



**Practical  
considerations for  
your “best execution  
compliance program”**

March 2017



Building a better  
working world



# Regulatory landscape

- ▶ In late 2015, FINRA issued **Regulatory Notice 15-46** to: (1) restate the best execution obligations applicable to firms when they receive, handle, route or execute customer orders in equities, options and fixed income securities; and (2) remind firms of the obligation to **repeatedly and thoroughly examine execution quality** likely to be obtained from the **different markets trading a security**. In parallel, the **MSRB released its best execution guidance for municipal securities**, which, in large part, resonates with the sentiment of FINRA 15-46.
- ▶ In 2016, a leading online, retail brokerage was **fined \$900k** for failing to conduct an adequate review of the quality of execution of its customers' orders and for supervisory deficiencies concerning the **protection of customer order information**.
- ▶ In early 2017, the SEC fined one of the largest market makers in the industry **\$22.6m**, the largest fine of its kind, to settle charges that its team that processes retail customer orders from other brokerage firms misled those customers about the way it priced trades from 2007 to 2010.
- ▶ **MIFID II**, set to take effect on January 3, 2018, may force certain institutions to consider new data points in routing decisions and, in some cases, make these data points available for public consumption.

# Best execution challenges

Common best execution challenges	
Principle-based rule	<ul style="list-style-type: none"> <li>▶ Limited, proscribed calculations, metrics or methodology to measure execution quality and validate best execution</li> <li>▶ Increased scrutiny on order handling disclosures and operational practices</li> <li>▶ No defined ranking of factors (e.g., price, speed, fees/rebates, chance of fills) that firms must consider when making routing and execution decisions</li> <li>▶ Lack of clarity on "order-by-order" review requirements to explain what order-by-order analysis entails and requires for specific orders and executions</li> </ul>
Limited effectiveness of best execution review committee	<ul style="list-style-type: none"> <li>▶ Best execution review committees have become "check-the-box" exercises as opposed to providing meaningful, "regular and rigorous" review of execution quality and order handling practices</li> <li>▶ Limited priorities, expectations, roles and responsibilities, and ultimate accountability for making decisions regarding order handling and execution quality</li> </ul>
Inability to address diverse business operations	<ul style="list-style-type: none"> <li>▶ While the primary best execution responsibility lies with the business, including developing strategies and monitoring execution quality, there are limited skill sets outside the business to provide appropriate challenge and review execution performance as second and third line functions</li> <li>▶ Limited "tone from the top" establishing expectations, roles and responsibilities, and ultimate accountability for delivering and reviewing execution quality</li> </ul>
Lack of quantitative analysis and inefficient supervisory procedures	<ul style="list-style-type: none"> <li>▶ Lack of meaningful analysis and metrics to truly demonstrate best execution</li> <li>▶ Excessive reliance on traditional 605 metrics, with limited ability for drill down and analysis on an order-by-order basis</li> </ul>



# Key components of best execution compliance program

While every firm has unique needs for its respective structure, below are some key components that should be embedded in every best execution compliance program.

Focus areas	Subtopics
<b>Governance</b>	<ul style="list-style-type: none"> <li>▶ Involvement of appropriate stakeholders and roles in the best execution review process</li> <li>▶ Establishment and awareness of clear roles and responsibilities among stakeholders, including defined committee charter/mandate</li> <li>▶ Defined escalation processes and protocols to identify significant trends and issues</li> </ul>
<b>Purpose, objectivity and action items</b>	<ul style="list-style-type: none"> <li>▶ Well-defined and understood agenda and objective for best execution review meetings</li> <li>▶ Clear set of action items at the end of meetings and adherence to follow-up action plan</li> </ul>
<b>Reporting components</b>	<ul style="list-style-type: none"> <li>▶ Generation and review of relevant metrics, trends, reports, etc., as well as a defined process for developing new metrics and approach considerations, as part of best execution process</li> <li>▶ Customization of data points pertinent to business activity</li> </ul>
<b>Regulatory and business coverage</b>	<ul style="list-style-type: none"> <li>▶ Inclusion of all relevant products, lines of business, geographies, etc., for best execution review</li> <li>▶ Consistent approach across products, lines of business, geographies, etc.</li> </ul>
<b>Process and controls</b>	<ul style="list-style-type: none"> <li>▶ Existence of well-defined, end-to-end processes with associated preventive and detective control points that can be monitored and assessed</li> <li>▶ Embedded best execution considerations in key processes, e.g., change management and incident management</li> </ul>
<b>Monitoring and testing</b>	<ul style="list-style-type: none"> <li>▶ Existence of a testing program that includes best execution processes and controls as part of the risk assessment and periodically assesses their adequacy and effectiveness</li> </ul>
<b>Technology enablement</b>	<ul style="list-style-type: none"> <li>▶ Usage of appropriate technology tools and solutions in execution monitoring, surveillance, review, resolution and reporting activities</li> </ul>
<b>Documentation</b>	<ul style="list-style-type: none"> <li>▶ Existence and adoption of complete policies and procedures governing best execution review process</li> <li>▶ Documentation for rationale of key decisions (e.g., order-by-order analysis vs. periodic look-back)</li> </ul>



