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Court Decision Reinforces SAR Obligations of Penny Stock Clearing Brokers

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- All Federal

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Second Post in a Two-Part Series

Opinion Stresses Importance of Narrative Sections and Supporting Documentation for SARs

In our first post in this series, we discussed the Securities and Exchange Commission's ("SEC") enforcement action against Alpine Securities, Inc. ("Alpine"), a clearing broker that provides services for microcap securities traded in the over-the-counter market, and in particular Alpine's continued challenge to the SEC's authority to enforce alleged violations of the Bank Secrecy Act ("BSA"). Judge Denise Cote of the Southern District of New York has repeatedly rejected that argument and, on December 11, granted partial summary judgement in the SEC's favor, finding in part that the SEC indeed has the authority not only to exam for, but also to enforce, alleged BSA violations.

In this post, we turn to the court's very detailed findings in support of its grant of summary judgment in favor of the SEC as to most of the case, finding that Alpine committed thousands of violations relating to Suspicious Activity Reports, or SARs. Specifically, the court found as a matter of summary judgment that Alpine was liable, among other things, for thousands of violations of Rule 17a-8 of the Securities Exchange Act of 1934 ("Exchange Act"), which obligates a broker-dealer

to comply with certain regulations promulgated under the BSA, including 31 C.F.R. § 1023.320 ("Section 1023.320"), which dictates how a broker-dealer must file SARs.

Although the decision clearly carries significant implications for the SEC's case against Alpine, it also may serve as a potential bellwether for other broker-dealers who transact microcap securities. The district court's opinion sets forth extremely detailed findings regarding a variety of SAR-related failures, including alleged failures to (i) provide adequate narrative descriptions in SARs actually filed; (ii) file required SARs; (iii) file SARs on time; and (iv) maintain adequate supporting documentation regarding decisions whether to file a SAR. The opinion also underscores the dangers in AML/BSA compliance of relying on templates and mechanistic or "cookie cutter" processes. It is not enough to simply file SARs defensively – rather, once a decision to file a SAR has been made, each SAR must be supported and contain adequate detail.

A Focus on the SAR Narrative Requirement

The court's December 11 Order centers on the SEC's second summary judgment motion – on March 30, 2018, the court determined, *inter alia*, that the SEC had the authority to pursue SAR violations under the Exchange Act, that Rule 17a-8 is a permissible interpretation of that Act, and that the Commission was not required to engage in notice-and-comment proceedings before enforcing Rule 17a-8 against Alpine ("March 30 Opinion"). The court also found in part that summary judgment was proper where Alpine omitted from SARs seven subcategories of required information, assuming that Section 1023.320 required these SARs to be filed.

At the close of discovery, the SEC filed the instant summary judgment motion, seeking to hold Alpine liable, in part, under Rule 17a-8 and Section 1023.320(a) because it allegedly:

- omitted from more than 1,500 SARs required information in the narrative section of the SARs;
- failed to file SARs reporting suspicious sales following large deposits of low-priced securities ("LPS");
- filed untimely SARs; and
- failed to maintain support files for many of the SARs filed.

Section 1023.320(a)(1) mandates that "[e]very broker or dealer in securities within the United States . . . shall file with FinCEN, to the extent and in the manner required by [Section 1023.320], a report of any suspicious transaction relevant to a possible violation of law or regulation." SARs on transactions "conducted by, at, or through" a broker-dealer like Alpine are mandatory if the (1) transaction involves or aggregates assets or funds of at least $5,000; and (2) the firm knows, suspects, or has reason to suspect that the transaction, or a pattern of transaction of which the transaction is a part, fits into one or more of the four categories of suspicious and potentially criminal conduct set forth in Section 1023.320(a)(2).

The court's March 30 Opinion is lengthy and complex and will be summarized here only; further, we will focus on the first bullet point: the alleged failure to provide sufficient narratives.

In its March 30 Opinion, the court noted that the second element noted above (that is, whether the broker-dealer has reason to suspect that the transaction requires reporting under the rule) is satisfied by an objective standard. In that regard, the SEC proposed a two-part test for determining whether to file a SAR – first, whether the underlying transaction involved a large deposit of LPS, and second, whether the transaction also involved either one of six "red flags" or the transaction was conducted by a certain customer (*e.g.*, use of a shell company or the involvement of foreign entities). The SEC then argued that, out of 1,593 SARs filed by Alpine, 1,032 failed to mention in its narrative section one or more relevant red flags. Thus, in addition to proposing a threshold test for filing a SAR, the SEC also proposed an objective test for SAR narrative adequacy – an area typically subject to the general (although not total) discretion of the filing institution.

