

DFS NY 504.3

A strategic approach to dealing with the final rule

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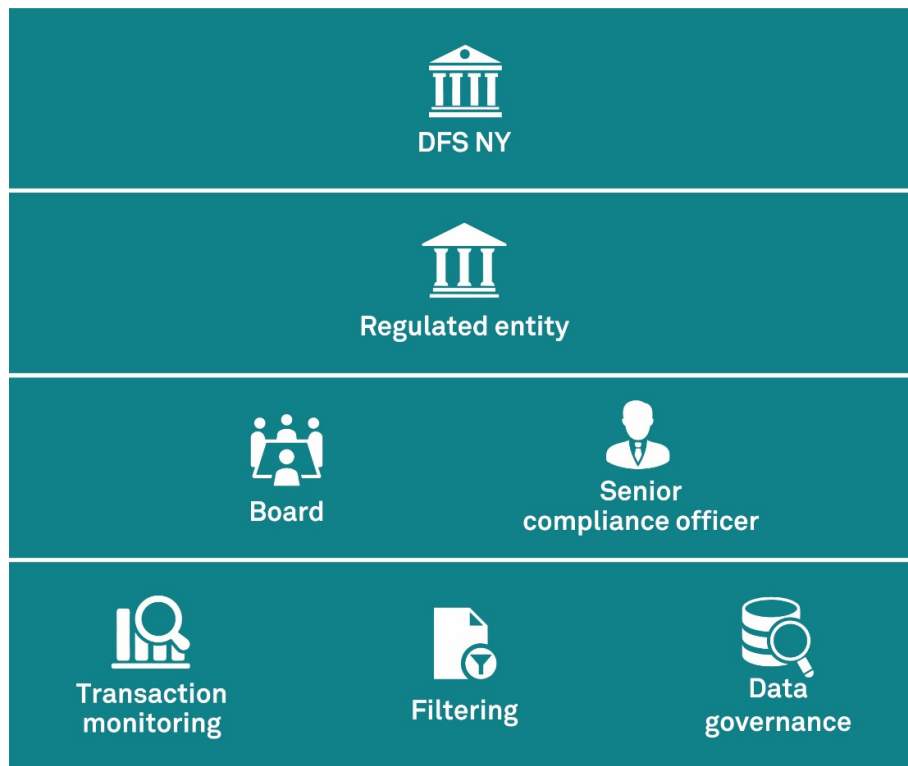
In June 2016, the Department of Financial Services (DFS) of New York State adopted a new rule that requires financial institutions (both regulated and non-regulated) based in its jurisdiction to strengthen their anti-money laundering (AML) programs. This was driven by negative findings such as shortcomings in the transaction monitoring and filtering programs at these institutions stemming from inadequacies in governance, oversight, and accountability at senior levels.

The regulation came into effect on January 1, 2017, with the first compliance findings due by April 15, 2018.

To address the shortcomings in the existing AML programs, the final regulation makes it mandatory for regulated financial institutions to implement, maintain, update, and improve their transaction monitoring and filtering programs. They are also required to maintain exhaustive documentation on the process followed. Annually, the governing body or senior compliance officer must personally certify that the AML program is compliant to the best of their knowledge.

That means the governing body and key senior positions are now exposed to heightened risk of liability in the AML program. As a result, regulated institutions will have to carefully evaluate various aspects of the final rule and consider their likely impact on operations, compliance cost and regulatory risks.

Self-certification workflow



The final rule has factored in the comments submitted on behalf of the financial services industry based in New York, and has changed some of the key aspects compared with the proposed rule, mainly:

- Criminal liability clause for governing body/officers if the program deficiency has been changed to ‘under any applicable laws’
- Leniency in terms of tuning the transaction monitoring and filtering systems to manage the number of alerts
- Filtering programs to only screen against the Office of Foreign Assets Control (OFAC) sanctions list

Depending on how the final rule is interpreted and applied, it could have a significant impact on the operating costs of regulated institutions, and most certainly will provide the DFS with increased enforcement powers.

DFS, New York State

The DFS is a part of New York State government responsible for regulating financial services and products. Within the DFS, the Financial Frauds and Consumer Protection Division (FFCPD) investigates any violation of financial services law and banking law. The division also conducts enforcement proceedings wherever applicable.

The DFS is a powerful regulatory body that supervises approximately 4,000 financial services entities, covering an asset base of more than \$6 trillion.

Regulated entities

Their regulation covers all entities chartered under the New York Banking Law, including regulated banking entities (banks, trusts, private banks) and regulated non-banking entities (money services businesses, check cashers).

Representative offices of foreign banks (ROFBs) are excluded from Rule 504, as they do not actively solicit or perform transactions.

Furthermore, the final rule does not apply to bank and non-bank institutions that are not already under the purview of the DFS, such as national banks, federal savings banks, and federal savings and loan associations chartered by the Office of the Comptroller of the Currency, or out-of-state US banks with branch offices or other facilities located in New York.

Key elements

Each regulated institution has to establish and maintain a risk-based transaction monitoring and filtering program that suits its risk profile. Among other program characteristics, the regulated institution must develop and implement a program that 1) includes documentation of the design and monitoring and filtering parameters; 2) shows that it is periodically tested on end-to-end effectiveness; 3) catalogues any rule and threshold changes; and, 4) is subject to ongoing analyses to assess the reasonableness, effectiveness and relevancy of the controls.

