Client Alert

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FINRA Focuses AML Enforcement on a BD Doing Business in Mexico

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The Financial Industry Regulatory Authority (FINRA) recently took formal disciplinary action against a New York-based broker-dealer that is affiliated with a Mexican broker-dealer and a Mexican bank for inadequate anti-money laundering (AML) systems and procedures. FINRA also found that the firm failed to register 200 to 400 foreign finders who functioned as the firm's primary points of contact with its Mexican clientele. FINRA also named the firm's former AML officer and Chief Compliance Officer (CCO) for these violations.

FINRA rules require all member firms to develop and implement a written AML program reasonably designed to achieve and monitor the members' compliance with the requirements of the Bank Secrecy Act (BSA) and implementing its regulations. In its January 28 settlement order, FINRA found that, between 2008 and 2013, the firm failed to develop such a program. Specifically, the firm failed to: (a) adopt AML procedures adequately tailored to its business; (b) fully enforce its AML program as written; and (c) investigate certain suspicious activities. FINRA specifically took issue with the firm's reliance on off-the-shelf procedures not customized to identify the risks unique to opening accounts, transferring funds and effecting securities transactions for customers located in Mexico, a high-risk jurisdiction for money laundering, or the risks arising from the firm's reliance on foreign finders.

FINRA fined the firm $475,000 and required it to certify that it has established systems and procedures reasonably designed to achieve compliance with all of its AML and registration obligations, and not simply that it remediated the deficiencies identified. FINRA also suspended the former CCO for 30 days in a principal capacity, because he was responsible for the firm's AML procedures and for monitoring for suspicious activities, and because he failed to fully enforce the firm's AML program.

FAILURE TO TAILOR THE AML PROGRAM TO THE FIRM'S BUSINESS MODEL

FINRA's rules require broker-dealers to tailor their AML programs to their businesses, including considerations of size, location, business activities, types of accounts and transactions and technological environment. Firms must recognize that there is no "one-size-fits-all" approach.

According to its order, FINRA expected the firm to have a robust AML program in place, given the following considerations:

1) 95% of the firm's business consisted of servicing high net worth Mexican nationals with banking and brokerage relationships with the firm's foreign affiliates;

2) Mexico's status as a high-risk money laundering environment;

3) The firm's use of foreign finders to interact with the foreign clients; and

4) Customers' use of accounts to transfer large sums of money in and out of Mexico while conducting few, if any, securities transactions.

Instead of considering these factors and attendant compliance challenges posed by its customer base, business strategy and operating environment when devising an appropriate AML program, the firm chose to purchase generic off-the-shelf written supervisory procedures (WSPs) from a third-party vendor, and implemented those WSPs without modification.

For instance, the business overview section of the WSPs, designed to describe the firm's products, services and customer base, was left blank until 2012; the red flags section was generic and failed to discuss any of the relevant risks faced by the firm; and the discussion of high-risk jurisdictions failed to acknowledge that nearly all of the firm's accounts originated in a high-risk jurisdiction.

FINRA found that the firm's AML officer and CCO failed to carry out his responsibility for tailoring the WSPs to the firm's business model. In addition, between 2008 and 2010, he and other senior management failed to conduct an annual review of the firm's business to identify potential money-laundering risk. After the CCO departed the firm, no such review was conducted until 2011, and the reviews conducted in 2011 and 2012 failed to sufficiently discuss the risks associated with operating in Mexico and the firm's reliance on foreign finders.

FAILURE TO ENFORCE THE AML PROGRAM AS WRITTEN

FINRA also found that the firm failed to enforce its suspicious activity detection procedures and its Customer Identification Program (CIP).

The firm's WSPs required that the firm's AML principal work with its clearing firm to ensure that exception reports were made available to the firm to allow monitoring of suspicious activity and request additional exception reports when needed. The clearing firm's AML rules engine identified thousands of possible AML exceptions between 2009 and 2011 – a reflection of the firm's customer base – but the firm failed to use any of those exception reports to detect suspicious activity, or work with the clearing firm to create alternate reports, customize existing ones, or otherwise monitor the firm's activity in a manner reasonably designed to allow the firm to detect and report suspicious activities.

As part of its CIP, the firm's WSPs required registered personnel to obtain more than one documentary verification of the customers' identity. FINRA found, however, that because registered personnel had no direct contact with customers – foreign finders collected and submitted customers' documentary verification data to registered personnel – the firm failed to comply with this requirement. Registered personnel were therefore unable to independently verify the information provided.

