The SEC's New Enforcement Tool?

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It appears that the U.S. Securities and Exchange Commission is beginning to use a new weapon against broker-dealers and other financial institutions. In SEC v. Alpine Securities Corp., the SEC filed suit against a broker-dealer, alleging that it "routinely and systematically" violated the Bank Secrecy Act by failing to file suspicious activity reports for stock transactions it had flagged as suspicious, and by filing SARs that omitted critical information, such as the customer's history of criminal or regulatory violations or connections to foreign institutions. As discussed below, certain financial institutions are required to file a SAR to report transactions or patterns of transactions involving at least $5,000 where the filer "knows, suspects, or has reason to suspect" that the transaction involves funds representing ill-gotten gains, is intended to hide funds from illegal activities, is designed to evade the BSA, or has no business or apparent lawful purpose.

The SEC alleges that the broker-dealer violated Section 17(a) of the Securities Exchange Act of 1934 (the Exchange Act in Section 10(b) generally prohibits fraud and misrepresentations in the sale of securities), and Rule 17a-8 thereunder, which specifically requires broker-dealers to comply with the record-keeping, retention and reporting obligations of the BSA. Although the broker-dealer had an anti-money laundering compliance program (as required for broker-dealers by both the BSA and FINRA Rule 3310), the complaint alleges that the defendant did not properly implement the program, and that required SARs either were deficient or were not filed at all, despite an earlier warning from the Financial Industry Regulatory Authority.

Under the BSA, broker-dealers and mutual funds must establish and implement written AML and customer-identification programs, file SARs with the Financial Crimes Enforcement Network, and comply with other filing, due diligence and record-keeping requirements. And the already broad reach of the BSA is expanding. In September 2015, FinCEN published a proposed rule that is expected to become a new regulation. It would require SEC-registered investment advisers to establish AML programs, file SARs, and comply with other filing and record-keeping requirements under the BSA.

Violations of the BSA can represent both civil and criminal offenses. However, historically, AML and BSA enforcement has been pursued solely by the U.S. Department of Justice, FinCEN, federal bank examiners, the FBI and the IRS. These agencies have extracted high-profile

AML/BSA settlements from banks and other financial institutions. This recent action suggests that the SEC is increasingly going to use this tool and bring BSA/AML cases against entities that have not typically faced this type of scrutiny.

This most recent complaint filed by the SEC is not an isolated event, but rather appears to be part of a trend. Earlier this year, the SEC charged another broker-dealer with failing to file SARs. These enforcement actions — and others — are consistent with the public pronouncements of the former SEC enforcement director, who has stated that the SEC Broker-Dealer Task Force must "pursue stand-alone BSA violations to send a clear message about the need for compliance."

Akin to the SEC's now-established role in pursuing alleged violations of the Foreign Corrupt Practices Act, another statute that historically had been the province of other enforcement agencies, the SEC has confirmed its desire to stake its own claim in AML/BSA enforcement.

Reducing Risk of an SEC AML Investigation

The securities industry must anticipate and prepare for this emerging trend. As the SEC's recent actions reflect, a solid AML compliance plan is a must for any company covered by the BSA. Even more important is the effective real-world implementation of such a plan. Conversely, an AML program with systemic failures will be a bull's-eye for regulators.

AML programs with systemic problems in either their formulation or implementation are usually characterized by: (1) issues continuing unabated for substantial periods of time (particularly after prior warnings from the regulator); (2) red flags being consistently ignored; (3) substantial customer harm; and/or (4) access to the financial institution by bad actors. There is no magic formula for creating an AML compliance plan that is immune to criticism. But to minimize risk, financial institutions should focus on establishing a compliance program with a good process.

There are six general areas to emphasize in creating a good AML process:

The first area is creating a culture of compliance. This involves drafting a formal written BSA/AML process, training your employees on this process, and ensuring that your employees follow the process in a disciplined and nonarbitrary fashion. This will help guarantee that employees do not handle unique circumstances in an ad hoc manner or make exceptions that allow problems to slip through the cracks. A culture of AML compliance starts at the top.

The second area involves understanding specific risks to your business. A good AML process is built to specifically respond to the challenges facing that institution. Some specific risks to evaluate include assessing whether the institution has a stable local customer base or a short-term international customer base, the institution faces specific geographic risks like handling clients located in an area known for money laundering or for the prevalence of other financial crimes, and whether the financial institution deals with high-risk financial instruments such as digital currency or penny stocks.

The third area involves creating a sound process for detecting red flags. Federal regulators want to see a system that spots transactions designed to evade the requirements of the BSA; designed

to hide or disguise funds or other assets derived from illegal activity; different from the sort usually engaged in by the customer (e.g., transactions involving unusually large amounts of money, unusual international wire transfers, etc.); and that have no apparent business or lawful purpose. A key issue in recent AML regulatory and enforcement efforts has been the identification of the true "beneficial owners" — i.e., those with true ownership or control — behind entities conducting financial transactions. Accordingly, red flags suggesting efforts to obscure beneficial ownership should be treated with particular caution.

The fourth area concerns creating processes to assist law enforcement in detecting and investigating crimes. This involves drafting SARs that are timely, have thorough documentation and accurate detail, are filed with FinCEN, and maintained as required. The need to file adequate SARs cannot be understated. Because SAR filings are the primary engine of AML/BSA enforcement, enforcement actions often rest on the alleged failure to file sufficient SARs. This allegation is at the heart of the Alpine complaint.

The fifth area involves protecting SAR information. For law enforcement to effectively use data from financial institutions, the data cannot be widely disseminated. Moreover, disclosure of protected SAR information can be a criminal offense. A good AML process involves setting up a system where access to SAR information is limited only to the people who need to know it. This may mean creating a physical space with access limited only to those who work with SAR information, or setting up a separate computer network that is walled off from the financial institution’s other IT systems.

Finally, a good AML process involves self-auditing. Financial institutions should have a procedure in place to review the efficacy of their AML process. This means that firms using electronic monitoring to detect red flags should analyze whether those electronic systems are adequately detecting suspicious conduct.

While a financial institution with a good BSA/AML process may not detect every unlawful transaction, having a process that sufficiently addresses these areas will minimize the risk of an SEC examination turning into an investigation and enforcement action, and will maximize the institution's ability to defend against any enforcement action.

Clarification and update: This article has been updated to clarify which section of the Securities Exchange Act of 1934 prohibits fraud and misrepresentations in the sale of securities.