The Annual Board Resolution or Senior Officer(s) Compliance Finding requires the board of directors or senior officer to 'certify' that:

- 1) The signee(s) reviewed necessary documents, reports, certifications and opinions necessary to make such certification;
- 2) The signee(s) took all steps necessary to confirm the regulated institution is in compliance with the final rule; and,
- 3) To the best of their knowledge, the transaction monitoring and filtering program complies with Section 504.3.

The key elements of DFS NY 504.3 intend to have a more granular outlook on the current compliance program by specifically stating the areas of interest, as shown below:

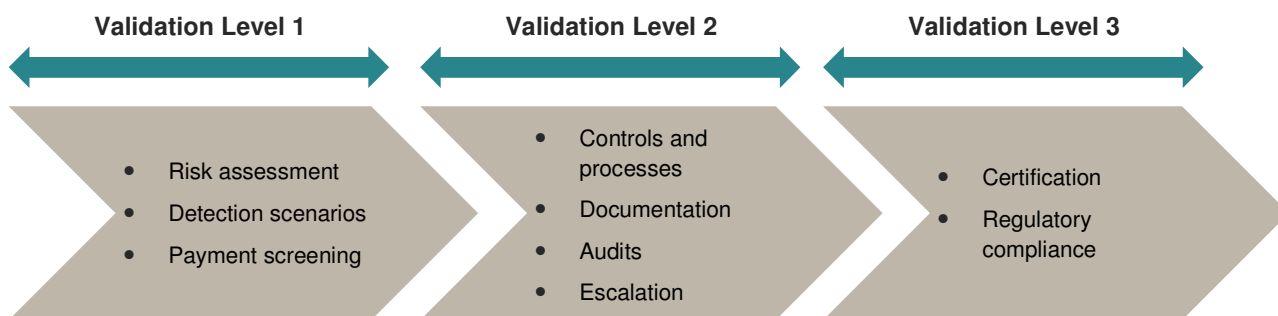
Detailed description of activities required as per DFS NY 504.3

	Transaction monitoring	Filtering programs	Data and governance
Key requirements	<ul style="list-style-type: none"> • Risk assessment of the institution • Amenable to change in BSA/AML laws and regulations • Risk appropriate to customers/business, products and service • Scenarios with threshold values designed to detect money-laundering activities • End-to-end implementation testing • Detailed documentation of current scenarios • Alert clearing protocols and ownership documentation • Ongoing performance analysis 	<ul style="list-style-type: none"> • Risk assessment of the institution • Based on technology or tools for matching names and accounts • Risk appropriate for transaction and product profiles • End-to-end implementation testing • Logic of matching technology or tools • Detailed documentation of filter tools, process or technology • Ongoing analysis to assess logic and performance of filters against OFAC sanctions list and thresholds • Limited to OFAC sanctions list only 	<ul style="list-style-type: none"> • Identification of relevant data sources • Data validation for integrity, accuracy and quality of data flows • Data extraction and loading processes • Governance and management oversight for change-management • Funding for design, implementation and maintenance • Consulting for case management, review and potential filing • Periodic training for all stakeholders • Documentation of remedial terms

Meeting regulatory requirements

Many clauses in the final rule are similar to the existing expectations imposed on regulated institutions by federal regulators such as customer identification program, customer due diligence/enhanced due diligence, etc. The distinguishing factor of the final rule is the extra enforcement leveraged through annual certification by the governing body.

Various level of validation and ownership



While medium- and large-sized financial institutions may have a framework to generate the necessary documents and provide sign-offs for certification, the impact of the final rule may be particularly challenging for smaller non-bank regulated institutions such as money transmitters and other money services business.

These entities may not have the financial resources to implement robust transaction monitoring and filtering programs in a short period of time, even though their risk profiles may require such actions. These types of institutions should carefully evaluate their allocation of resources, and implement their transaction monitoring and filtering programs in a thoughtful and deliberate manner.

Strategic approach to meeting 504.3 guidelines

Regulatory compliance for DFS NY 504.3 can be achieved by systematically approaching each pillar of compliance, such as data and governance, transaction monitoring, and filtering. That would serve as a base for future validation to meet regulatory examinations. The following framework shows the various aspects of the tasks required under the key pillars. The following diagram outlines the key activities required in each of the three pillars that would require detailed attention.

Key activities in each pillar

Transaction monitoring	Filtering programs	Data and governance
<ul style="list-style-type: none"> Independent risk assessment Adaptive segmentation Scenario development Independent validation Documentation and case support Automated performance reports 	<ul style="list-style-type: none"> Independent risk assessment Adaptive segmentation Independent test and validation Matching logic Documentation and case support Automated performance reports 	<ul style="list-style-type: none"> Independent data validation Data model validation Data quality reports Governance review Training and documentation

The framework mentioned above is similar to the ones followed for risk management, but includes additional activities to support scenarios that generate high false positives.

Despite these expected challenges, institutions will encounter unique situations when planning and implementing the requisite control framework. There could be resulting effects on data, requiring enhanced forensic data analytics and historical transaction analyses.

Key questions

- What level of compliance failure would constitute criminal liability?
- Does the prerogative of tuning of monitoring tools lie solely with the institutions, provided justifiable evidence is documented
- Does the third-party AML solutions supplier validate these systems?
- As the DFS is another layer of regulation on top of the Federal Reserve regulations, how would it assess the effectiveness of the system, given the fact that it already meets Fed standards?
- Who has the final say in enforcement proceedings — the Fed or the DFS?
- As this is an annual exercise, would having an automated framework help expedite this time-consuming validation exercise?

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