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Independent AML Testing of Introducing Broker-Dealers

Gina Storelli, CRCP, CAMS-Audit

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Identify and describe a risk-based approach for independent testing of introducing broker-dealers in evaluating the effectiveness of a firm's AML compliance program and aid in the detection of suspicious activity.

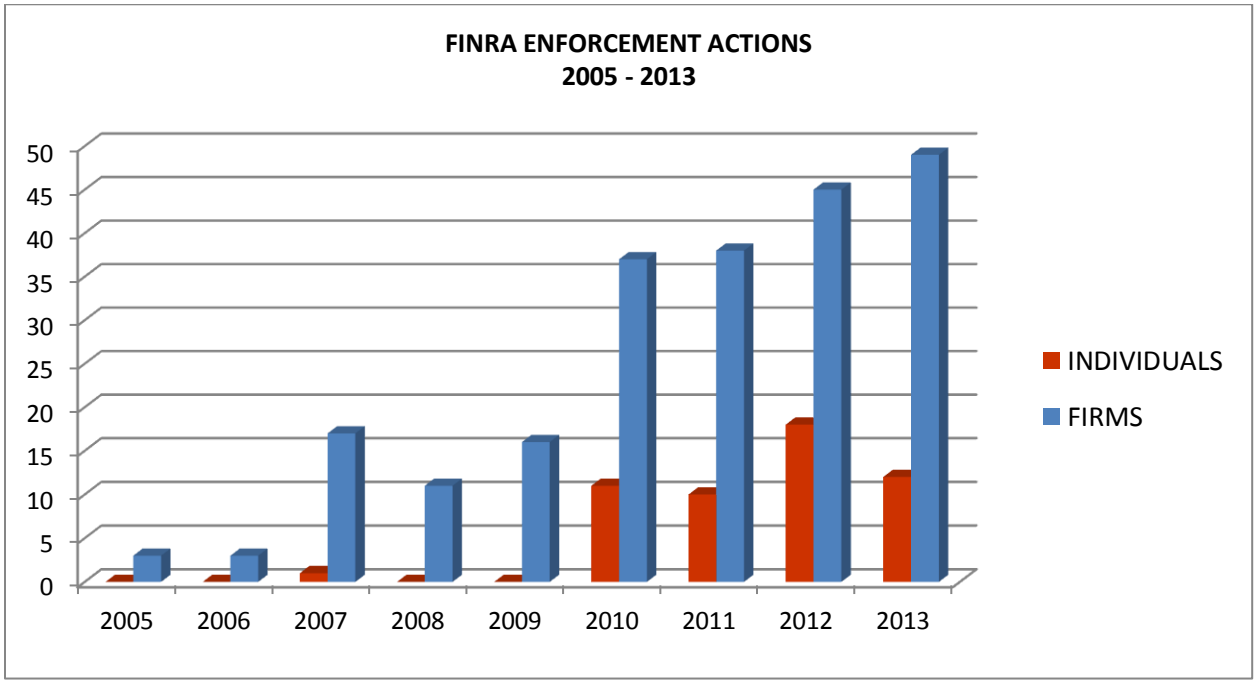
Introduction

In October of 2001, the United and Strengthening America by Providing Appropriate Tools Required to Intercept and Obstruct Terrorism ("USA PATRIOT" or "PATRIOT") Act was enacted by Congress in response to the September 11, 2001 terrorist attacks. Among other things, the PATRIOT Act amended and strengthened the Bank Secrecy Act ("BSA") and imposed new obligations on financial institutions intended to detect and deter money laundering and terrorist financing activities.

Beginning in April of 2002, broker-dealers were required to establish and implement Anti-Money Laundering ("AML") compliance programs. The basic elements of such programs were to include: (i) a system of internal policies, procedures and controls; (ii) the designation of an AML Compliance Officer responsible for implementing and monitoring the day-to-day operations and internal controls of the program; (iii) ongoing employee training; and, (iv) independent testing of the AML Program. Since then, AML has been a focus of regulators as evidenced by its consistent inclusion as an examination priority by the Financial Industry Regulatory Authority ("FINRA") and the Securities and Exchange Commission ("SEC") however firms are still struggling with the implementation of AML compliance.

