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NASD OFFICE OF HEARING OFFICERS

DEPARTMENT OF ENFORCEMENT, Complainant, v. Respondent.	Disciplinary Proceeding No. E0120040071-01 Hearing Officer – DMF **HEARING PANEL DECISION** August 3, 2006

Respondent violated NASD Rules 3011 and 2110 and MSRB Rule G-41 by failing to develop and implement a written anti-money laundering (AML) program reasonably designed to achieve and monitor compliance with applicable AML laws, rules and regulations. For this violation, Respondent is fined $2,500 and ordered to retain an independent consultant to review its AML program and its implementation of that program. Respondent is also assessed costs.

Appearances

Jacqueline D. Whelan, Esq., San Francisco, CA and Heather Hawker, Esq., Denver, CO (Rory C. Flynn, Esq., Washington, DC and Mark Dauer, New Orleans, LA, Of Counsel) for Complainant.

Irving M. Einhorn, Esq., Manhattan Beach, CA, for Respondent.

DECISION

I. Procedural History

The Department of Enforcement filed a Complaint on February 8, 2006, charging that Respondent violated NASD Rules 3011 and 2110 and MSRB Rule G-41 by failing to develop and implement a written anti-money laundering (AML) program reasonably designed to achieve and monitor compliance with applicable AML laws, rules and regulations.

Respondent filed an Answer contesting the charges on March 7, 2006, and requested a hearing, which was held before a Hearing Panel in San Francisco, CA on June 22, 2006.

II. Facts

1. Respondent

Respondent has been a member of NASD since 1987. It is a small firm, consisting of DR, the firm's president and sole owner; three registered representatives; an operations manager, who serves as the firm's second registered principal; and, sometimes, a second, subordinate operations person. Neither the firm nor DR has any prior disciplinary history. (CX 1; Tr. 105; Stip. 1.)[1]

2. AML Requirements

The PATRIOT Act became law on October 26, 2001.[2] Title III of the USA PATRIOT Act, referred to as the International Money Laundering Abatement and Anti-Terrorist Financing Act of 2001, imposes obligations on broker/dealers and other financial institutions under new anti-money laundering (AML) provisions and amendments to the existing Bank Secrecy Act (BSA) requirements.[3]

Among other things, all financial institutions, including broker/dealers, were required to establish and implement, by April 24, 2002, AML programs designed to achieve compliance with the BSA and the regulations promulgated thereunder. In February 2002, NASD proposed Rule 3011 to prescribe the minimum standards for each

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[1] In this decision, Complainant's exhibits are cited as "CX," Respondent's exhibits are cited as "RX," the hearing transcript is cited as "Tr." and the stipulations of the parties are cited as "Stip."

[2] Uniting and Strengthening America by Providing Appropriate Tools Required to Intercept and Obstruct Terrorism Act of 2001, Pub. L. No. 107-56, 115 Stat. 272 (2001).

[3] 31 U.S.C. §§ 5311, *et seq.*

NASD member's AML program. The rule became effective on April 24, 2002 and was amended effective October 22, 2002.[4] Rule 3011 required each member to develop and implement a written AML program by April 24, 2002. In its AML program, the member was required, at a minimum, to:

> (a) Establish and implement policies and procedures that can be reasonably expected to detect and cause the reporting of transactions required under 31 U.S.C. 5318(g) and the implementing regulations thereunder;
>
> (b) Establish and implement policies, procedures, and internal controls reasonably designed to achieve compliance with the Bank Secrecy Act and the implementing regulations thereunder;
>
> (c) Provide for annual independent testing for compliance to be conducted by member personnel or by a qualified outside party;
>
> (d) Designate, and identify to NASD (by name, title, mailing address, e-mail address, telephone number, and facsimile number) an individual or individuals responsible for implementing and monitoring the day-to-day operations and internal controls of the program and provide prompt notification to NASD regarding any change in such designation(s); and
>
> (e) Provide ongoing training for appropriate personnel.[5]

In addition to issuing Rule 3011, NASD provided a variety of information and assistance to members in fulfilling their AML obligations, including a number of Notices to Members and several call-in workshops offered by NASD staff in April, May and November 2002. Most significantly, for purposes of this proceeding, NASD created a Small Firm Template to assist members in creating their required written AML program. (CX 2-4, 21-23; Tr. 29-33.)

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[4] Rule 3011 was amended again effective March 6, 2006, after the period at issue in this proceeding.

