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Bridging the Week: March 26 to 30 and April 2, 2018 (AML; Red Flags; Pump and Dump; Bitcoin ETFs) [VIDEO]

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Bridging the Week

- Communications, Media & Internet
- Criminal Law / Business Crimes
- Securities & SEC
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Two broker-dealers' purported failure to act on red flags – both involving customer trading – resulted in separate Securities and Exchange Commission enforcement actions against the firms. In connection with one action, two former anti-money laundering compliance officers were also sued for their roles in their firm's alleged failure, as was the firm's chief executive officer. Unrelatedly, the SEC asked for public comment on NYSE Arca, Inc.'s proposed rule change to list and trade shares of exchange-traded funds based on bitcoin futures contracts. As a result, the following matters are covered in this week's edition of *Bridging the Week*:

- Broker-Dealer, CEO and AML Compliance Officer Settle SEC Charges for Not Filing Suspicious Activity Reports in Response to Red Flags (includes **Compliance Weeds 1** and **Compliance Weeds 2**);

- Pump and Dump Fraud Results in SEC Charges Against Broker-Dealer and Salesperson;

- SEC Considers NYSE Bitcoin Futures ETFs (includes **Follow-Up**); and more (including a **Letter to the Editor**).

Video Version:

Article Version:

Briefly:

- **Broker-Dealer, CEO and AML Compliance Officer Settle SEC Charges for Not Filing Suspicious Activity Reports in Response to Red Flags**: Aegis Capital Corporation, a Securities and Exchange Commission-registered broker-dealer, agreed to resolve separate charges brought by the Commission and the Financial Industry Regulatory Authority that, from at least January 2012 through April 2014, it failed to file suspicious activity reports with the Financial Crimes Enforcement Network of the United States Department of Treasury, as required, in connection with transactions that potentially involved market manipulation of low-priced securities.

The firm settled its SEC matter by agreeing to pay a fine of US $750,000 and committing to certain undertakings, including instituting recommendations made by a compliance consultant. Aegis settled its parallel charges by FINRA by agreeing to pay a fine of US $550,000.

Contemporaneously, Robert Eide, Aegis's ultimate 100-percent owner and chief executive officer, and Kevin McKenna, the firm's anti-money laundering compliance officer from June 2012 through June 2013, also agreed to resolve SEC charges related to Aegis's SEC enforcement action. Mr. Eide agreed to pay a fine of US $40,000 while Mr. McKenna consented to pay a penalty of US $20,000 and not serve as a compliance officer or an AML compliance officer of a broker-dealer or similar organization for at least 18 months. Separately, the SEC filed an administrative complaint against Eugene Terracciano, Aegis's AML CO from September 2013 through approximately September 2015. Mr. Terracciano did not settle his SEC matter.

According to the SEC and FINRA, during the relevant time, Aegis failed to file SARs "on hundreds of transactions" it should have suspected constituted fraudulent activity or had no legitimate business purpose. These transactions involved the purchases and sales of low-priced securities by customers that evidenced red flags of market manipulation, including sudden high trading volumes of stocks of companies during periods of low business activity, increasing stock prices not supported by the companies' financial performance, and promotional campaigns. The regulators claimed that Aegis's daily review process did not identify the relevant transactions as suspicious, nor did the firm adequately follow up on alerts provided by the firm's clearing broker or on inquiries by regulators. These alerts, noted the SEC, were received by Aegis's then AML CO. Additionally, said the SEC, Aegis did not adequately train its employees regarding AML issues associated with low-priced securities transactions.

Among other things, the SEC said that the failure of the AML COs to double check why the firm's daily review process did not identify potentially problematic transactions, as well as their failure to file SARS or create written analyses indicating that they even considered filing SARs after red flags of suspicious conduct were expressly brought to their attention, evidenced their willful aiding and abetting of Aegis's violations. Mr. Eide was charged with causing the violations directly.

The SEC seeks civil penalties and other "appropriate" remedial action against Mr. Terracciano.