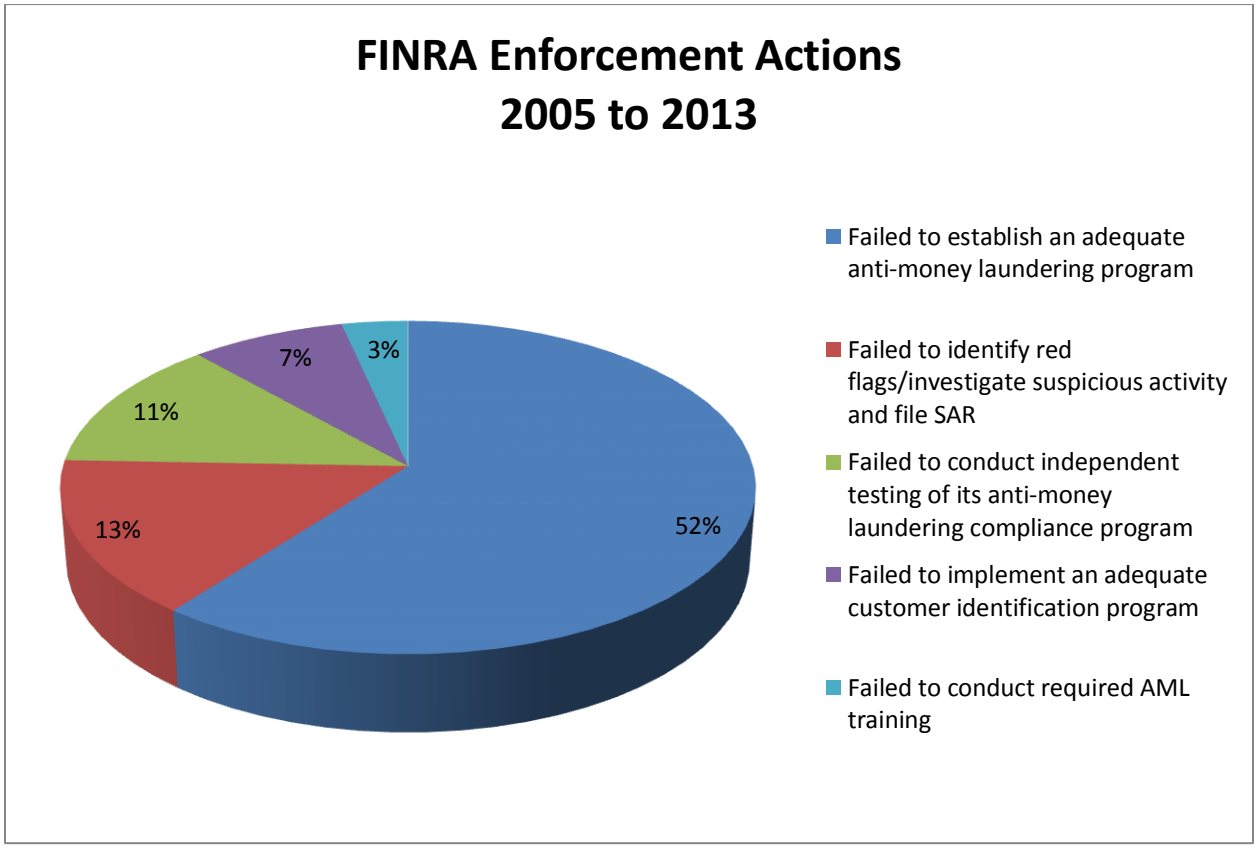
"FINRA continues to find problems with brokerages' programs for complying with anti-money laundering rules more than 12 years after the Patriot Act added more surveillance and reporting requirements for them to follow"
- Michael Rufino,
FINRA Member Regulation

Over the past five years, we have seen the formation and continued expansion of a specialized anti-money laundering examination team by FINRA as well as a significant increase in the number and severity of published enforcement actions against firms, and more recently, individuals for AML related violations. It should be noted that individuals have been the recipients of approximately 25% of these actions.



Examination Findings

A review of enforcement actions from 2005 through 2013 showed that 52% were the result of firm's failure to establish and enforce adequate AML programs to detect and report suspicious transactions; 13% were for firm's failure to identify red flags/investigate suspicious activity and file Suspicious Activity Reports ("SARs"); 11% failed to conduct independent testing of its anti-money laundering compliance program; 7% failed to implement an adequate customer identification program and 3% failed to conduct required AML training. These actions do not include exceptions noted during regulatory examinations of firms resulting in sanctions of less than $5,000 which are not made publicly available. However, a sampling of non-published AML examination findings reviewed in my role as an independent tester of introducing broker-dealers has concluded that most AML violations occur due to firm's failure to establish and enforce adequate AML programs.



