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Court Upholds SEC Authority and Finds Broker-Dealer Liable for Thousands of Suspicious Activity Reporting Violations

Decision Provides Rare Judicial Guidance on SAR Filing Requirements

On December 11, 2018, the Securities and Exchange Commission (SEC) obtained a victory in its enforcement action against Alpine Securities Corporation, a broker that cleared transactions for microcap securities that were allegedly used in manipulative schemes to harm investors.[1] Judge Cote of the U.S. District Court for the Southern District of New York issued a 100-page opinion partially granting the SEC's motion for summary judgment and finding Alpine liable for thousands of violations of its obligation to file Suspicious Activity Reports (SARs).[2]

Because most SAR-related enforcement actions are resolved without litigation, this decision is a rare instance of a court's detailed examination of SAR filing requirements. The decision began by rejecting—for a second time[3]—Alpine's argument that the SEC lacks authority to pursue SAR violations. The court then engaged in a number of line-drawing exercises, finding that various pieces of information, as a matter of law, triggered Alpine's SAR filing obligations and should have been included in the SAR narratives. This mode of analysis, which applies the SAR rules under the traditional summary judgment standard, may appear to contrast with regulatory guidance recognizing that SARs involve subjective, discretionary judgments.[4]

Although the decision has particular relevance in the microcap context, all broker-dealers—and potentially other entities subject to SAR filing requirements—may wish to review the court's reasoning for insight on a number of SAR issues, including the adequacy of SAR narratives and the inclusion of "red flag" information. Among other cautions, the decision illustrates the dangers of relying on SAR "template narratives"[5] that lack adequate detail.

More broadly, the SEC's action against Alpine is another indicator of heightened federal interest in ensuring broker-dealer compliance with Bank Secrecy Act (BSA) requirements. For example, last month the U.S. Attorney for the Southern District of New York brought the first-ever criminal BSA charge against a broker-dealer, noting that this charge "makes clear that all actors governed by the Bank Secrecy Act—not only banks—must uphold their obligations."[6]

Background

The Department of the Treasury has delegated authority to administer the BSA to its Financial Crimes Enforcement Network (FinCEN).[7] Separately, the Treasury Department delegated the power to "examine

institutions to determine compliance with the requirements" of the BSA to the SEC "with respect to brokers and dealers in securities."[8] The same Treasury regulation that granted the SEC examination power provides that "[a]uthority for the imposition of civil penalties for violations of this chapter lies with the Director of FinCEN."[9]

The SEC regularly brings enforcement proceedings against broker-dealers for failing to file SARs, including two recent enforcement actions in the microcap context.[10] The SEC brings these enforcement actions under Rule 17a-8,[11] which requires broker-dealers to comply with certain BSA regulations, including 31 C.F.R. 1023.320, which includes SAR filing and recordkeeping requirements.

In 2017, the SEC filed an enforcement action in the Southern District of New York against Alpine, a Salt Lake City firm that clears microcap securities.[12] The SEC alleged that from 2011 to 2015 Alpine filed SARs with deficient narratives, failed to file SARs, filed untimely SARs, and failed to maintain supporting documentation for SARs. Many of the underlying transactions involved Scottsdale Capital Advisors (which shares an owner with Alpine) as the introducing broker. As the district court noted, the SEC's enforcement action built upon findings from the Financial Industry Regulatory Authority (FINRA) in 2012 and the SEC's Office of Compliance Inspections and Examinations (OCIE) in 2015 that criticized Alpine's SAR filings and other aspects of its anti-money laundering compliance program. As the court also noted, the low-priced securities market, encompassing penny stocks and microcap stocks, has received regulatory scrutiny for its heightened risks of securities fraud and market manipulation.

The Court Upheld the SEC's Authority to Pursue SAR Violations

Alpine objected to the SEC's authority to pursue these violations, and Judge Cote rejected these arguments in her rulings on March 30, 2018 and December 11, 2018.