Compliance Weeds 1: Applicable law and FinCEN rules require broker-dealers and other covered financial institutions (banking institutions, Commodity Futures Trading Commission-registered futures commission merchants and introducing brokers and SEC-registered mutual funds) to file a SAR with FinCEN in response to transactions of at least US $5,000 which a covered entity "knows, suspects, or has reason to suspect" involve funds derived from illegal activity; have no business or apparent lawful purpose; are designed to evade applicable law; or utilize the institution for criminal activity.

Covered financial institutions should continually monitor transactions they facilitate; ensure they maintain and follow written procedures to identify and evaluate red flags of suspicious activities; and file SARs with FinCEN when appropriate. (Click here for a helpful overview of anti-money laundering requirements for broker-dealers, including SAR requirements. Click here for a similarly helpful compilation of AML resources for members of the National Futures Association.)

Moreover, covered institutions should ensure that problematic transactions identified by non-AML personnel (e.g., compliance staff) that may violate legal or regulatory standards are evaluated by AML personnel to determine whether a SAR should be filed with FinCEN. Indeed, the more consolidated a ledger a firm can maintain of potential problems identified across otherwise separate surveillance functions, the more likely a firm will be able to recognize and act holistically upon material red flags.

Compliance Weeds 2: Beginning May 11, covered financial institutions must begin to identify the beneficial owners of their legal entity customers for new accounts. Currently such entities are mandatorily required to know the identity of each of their legal entity customers, but not necessarily their beneficial owners.

By May 11, covered institutions must establish and maintain written procedures reasonably designed to identify and verify the identities of beneficial owners of legal entity customers unless such customers are expressly excluded (e.g., certain US or non-US regulated financial entities).

Beneficial owners include each real person who directly or indirectly has a 25 percent or more equity ownership interest in the legal entity customer, and a single individual with "significant responsibility to control, manage, or direct a legal entity customer, including an executive officer or senior manager or any other individual who regularly performs similar functions." Legal entity customers include corporations, limited liability companies, partnerships and other similar business entities.

A covered financial institution must evidence its compliance with FinCEN's new requirements by obtaining a mandatory certification form from a legal entity customer that identifies its beneficial owners or by receiving the information required by the form (i.e., for each beneficial owner, name, date of birth, address, and social security number, or for non-US persons, passport number) by another means with an appropriate certification. A covered firm must also verify the identity of each enumerated beneficial owners according to risk-based procedures that contain the elements required for verifying the identity of individuals under FinCEN's existing relevant rules through documents or non-documentary methods (i.e., Customer Identification Program requirements). However, a covered firm may use photocopies or reproductions of original documents in connection with such verification.

Under FinCEN's new rules, one covered institution may delegate its responsibilities to another covered firm, but only pursuant to a written contract that includes certain enumerated obligations.

Likely, bigger covered financial institutions are in the process now of finalizing their written procedures and processes to ensure compliance with FinCEN's new requirements. However, smaller firms should also ensure they are ready for their new obligations.

(Click here for further background in the article "FINRA Provides AML Guidance to Members" in the December 3, 2017 edition of *Bridging the Week*.)

- **Pump and Dump Fraud Results in SEC Charges Against Broker-Dealer and Salesperson**: Wedbush Securities Inc., a broker-dealer, and Timary Delorme, a registered representative with the firm since 1981, were named in separate administrative proceedings initiated by the Securities and Exchange Commission for their role in an alleged pump and dump scheme aimed at retail investors from 2008 to 2014. Simultaneously, Ms. Delorme settled her SEC action by agreeing to pay a fine of US $50,000 and to never associate with a broker-dealer, among other sanctions.

According to the SEC, Ms. Delorme benefited from investing her customers in microcap securities that were subject to a pump and dump scheme by Izak Zirk Engelbrecht (a/k/a Zirk de Maison) – who last year was sentenced to 12 years' imprisonment for his role in the fraud that resulted in a US $39 million loss to customers. (Click here for a copy of the Department of Justice's press release regarding Mr. Engelbrecht's sentencing.) The SEC also previously brought charges against Mr. Engelbrecht and others related to the alleged manipulative scheme. (Click here for a copy of the SEC's complaint.)