Fully disclosed broker-dealers

In a fully disclosed clearing arrangement, the introducing broker-dealer introduces transactions to the clearing firm for clearance, settlement and custody. The arrangement is called fully disclosed because division of the functions between the clearing firm and introducing firm is disclosed in a notice to the customers of the introducing firm.[1] Clearing agreements outline the

[1] Paul B. Uhlenhop and Bryan D. Pfister, "Clearing Arrangements of Introducing Firms – Who's Responsible" (paper presented at the National Society of Compliance Professionals National membership meeting, Washington, D.C., October, 2006).

AML responsibilities of each party. In most cases, the introducing firm has primary responsibility with respect to verification of customer identity, background, obtaining necessary information and monitoring transactions in the account while a clearing firm can provide tools to help the introducing firm monitor its accounts for potential suspicious activity. "Clearing firms are also expected to provide monitoring resources such as reports of wire activity, journal of funds and securities, and other transaction activity, to their introducing brokers so they can comply with their own reporting responsibilities".[2] The Financial Crimes Enforcement Network ("FinCEN") has come to the view that it would be appropriate to require only the introducing firm to comply with the requirements of the CIP rule with respect to customers introduced to a clearing firm pursuant to a clearing agreement that allocates functions in the manner described above.[3]

Introducing and clearing firms are both responsible for filing SARs for suspicious transactions and if involved in the same transaction may file a SAR jointly as long as it includes all relevant facts about the transactions and is otherwise permissible under the law. However, there continues to be a common misconception among introducing broker-dealers that clearing firms are responsible for review, detection and reporting of suspicious activity when, in fact, all broker-dealers have an independent responsibility to comply with suspicious activity reporting requirements. In 2010, FINRA published a revised AML Small Firm Template which modified sample language relative to clearing/introducing firm relationships stating that introducing broker-dealers would obtain certain exception reports offered by the clearing firm to monitor customer activity vs. the earlier published language that stated that clearing firms would monitor customer activity on behalf of introducing broker-dealers. As we know that this mindset still exists and poses great risk in effectively detecting and reporting suspicious transactions, testers should be mindful and account for this risk in their course of independent testing.

Independent testing of introducing broker-dealers

Since 2002, financial institutions have been required to provide for independent testing of their AML Programs. In 2010, the FINRA revised AML Small Firm Template included the following guidance relative to independent testing:

> As a general matter, independent testing of your firm's AML compliance program should include, at a minimum: (1) evaluating the overall integrity and effectiveness of your firm's AML compliance program; (2) evaluating your firm's procedures for BSA reporting and recordkeeping requirements; (3) evaluating the implementation and maintenance of your firm's CIP; (4) evaluating your firm's customer due diligence

[2] Daniel Nathan & Alma Angotti, "Broker-Dealer AML Transaction Monitoring: The Devil's in the Details", 2012, http://www.navigant.com/~/media/WWW/Site/Insights/Disputes%20Investigations/nathan_angotti_broker_dealer.ashx

[3] FIN 2008-G002 (March 4, 2008) clarifies FinCEN's position respecting the customer identification program rule ("CIP rule") obligations of a clearing firm, with respect to a customer that has been introduced to it by an introducing firm, when the functions of opening and approving customer accounts are directly receiving and accepting orders from the introduced customer are allocated exclusively to the introducing firm and the functions of extending credit, safeguarding funds and securities and issuing confirmations and statements are allocated to the clearing firm.

requirements; (5) evaluating your firm's transactions, with an emphasis on high-risk areas; (6) evaluating the adequacy of your firm's staff training program; (7) evaluating your firm's systems, whether automated or manual, for identifying suspicious activity; (8) evaluating your firm's system for reporting suspicious activity; (9) evaluating your firm's policy for reviewing accounts that generate multiple SARs filings; and (10) evaluating your firm's response to previously identified deficiencies.[4]

A description of the testing processes employed and items reviewed to meet the standards described above should be included in the independent tester's final examination report.

Given the size and frequency of AML related enforcement actions, we must question the effectiveness of independent testing of AML programs. Little to no guidance has been offered with respect to the conduct of independent testing of broker-dealer AML Programs. Testers have relied upon the Federal Financial Institutions Examination Council ("FFIEC") Bank Secrecy Act/Anti-Money Laundering Examination Manual which, while intended for use by bank examiners, offers direction for carrying out a BSA/AML examination. As a banking industry tool, the manual does not offer sufficient detail related to testing of securities industry specific customer types, products or services (i.e., master/sub-accounts, micro-cap securities, online customer trading accounts) therefore leaving the tester with independent subjectivity as to how to perform testing. Yet, the common thread throughout the manual, the application of a risk-based approach to testing, has certainly become a much more widely recognized approach in recent years transcending prior testing methodologies.