# Functional structure to support best execution

In order to effectively implement key components of a best execution compliance program, firms can consider aligning key functions of their organization with best execution specific roles and responsibilities.



## Key questions to consider

While the below are illustrative, these are some of the key questions firms need to ask themselves:

- ▶ How does my firm define best execution?
- ▶ Does my current operating model adequately account for best execution considerations? Does each function (e.g., business, compliance, risk) know its role?
- ▶ Does my best execution review committee understand its purpose? Does it provide appropriate challenge and assessment?
- ▶ Do I have meaningful metrics and analysis, outside of regulatory reporting (e.g., 605 and 606), to meaningfully assess execution quality?
- ▶ Can I effectively monitor and surveil my execution quality?
- ▶ Is there appropriate oversight and review of changes to my order routing strategies and algorithms?

## EY service offerings

Our team brings extensive electronic trading and best execution experience. EY has assisted leading market makers and broker-dealers in assessing and redefining their best execution review operating models, functional structures, monitoring and surveillance programs, and metrics.

For additional information on how we can assist you with your best execution program, please contact a member of our team:



**David Contompasis**  
*Executive Director*  
Ernst & Young LLP  
david.contompasis@ey.com  
+1 212 773 2854



**Nancy Reich**  
*Executive Director*  
Ernst & Young LLP  
nancy.reich@ey.com  
+1 212 773 0300



**Sayak Mukherjee**  
*Senior Manager*  
Ernst & Young LLP  
sayak.mukherjee@ey.com  
+1 212 773 7677



**Nikhil Khanna**  
*Manager*  
Ernst & Young LLP  
nikhil.khanna@ey.com  
+1 212 773 7241

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# Securities AML and sanctions regulation: a primer for broker dealers and clearing firms





US regulators have been increasingly focused on Bank Secrecy Act (BSA)/anti-money laundering (AML) and OFAC sanctions compliance for broker-dealers and clearing firms (sanctions). With this enhanced regulatory scrutiny and the heightened expectation concerning the effectiveness of the compliance function, common compliance mistakes can be costly, as evidenced by increasing fines and sanctions imposed by regulators for violations of relevant regulations. Addressing the firm's AML and sanctions risks (known or unknown) and investigating potential issues can greatly reduce the risk of adverse examination findings and enforcement actions

## Navigating increased regulatory focus

### According to the 2016 SEC and FINRA Priorities letters:

- ▶ There is an increasing regulatory concern regarding the AML policies, systems and surveillance at broker-dealers and clearing firms, leading to increased efforts to monitor and enforce compliance with the Bank Secrecy Act (BSA) and FINRA Rule 3310.
- ▶ The SEC will be using data analytics to determine whether clearing and broker-dealer activity is consistent with their ongoing FinCEN filings.
- ▶ Regulators will be looking at firm filings in relation to the number of firm registered representatives, number of customer accounts, risk level of activity and filings by similar institutions.

“When you compare [4,700-4,800 US broker-dealers] with the number of SARs filed by broker-dealers every year, that means that on average, each firm in the U.S. files about five SARs per year. This is disconcerting and hard to understand. Think about your businesses - is it possible that only five transactions a year were suspicious enough to justify a SAR filing?”

