

## FINRA Takes Enforcement Action Against On-Line Broker-Dealer for Failure to Maintain an Adequate Anti-Money Laundering Compliance Program

As part of Daylight's continuing efforts to keep financial institutions informed of regulatory developments relating to anti-money laundering compliance, we are sending you a summary of recent activity by the Financial Industry Regulatory Authority (FINRA).

### I. INTRODUCTION

On October 26, 2009, FINRA announced an enforcement action against Scottrade, Inc. based on its failure to implement an anti-money laundering compliance program ("AML program") reasonably designed to detect, investigate and report suspicious transactions as required by the Bank Secrecy Act (BSA) and NASD rules. Scottrade settled the matter by consenting to FINRA's findings and a fine of \$600,000.<sup>1</sup>

### II. ALLEGED VIOLATIONS OF THE BANK SECRECY ACT AND NASD RULES 2110 and 3011

#### A. Scottrade's Business Model

Scottrade, a registered broker-dealer provides on-line trading capabilities to its customers and between 2003 and 2007 saw its trading volume increase from approximately 49,000 trades per day to approximately 150,000 trades per day. According to the FINRA Order, Scottrade's trading platform exposed it to increased risks of identity theft, account intrusion and the use of customer accounts to launder money.

#### B. Inadequate Policies, Procedures, Controls and Resources

Between April 2003 and January 2005, Scottrade did not have any systematic or automated system designed to detect potentially suspicious transactions. Instead, it used a manual system for monitoring accounts and transactions for suspicious activity that relied on internal personnel to identify and refer such activity to the risk management department for further review. In addition, until June 2004, when Scottrade hired a single risk management analyst, the firm's AML compliance officer and director of risk management was the only individual responsible for investigating referrals of potentially suspicious activity. Compounding the lack of adequate resources, FINRA alleged that Scottrade's AML program failed to provide adequate guidance to any of its employees on how to detect or review accounts or transactions.

While Scottrade finally implemented an automated transaction monitoring system in February 2005, FINRA alleged that the system was inadequate for several reasons. First, virtually of all the system's filters were designed to monitor accounts and transactions only for suspicious money movement in or out of an account. In other words, potentially suspicious activity, such as wash or matched sales within the same account, would not trigger

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<sup>1</sup> Financial Industry Regulatory Authority Letter of Acceptance, Waiver and Consent No. 2007009026302 ("FINRA Order").

an alert. Secondly, while on average, 1,300 alerts were generated monthly, not all alerts were reviewed, and those that were not reviewed were simply archived. Thirdly, while in September 2006, Scottrade implemented a proprietary volume exception report designed to detect "pump-and-dump" account intrusions and unauthorized trading activity resulting from such account intrusions, the firm failed to utilize this report to detect suspicious trading activity by bona fide account holders. Lastly, the firm's AML program failed to provide employees with adequate guidance on the system's capabilities and how alerts should be treated.

### **III. WHAT THIS CASE MEANS FOR BROKER-DEALERS**

#### **A. Importance of a Tailored, Risk-Based AML Program**

FINRA Rule 3011 requires broker-dealers to establish and implement an AML program that complies with the BSA. According to FINRA, this obligation is not a "one-size fits all" requirement, meaning that every firm must customize its AML program to its size, location, business activities, types of accounts it maintains and the types of transactions in which its customers engage.<sup>2</sup> With respect to online firms, FINRA has specifically recommended the use of computerized surveillance of account activity to detect suspicious transactions. Susan Merrill, FINRA Executive Vice President and Chief of Enforcement, emphasized the importance of the implementation of an AML program tailored to a firm's specific risk profile when she noted, "In this case, despite the large volume of online trading at Scottrade, the firm failed to establish any systemic or automated surveillance until 2005. Then, the automated system the firm implemented remained inadequate because it focused only on suspicious trading that was accompanied by suspicious money movement."

#### **B. Ensuring the Presence of Adequate Resources to Investigate Potentially Suspicious Activity**

This case makes clear that firms should pay close attention to ensuring that resource levels are sufficiently adequate to ensure the effective operation of the AML program. Even in cases where documented policies, procedures and controls may be satisfactory, insufficient resources to administer the program may render it ineffective. In noting Scottrade's lack of resources FINRA stated, "The sheer volume of on-line trading rendered the lack of an automated system, along with the Firm's reliance on inadequate internal resources to detect suspicious activity unreasonable."<sup>3</sup>

#### **C. Understanding the Value and Capabilities of an Automated Transaction Monitoring System.**

Firms should undertake efforts to ensure that where they have implemented an automated transaction monitoring system, they take affirmative steps to understand the capabilities of such a system and how it can be used to effectively monitor accounts and transactions for the types of potentially suspicious activities specific to their business. In addition, firms should periodically test and monitor the operation of the system to make sure that it continues to operate effectively, especially in light of changes to the firm's risk profile. Finally, and perhaps most importantly, firms should make certain that employees are

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<sup>2</sup> See Special Notice to NASD Members 02-21.

<sup>3</sup> FINRA Order at pg. 5.

adequately trained to understand the system's capabilities and how to make full use of its alerts and exception reports.

#### **IV. HOW DAYLIGHT CAN HELP**

Daylight has unparalleled anti-money laundering expertise, and our professionals provide a complete array of anti-money laundering services to broker-dealers and other financial institutions. These services include assessing, enhancing, developing and implementing policies, procedures and internal controls; assisting with the implementation and conducting testing and validation of transaction monitoring systems; development and delivery of training programs; and conducting independent testing to ensure that a broker-dealer's anti-money laundering compliance program is in line with applicable regulatory requirements.

If you would like further information on Daylight's services in these areas, please contact Ellen Zimiles at (212) 554-2602 or Carmina Hughes at (202) 552-8402.