The following excerpts from annual FINRA publications suggest the evolution of AML oversight from a "check-the-box" prescriptive approach to a more risk-based program:

2002: [Anti-Money Laundering] "This area is an examination priority in order to assist member firms in meeting their obligations and to ensure that these obligations are being fulfilled."[5]

2003: "Anti-money laundering will remain an examination priority in order to determine industry compliance with these important rules, and to assist member firms in meeting their obligations."[6]

2004: "Anti-money laundering remains an examination priority in 2004 and substantive deficiencies in firm AML compliance programs and procedures may result in formal disciplinary action."[7]

[4] FINRA Anti-Money Laundering (AML) Template for Small Firms, January 1, 2010
[5] NASD 2002 Examination Priorities Letter
[6] NASD 2003 Examination Priorities Letter
[7] NASD 2004 Examination Priorities Letter

2005: "Anti-money laundering remains an examination priority and substantive deficiencies in firm AML compliance programs and procedures may result in formal disciplinary action."[8]

2006: "NASD Rule 3011 has been in effect since April 24, 2002, yet members continue to have trouble complying with the requirements of the rule. The requirement to have an AML program is a federal requirement, and there are no exceptions."[9]

2007: "As stated in last year's letter, all NASD member firms are required to comply with NASD Rule 3011. The nature of a firm's compliance program can and should be tailored to the firm's business mix."[10]

2008: "The AML requirements for broker-dealers, which have been in effect since April 24, 2002, continue to be an examination focus. It is important to note that the AML requirements in the Bank Secrecy Act and implementing regulations apply to all FINRA member firms—regardless of size or business model—even if the firm does not hold customer funds."[11]

2009: "FINRA examiners continue to focus on anti-money laundering (AML) requirements. Firms should ensure that their AML policies and procedures are appropriately tailored to the firm's business model, risk profile and volume of transactions, particularly with regard to monitoring, detecting and reporting suspicious activity."[12]

2010: "AML compliance continues to be a focus of FINRA examiners." "FINRA examiners will continue to closely review firms' systems for monitoring, detecting and reporting suspicious activity."[13]

2011: "FINRA expects firms to maintain robust supervisory systems and AML monitoring systems that reasonably are designed to detect and report suspicious transactions. These types of procedures should assist firms in identifying clients who engage in high-risk activity and determining whether their business activity is appropriate and whether the firm can adequately mitigate any risks associated with such client activity."[14]

[8] NASD 2005 Examination Priorities Letter
[9] NASD 2006 Examination Priorities Letter
[10] NASD 2007 Examination Priorities Letter
[11] FINRA 2008 Examination Priorities Letter
[12] FINRA 2009 Examination Priorities Letter
[13] FINRA 2010 Examination Priorities Letter
[14] FINRA 2011 Regulatory and Examination Priorities Letter

2012: "As part of their anti-money laundering (AML) responsibilities, member firms are obligated to monitor for suspicious activity and to file Suspicious Activity Reports where warranted."[15]

2013: "FINRA examiners continue to focus on AML compliance, particularly at firms with higher-risk business models due to their clients, products and service mix, or location in which they operate."[16]

2014: "In 2014, FINRA will focus on AML issues associated with institutional business."[17]

As regulatory expectations of firm's AML programs have matured, so too has the expectation of independent testing. In the early years of AML requirements for broker-dealers, testers were interested in whether or not firms had actually established AML Programs, as many did not for the first few years. Many firms were cited by regulators for this failure however sanctions were minimal during this unspoken "grace period". For firms who had established AML Programs, testing was focused more on the completion of a checklist to ensure that all required elements of the Bank Secrecy Act and relevant AML regulations were included in a firm's written AML program and that firms could evidence compliance with such regulations including CIP reviews to determine if the firm was obtaining sufficient evidence to verify the identity of a customer. Little attention was given to transaction testing as most testers too were of the impression that the clearing firm was responsible for monitoring of customer activity. In 2009, FINRA's examination priority language related to AML began to introduce the expectation of a more risk-based approach as did FINRA's revised AML Small Firm Template the Securities and Exchange Commission's ("SEC") AML Source tool, both published in early 2010. Enforcement actions more than doubled from 2009 to 2010 with many of the actions occurring as results of failure to apply risk based AML programs.

Risk-based audit programs will vary depending on firm's size, complexity, scope of activities, risk profile, quality control functions, geographic diversity and methods of review. The frequency and depth of each activity's audit will vary according to the firm's risk assessment.