Alpine argued that only the Treasury Department, and in particular FinCEN, was empowered to enforce the BSA against broker-dealers, reasoning that FinCEN delegated to the SEC only the authority to examine a broker-dealer for compliance with the BSA, but not the authority to enforce the BSA. The court agreed that "FinCEN has not expressly delegated BSA enforcement authority to the SEC," but held that Section 78q(a)(1) of the Exchange Act grants the SEC "independent authority to require broker-dealers to make reports" and "enforcement authority over those broker-dealer reporting obligations."[13] Further, the court held that the SEC's Rule 17a-8, which requires broker-dealers to comply with the reporting and other requirements of BSA regulations, including 31 C.F.R. 1023.320, was a valid exercise of that broad authority.[14]

The court also rejected Alpine's assertion that holding it liable under the SEC's theory would be "extraordinary" and would "wreak havoc" with the SAR regime and the broker-dealer industry.[15] The court stated that its decision held the SEC to the "well-established summary judgment standard," requiring the SEC to demonstrate that no question of fact exists regarding whether Alpine complied with the applicable

requirements for each alleged deficient SAR, missing SAR, or missing SAR support file on which it sought summary judgment.[16] The court noted that it denied summary judgment whenever the SEC's presentation was "deficient" and whenever Alpine identified a question of fact as to a specific SAR or transaction at issue.[17] The court also observed that the SEC demonstrated that Alpine's SAR failures were "stark," and that, "[g]iven the sheer number of lapses at issue in this case, there is no basis to conclude that a broker-dealer that reasonably attempts to follow the requirements of Section 1023.320 will be at risk."[18]

The Court Found Thousands of SAR Violations As a Matter of Law

Applying the summary judgment standard, Judge Cote found Alpine liable for thousands of SAR-filing violations. The court stated that it based its analysis primarily on Section 1023.320's language and the SAR form's instructions, including the requirement that SAR narratives provide a "clear, complete and chronological description [of] what is unusual, irregular or suspicious about the transaction(s)."[19] The court held that these "instructions have the force of law, having been issued as FinCEN regulations following a notice and comment period."[20] The court also relied on FinCEN guidance documents, which explain that "certain fact patterns are typical of suspicious activity and should be reported by SAR filers."[21] These guidance documents include the SAR Narrative Guidance, which states that a SAR narrative should include the "who, what, when, why, where, and how of the suspicious activity (the 'Five Essential Elements')."[22] The court noted that Alpine did not argue that FinCEN's guidance "unreasonably interprets either Section 1023.320 or the SAR Form."[23]

Deficient SAR Narratives. In its first category of claims, the SEC alleged that 1,593 SARs filed by Alpine had deficient narratives and that the omitted information was found in Alpine's support files for each of these SARs.[24] The court considered as an initial matter whether the SARs at issue were mandatory as opposed to voluntary (had they been voluntary, Alpine could not be faulted for deficiencies in the narratives). The court accepted the SEC's two-part test, according to which, in these circumstances, Alpine had a duty to file a SAR when (1) the underlying transaction involved a large deposit of low-priced securities (LPS) and (2) the transaction also involved one of six "red flags"[25] or the transaction was conducted by customers with certain characteristics.

With respect to the first factor, the court stated that Alpine did not contest that "the market for LPS is vulnerable to securities fraud and market manipulation schemes" or that these "schemes depend on the deposit of a large amount of securities with a broker-dealer so that those securities can enter the market." The court also added that it 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 . . . ."[26]

With respect to the second factor, the SEC claimed that 1,302 of the SARs omitted red flag information that was contained in Alpine's support files.[27] The court noted that, with one exception, Alpine did not "contest

that the red flags on which the SEC relies are indeed red flags and that a broker-dealer should focus on these issues when reviewing transactions."[28] The court found that the SEC's six red flags were derived from the SAR Form and its instructions, as well as FinCEN and other guidance interpreting Section 1023.320, and that they "take into account the unique characteristics of the LPS markets such as the difficulty in obtaining objective information about issuers, the risk of abuse by undisclosed insiders, and the opportunity for market manipulation schemes."[29] The court further held that not only did these red flags (combined with the circumstance of a large LEP deposit) trigger a duty to file a SAR, but the red flag information must be included in the SAR narrative to comply with the SAR Form's instructions to provide a "clear, complete and chronological description [of] what is unusual, irregular or suspicious about the transactions."[30]

We summarize below the court's reasoning regarding the six red flags:

