

FINRA REGULATORY NOTICE 17-40: FINCEN'S CUSTOMER DUE DILIGENCE REQUIREMENTS FOR FINANCIAL INSTITUTIONS AND FINRA RULE 3310

By Alma Angotti and Tracy Angulo

I. FINRA PROVIDES GUIDANCE TO FIRMS REGARDING ANTI-MONEY LAUNDERING (AML) PROGRAM REQUIREMENTS UNDER FINRA RULE 3310 FOLLOWING ADOPTION OF FINCEN'S FINAL RULE TO ENHANCE CUSTOMER DUE DILIGENCE REQUIREMENTS FOR FINANCIAL INSTITUTIONS

With the May 11, 2018, implementation deadline fast approaching for the U.S. Treasury Department Financial Crimes Enforcement Network's (FinCEN's) final rule on Customer Due Diligence Requirements for Financial Institutions (CDD Rule — effective date effective July 11, 2016), the Financial Industry Regulatory Authority (FINRA) provided guidance on Nov. 21, 2017, to member firms under FINRA Rule 3310, AML Compliance Program (FINRA Guidance).¹

A. Summary of Impact on Member Firms

FinCEN's CDD Rule does not change the requirements of FINRA Rule 3310.² The following are the key points of the FINRA Guidance for member firms. The subsequent sections describe each point in detail.

1. New requirement to verify the identity of beneficial owners (BOs) of all legal entity customers at account opening, subject to certain exclusions and exemptions.
2. Amends the minimum statutory requirements for member firms' AML programs by requiring such programs to include risk-based procedures for conducting ongoing CDD,³ or "fifth pillar."
3. Member firm must understand the nature and purpose of the customer relationship to develop a customer risk profile.
4. During normal monitoring for suspicious activity, if the firm detects information relevant to assessing the customer's risk profile, it must update the customer information, including the BO information.

1. Customer due diligence is generally defined as the steps a financial institution must take to identify its customers and the process by which the institution verifies its customers are who they say they are.

2. FINRA Guidance, p. 3. http://www.finra.org/sites/default/files/notice_doc_file_ref/Regulatory-Notice-17-40.pdf.

3. Ibid., p. 3.



5. No requirement or expectation that member firms integrate customer information or the customer risk profile into existing transaction monitoring systems, but must use data as appropriate.

B. Background on FINCEN's CDD Rule

FinCEN issued the CDD Rule to clarify and strengthen customer due diligence requirements of financial institutions, including broker-dealers.⁴ In its CDD Rule, FinCEN identifies four components of CDD: (1) customer identification and verification; (2) beneficial ownership identification and verification; (3) understanding the nature and purpose of customer relationships; and (4) ongoing monitoring for reporting suspicious transactions and, on a risk basis, maintaining and updating customer information.⁵

The CDD Rule focuses on the last three components. First, on “beneficial ownership identification and verification” by adding a new requirement: To verify the identity of the beneficial owners of all legal entity customers at the time a new account is opened, subject to certain exclusions and exemptions.⁶ The CDD Rule addresses the third component, “understanding the nature and purpose of customer relationships” and the fourth component, “ongoing monitoring for reporting suspicious transactions and, on a risk basis, maintaining and updating customer information” by requiring these components to be included in the AML Programs as a new “fifth pillar”⁷ to the existing four pillars required by the Bank Secrecy Act (BSA).⁸

II. AMENDMENTS TO MINIMUM REQUIREMENTS FOR MEMBER FIRM'S AML PROGRAMS UNDER FINRA RULE 3310

FinCEN's CDD Rule amends the minimum statutory requirements for member firms' AML programs by requiring such programs to include risk-based procedures for conducting ongoing CDD,⁹ or fifth pillar. The fifth pillar requires member firms to update their AML programs to include: (1) understanding the nature and purpose of customer relationships for the purpose of developing

a customer risk profile; and (2) conducting ongoing monitoring to identify and report suspicious transactions and, on a risk basis, to maintain and update customer information.¹⁰ FINRA is considering whether further rulemaking is necessary to align FINRA Rule 3310 with FinCEN's CDD Rule in light of the now-codified fifth-pillar requirement for firms' AML programs.¹¹

III. CONCLUSION: FIFTH-PILLAR REQUIREMENTS FOR BROKER-DEALERS

The CDD Rule states that firms must understand the nature and purpose of the customer relationship to determine whether a transaction is potentially suspicious and, in turn, to fulfill their suspicious-activity reporting obligations. The fifth-pillar requirements are broken down into three sections: Understanding the Nature and Purpose of Customer Relationships, Conducting Ongoing Monitoring, and Identifying and Verifying the Identity of BOs of Legal Entity Customers. As stated in the CDD Rule, these requirements merely clarify existing expectations for firms to identify and report suspicious transactions adequately.