According to the SEC, in late 2012 and early 2013, Ms. Delorme's supervisors became aware of numerous red flags regarding her conduct, including by reviewing email that purportedly outlined her role in fraudulent transactions involving penny stocks; receiving copies of two customer arbitrations with the Financial Industry Regulatory Authority filed by her customers that made "serious allegations" regarding her role in the same penny stock issuers; and becoming aware of FINRA's investigations regarding her personal trading of one of the relevant penny stocks as well as of the allegations underlying the customer arbitrations. However, said the SEC, despite being aware of these red flags, Ms. Delorme's supervisors continued to permit her to make investment recommendations to her customers.

The SEC charged that Wedbush failed to have adequate supervisory systems to guide supervisors and staff to detect the facilitation of market manipulation by registered representatives, such as Ms. Delorme, or to investigate and handle red flags. As a result, claimed the SEC, "[t]here was substantial confusion as to whose responsibility it [was] to conduct investigations related to red flags of potential market manipulation by [Ms.] Delorme."

In explaining Ms. Delorme's seemingly modest settlement amount, the SEC noted that Ms. Delorme had provided the SEC with a sworn statement of financial condition, asserting her inability to pay a civil penalty. The SEC said it took this statement into account in determining the US $50,000 penalty.

In 2014, Wedbush and two senior officers resolved an enforcement action by the SEC alleging violations of the Commission's market access rule (Reg MAR; click here for background). Wedbush agreed to pay a fine of US $2.44 million, while the two individual officers agreed to pay a combined fine of US $85,000. Wedbush also agreed to retain a consultant to review its compliance with regulatory requirements related to its market access business, among other matters. (Click here for background in the article "Broker-Dealer and Two Senior Officers Fined US $2.5 Million for Market Access Violations" in the November 23, 2014 edition of *Bridging the Week*.) More recently, Wedbush agreed to pay a fine of US $1 million and US $250,000 in disgorgement to resolve SEC allegations that it violated the Commission's customer protection rule (click here for background on this rule, and here regarding the SEC's charges) between September 2014 and January 2015 and a fine of US $1.5 million to the Financial Industry Regulatory Authority related generally to the same offense. (Click here for background in the article "US Broker-Dealer Agrees to US $1.5 Million Fine to Resolve FINRA Charges Related to Capital and Customer Protection" in the February 11, 2016 edition of *Bridging the Week*.)

- **SEC Considers NYSE Bitcoin Futures ETFs**: The Securities and Exchange Commission announced that it would formally consider whether to approve or disapprove rule changes to authorize NYSE Arca, Inc. to list and trade shares of exchange-traded funds based on bitcoin futures contracts traded on either the Cboe Futures Exchange or the Chicago Mercantile Exchange. The SEC solicited comments specifically regarding whether the relevant funds would have sufficient information to assess the fair value of the relevant bitcoin futures contracts, what might be the potential impact of manipulation in the underlying bitcoin markets on the funds' net asset value; how the funds' valuation policies might be impacted by bitcoin forks; and what might be the impact of the high margin requirements for bitcoin futures contracts on the liquidity of such markets and the ability of funds to meet redemption orders, among other topics.

All comments must be submitted within 21 days of the SEC's announcement being published in the *Federal Register*; rebuttal comments must be submitted within 35 days of publication.

In January, the SEC's Davison of Investment Management issued a letter to two industry organizations stating its belief that, as of now, it was not appropriate for investment fund sponsors to seek registration of SEC-regulated funds—such as mutual funds or exchange-traded funds—to "invest substantially in cryptocurrency and related products." This is because "there are a number of significant protection issues that need to be examined before sponsors begin offering these funds to retail investors," said the Division. At the time, the Division implied that, until its questions were answered "satisfactorily," it was not likely to consider for approval any registered fund to invest in cryptocurrencies. (Click here for background in the article "SEC Not Feeling Groovy About Cryptocurrencies – Tells Registered Investment Funds: Slow Down, You Move Too Fast," in the January 21, 2018 edition of *Bridging the Week*.)