This white paper is intended to describe a risk-based approach for independent testing of introducing broker-dealers in evaluating the effectiveness of a firm's AML compliance program and aid in the detection of suspicious activity.

[15] FINRA 2012 Regulatory and Examination Priorities Letter
[16] FINRA 2013 Regulatory and Examination Priorities Letter
[17] FINRA 2014 Regulatory and Examination Priorities Letter

Risk Assessment

The main objectives of a risk assessment are to:

- Identify money laundering/terrorist financing exposure;
- Measure potential money laundering/terrorist financing risks applicable to a firm's business; and
- Implement proportionate measures and controls to reasonably mitigate risks.

FINRA, in its AML Small Firm Template, has suggested that "It is a good practice to develop a written analysis of your firm's money laundering and terrorist financing risk and how your firm's AML procedures manage that risk. This 'risk-assessment' will help to ensure that the AML program is the right one for your firm and is a useful tool for demonstrating to your firm's examiner that the firm used a reasonable approach for designing its AML Program."[18] A well-developed risk assessment can serve as an invaluable tool yet, as it is not a required component of the Bank Secrecy Act, one that many firms fail to develop.

The FFIEC suggests that in cases where the bank has not completed a risk assessment or risk assessment is inadequate, the examiner must complete a risk assessment based on available information.[19] The risk assessment developed by the independent tester may not be as detailed as if prepared by the firm, but can assist the tester and the firm in identifying and mitigating gaps in its controls. Additionally, the firm may utilize this information as the basis for developing a more comprehensive risk assessment of its own.

The risk assessment process for both banks and broker-dealers should begin by identifying specific products/services, customers and geographic locations, however, each industry has specific high risk products, For example, banks handling of high volumes of currency or currency equivalents which would not really be applicable for broker-dealers as cash is not accepted, therefore posing less "placement" stage risk. Conversely, micro-cap and penny stock transactions do not exist in the banking world. Such differences would obviously need to be accounted for in determining the quality of bank vs. broker-dealer inherent risk. Inherent risk is the risk that an activity would pose if no controls or other mitigating factors were in place. Broker-dealer related examples of criteria relative to each component are reflected as follow:

- Customer:
    - Type of customer:
        - Individuals: foreign/domestic
        - Entities: foreign/domestic; type of businesses
    - Length of relationship
    - Purpose of account
    - Type of account (i.e., online account, master/sub-account)
    - Type of activity: anticipated vs. actual

[18] FINRA Anti-Money Laundering (AML) Template for Small Firms, January 1, 2010
[19] FFIEC BSA/AML Examination Manual, 2010, page 29

- Product/Service:
    - Types of products/services:
        - Foreign securities
        - Microcap/penny stocks
        - Physical stock certificate deposits
        - Bearer bond deposits
        - Cash management accounts (with check writing capabilities)
        - Third party wires
        - Volume of transactions: anticipated vs. actual
        - Other high risk products

- Geographic risk:
    - Countries subject to OFAC sanctions[20]
    - Countries identified as supporting international terrorism under section 6(j) of the Export Administration Act of 1979, as determined by the Secretary of State [21]
    - Jurisdictions determined to be "of primary money laundering concern" by the Secretary of the Treasury, and jurisdictions subject to special measures imposed by the Secretary of the Treasury, through FinCEN, pursuant to section 311 of the USA PATRIOT Act[22]
    - Jurisdictions or countries monitored for deficiencies in their regimes to combat money laundering and terrorist financing identified as non-cooperative by international entities such as the Financial Action Task Force on Money Laundering (FATF)
    - Major money laundering countries and jurisdictions identified in the U.S. Department of State's annual International Narcotics Control Strategy Report (INCSR), in particular, countries which are identified as jurisdictions of primary concern[23]
    - Offshore financial centers (OFC)[24]
    - Other countries identified as higher-risk based on firm's prior experiences or other factors (e.g., legal considerations, or allegations of official corruption)

[20] A list of such countries, jurisdictions, and governments is available on OFAC's Web site: www.treas.gov/offices/enforcement/ofac.

[21] A list of the countries supporting international terrorism appears in the U.S. Department of State's annual "Country Reports on Terrorism." This report is available on the U.S. Department of State's Web site for its Counterterrorism Office: www.state.gov/s/ct/.

[22] Notices of proposed rulemaking and final rules accompanying the determination "of primary money laundering concern," and imposition of a special measure (or measures) pursuant to section 311 of the USA PATRIOT Act are available on the FinCEN Web site: www.fincen.gov/reg_section311.html.