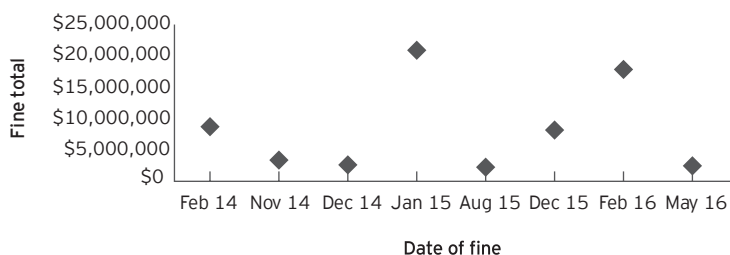
#### – Andrew Ceresney, Director

Division of Enforcement, Securities and Exchange Commission  
(2/25/2015 Remarks to SIFMA)

In 2015 and 2016, SEC and FINRA levied fines on institutions for failing to monitor, detect and report suspicious activity. Specifically, institutions have been targeted for insufficiently addressing unusual activity in high-risk areas, such as Microcap sales and deposits, cash management and direct market access.

In addition to institutional fines, broker-dealers and clearing firms have received additional regulatory enforcement such as appointment of independent monitors, firm undertakings, and fines/suspensions for compliance and operations personnel.

## Top fines for AML violations at broker-dealers and clearing firms



\*Note: In addition to the monetary fines illustrated in the graph, below are additional punishments levied on the institutions and their personnel:

- ▶ February 2014: The Global AML Compliance Officer was fined \$25,000 and suspended for one month.
- ▶ November 2014: Agreed to retain an independent consultant. Two executives were fined \$85,000 in total.
- ▶ January 2015: Agreed to retain an independent consultant to review their policies and procedures over a five-year period.
- ▶ August 2015: Required to retain an independent consultant to review its supervisory and AML systems and procedures. The Chief Compliance Officer and AML Compliance Officer agreed to fines of \$5,000 and \$10,000 and suspensions of 30 and 60 days, respectively.
- ▶ December 2015: An executive managing director and an equity trader were fined \$35,000 and \$25,000 and suspended for three and two months, respectively.
- ▶ February 2016: Agreed to retain an independent monitor to directly review their AML/customer identification program (CIP) policies, procedures and practices for the next two years.
- ▶ May 2016: Agreed to an undertaking to certify compliance with FINRA Rule 3310 within 180 days. The AML Compliance Officer was fined \$25,000 and suspended for three months.

## Challenges and common mistakes of brokers-dealers and clearing firms

Recent enforcement actions by FINRA and the SEC reinforce the need for increased awareness by compliance personnel of the challenges and risks facing the firm. Some of the common issues facing broker-dealers and clearing firms are the following:

Description of challenge/mistake	Category	Broker-dealers	Clearing firms
Purchasing off-the-shelf policies and procedures, including tools and parameters, without tailoring them specifically to the institution's business (e.g., risk profile, products, customers).	Policies and Procedures	✓	✓
Building silos in the transaction monitoring environment (e.g., failing to consider CIP, negative news, money movement and securities transactions as part of a cohesive monitoring system).	Transaction Monitoring	✓	✓
Taking on new lines of business without determining whether compatible monitoring systems are in place, leading to monitoring shortfalls. Failing to test existing parameters from time to time, especially when new business or other changes are made to the system	Transaction Monitoring	✓	✓
Filing generic BSA reports. Filings contain improper or insufficient content to meet BSA reporting guidelines.	Suspicious Activity Reporting	✓	✓
Suspicious activity monitoring responsibilities being passed onto an introducing broker.	Suspicious Activity Reporting		✓
Failing to perform adequate due diligence on customers or introducing brokers before entering into a relationship, including standard KYC, negative news and understanding who the customer really is and the underlying business being introduced.	Customer Due Diligence	✓	✓
Inappropriately applying SEC, FINRA, FinCEN and CFTC guidance on CIP and customer due diligence requirements in the context of omnibus accounts and sub-accounts.	Customer Due Diligence	✓	