[5] The Municipal Securities Rulemaking Board (MSRB) adopted a similar rule, MSRB Rule G-41, which requires municipal securities dealers to establish and implement AML programs. For municipal securities dealers that are members of NASD, such as Respondent, Rule G-41 provides that an AML program that complies with NASD Rule 3011 will be deemed to comply with Rule G-41.

In May 2003, the Treasury Department and the SEC jointly issued 31 C.F.R. §103.122, in accordance with Section 326 of the PATRIOT Act, which directed them to adopt

> a regulation that, at a minimum, requires brokers or dealers to implement reasonable procedures to verify the identity of any person seeking to open an account, to the extent reasonable and practicable; to maintain records of the information used to verify the person's identity; and to determine whether the person appears on any lists of known or suspected terrorists or terrorist organizations provided to brokers or dealers by any government agency.

68 Fed. Reg. 25113 (May 9, 2003). Under the regulation, every broker/dealer was required to establish and implement by October 1, 2003, a Customer Identification Program (CIP) "appropriate for its size and business."

> The CIP must include risk-based procedures for verifying the identity of each customer to the extent reasonable and practicable. The procedures must enable the broker-dealer to form a reasonable belief that it knows the true identity of each customer. The procedures must be based on the broker-dealer's assessment of the relevant risks, including those presented by the various types of accounts maintained by the broker-dealer, the various methods of opening accounts provided by the broker-dealer, the various types of identifying information available and the broker-dealer's size, location and customer base.

Further, "[t]he CIP must contain procedures for opening an account that specify identifying information that will be obtained from each customer." And "[t]he CIP must include procedures for making and maintaining a record of all information obtained" in verifying the customer's identity. The regulation requires that the broker/dealer's CIP be a part of its overall AML program. In June 2003, NASD issued Notice to Members 03-34 explaining member firms' CIP obligations in detail.

3. Origins of This Proceeding

In 2002, NASD staff conducted a routine examination of Respondent. During the examination, they discovered that the firm had no written AML program, as required by Rule 3011, beyond a brief mention of "money laundering" in its written supervisory procedures. The staff noted this deficiency in a letter of caution to the firm after the examination, and in response to the letter Respondent submitted a written AML program based upon NASD's Small Firm Template. The staff accepted Respondent's submission as an adequate response to the letter of caution, but did not review Respondent's program in detail to determine whether it satisfied all the requirements of Rule 3011, leaving that task for the next scheduled examination. The staff did not advise Respondent that it had not reviewed its AML program in detail. (Tr. 22, 33-36, 49-54.)

NASD's next routine examination of Respondent was in 2004. During this examination, NASD staff carefully reviewed Respondent's AML program, and concluded that both Respondent's written plan and its implementation of the plan were deficient in certain respects. In light of the prior letter of caution, the staff treated the deficiencies as a second violation and referred the matter to NASD's Department of Enforcement for action. This proceeding followed. (CX 20; Tr. 23-29, 45-46.)

4. Alleged Deficiencies in Respondent's AML Program

Enforcement alleged two deficiencies in Respondent's written AML program. First, Enforcement alleged that the procedures for detecting and reporting suspicious activities are deficient. Respondent's procedures incorporate general language derived from the Small Firm Template, reciting that the firm "will manually monitor a sufficient amount of account activity to permit identification of patterns of unusual size, volume,

pattern or type of transactions, geographic factors such as whether jurisdictions designated as 'non-cooperative' are involved, or any of the 'red flags' identified in [the written procedures]." The written procedures also indicate that the firm "will look at transactions, including trading and wire transfers, in the context of other account activity to determine if a transaction lacks financial sense or is suspicious because it is an unusual transaction or strategy for that customer." And the procedures designate the firm's AML Compliance Officer, DR, to carry out the monitoring, to document when and how it is carried out, and to report suspicious transactions to appropriate officials. (CX 5; Stip. 2.)

As Enforcement points out, however, while these generalities are appropriate, the firm's procedures fail to include any specifics. The Small Firm Template, after setting forth the general provisions adopted by Respondent, continues: "Our monitoring of specific transactions includes: [describe.]" (CX 4 at 17.) Respondent's procedures, however, omit this language and include no specific description of how Respondent will monitor transactions. They do not indicate which transactions will be monitored – for example, whether all transactions will be reviewed or only a random sample chosen by some specific method – or how the review will be conducted and documented. (CX 5 at 12.)