FAILURE TO DETECT AND INVESTIGATE CERTAIN SUSPICIOUS ACTIVITIES

FINRA's rules require members to establish and implement procedures reasonably designed to detect and cause the reporting of suspicious activity and transactions under the BSA, including provisions for monitoring, detecting, and responding to red flags. Broker-dealers have to file a Suspicious Activity Report (SAR) with the Financial Crimes Enforcement Network (FinCEN) to report a suspicious transaction that, alone or in the aggregate, involves at least $5,000 in funds or other assets when the broker-dealer knows, suspects, or has reason to suspect that the transaction:

1) Involves funds derived from illegal activity;

2) Is designed or structured to evade the BSA's requirements;

3) Appears to serve no business or apparent lawful purpose or is not the type of transaction expected of that customer, and the broker-dealer identifies no reasonable explanation after examining related circumstances; or

4) Uses the broker-dealer to facilitate criminal activity.

As explained in the order, to have a SAR filing obligation, the broker-dealer does not need to prove that the customer engaged in criminal activity or that it had knowledge of the customer's illicit or unlawful trading; it only needs to have reason to suspect that a transaction involved unlawful activity or lacked an apparent lawful purpose.

According to FINRA, the firm lacked an adequate system to identify and investigate suspicious activity, and failed to adequately investigate and report activity in three customer accounts.

For instance, the firm failed to perform adequate due diligence on a customer who opened two corporate accounts on behalf of several beneficial owners. Had the CCO performed a simple web search on the name of one of the beneficial owners when the account was opened or when the suspicious activity occurred, he would have found out that the person had been arrested and detained in 1999 for alleged ties to a drug cartel. This customer deposited $25.5 million in one of the accounts, and, despite stating that he was interested in long-term growth as an investment goal and wanted the funds invested for at least one year, he wired out $5 million to an overseas bank just three days after the last deposit. Shortly thereafter, he started purchasing Mexican Pesos and wired 200 million Mexican Pesos to his account with the firm's Mexican broker-dealer affiliate, depleting his account. The CCO failed to investigate the red flags, including the high velocity and volume of wire transfers in and out of the account without attendant securities transactions, despite the fact that these transfers appeared in a daily blotter that the CCO reviewed for red flags and approval. Even after the firm's clearing firm contacted the CCO in connection with the suspicious transfer into and out of another of the same customer's accounts, the CCO failed to adequately investigate the situation.

The FINRA order discusses two other situations involving rapid deposit and withdrawal of substantial amounts of money within a short period of time. These situations were also flagged on the daily wire report reviewed by the CCO and brought to his attention by the clearing firm. In those cases as well, the CCO failed to adequately investigate the transactions and accepted the representations and explanations of the foreign finders without further investigation or documentation supporting the claimed purpose of the transactions.[1]

[1] In a similar case, FINRA fined another broker-dealer last year for failing to adequately monitor activity in certain of its customers' accounts, despite the fact that the firm's procedures identified certain account activity as red flags that were potential indicia of suspicious transactions. That firm also used foreign associates to interact with its South American clientele. The red flags consisted of: large numbers of wire transfers to unrelated parties inconsistent with the customer's legitimate business purpose; unexplained levels of account activity with very low levels of securities transactions; customers appearing to act as agents for undisclosed principals and being reluctant to provide information about those principals; and large transactions involving cash or other monetary instruments appearing to be structured to narrowly avoid the $10,000 reporting threshold.

TAKEAWAYS

The violations found in FINRA's action appear to have been the result of a substantial increase in the broker-dealer's unregistered finders – who were functionally brokers – handling wealthy Mexican clients, resulting from a merger with another firm. However, FINRA's findings are comprehensive, and provide a road map to FINRA's concerns about AML compliance programs for all broker-dealers. Broker-dealers should review their procedures to ensure that they are adequately tailored to their business and its unique risks, particularly if their business includes a significant foreign component, and should regularly update the procedures to accommodate any changes in their business model. Firms should also ensure that they are consistently applying existing procedures, investigating suspicious activities, and taking advantage of available resources, such as monitoring any exception reporting by their clearing firms.

Discussions of other recent FINRA AML enforcement actions can be found here, here and here.

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