Last week, in response to the Division's January letter, Cboe submitted a letter to the SEC encouraging it to view virtual currency exchange-traded products "holistically and from the same perspective that it has historically approached commodity-related EPTs: where exposure to the underlying reference asset could reasonably be included in an investment portfolio, an ETP would provide a more transparent and easily accessible vehicle for gaining such exposure, and the market infrastructure for the underlying reference asset and its associated derivatives do not give rise to significant concerns in any of the … issues raised in the Staff Letter." (Click here for a copy of Cboe's letter.)

Unrelatedly:

- NFA Reminds Members to Update Questionnaires Regarding Virtual Currencies: The National Futures Association reminded introducing brokers, commodity pool operators and commodity trading advisors to update the firm-level section of their annual questionnaire if they become involved with virtual currency derivatives, and for CPOs and CTAs only, if they trade in virtual currencies of any type. (Click here to access a copy of the NFA notice and here for additional background in the article "NFA Virtual Currency Reporting Obligations" in the January 7, 2018 edition of*Bridging the Week*.)

- ESMA Restricts Cryptocurrency CFDs: The European Securities and Markets Authority will impose a temporary restriction on the marketing, distribution or sale of contract for differences to retail investors, including CFDs based on cryptocurrencies. Two months after formal adoption by ESMA through publication of a notice on its website, there will be a maximum leverage limit for CFDs based on cryptocurrencies of 2:1. This means that retail investors will have to post at least 50 percent of the notional value of such a CFD when entering into it. Thereafter, a position must be closed out if the retail client's open CFD margin declines 50 percent or more of the minimum initial required margin. ESMA will also impose restrictions on binary options. (Click here for background.) The Financial Conduct Authority indicated it would consider making these temporary measures permanent in the United Kingdom (click here for background).

- Massachusetts Stops ICOs: Massachusetts has obtained consent orders against five state-located issuers of digital tokens involved in initial coin offerings, requiring them to cease and desist from offering unregistered securities, until such securities are registered or lawfully exempt from registration. Moreover, each issuer must offer rescission of sales to investors. The entities subject to the orders are: Across Platforms, Inc., 18moons, Inc., Mattervest, Inc., Pink Ribbon and Sparkco, Inc. (Click here to access all the consent orders.)

- Bitcoin Trader Convicted of Money Laundering: Thomas Costanzo was convicted of money laundering in a trial held in a federal court Arizona. Mr. Costanzo purportedly assisted undercover federal agents posing as drug dealers launder funds by accommodating their purchases and sales of bitcoin over a two-year period (click here for details).

Follow-Up: Oral arguments are scheduled for April 27 in a federal court in Brooklyn, New York, in connection with Maksim Zaslavskiy's motion to dismiss his indictment charging that he engaged in illegal unregistered securities offerings and securities fraud in connection with the initial coin offerings of two digital tokens (REcoin and DRC) organized by two of his companies, REcoin Group Foundation, LLC and DRC World, Inc. (Click here for background on Mr. Zaslavskiy's indictment in the article "Federal Court, Treasury and SEC Provide Further Guidance on Cryptocurrencies; Subject of Criminal Complaint for ICO Asks Court to Dismiss Prosecution Claiming Cryptocurrencies Are Not Securities" in the March 11, 2018 edition of *Bridging the Week*.) Last week, in supplemental papers submitted by his counsel, Mr. Zaslavskiy repeated earlier arguments that the digital tokens he issued were currencies and thus not securities under applicable law, and that, in any case, the digital tokens were not investment contracts, applying the Supreme Court's multi-prong test in *SEC v. W.J. Howey Co.* (click here to access). The Department of Justice and the SEC rejected these views in papers filed earlier in March. (Click here for background in the article "Department of Justice Argues Against Motion to Dismiss Indictment of ICO Sponsor Claiming That Relevant Digital Tokens Are Securities" in the March 25, 2016 edition of *Bridging the Week*.) Mr. Zaslavskiy's counsel also argued last week that the Securities and Exchange Commission had not given adequate notice of its view that cryptocurrencies are securities, as purportedly required by applicable law. (Click here and here to obtain copies of Mr. Zaslavskiy's latest submissions.)

