



RISK ALERT

DIVISION OF EXAMINATIONS

July 31, 2023

OBSERVATIONS FROM ANTI-MONEY LAUNDERING COMPLIANCE EXAMINATIONS OF BROKER-DEALERS

The Division of Examinations* conducts examinations of broker-dealers (also referred to herein as firms or registrants) regarding their compliance with anti-money laundering (AML) and countering the financing of terrorism (CFT) requirements. In 2021, the Division published a Risk Alert discussing compliance issues in the suspicious activity monitoring and reporting components of broker-dealers' AML programs, noting the critical importance of AML compliance to the Commission and law enforcement's pursuit of misconduct that could threaten the safety of investor assets and the integrity of the financial markets.¹ This Risk Alert presents examination observations about other key AML requirements, such as independent testing of firms' AML programs and training of their personnel, and identification and verification of customers and their beneficial owners.

Before discussing those specific observations, the Division would like to highlight two other, more general staff observations about registrants' AML programs. First, some registrants did not appear to devote sufficient resources, including staffing, to AML compliance given the volume and risks of their business. This issue can be exacerbated in the current environment of new and increasing sanctions imposed by the Office of Foreign Assets Control (OFAC) against individuals and entities,² particularly where the same firm personnel perform both AML and sanctions compliance functions. Second, the staff observed that the effectiveness of policies,

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¹ Division, "[Compliance Issues Related to Suspicious Activity Monitoring and Reporting at Broker-Dealers](#)" (Mar. 29, 2021).

² See, e.g., "FinCEN Advises Increased Vigilance for Potential Russian Sanctions Evasion Attempts," [FIN-2022-Alert001](#) (Mar. 7, 2022).

procedures, and internal controls was reduced when firms did not implement those measures consistently. With the goal of assisting registrants in reviewing and enhancing their AML programs, EXAMS reminds registrants of their obligations to comply with all applicable AML and financial sanctions laws and regulations.

I. AML Programs:³ Spotlight on Independent Testing and Training

Broker-dealers are required to implement and maintain a written AML program, approved in writing by senior management, that includes, at a minimum:⁴

- policies, procedures, and internal controls reasonably designed to achieve compliance with the Bank Secrecy Act (BSA)⁵ and the implementing regulations thereunder;
- policies and procedures that can be reasonably expected to detect and cause the reporting of transactions under 31 U.S.C. § 5318(g) and the implementing regulations thereunder;
- the designation of an AML compliance officer responsible for implementing and monitoring the operations and internal controls of the program (including notification to FINRA);
- ongoing employee AML training;
- an independent test of the firm’s AML program, annually for most firms;⁶ and

³ FinCEN amended its AML Program Rule for broker-dealers, 31 C.F.R. § 1023.210, in 2016, when it adopted the Customer Due Diligence (CDD) Rule, 31 C.F.R. § 1010.230. *See* FinCEN, Customer Due Diligence Requirements for Financial Institutions, 81 Fed. Reg. 29398 (May 11, 2016) (CDD Adopting Release). The Anti-Money Laundering Act of 2020 (AMLA) and the Corporate Transparency Act, William M. (Mac) Thornberry National Defense Authorization Act for Fiscal Year 2021, Pub. L. No. 116-283, § 6216, 134 Stat. 3388, 4582-83 (2021), require the Secretary of the Treasury to, among other things, revise the AML Program Rule and the CDD Rule. This Risk Alert discusses the relevant rules as they existed during the period of the examinations.

⁴ *See* 31 U.S.C. § 5318(h)(1); 31 C.F.R. § 1023.210; and Financial Industry Regulatory Authority (FINRA) Rule 3310. 31 C.F.R. § 1023.210(c) provides that a broker-dealer’s AML program that, among other things, complies with the rules, regulations, or requirements of its self-regulatory organization governing such programs will be deemed to satisfy the requirements of 31 U.S.C. § 5318(h)(1).

⁵ 31 U.S.C. §§ 5311 *et seq.*

⁶ Testing should be done more frequently if circumstances warrant. *See* FINRA Rule 3310 Supplementary Material .01(a). Independent testing is required to be done annually unless the member broker-dealer does not execute transactions for customers or otherwise hold customer accounts or act as an introducing broker with respect to customer accounts, in which case the independent testing is required every two years. FINRA Rule 3310(c).