[23] The INCSR, including the lists of high-risk money laundering countries and jurisdictions, may be accessed on the U.S. Department of State's Bureau of International Narcotics and Law Enforcement Affairs Web page www.state.gov/p/inl/rls/nrcrpt/.

[24] OFCs offer a variety of financial products and services. For additional information, including assessments of OFCs, refer to www.imf.org/external/ns/cs.aspx?id=55.

- Domestic higher-risk geographic locations - High Intensity Drug Trafficking Areas (HIDTA)[25]; High Intensity Financial Crime Areas (HIFCA).[26]

Once the quality of inherent risk has been determined, an assessment of the adequacy/quality of controls to mitigate risks should be applied in order to ascertain the firm's residual risk. Residual risk is the risk that remains after controls are accounted for.

Main areas of potentially mitigating controls include:

1. **Detection and Monitoring Risk:** Risk associated with the firm's ability to monitor, detect and report suspicious or unusual activity which would be assessed by the quality of surveillance tools, systems and processes employed.

2. **Identification and Verification Risk**: Risk associated with the firm's ability to form a reasonable belief that it knows the true identity of its customers which would be assessed by examination of controls in place to ensure all required KYC and CIP functions have been performed prior to account opening.

3. **Compliance Risk**: Risk associated based on the maturity/comprehensiveness of the compliance program including policies and procedures, risk assessment, compliance monitoring and testing of key controls, transactions, risk indicators and metrics, issue management and training programs.

4. **Regulatory/Prior Audit Risk**: Risk would be determined based on reported conclusions of prior regulatory examinations or internal audits with exceptions noted and the severity of such exceptions.

Planning and Scope

The planning and scoping process should allow for the tester to become familiar with the firm's AML compliance program, compliance history and risk profile. In an effort to obtain sufficient knowledge of the firm's risks in order to determine the program's adequacy, the independent tester should conduct the following as part of its scoping and planning:

- Discussions with senior management to gain an understanding of the firm's compliance program, risk assessment, customer profiles, jurisdictions, products/services, suspicious

[25] The Anti-Drug Abuse Act of 1988 and The Office of National Drug Control Policy (ONDCP) Reauthorization Act of 1998 authorized the Director of ONDCP to designate areas within the United States that exhibit serious drug trafficking problems and harmfully impact other areas of the country as HIDTAs. The HIDTA Program provides additional federal resources to those areas to help eliminate or reduce drug trafficking and its harmful consequences. A listing of these areas can be found at www.whitehousedrugpolicy.gov/hidta/index.html.

[26] HIFCAs were first announced in the 1999 National Money Laundering Strategy and were conceived in the Money Laundering and Financial Crimes Strategy Act of 1998 as a means of concentrating law enforcement efforts at the federal, state, and local levels in high intensity money laundering zones. A listing of these areas can be found at www.fincen.gov/hifcaregions.html.

activity monitoring, reporting and transaction monitoring reports, systems and/or processes utilized to aid in the detection of unusual activity;
- AML Compliance Officer contact information and related AML expertise and experience;
- Review of prior independent AML examination reports accepted by senior management and management responses to previously identified deficiencies and/or recommendations;
- Review of communications between the firm and its regulator(s) regarding AML related inquiries/findings and responses;
- Review of AML sections of the firm's fully-disclosed clearing agreement.

The independent tester should develop an examination plan based upon his determination of residual risk as well as evaluation of the above.

Policies & Procedures

With over half of published examination findings resulting in firms' failure to establish and enforce adequate AML programs to detect and report suspicious transactions, it is imperative that Policies and Procedures (hereinafter referred to as "Policies") are designed to be commensurate with the firm's AML risk profile. Policies must provide for: (i) a system of internal controls to ensure ongoing compliance; (ii) independent testing; (iii) designation of an individual responsible for managing AML compliance; and (iv) training of appropriate personnel. Policies must be designed to ensure compliance with all applicable AML related rules and regulations and should be reviewed and updated regularly to account for changes in regulations and/or the firm's business.