## Ways to improve your AML/sanctions compliance program

While enhancing compliance programs is a continual focus, it is particularly prudent to anticipate your next regulatory review or examination, proactively identify areas that may be the subject of concern to a regulator and then implement a plan to address those areas. FINRA and SEC consider proactive identification and disclosure to be a significant factor when determining fines, sanctions and/or the implementation of a monitor. Consider the following industry insights when planning for your next regulatory inquiry:

- ▶ AML and microcap securities parameters should be tailored to meet the business activity/risk and specifically address the Money Laundering Red Flags as noted in NASD Notice to Members 02-21 and Microcap Trading Red Flags in FINRA Regulatory Notice 09-05.
- ▶ Alerts, escalation numbers and SAR filings should be reviewed to determine if a reasonable amount of alerts generated resulting in case escalations and SAR filings compared to industry standards. Existing parameters should be reviewed and tested. Internally driven historical transaction reviews and volume comparisons are an effective method of gauging system integrity and investigation quality.
- ▶ A successful CIP identifies not only the end customer of the financial institution, but also the business type, account type

(proprietary vs. omnibus), customer risk (sanctions & watch lists, PEPs, insiders), and trading profile.

- ▶ Risk-based due diligence should be reasonably designed and provide enhanced policies, procedures and controls for accounts deemed "high-risk." Specifically, correspondent accounts, omnibus accounts and foreign financial institutions may require "enhanced due diligence" procedures.
- ▶ CIP and customer due diligence requirements for omnibus accounts and sub-accounts should be applied appropriately based on regulatory guidance and product type.
- ▶ New business lines (including introducing broker activity) should be communicated to AML Compliance for risk review, including updating surveillance systems and parameters.
- ▶ Relevant tailored employee training to the business function (i.e., separate training for traders/KYC/surveillance) to cover how AML/sanctions responsibilities relate to their specific job function.
- ▶ Cooperation and teaming with the regulator and/or monitor, which may reduce the impact and extent of fines/sanctions. For example, self-reporting of misconduct; remediation (including disciplining wrongdoers); assisting the examination by providing all necessary and relevant information for focus areas; providing substantial assistance during examinations and/or investigation of underlying misconduct.

## Emerging issues

An effective oversight program will identify key issues in the industry that impact (or may impact at some later date) the risk profile of your business model. Ask yourself these questions:

- ▶ How will the recent enforcement focus, new and proposed BSA regulations and global events affect your AML/Sanctions compliance program? For example, have you considered the impact of the newly issued CDD Final Rule?
- ▶ Do you really Know Your Customer? How might the Panama Papers and focus on beneficial ownership impact KYC/CIP compliance?
- ▶ With regulators correlating business risk to SAR filings, are you filing enough SARs?
- ▶ What does FINRA's focus on individual liability mean for your AML compliance officer?
- ▶ How will funding portals need to comply with changing BSA regulations?
- ▶ If an investigation is ongoing, what are the measures you can take to mitigate any pending enforcement action?

## How we can assist

EY's Fraud Investigation and Dispute Services (FIDS) professionals offer a broad spectrum of services, tailored to address the issues facing the securities industry. For example:

- ▶ Assistance with regulatory inquiries and enforcement actions, including formal information requests, examination inquiries, support in connection with monitorships and undertakings
- ▶ Conducting investigations, including on a privileged basis under the direction of counsel, in response to regulatory and enforcement requirements, whistleblower allegations and litigation claims into financial crime issues such as allegations of fraud, AML, OFAC sanctions and ABAC
- ▶ Developing an investigation playbook to create formal processes and procedures when dealing with regulatory enforcement actions, including document control and analysis procedures, investigation and response plans, and designated internal and external resource

### Contacts

**Brad Massam***Partner*

+1 212 773 5620

bradley.massam@ey.com

**Walid Raad***Partner*

+1 212 773 0956

walid.raad@ey.com

**Chris Sercy***Principal*

+1 212 773 3916

chris.searcy@ey.com

**Donna Daniels***Executive Director*

+1 212 360 9132

donna.daniels@ey.com

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