored to the firm's business model and particular risks. The SEC will review whether broker-dealers "consider and adapt their programs, as appropriate, to current money laundering and terrorist financing activities," suggesting that the tailoring should also address new trends and new typologies that the firm should learn about either through its experience or through guidance and other available information.

Thus, the institution must be attentive to the particular risks posed by its products, services, markets, and customers and must adapt its AML program to those specific risks and, inferentially, be prepared to demonstrate to examiners it has done so. It will not be enough to simply assess the risks once. Given the dynamic nature of money laundering and terrorist financing risks and the SEC's focus on the currency of adaptation, institutions should periodically reassess their risk profile in light of how and with whom they conduct their business and what kinds of risks are evolving in the marketplace.

The second SEC examination area of AML focus is suspicious activity detection and reporting. SEC examinations will emphasize firm's AML program monitoring for suspicious activity and how it foots to the risks presented. They will also focus on the effectiveness of the reporting process. In assessing suspicious activity reporting, the SEC will evaluate the "timeliness and completeness of SARs filed." These factors are in contrast to the 2016 priority letter focus on the number of SARs filed by an institution. This 2017 emphasis implies a concern that there be adequate resources to investigate and assess suspicious activity and sufficient governance to drive timely decisions that are coherently documented and well written. The import here is that examiners will be reading SARs to ensure they make sense, have back up documentation, and that they were expeditiously and thoroughly investigated, as well as filed within the 30 day time limit.

Firms should consider how robust their quality assurance processes are around these aspects.

The third area of SEC examination focus will be assessing the "effectiveness of independent testing." Whether the testing is conducted by an internal audit department and/or an external vendor, the standards for independence and completeness are the same. As with 2016, the independent testing should address the elements of the AML program. The SEC is especially concerned that the testing consider the tailoring of the AML program, including the degree to which it has been updated to meet changing risks or business practices.

Although the SEC priority letter has a particular AML section, various other items in other sections are also worthy of AML attention. For example, the SEC lists a concern about recidivist registered representatives (and their firms), repeated from 2016, and that may encompass how AML policies and procedures are implemented and their corresponding supervision. Similarly, concerns about market manipulation and adequate recordkeeping could well find their way into the examination process regarding the tailoring of the AML surveillance program to the firm's risks, and the documentation of Suspicious Activity Reports.

While broker-dealers are spotlighted in the AML section of the exam priorities letter, the SEC has used a different document to point to its priorities for investment advisors. On February 7, 2017, it issued a Risk Alert<sup>2</sup> announcing its five most common areas of observed deficiencies for investment advisers. Although this Risk Alert does not specifically mention AML, some of its concerns readily apply to AML issues. These will especially arise if the pending AML rule<sup>3</sup> for Investment Advisers becomes final. The Risk Alert priorities include implementing

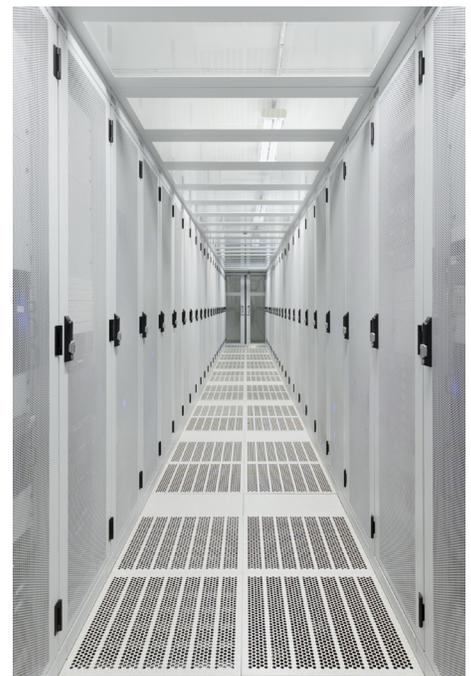
<sup>2</sup> See <https://www.sec.gov/ocie/Article/risk-alert-5-most-frequent-ia-compliance-topics.pdf>

<sup>3</sup> See Notice of Proposed Rulemaking dated August 1, 2015, Anti-Money Laundering Program and Suspicious Activity Report Filing Requirements for Registered Investment Advisers. <https://www.gpo.gov/fdsys/pkg/FR-2015-09-01/pdf/2015-21318.pdf>

a set of risk-based written policies and procedures tailored to the investment adviser's business practices, designation of a compliance officer to administer the program, a regular review akin to independent testing to assess the compliance program's adequacy and effectiveness, and maintenance of an appropriate set of books and records. These are all structurally in line with examination approaches to AML programs for brokers.

The SEC will continue to emphasize broad issues surrounding the development of an AML compliance program and will scrutinize the finer issues necessary to the proper implementation of that program. At both levels, the program will need to be tailored to institution-specific risks.