A review of Policies should determine if processes are in place to:
- Identify higher risk customers, products/services and/or geographies
- Identify firm operations that are more vulnerable to abuse by money launderers
- Keep senior management informed of compliance initiatives, deficiencies and corrective actions taken and SARs filings
- Comply with recordkeeping and reporting requirements
- Ensure timely updates in response to changes in regulations
- Implement risk-based customer due diligence processes
- Identify reportable transactions and timely filing of required reports
- Provide sufficient controls and monitoring systems for timely detection and reporting of suspicious activity
- Ensure timely and adequate training of personnel
- Perform independent testing by a qualified individual
- Evaluate the quality of exception reports utilized
- Support the operational processes involved in transaction monitoring

Fieldwork & Testing

Fieldwork and testing are instrumental in determining the effectiveness of a firm's AML program. The independent tester should begin by conducting interviews and requesting walkthroughs of processes with staff to gain an understanding of the practices employed. Next, a selection of provisions stipulated in the firm's Policies should be tested for operational application. Testing of processes will include risk-based sampling and reviews of documentation as evidence of functions performed. Selections may be random or judgmental and sizes may be statistical or proportional, with a greater sampling of areas of the firm that have been determined to be of more vulnerable to AML risk. Additionally, in cases where testing is returning exceptions, the tester should elect to increase the sampling size.

Considerations for testing of key areas:

CIP/KYC

- Greater sampling of higher risk customers
- Documentary and non-documentary evidence on file
- Ensure that documentation is in compliance with both regulatory requirements and firm's Policies
- Ensure initial and ongoing enhanced due diligence is risk-based and appropriate

Regulatory Reporting

- Determine the applicability of an introducing broker's reporting requirements as introducing brokers do not accept, custody or deliver funds yet may be required to file Foreign Bank and Financial Account Reports ("FBARs") for foreign bank, securities or other financial accounts with aggregate value in excess of $10,000 for which the broker-dealer has financial interest or authority
- Suspicious Activity Reporting ("SAR") – Examination of suspicious activity review process including source and quality of alerts, investigative and decisioning processes
- Review sampling of SARs filed during the review period along with supporting documentation for quality, accuracy and timeliness of filing(s)
- Review sampling of supporting documentation of "no SAR" decisions to ensure rationale of determination is clearly and accurately recorded and that customer has been added to firm's watch list for future enhanced due diligence
- Tester should review a greater sampling of no SAR decisions than SARs as they may be indicative of inadequate investigations performed

Office of Foreign Assets Control ("OFAC")

- Conduct a sampling of evidence maintained to review the process employed by the firm to ensure that a customer does not appear on the Specially Designated Nationals and Blocked Persons ("SDN") list prior to account opening and on an ongoing basis

- Review clearing agreement to determine if any OFAC compliance related functions are being performed by clearing firm (i.e., screening, rejecting/blocking and reporting)

Financial Crimes Enforcement Network ("FinCEN")

- Conduct a sampling of evidence of self-verifications maintained for FinCEN requests confirming timely submissions

Voluntary Information Sharing

- Review of initial and annual notices filed with FinCEN prior to sharing of permissible information with another financial institution
- Review of law enforcement requests (i.e., subpoenas, National Security Letters ("NSLs")) and supporting documentation to determine timeliness of responses and, if warranted filing of a SAR
- Review of evidence that the firm has verified submission of the requisite notification to FinCEN by the other financial institution

Cash Management

- Sampling of Automated Clearing House ("ACH") payments and wire transfers to ensure reviews performed by the firm in connection with movement of funds and maintenance of requests, transmittals, etc. (including letters of authorization and due diligence related to third party wires) as well as frequency of wires to/from related accounts

Recordkeeping

- Conduct a sampling of records to ensure they are being maintained in accordance with the firm's Policies

AML Compliance Officer & Compliance Department

- Review evidence that the firm designated an AML Compliance Officer and that contact information for this person has been provided to FINRA via the FINRA Contact System
- Make inquiry as to the AML Compliance Officer's working knowledge of the Bank Secrecy Act and its implementing regulations and qualifications by way of experience, knowledge and training
- Review and assess compliance department resources as to appropriate levels of staffing, tools and resources to effectively manage the firm's AML program

Training

- Confirm timely completion of AML training by required persons
- Review of training materials to determine whether or not training is targeted for individuals specific duties, responsibilities and job functions

- Evaluate training materials for adequacy and comprehensiveness
- Review evidence of mandatory completion by all required persons

Transaction Monitoring

- The following should be considered in testing of transaction monitoring:
  - Accounts or customers identified during testers review of information
  - Greater sampling of higher risk products (such as penny stocks/micro-cap securities) and services, customers, entities and geographic locations for which it appears that firm may not have appropriate internal controls (determined in scoping/planning process)
  - New products, services, customer and entities and geographies included since last examination
  - Level of customer activity
  - Policies to support operational processes involved in transaction monitoring

Most introducing broker-dealers will utilize clearing firm generated exception reports for transaction monitoring responsibilities. The tester should determine whether or not adequate reports exist to address all areas of the firm's AML risk. If not, are other reports available from the clearing firm that the introducing broker-dealer is not receiving? The types of reports reviewed should be based on the firm's risk profile. Reports may include information with regard to money movement, securities turnover, high risk accounts opened, third party wires, trading in low-priced securities, as well as daily transaction reports.