More Briefly:

- **International Bank Agrees to Pay US $2 Billion to Resolve Federal Claims Related to Sales of Mortgage-Backed Securities**: Barclays Capital, Inc. and several of its affiliates agreed to pay a fine of US $2 billion to resolve a civil action brought by the Department of Justice that, between December 1, 2005 and December 31, 2007, it engaged in a fraudulent scheme to sell 36 residential-mortgage-backed securities by not disclosing that mortgage loans backing the deals were less creditworthy than represented, As a result, DoJ had charged that investors sustained billions of dollars in losses when more than half of the underlying loans defaulted. Two former Barclays managing directors named in the initial lawsuit also settled by payment of a combined sum of US $2 million. The individuals are Paul Menefee and John Carroll. The original complaint was filed in a federal court in Brooklyn, New York.

- **Brokerage Company Settles NY Charges Related to Nondisclosure of Order Execution Practices**: Bank of America Corporation and Merrill Lynch, Pierce, Fenner and Smith Incorporated settled charges brought by the New York State Attorney General that the firms (collectively, "BofAML") fraudulently misled customers regarding their electronic trading services. Specifically, the NYAG claimed that, beginning March 2018, BofAML entered into arrangements with electronic liquidity providers to execute a portion of its institutional clients' orders. However, charged the NYAG, BofAML failed to disclose this arrangement to its clients, and instead advised them their orders were executed in-house. Moreover, said the NYAG, BofAML amended post-trade messaging to disguise the nature of executions to their clients, and on occasion, BofAML failed to disclose this execution arrangement when expressly asked by their clients about how orders would be routed. BofAML agreed to pay a fine of US $42 million to resolve this matter.

Letter to Editor:

- **Is a Hess Toy Truck a Security Too?**: Referencing **My View** in the article "Department of Justice Argues Against Motion to Dismiss Indictment of ICO Sponsor Claiming That Relevant Digital Tokens Are Securities" in the March 26 edition of *Bridging the Week* (click here to access), I agree when you say that the "reasonable expectations of profits at the expense of others" is potentially not present in the SEC's application of the *Howey* test to many ICO-issued securities. It seems to me that underlying the SEC's assertion of jurisdiction is that this is something where there is a lot of volatility, thus a lot of chance that people could lose (or make) a lot of money, so the SEC cannot be seen not to act. Practical perhaps, but not principled.

Permit me to provide an analogy. Your readers (and their children) may be familiar with Hess toy trucks. I was a lawyer at Hess back in the '90s. At that time, the trucks were made available for purchase at Hess gas stations between Thanksgiving and

Christmas. They may have been available “with purchase” so there was a tie-in to Hess’s core business. I think most trucks were bought by people to put under their Christmas tree. But some people bought them as collectors’ items, in many cases with the hope that they would appreciate over time, especially if they were left unopened. A secondary market has existed, mostly on eBay in recent years.

Hess exited the retail gas business about five years ago, when they sold that business to Speedway. They have, however, continued to produce Hess toy trucks. They are made available for purchase online at a fixed price between Thanksgiving and Christmas (or until supplies last). The money goes to the Hess company to do with it whatever they want in their operations. No one expects Hess to take the proceeds of the sale and work solely to enhance the value of the trucks; they will use the proceeds to increase the value of the company. In theory, that might raise the value of the trucks on secondary markets, but that is pretty attenuated. Practically, this is no different from what I understand many sponsors of ICOs are doing. They are not promising any direct income to purchasers of digital tokens; they solely will be using proceeds of the ICO to increase the value of their project. Similar to the Hess truck, that might indirectly raise the value of the associated digital tokens on a secondary market, but that is pretty attenuated.

As **My View** noted, the SEC’s assertion would “make so many unlikely things securities.” If there is an assertion that the thing offered in the ICO (the token) is considered to be a security, why wouldn't one make the same assertion about the Hess toy truck?

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