In response, Alpine argued that the SEC's proposed test fails to meet the reasonable suspicion standard in criminal law pursuant to the Fourth Amendment. According to Alpine, that standard imposes on the SEC the duty to point to "specific and articulable" facts in Alpine's possession that would have given it a basis to believe there was a reasonable possibility that an entity or individual was involved "in a definable criminal activity or enterprise."

The court concluded that the SEC's proposed test was "faithful" to the letter and spirit of Section 1023.320. Notably, the court spent considerable time in its opinion describing the "uncontested" fact that "the market for LPS is vulnerable to securities fraud and market manipulation schemes," and that "[t]hese schemes depend on the deposit of a large amount of securities with a broker-dealer so that those securities can enter the market." With respect to Alpine's "Fourth Amendment concept," the court found that it does not pass muster, because "[b]y design, the SAR regime does not depend on or require a broker-dealer to make any finding of wrongdoing before it files a SAR."

As to the allegedly inadequate narratives in the filed SARs, the court held Alpine accountable for its predicate decisions to file SARs: "[I]t is not unreasonable to infer from Alpine's very act of filing a SAR that the reported transaction had sufficient indicia of suspiciousness to mandate the creation and filing of a SAR. None of these SARs suggests that the filing was simply a voluntary act or otherwise filed outside of Alpine's attempt to comply with its duties under the law." The primary problem here appears to be the fact that "Alpine repeatedly used template narratives that failed to include any details, positive or negative, about the transactions." Although Alpine argued that a "red flag" which triggered a duty to investigate did not necessarily need to be disclosed in the SAR's narrative, the court found that the SAR form itself requires a "clear, complete and chronological description" of the suspicious activity, and that Alpine's records supporting its SAR filings contained no indications that the red flags at issue had been deemed to be not suspicious. Thus, voluminous but meaningless SARs represent voluminous violations, not compliance.

One question raised but not addressed by the *Alpine* case is: when the business was filing hundreds of SARs in regards to certain specific customers, why did Alpine keep doing business with them?

Other Violations

In regards to the alleged failures to file SARs, the court granted the SEC's motion for summary judgment as to 3,568 individual sales of shares over $5,000 because, although Alpine had filed initial SARs reflecting large deposits of LPS, it did not file a new or continuing SAR regarding the sales that followed those deposits. For example, one customer had deposited over 12 million shares of a LPS – which resulted in SAR filings – and then sold 10 million of those shares through 12 transactions – which did not result in SAR filings. The court essentially found that the liquidation of a LPS deposit which triggered a SAR also should trigger a SAR, and that Alpine's concern regarding a "flood" of SARs was misplaced because a single SAR may pertain to numerous transactions.

The court also granted summary judgment to the SEC on the issue of Alpine failing to maintain adequate support files for filed SARs. Noting that Rule 17a-8 and Section 1023.320 both require a broker-dealer to maintain all supporting documentation for five years from the date of filing a SAR, the court observed that no such records existed for 496 SARs. This issue of adequate support files also relates back to the primary issue regarding Alpine's SAR narrative sections – as noted, the support files did not explain why red flags were not discussed in many SAR narratives.

Alpine did beat back summary judgement on one issue: the court denied summary judgment as to 251 SARs filed more than six months after the transactions at issue (and therefore, beyond the 30-day period for filing a SAR once the triggering suspicious activity has been detected) because the SEC had failed to show as a matter of law that Alpine had a duty to file these SARs.

Key Takeaways

Alpine argued that adoption of the SEC's theory of liability "would be extraordinary and wreak havoc with the SAR regime and the broker-dealer industry." Although this claim represents some overstatement, given the alleged conduct at issue, this matter certainly underscores the regulatory hazards that broker-dealers, clearing houses and banks face, particularly in the microcap securities market. Indeed, Alpine is not the only broker-dealer to face regulatory scrutiny in 2018: earlier this year, the SEC settled with broker-dealers Chardan Capital Markets LLC and Industrial and Commercial Bank of China Limited for failing to file SARs for billions in microcap sales. These actions come on the heels of the announcement that Bank of America's Merrill Lynch division will no longer allow clients to sell microcap stocks, absent a regulatory review, and will outright ban those deemed most risky. As the case against Alpine further crystalizes, firms operating in the microcap space should have strong policies and procedures in place to ensure SARs are complete, accurate and timely filed. The quality of SARs is more important than their quantity.