Testing should include a sampling of exception reports reviewed along with underlying support for suspicious activity noted and investigated. Again, testing should be risk-based and conducted from a securities perspective with an eye toward transaction report reviews of wash sales, manipulative trading, securities fraud and insider trading. For firms engaging in penny stock activities, a sampling of trades to address related risks including shortcomings in trade monitoring and asset movement as well as compliance with Section 5 of the Securities Act of 1933, which requires a registration statement to be in effect for such security or sales pursuant to an exemption from registration.

Recommendations and reporting

Effective communication is essential in relaying findings to senior management. As an outsourced independent tester's engagement typically concludes upon issuance of a final testing report, I have found that communicating throughout the audit process has been an effective strategy in encouraging management to focus on deficiencies when found. This early notification tends to assist in the consideration of possible corrective measures to the exceptions noted. Ideally, revised processes to address exceptions noted would be implemented prior to issuance of the final report. If so, I have noted such as a reflection of the priority with which the firm has addressed its AML responsibilities.

In order to quickly get the attention of the firm's senior management or board of directors, I will begin my report with a concise summary risk profile rating, evaluation of the program's adequacy, exceptions noted and suggested recommendations.

Since no two broker-dealers are the same, the format and layout of the testing report will vary and depend on the complexity of the firm's business and/or subsequent findings. For example, in cases where numerous gaps have been identified, it may be appropriate to consider presenting a gap analysis detailing processes described in the firm's Policies, items reviewed and results of testing. Nevertheless, a detailed description of the audit performed, testing results, work papers and recommendations for process and procedure improvements will be included in every report to allow the reader to reach a conclusion as to the overall quality of the AML Program. (Due to the confidential nature of SARs, copies must not be stored with audit work papers.)

Challenges of Independent Testers

Outsourced independent testing of fully-disclosed broker-dealers certainly comes with its share of challenges.

Testers are engaged by the broker-dealer and must rely on representations made by the firm's staff and senior management with limited verification ability. As all documentation reviewed is provided by the firm, the tester is left to base his examination solely on what is remitted. There is no way to determine whether all pertinent information has actually been provided by the firm. Additionally, testers do not have access to the monitoring rules, models or filters employed by clearing firms to design their exception reports. As such, testers are rendered unable to determine the quality of the exceptions isolated on these reports which in turn, does not enable the tester to accurately validate the risk factors pertinent to the broker-dealer.

Risk assessment development, or lack thereof, by broker-dealers proves challenging for testers in that the AML programs established are not commensurate with the firm's corresponding risk profile. An additional obstacle may be the firm's failure to include all business lines or customer types in its assessment. For example, firms may disregard contemplation of business lines that make up a minimal percentage of its overall revenue stream but, conversely, may represent a significant amount of risk.

Lastly, there is no published manual for independent AML testing of broker-dealers. Most testers rely on the FFIEC BSA/AML Examination Manual which does not account for securities transactions and products thereby leaving the tester to independently adapt the underlying guidelines. As there is no parallel application which translates effectively to this very different business model, it is imperative that firms recognize the value in engaging skilled professionals (i.e., CAMS-Audit certified) who are qualified to conduct independent AML testing which will return valuable results.

Conclusion

There is no prescribed method of conducting independent AML testing of introducing broker-dealers. However, it is clear that a risk-based examination is more likely to return meaningful results in assessing the effectiveness of a firm's AML Program than a prescriptive format.

Although regulations have not changed, the expectation and rigorousness of compliance and independent testing of firms have certainly increased. As AML violations have become more sophisticated so too is the expectation of AML Programs with rising enforcement actions being a leading indicator of the priority with which AML compliance continues to be pursued.

"…the undeniable lessons learned from the recent regulatory actions are that FINRA's AML 'grace period' is long over and broker-dealers should expect FINRA to take a deep dive into their suspicious activity detection and reporting systems and the independent tests of such programs."[27]

[27] Nick Hartofilis & Bao Q. Nguyen, "Broker-Dealer Anti-Money Laundering Compliance: The Untenable Chase of Perfection", 2013, http://www.kaufmanrossin.com/news-detail.php?id=470