- appropriate risk-based procedures for conducting ongoing CDD. These should include, but not be limited to, procedures to: (1) understand the nature and purpose of customer relationships to be able to develop a risk profile, and (2) conduct ongoing monitoring to identify and report suspicious transactions as well as maintain and update customer information, including beneficial ownership information for legal entity customers.

Information gathered as part of CDD should also be used for compliance with OFAC regulations.⁷ With respect to beneficial ownership information for legal entity customers, broker-dealers are reminded that Rule 17a-8 under the Securities Exchange Act of 1934 requires compliance with the reporting, recordkeeping, and record retention requirements of the BSA—including the recordkeeping obligations set forth in the CDD Rule.

Regarding the independent testing requirement, the staff observed:

- Broker-dealers that did not conduct testing in a timely manner or could not demonstrate (for example, by a report or other documentation) that they conducted such testing.
- Independent tests that appeared ineffective because: they did not cover aspects of the firm’s business or AML program; the personnel conducting the testing was not independent or did not have the appropriate level of knowledge of the requirements of the BSA; or the testing was conducted under requirements not applicable to the securities industry. In other instances, the firm was

OFAC Compliance

All U.S. persons, including broker-dealers as well as investment advisers and registered investment companies, must comply with regulations promulgated by OFAC, which administers and enforces sanctions against certain jurisdictions and foreign persons based on U.S. foreign policy and national security interests.

[OFAC’s website](#) provides [tools](#) for searching its sanctions lists and [best practices for compliance](#).

During the course of examinations for compliance with the federal securities laws and the BSA, EXAMS staff observed certain weaknesses in OFAC compliance programs, including instances in which entities did not adopt or implement reasonable, risk-based internal controls for (1) following-up on potential matches with the sanctions lists and documenting the outcome of such follow-up; (2) performing periodic or event-based screening of existing clients or customers based on, among other things, changes in ownership or to the sanctions lists; and (3) conducting OFAC searches in a timely manner (or documenting that such searches were completed).

⁷ CDD Adopting Release, *supra* note 3, at 29398; *see also, generally*, 31 C.F.R. Chapter V.

unable to demonstrate, via documentation or otherwise, that the independent testing adequately tested the firm's compliance with its AML program.

- Broker-dealers that did not timely address, or have procedures for addressing, issues identified by independent testing.

As to ongoing training, the staff observed:

- Training materials that were not updated based on changes in the law (e.g., the adoption of the CDD Rule) or tailored to the risks, typologies, products and services, and business activities of the broker-dealer (e.g., training materials focused on bank AML requirements).⁸
- Broker-dealers that could not demonstrate that all appropriate personnel attended the firms' ongoing training or did not establish a process for following up with personnel who did not attend required training.

II. Customer Identification Program (CIP) Rule⁹

The CIP Rule requires a broker-dealer to establish, document, and maintain a written CIP appropriate for its size and business that includes, at a minimum, procedures for certain requirements including:

- Obtaining the minimum specified customer identifying information from each customer prior to account opening;
- Verifying the identity of each customer, to the extent reasonable and practicable, within a reasonable time before or after account opening—and, in circumstances in which the firm cannot verify a customer's identity, implementing follow-on procedures describing: when the firm should not open an account for the customer; the terms under which a customer may conduct transactions while the firm attempts to verify the customer's identity; when

⁸ See "NASD Provides Guidance to Member Firms Concerning Anti-Money Laundering Compliance Programs Required by Federal Law," [Notice to Members 02-21](#) (Apr. 10, 2002). For an example of material that in the staff's view may be appropriately tailored for some firms, see SEC's Division of Trading and Markets' [Staff Bulletin: Risks Associated with Omnibus Accounts Transacting in Low-Priced Securities](#), which highlights various risks arising from illicit activities associated with transactions in low-priced securities through omnibus accounts, particularly transactions effected on behalf of omnibus accounts maintained for foreign financial institutions.