Second, Enforcement alleged that the provisions for independent testing in Respondent's AML program are also deficient. At the relevant time,[6] Rule 3011 required that each member's program include "an independent testing function to review and assess the adequacy of and level of compliance with the firm's AML compliance program." (CX 2 at 17.) Respondent's written procedures include a testing program, but

[6] In March 2006, the independent testing provision of the rule was amended in certain respects not relevant to this proceeding.

those provisions merely indicate that testing will be done by non-management personnel of the firm whose qualifications are described simply as "years of experiences [sic], knowledge, and industry background." Moreover, although the AML procedures provide that independent testing "will be completed at least annually," they do not describe what that testing will include. (CX 5 at 19.)

5. Alleged Deficiencies in Respondent's Implementation of Its AML Program

Enforcement also alleged that Respondent's implementation of its written AML program was deficient in two respects. First, the independent testing in 2003 consisted of a subordinate operations employee interviewing DR, who is Respondent's AML Compliance Officer. The employee asked DR a series of questions about Respondent's AML procedures, and wrote down his answers, but there is no indication that the employee conducted any tests to determine whether Respondent was actually following its written procedures. And in 2004, the firm did not conduct an independent audit of any kind, because DR concluded that none of Respondent's employees was sufficiently independent and qualified. (CX 7; Tr. 29, 120-21; Stip. 5-8.)

Second, Enforcement charged that Respondent failed to implement the CIP portion of its AML program, because it did not confirm the identity of persons who opened new accounts as set forth in its written procedures. The testimony and evidence at the hearing and the arguments of the parties focused primarily on this charge.

Respondent's AML procedures state: "Based on the risk, and to the extent reasonable and practicable, we will ensure that we have a reasonable belief that we know the true identity of our customers by using risk-based procedures to verify and document the accuracy of the information we get about our customers." The procedures provide

that the firm "will verify customer identity through documentary evidence, non-documentary evidence, or both." Documents are to be used "when appropriate documents are available," and may include "[a]n unexpired driver's license, passport, or other government identification …." According to the procedures, "use of non-documentary evidence [to verify customer identification] is mandatory" if the customer cannot provide an appropriate identification card; or when the documents presented by the customer are unfamiliar to the firm; or when the customer and the firm do not have face-to-face contact; or "when there are other circumstances that increase the risk that the firm will be unable to verify the true identity of the customer through documentary means." The firm's AML plan states that the firm "will use the following non-documentary methods of verifying identity:

- Contact the customer after the account has been opened (although we cannot rely solely on customer contact as a means of verification);
- Obtain financial statements from the customer;
- Compare information obtained from the customer against databases, such as Equifax, Experion, Lexis/Nexis, or other in-house or custom databases;
- Compare information obtained from customer with information available from a trusted third-party source (such as a credit report);
- Check references with other financial institutions; and
- Any other non-documentary means deemed appropriate."

Respondent opens only about six to 10 new accounts per year; during the period between the 2002 and 2004 examinations it opened accounts for only a total of 12 new

customers. Respondent did not obtain documentary evidence to verify the identity of any of these customers; instead, it relied on various types of non-documentary information.

Specifically, during the period in question, one of Respondent's registered representatives, VS, opened six new accounts. According to his testimony at the hearing, he verified new customer DO's identity based on DO being the son of a man with whom VS had worked for many years and his having been a customer of VS at a prior firm. He was uncertain how he had verified the identities of new customers JB and PB, but noted that one of them was quite elderly, according to her birth date on the new account form, and that no transactions had ever been effected in the account. He verified the identity of new customer HO based on her being the daughter of a friend and customer and having known her for many years. He verified the identity of new customers JB and DB based on knowing members of their family. He verified new customer PM's identity based on PM's claim that he had been referred by a woman who VS did not know, but who, according to PM, was acquainted with one of VS's customers (VS did not confirm this with the customer). In addition, he relied on the fact that the funds to open PM's account were transferred from Fidelity, which, he assumed, had verified PM's identity. And he verified the identity of new customer LR based upon having been acquainted with him for 30 years. He did not record any of this information on the customers' new account forms. (CX 8-10, 14, 17, 18; Tr. 83-90; Stip. 9, 11-16, 23-24, 29-32.)

