

5th Pillar Of AML Compliance Is Here, But Questions Remain

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Today, May 11, marks the long-awaited compliance deadline for the Financial Crimes Enforcement Network’s customer due diligence rule, the so-called “fifth pillar”^[1] of Bank Secrecy Act/anti-money laundering programs. The CDD rule aims to clarify and strengthen customer due diligence by requiring firms to develop customer risk profiles and to collect and verify beneficial-ownership information for legal-entity customers.

The rule applies to covered financial institutions, including broker-dealers, banks, mutual funds and futures commission merchants. Of note to broker-dealers is the Financial Industry Regulatory Authority’s recent amendment to its rule for anti-money laundering compliance programs, Rule 3310, to conform to the CDD rule’s requirements.^[2] The implementation date of the amendment is today as well.

Since FinCEN finalized the CDD rule two years ago, it has issued an amendment and published two sets of frequently asked questions, which emphasize that several aspects of the rule simply codify current expectations.^[3] Overall, however, the rule aims to help firms identify suspicious activity, particularly activity that is consistent with the attempts of criminals, kleptocrats and other nefarious actors to hide gains.

Knowns and Unknowns

While FinCEN has clarified numerous technical questions in its FAQs, certain interpretive issues remain, such as the handling of customers in pooled investment vehicles. Time will tell how financial institutions proceed with their risk-based approaches and whether those approaches are more conservative than what the rule requires. For example, many financial institutions already use an ownership threshold of

10 percent for riskier customers, rather than the required 25 percent. Over time, the availability and value of data analytics and artificial intelligence technology are likely to inform changes to firms' approaches.

Effective CDD Is Critical to Preventing Illicit Financial Activity

The process steps for effective customer due diligence are:[4]



Requirements of FINRA's Amended Rule 3310

On May 3, 2018, FINRA filed for an amendment to Rule 3310 to conform to FinCEN's CDD rule. For FINRA member firms, Rule 3310 now requires that AML programs must, "at a minimum, include appropriate risk-based procedures for conducting ongoing customer due diligence." [5] Specifically, firms are required to:

- Understand "the nature and purpose of customer relationships for the purpose of developing a customer risk profile";[6]
- Conduct monitoring on an ongoing basis to "identify and report suspicious transactions" and "to maintain and update customer information," including "information regarding the beneficial owners of legal-entity customers (as defined in 31 CFR 1010.230(e))."[7]

Developing Customer Risk Profiles

Firms must understand the "nature and purpose of customer relationships" and establish a "baseline" to assess suspicious activity (i.e., a customer risk profile).[8] Customer risk profiles should include:

- The activity history of existing customers;[9]
- A determination of whether flagged transactions are suspicious (although firms are not "necessarily required" to make profiles part of their transaction monitoring systems).[10]

According to its stated exam priorities, the U.S. Securities and Exchange Commission will also assess whether firms are taking "reasonable steps to understand the nature and purpose of customer relationships." [11]

Updating Customer Risk Profile Based on Monitoring

Firms must maintain and update customer information, including beneficial-ownership information. While they do not need to update customer information on a continuous basis, they must update information if suspicious-activity monitoring reveals “information that is relevant to assessing the customer’s risk profile.”[12]

Much of this provision codifies existing supervisory and regulatory expectations. In addition, Rule 3310 has long required broker-dealers to establish and implement policies and procedures reasonably designed to detect (and prompt reporting of) suspicious activity. Maintaining accurate customer risk profile information is necessary for such monitoring.[13]

Exam and Enforcement Priority

AML compliance remains a focus of securities regulators and is one of FINRA’s 2018 regulatory and examination priorities.[14] FINRA has stated that member firms should ensure their AML programs are updated, as necessary, to comply with the CDD rule. FINRA expects customer information procedures to be in place and able to describe how the results of suspicious activity monitoring affect customer information.[15]

Identifying and Verifying Beneficial Ownership

Firms must maintain written procedures for identifying and verifying the beneficial owners of legal-entity customers. Firms must identify: (1) individuals who directly or indirectly own 25 percent or more of the legal entity, and (2) one “control” owner,[16] or a senior individual with access to day-to-day information about the entity (e.g., a C-suite executive).

The following guidelines and scenarios also apply:

- Collection should be on a going-forward basis, unless monitoring suggests that a reassessment of customer risk is necessary.
- If customers open multiple accounts with the same institution, the institution may rely on previously provided beneficial-ownership information if the customer certifies or confirms (verbally or in writing) that the information is up-to-date and accurate at the opening of each subsequent account and the institution has no data to suggest otherwise.[17]
- Certain requirements, particularly those related to customers of securities firms, remain unclear. Implementation approaches may ultimately depend on the risk appetite of each firm.

Suggestions for Securities Firms

The broad reach of the CDD rule, its amendment and some lingering interpretive issues have made it difficult for firms to operationalize the rule’s requirements while ensuring full compliance. Many continue to struggle with implementation and are likely to look to industrywide regulatory developments, alerts, guidance and examinations — rather than enforcement actions — for clear, practicable expectations and best practices.

However, even though the deadline for compliance with the CDD rule and the implementation date of FINRA’s Rule 3310 has passed, and even though interpretation of some of the the CDD rule’s requirements remains unclear, there are several steps firms can take to make their AML programs

consistent with the rules. For instance, firms can develop written, risk-based procedures for ongoing due diligence, operationalize processes to develop customer risk profiles, and demonstrate links between customer risk profiles and suspicious activity monitoring. Firms should also consider the new due diligence rules' "minimum" requirements and determine any additional measures to take based on the unique risks they face, and they should confirm the comprehensiveness of AML programs during upcoming audit cycles to assess adequacy before examiner reviews and comply with independent review requirements.

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[1] The other four pillars are: (1) internal controls, (2) independent testing, (3) designation of an anti money laundering compliance officer, and (4) ongoing training. The Financial Industry Regulatory Authority's AML compliance program rule also requires the development of procedures to detect and enable monitoring of suspicious activity.

[2] "Regulatory Notice 18-19," FINRA (May 3, 2018).

[3] The rule was published on May 11, 2016 and amended on Sept. 29, 2017.

[4] "Customer Due Diligence Requirements for Financial Institutions," Financial Crimes Enforcement Network and Department of the Treasury, Federal Register (May 11, 2016).

[5] "Regulatory Notice 18-19," FINRA (May 3, 2018).

[6] Ibid.

[7] Ibid.

[8] "Regulatory Notice 17-40," FINRA (Nov. 21, 2017).

[9] Ibid.

[10] Ibid.

[11] "2018 National Exam Program Examination Priorities," Securities and Exchange Commission (Feb. 7, 2018)

[12] "Regulatory Notice 17-40," FINRA (Nov. 21, 2017).

[13] Ibid.

[14] "2018 Regulatory and Examination Priorities Letter," FINRA, (Jan. 8, 2018).

[15] "Regulatory Notice 18-19," FINRA (May 3, 2018).

[16] "Frequently Asked Questions Regarding Customer Due Diligence Requirements for Financial Institutions," FinCEN (April 3, 2018).

[17] Ibid.