⁹ 31 C.F.R. § 1023.220. Customer identification and verification pursuant to a broker-dealer's CIP is another core element of CDD. See CDD Adopting Release, *supra* note 3, at 29398.

the firm should close an account after attempts to verify a customer's identity fail; and when the firm should file a Suspicious Activity Report; and

- Making and maintaining a record of information obtained under the firm's procedures.

The procedures of the CIP must enable the broker-dealer to form a reasonable belief that it knows the true identity of each customer and be based on the broker-dealer's assessment of the relevant risks, including risks involved in the types of accounts and methods of opening accounts, types of identifying information available, and a broker-dealer's size, location, and customer base. The rule permits the use of documentary or non-documentary methods, or a combination of both, to verify a customer's identity.¹⁰

The staff observed broker-dealers whose CIPs appeared not to be properly designed to enable the firm to form a reasonable belief that it knows the true identity of customers. For example, the staff observed registrants that did not:

- Perform any CIP procedures as to investors in a private placement, where customer relationships established with the registrant to effect securities transactions appeared to be formal relationships for purposes of the CIP Rule.¹¹
- Collect customers' dates of birth, identification numbers, or addresses, or permitted accounts to be opened by individuals providing only a P.O. box address.
- Verify the identity of customers, including instances in which the firms' files indicated that verification was complete but required information was missing, incomplete, or invalid.
- Use exception reports to alert the firm when a customer's identity is not adequately verified in accordance with the CIP Rule, even though such use would be appropriate given the size and nature of the firm's business.

¹⁰ 31 C.F.R. § 1023.220(a)(ii). Particularly when accounts are opened by electronic means, the use of a combination of documentary and non-documentary methods may help address risks related to the use of stolen or synthetic identities to attempt to open an account. *See* "FINRA Reminds Firms to Beware of Fraud During the Coronavirus (COVID-19) Pandemic," [Reg. Notice 20-13](#) (May 5, 2020).

¹¹ 31 C.F.R. § 1023.100(a)(1) and (d)(1); *see also* Joint Final Rule: Customer Identification Programs for Broker-Dealers, Exchange Act Release No. 47752 (Apr. 29, 2003), 68 Fed. Reg. 25113, 25115 (May 9, 2003) (indicating that the definition of "account" can include transactions in which the broker-dealer's role is limited); *but see* 31 C.F.R. § 1023.100(a)(2), (d)(2) (exclusions from the definitions of "account" and "customer").

- Accurately document aspects of a firm’s CIP regarding the firm’s review of alerts generated by third-party vendors to monitor for missing, inconsistent, or inaccurate information.
- Follow procedures of their own CIP, which included: reviewing and documenting the resolution of discrepancies in customer information and conducting searches through third-party vendors.

III. Customer Due Diligence and Beneficial Ownership Requirements¹²

Adopted in 2016, the CDD Rule requires a broker-dealer’s AML program to contain written procedures that are reasonably designed to identify and verify the identity of beneficial owners of legal entity customers, as that term is defined in the rule.¹³ The procedures should enable a broker-dealer to identify the beneficial owners—generally, up to four individuals directly or indirectly owning 25% or more of the equity interests of the legal entity and also a single individual with significant responsibility to control, manage, or direct the legal entity—of each of its legal entity customers at the time a new account is opened. A broker-dealer may comply with this requirement by using the [FinCEN certification form](#) in the appendix to the rule or by collecting the information required by the form (names, addresses, dates of birth, and Social Security Numbers) by other means.

A broker-dealer must use risk-based procedures, to the extent reasonable and practicable, to verify the identities of each beneficial owner. These procedures must, at a minimum, contain the elements required for verifying the identity of customers who are individuals under the CIP Rule. The CDD Rule also has a recordkeeping component, which requires a broker-dealer to establish procedures for creating and maintaining a record of all information obtained under its CDD procedures, including descriptions of documents relied on for identity verification and non-documentary methods used, and the resolution of substantive discrepancies in the verification.

At the same time that FinCEN adopted the CDD Rule, it also amended the AML Program Rule to explicitly include risk-based procedures for conducting ongoing customer due diligence, to include understanding the nature and purpose of customer relationships for the purpose of developing a “customer risk profile”—that is, “information gathered about a customer to develop

¹² As discussed above, pursuant to the AMLA and the Corporate Transparency Act, the requirements of 31 C.F.R. § 1010.230 may change.