Another of Respondent's registered representatives, HS, opened five new accounts during the period. At the hearing, he testified that he verified the identity of new customer ES based on her being the secretary of a friend and customer. He verified the identity of new customer CL based on her being a co-worker of another customer. He

verified the identity of new customer ML based on her being the sister of another customer. He verified the identity of new customers C&CD based on one of them being the brother of another customer. And he verified the identity of new customer BH based on BH being the son of a long-time friend and customer.[7] Like VS, he did not record any of this information on the customers' new account forms. (CX 11-13, 15, 16; Tr. 62-66; Stip. 10, 17-22, 25-28.)

Finally, DR opened one new account during the period. He testified that he verified the identity of new customer PC based on having known him for more than 50 years. DR also failed to note this information on the new account form. (CX 19; Tr. 134-35; Stip 33-34.)

III. Discussion

Respondent is a small broker/dealer. It does not solicit new customer accounts and rarely opens them, and it typically executes only a total of three or four trades a day for its customers. (Tr. 155.) Nevertheless, like all other broker/dealers and other financial institutions, Respondent must have and implement a written AML program, as required by the PATRIOT Act, the rules and regulations issued pursuant to the Act, NASD Rule 3011 and MSRB Rule G-41. While the Act and the various rules and regulations afford each broker/dealer flexibility to establish a program that is appropriate for its particular business, the program must be reasonably designed to achieve and monitor compliance with applicable AML laws, rules and regulations, and the program must be implemented as written.

One important aspect of an effective AML program is the identification of suspicious transactions. As explained above, Respondent's written AML procedures

[7] HS has never actually met customers CL, ML or C&CD. (Tr. 69-70.)

provide that, in general, Respondent will manually review transactions for suspicious activity, but they contain no specific guidance concerning which transactions will be reviewed or how the review will be documented. DR testified that in his capacity as Respondent's president his practice is to review all transactions, and in conducting his review he is alert for any suspicious activity, but that practice is not set forth in Respondent's AML program, and the program does not indicate how the review will be conducted or documented.

DR argued that, in fact, he did review all transactions for suspicious activity, and "there wasn't much more that I could think of that I could be doing." (Tr. 119.) He acknowledged that the firm's procedures did not include any detailed description of this review, but argued that was a virtue: "If I tell my compatriots, exactly as you would have me do, A, B, C, D, 'This is how I avoid fraud or money laundering,' or whatever it's going to be, then I could be a victim of that." (Tr. 173.) Nothing in Rule 3011 or the other AML laws or regulations, however, requires that Respondent share its AML procedures with the firm's employees who are not responsible for AML compliance, or with its customers. They do, however, require that the firm have and follow specific procedures, and Respondent is not entitled to override those laws and regulations.

Another important and required element of a firm's written AML program is a plan for periodic review and assessment of the program and its implementation. Once again, Respondent's written program includes a general provision calling for an annual independent review, but no details. The program states that "non-management" staff will conduct the review, but simply indicates that the reviewer's qualifications for reviewing an AML program will include years of experience, knowledge and industry background,

without further detail. Moreover the program does not describe the substance of the testing at all.

The weaknesses in this aspect of the plan carried over to its implementation. Respondent selected the subordinate operations employee to conduct the 2003 test because he had no responsibility for implementing Respondent's AML procedures, but there is nothing to indicate that he had any training or experience that would qualify him to conduct an effective review of the program. In fact, he merely interviewed DR, asking written questions that appear to have been prepared by DR and recording DR's answers. The questions and answers provided a description of Respondent's AML procedures, but there was no "testing for compliance" with those procedures, as required by Rule 3011.

As previously noted, most of the hearing focused on Respondent's implementation of its procedures for verifying customer identity. As explained above, the PATRIOT Act and Treasury/SEC rules require, as a matter of national policy, that every broker/dealer, including Respondent, establish <u>and implement</u> a CIP as part of its AML procedures. Respondent had a detailed CIP, but did not follow it. Instead, Respondent followed an <u>ad hoc</u> practice, relying on a wide variety of circumstances not set forth in its written CIP to verify its customers' identities. Moreover, Respondent kept no records reflecting how it had verified the customers' identities.

Respondent argued that its "know your customer" approach was actually superior to requiring customers to offer documentary proof of their identity. As Enforcement points out, however, in issuing the final CIP rule, Treasury and the SEC specifically addressed and rejected comments on the draft rule that suggested "long-time acquaintances need not be verified," explaining that "we believe it would be

inappropriate to provide special treatment for such customers. The rule is sufficiently flexible to make their verification as unobtrusive as possible." 68 Fed. Reg. at 25114, 25119.