A. Understanding the Nature and Purpose of Customer Relationships in the CDD Rule

1. The member firm must understand the nature and purpose of the customer relationship to develop a customer risk profile.
2. Customer risk profiles may consist of individualized risk scoring, placement of customers into risk categories or another means of assessing customer risk that allows firms to understand the risk posed by the customer and to demonstrate that understanding.¹²
3. Neither FinCEN nor FINRA require or expect member firms to integrate customer information or the customer risk profile into existing transaction monitoring systems, but expect firms to use the customer information and risk profile as appropriate to fulfill their obligations pursuant to the BSA.

4. On Nov. 21, 2017, FINRA issued Regulatory Notice 17-40: FinCEN's Customer Due Diligence Requirements for Financial Institutions and FINRA Rule 3310 (FINRA Guidance).

5. Ibid., p. 2.

6. Ibid., p. 2.

7. Ibid., p. 2.

8. The existing four pillars are: (1) the establishment and implementation of policies, procedures, and internal controls reasonably designed to achieve compliance with the applicable provisions of the BSA and implementing regulations; (2) independent testing for compliance by broker-dealer personnel or a qualified outside party; (3) designation of an individual or individuals responsible for implementing and monitoring the operations and internal controls of the AML program; and (4) ongoing training for appropriate persons. 31 CFR 1023.210(b) – Anti-Money Laundering Program Requirements for Brokers or Dealers in Securities.

9. Ibid., p. 3.

10. Ibid., p. 3.

11. Ibid., p. 3.

12. Ibid., p. 4.

B. Conducting Ongoing Monitoring in the CDD Rule

1. During its normal monitoring for suspicious activity, should the member firm detect information that is relevant to assessing the customer's risk profile, the firm must update the customer information, including the information regarding the BO of legal entity customers.
2. There is no regulatory requirement or expectation to integrate customer information or the customer risk profile into existing transaction monitoring systems.¹³

C. Identifying and Verifying the Identity of BOs of Legal Entity Customers in the CDD Rule

1. Member firms must obtain, from the natural person opening the account on behalf of the legal entity customer, the identity of the BO of the entity. In addition, that individual must certify, to the best of his or her knowledge, that the information is accurate.
2. Member firms must have procedures for maintaining a record of information obtained in connection with identifying and verifying BOs for a period of five years after the date of account closure.
3. Member firms must verify the identity of the BOs (i.e., that they are who they say they are and not their status as BOs) using risk-based procedures that include, at a minimum, the elements required for member firms' Customer Identification Program procedures. During the identification and verification process of BOs, member firms also must:
 - a. Complete identification and verification within a reasonable time after account opening.
 - b. Identify legal entity ultimate BOs and not "nominees" or "straw men."
4. Member firms may rely on the beneficial ownership information supplied by the individual opening the account, provided they have no knowledge of facts that would reasonably call into question the reliability of that information.
5. The CDD Rule's requirements with respect to BOs of legal entity customers applies on a prospective basis; that is, only with respect to legal entity customers that open new accounts from the date of the CDD Rule's implementation (May 11, 2018).

A member firm, however, should obtain beneficial ownership information for an existing legal entity customer if, during normal monitoring, it receives information that is needed to assess or re-evaluate the risk of the customer.¹⁴

IV. NAVIGANT'S RECOMMENDATIONS

A. Creation of a Customer Risk Profile

Navigant recommends that member firms obtain the following information when creating customer profiles:

1. Type of customer, account, or service offered
2. Customer's income
3. Net worth
4. Domicile
5. Principal occupation or business
6. The products and services used by the customer and for what purpose(s)
7. Whether the customer operates through an intermediary
8. Customer's history of activity (in the case of existing customers)

B. Using the Customer Risk Profile

Navigant suggests that member firms consider, and document, what potential events will trigger customer information refresh. For example, a monitoring-triggered update of customer profile information when the member firm learns of material information relevant to assessing customer risk during normal monitoring.

Additionally, member firms may want to consider a periodic review or refresh of existing customer accounts using a risk-based approach. Navigant typically recommends a periodic review of high-risk customer accounts every 12 months, and medium- or low-risk accounts at least every 24 months, in addition to a review based on a triggering event.

V. HOW NAVIGANT CAN HELP

Navigant's team of experts have experience to assist member firms with changes and revisions to existing know-your-customer and CDD policies, procedures, and controls. Navigant can provide member firms with highly skilled resources for the short-term implementation of these regulatory changes until your firm has incorporated these changes as "business as usual."

13. For example, to serve as the baseline for identifying and assessing suspicious transactions on a contemporaneous basis. Ibid., p. 4.

14. Ibid., p. 4.

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