In 2016, FINRA assessed a fine of \$17 million against a firm for failing to have an adequate AML compliance program in place to look for and detect suspicious activity.



### 2017 FINRA priorities letter

On January 4, 2017, FINRA released its 2017 examination priorities letter. In contrast to FINRA'S 2016 letter, this letter emphasizes specific concerns more than overall process. Thus culture is not mentioned at all in 2017 but the letter notes that FINRA intends to focus on areas in AML where it has "found shortcomings." As with previous years, FINRA will continue to examine member firms' AML programs and continues to list AML program failings as an operational issue.

Whereas the SEC's priority letter focuses on broader program areas, FINRA's letter hones in on several specific areas of concern based on its observations in prior years. The identification of these specifically targeted areas should not be misunderstood to mean that FINRA will not be examining on programmatic deficiencies. It simply means FINRA remains focused on certain perceived high-risk activities. As with previous FINRA priorities, a firm's AML program must have a risk-based design to capture the specific risk faced by the firm.

The most prominent area in which FINRA has observed deficiencies in AML programs is "gaps in firms' automated trading and money movement surveillance systems caused by data integrity problems, poorly set parameters or surveillance patterns that do not capture problematic behavior such as suspicious microcap activity." As with 2016, data integrity is an issue of concern for FINRA. Firms need to ensure that the transaction data is properly feeding into their surveillance systems. They must also ensure that the rules within their surveillance systems are tuned to the specific risks faced by that institution and are properly designed to capture suspicious activity.

Another area in which FINRA has observed AML deficiencies is the monitoring of "foreign currency transactions and transactions that flow through suspense accounts." FINRA also noted that "[f]irms may perform anti-money laundering suspicious activity monitoring using the same trading surveillance they use for

supervisory purposes, but that surveillance must also include alerts tailored to the firm's anti-money laundering red flags."

The AML segment of the priorities letter also addresses nominee companies and the controls on their accounts. FINRA "expect[s] firms to determine whether they need to implement policies and procedures to identify accounts held by nominee companies and whether they should apply heightened scrutiny to those accounts." This concern should be seen broadly in the sense that a firm cannot evaluate the credibility or legitimacy of activity if it does not know the identity of the controlling party, and nominee accounts, like shell companies, can in some instances be structured to obscure that understanding. Information about the reason and reality of nominees may thus be critical to evaluating whether activity is suspicious and reportable.

Although not specifically tagged to AML, FINRA gives some specific examples of its concerns under the heading of *Sales Practices* and notes that it will assess whether firms have appropriate supervisory mechanisms in place to detect problematic sales practices. FINRA identifies, among other sales practices, some that are frequently the subject of AML reportable events, including microcap or "penny" stock fraud schemes, overconcentration in certain products, and excessive and/or short-term trading of long-term products. These all can be the predicate for Suspicious Activity Reports or otherwise implicate the effectiveness of the AML program. Similarly, FINRA makes very salient its concerns about rogue brokers, who presumably can deviate from their AML expectations in their extreme activity, including regarding problematic sales practices.

One notable change from prior years, not specific to AML compliance but impacting AML compliance examinations, is that FINRA is initiating, for a select group, supplemental off-site reviews. This process will allow FINRA to make targeted inquiries of institutions focusing on specific areas of concern. This remote process will make it more convenient for FINRA to conduct a targeted AML

examination of a particular issue of concern or high risk problem. Consequentially, firms will likely require enhanced capability to maintain documentation in a manner that is readily available, understandable, and transmittable. Also, given the remote nature of the examination, firms should expect to have fewer opportunities to interact with the examiner(s), which could prove problematic to a firm's ability to readily explain idiosyncrasies and complexities within the data and documentation. In other words, there is an increasing premium on having the documentation be able to stand alone, without an informal walk through that in a regular examination could take place in a conference room on-site.

### Conclusion

Both the SEC and FINRA exam priorities letters make tailoring of the AML program, including the choice tuning of surveillance parameters and rules, a high priority. It is hard to see how firms can demonstrate that they have tailored programs without having detailed, updated, and intelligently documented risk assessments. Tailoring, of course, includes updating, and given the attention paid to previously observed deficiencies, it is fair to infer that enforcement actions brought by the regulators will continue to be a good indicator of their own evolving priority for examination content. It probably also suggests that problems that a given firm has already experienced, or that its peers are seen as experiencing, will receive increased focus in the examination. Institutions should continue to bring enhanced efforts around designing and implementing AML compliance programs that detect and prevent money laundering by taking a comprehensive view of the risks actually presented to their business, including AML risks that become known on a current basis. Additionally, firms need to routinely test their AML compliance systems for effectiveness. Both FINRA and the SEC expect robust programs with adequate levels of experience and staffing to meet the program priorities.

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