Respondent also argued that merely requiring a customer to provide a driver's license to confirm his or her identity would be meaningless, because it is not difficult to obtain a falsified license. But the CIP rule does not authorize broker/dealers to rely blindly on drivers' licenses or any other type of documentation; rather, it requires firms to verify the identity of any person seeking to open an account, to the extent reasonable and practicable. Respondent's own plan, in keeping with the rule, provides: "In light of the increased instances of identify fraud, we will supplement the use of documentary evidence by using the non-documentary means described below whenever possible. We may also use such non-documentary means, after using documentary evidence, if we are still uncertain about whether we know the true identity of the customer." (CX 5 at 5.)

But Respondent did not follow its own plan. It did not obtain documentary evidence of any sort from any of the customers who opened accounts during the period in question. And it did not utilize any of the specific non-documentary means for verifying identity set forth in its plan. Instead, it relied on a variety of informal and unrecorded verification methods not set out in the plan. As HS testified: "That's how we've done things, you know. I'd bring an account in, and [DR] would ask me, 'Well, how do you know this person,' you know, and I'd tell him." (Tr. 75.) Yet, as described above, in several instances the registered representative who opened the account did not know the customer. Because it did not follow its own plan, Respondent's verification of customer identities was inconsistent, undocumented and unreliable.

The Panel concludes, therefore, that Respondent failed to establish and implement an AML program as required by Rule 3011 and MSRB Rule G-41. It is well established that a violation of any specific NASD rule, such as Rule 3011, is also a violation of Rule 2110.

IV. Sanctions

There are no Sanction Guidelines for AML violations. Based upon its assessment of the relevant general Principal Considerations set forth in the Guidelines, Enforcement recommends that Respondent be fined $10,000.

Respondent is a small firm that, during the relevant period, added only a few new customers and effected relatively few transactions on behalf of all its customers. There is no allegation or evidence that Respondent failed to identify any suspicious transactions by its customers, or that it was deceived as to the identity of any of its customers. The Panel is also aware that, particularly during the period in question, the development and implementation of AML programs presented a challenge for many small member firms such as Respondent. Nevertheless, as explained above, it is important as a matter of national policy that every NASD member have and implement an effective AML program. As explained above, Respondent failed to fulfill this obligation in several respects; moreover, it appears that the deficiencies in Respondent's written program and its implementation of the program have still not been corrected.

The Sanction Guidelines explain that the principal goal of sanctions is "to remediate misconduct by preventing the recurrence of misconduct, improving overall standards in the industry, and protecting the investing public." NASD Sanction Guidelines (2006) at 2. The Panel concludes that a substantial fine alone, as recommended by Enforcement, will not accomplish those goals in this case. Instead, to

prevent recurrence, improve industry standards and protect the public, it is most important to ensure that, going forward, Respondent's AML procedures and its implementation of those procedures fulfill the national goals embodied in the PATRIOT Act and its implementing regulations. Therefore, the Hearing Panel finds that the appropriate remedial sanctions in this case are a smaller fine than Enforcement recommends, coupled with a requirement that Respondent retain a consultant to review Respondent's written AML program and its implementation of the program, and make whatever recommendations may be required to ensure that both the program and its implementation comply with Rule 3011.

V. Conclusion

Respondent violated NASD Rules 3011 and 2110 and MSRB Rule G-41 by failing to develop and implement a written anti-money laundering (AML) program reasonably designed to achieve and monitor compliance with applicable AML laws, rules and regulations. For this violation, Respondent is fined $2,500. In addition, within 75 days of this decision becoming NASD's final disciplinary action Respondent shall retain an independent consultant with experience in designing and evaluating broker/dealer AML procedures, who shall be approved by NASD District 1 staff, to conduct a prompt review of Respondent's written AML program and its implementation of that program, including but not limited to those deficiencies found in this proceeding. Upon completion of the consultant's review, Respondent shall submit to District 1 a report setting forth the consultant's findings and recommendations, and Respondent's actions to implement those recommendations.

Finally, Respondent is ordered to pay costs in the amount of $2,254.75, which includes an administrative fee of $750 plus the costs of the hearing transcript. These sanctions shall be effective on a date set by NASD, but not sooner than 30 days after this decision becomes NASD's final disciplinary action in this proceeding.[8]

HEARING PANEL

By: David M. FitzGerald
Hearing Officer

[8] The Hearing Panel has considered and rejects without discussion all other arguments of the parties.