¹³ CDD Adopting Release, *supra* note 3. Subject to conditions set forth in the rule, a firm may rely on another financial institution to perform the requirements of the rule. 31 C.F.R. § 1010.230(j). Firms are encouraged to review the rule and release for definitions of key terms (such as “legal entity customer”), as well as exemptions from the rule. For further information, see FinCEN resources on the CDD Rule, available at: <https://www.fincen.gov/resources/statutes-and-regulations/cdd-final-rule>.

the baseline against which customer activity is assessed for suspicious transaction reporting.”¹⁴ The ongoing nature of customer due diligence refers to the expectation that firms “conduct[] ongoing monitoring to identify and report suspicious transactions and, on a risk basis, to maintain and update customer information.”¹⁵

The staff observed broker-dealers that had not updated their AML programs and, as appropriate, new account forms and procedures to account for the adoption of the CDD Rule. In addition, the staff observed:

- Procedures that, in violation of the CDD Rule, permitted an entity to be listed as a beneficial owner without a corresponding requirement to obtain adequate information about beneficial owners of the entity.¹⁶
- The opening of new accounts for legal entity customers without identifying all of the legal entity’s beneficial owners, including where no beneficial ownership information was obtained, required information was missing, or no control person was identified.
- Relatedly, some firms did not obtain documentation necessary to verify the identity of beneficial owners of legal entity customers, including by accepting expired government-issued identification, or otherwise did not perform such verification, or did not document the resolution of discrepancies noted by firm personnel or a firm’s third-party identity verification vendor.
- Failure to follow internal procedures that required obtaining information about certain underlying parties acting through omnibus accounts.¹⁷

¹⁴ 81 Fed. Reg. at 29422. Note, however, that FinCEN did not expect “the customer risk profile to necessarily be integrated into existing monitoring systems”; instead FinCEN expected firms “to utilize the customer risk profile as necessary or appropriate . . . to determine whether a particular transaction is suspicious.” *Id.*

¹⁵ *Id.* at 29399.

¹⁶ *See id.* (noting that, for FinCEN, one of the key elements of CDD is “identifying and verifying the identity of beneficial owners of legal entity customers (*i.e.*, the natural persons who own or control legal entities)”); *see also* 31 C.F.R. § 1010.230(d).

¹⁷ While the CDD Rule does not require broker-dealers to collect information regarding the underlying transacting parties in an omnibus account of another financial institution opened at the broker-dealer, broker-dealers may determine that certain financial institutions present higher risk profiles and, accordingly, collect additional information to better understand the customer relationships. FinCEN, “Frequently Asked Questions Regarding [CDD] Requirements for Covered Financial Institutions,” [FIN-2020-G002](#) (Aug. 3, 2020).

Conclusion

In sharing the information in this Risk Alert, EXAMS encourages registrants to review and strengthen the policies, procedures, and internal controls of their AML programs to further their compliance with federal AML rules and regulations, and to monitor for amendments, pursuant to the AMLA and the Corporate Transparency Act, to the rules implementing the BSA. FinCEN provides updates on its implementation of the AMLA and the Corporate Transparency Act at: <https://www.fincen.gov/anti-money-laundering-act-2020>.

Additional resources on the topics discussed herein can be found in EXAMS' online research guide, or "source tool," that contains compilations of key AML laws, rules, orders, and guidance applicable to broker-dealers: AML Source Tool for Broker-Dealers, <https://www.sec.gov/about/offices/ocie/amlsourcetool.htm>.

This Risk Alert is intended to highlight for firms risks and issues that EXAMS staff has identified. In addition, this Risk Alert describes risks that firms may consider to (i) assess their supervisory, compliance, and/or other risk management systems related to these risks, and (ii) make any changes, as may be appropriate, to address or strengthen such systems. Other risks besides those described in this Risk Alert may be appropriate to consider, and some issues discussed in this Risk Alert may not be relevant to a particular firm's business. The adequacy of supervisory, compliance and other risk management systems can be determined only with reference to the profile of each specific firm and other facts and circumstances.