1. **Related Litigation**. The 2002 SAR Form directs filers to "indicate whether there is any related litigation, and if so, specify the name of the litigation and the court where the action is pending."[31] The SEC contended that 675 SARs were deficient because they omitted information on "related litigation" that was available in Alpine's files. Judge Cote agreed that the SEC proved that 668 SARs lacked such information,[32] which in many cases involved SEC enforcement actions against the issuer or the customer (or an affiliate). The court rather broadly held that a litigation was "related" when there is a "connection between the litigation and the reported transaction," and that connection is established when the "litigation at issue concerns either the issuer of the securities in the transaction or the customer engaged in the transaction."[33] In one instance, Alpine argued that information that a customer's president had settled allegations of mortgage fraud in connection with another entity that he owned, three or four years before the filing of the SARs in question, was too attenuated to qualify as "related litigation." The court disagreed: "These arguments do not raise a question of material fact about the duty to include the omitted information in the SARs. The settlement was not so distant in time that the highly pertinent information about a fraudulent scheme in which Customer D's president participated had become irrelevant when these transactions occurred."[34] By contrast, the court rejected summary judgment as to seven SARs. For example, the court held that a question of fact existed as to whether the fact that the CEO of an issuer had been charged with a kickback scheme 14 years earlier was "sufficiently related," given the passage of time, to the transaction at issue to mandate its inclusion.[35]

2. **Shell Companies or Derogatory History of Stock**. The SEC claimed that 241 SARs wrongly omitted this type of red flag information.[36] Citing FinCEN's SAR Narrative Guidance and Shell Company Guidance, the court held that being a suspected shell entity is one of several "common patterns of suspicious activity,"[37] and that Alpine thus was required to note in its SARs involving large LPS deposits whether the customer or issuer was a suspected shell company. The court, however, accepted Alpine's argument that it was not always required to disclose that an issuer was "once a shell corporation," noting that the SEC had failed to establish the significance of an issuer's

former status as a shell company or establish for "how long or in what circumstances such former shell status remains relevant."[38] Judge Cote granted the SEC summary judgment as to the SARs where the issuer was a shell company when the transaction occurred or had been a shell company within one year preceding the transaction.[39] In addition, the court accepted the SEC's argument that various SARs incorrectly omitted other derogatory information—such as frequent name changes by an issuer, trading being suspended on an issuer's security, the issuer having a "caveat emptor" designation, the issuer having sold unregistered shares, and the issuer having been delisted—which information "may indicate that the issuer is engaging in unlawful distributions of securities or is attempting to evade requirements of the securities laws."[40]

3. **Stock Promotion**. Noting that the "promotion of an issuer's stock is a classic indicator that a low-priced stock's price is being manipulated as part of a pump-and-dump scheme,"[41] the court held that Alpine was required to file a SAR and include in the narrative where stock promotion occurred within six months of a substantial deposit of LPS.[42] The court rejected Alpine's proposed one-month cut off as "clearly too short a period," and noted that while a fact finder must "determine the outer limit," promotion activity "within six months of these deposits constituted, as a matter of law, a red flag requiring disclosure in the SAR."[43] On this basis, the court granted summary judgment on 41 of the 55 SARs the SEC alleged were deficient.[44]

4. **Unverified Issuers**. The court agreed with the SEC that 36 SARs were deficient where Alpine omitted that the issuer had an expired business license, a nonfunctioning website, or no current SEC filings.[45] Alpine argued that it was not required to report these facts when it otherwise determined that the issuer was an "active and functioning entity."[46] The court rejected this contention: "If a SAR must be filed for a transaction, then the information casting doubt on the legitimacy of the issuer must be included in the SAR. And that is so even when other information also exists that suggests the issuer may be a functioning business. The duty of the filer is not to weigh and balance the competing inferences to be drawn from the negative and the more reassuring pieces of information, but to disclose 'as much information as is known to' the filer about the subjects of the filing."[47]

5. **Low Trading Volume**. The SEC claimed that 700 SARs omitted this red flag information. The court held that if there is a deposit of LPS that is substantial in comparison with that stock's average volume of trading, then there is a "duty to report both the size of the deposit and the relatively thin trading volume."[48] The court determined that, given the underdeveloped evidentiary record, "a trial will be necessary to determine the precise ratio that triggers the duty to include the average trading volume. It is safe to find, however, that a failure to report the average trading volume when the substantial deposit exceeds a month's worth of the average daily trading in the LPS will always be a violation of the SAR reporting obligations."[49] Notably, the court rejected as "meritless" Alpine's argument that trading volume is already available to law enforcement: "Other categories of

information, such as related litigation, are publicly available but must be included in the SAR. The purpose of a SAR is to provide law enforcement with timely and 'complete' access to information that permits them to understand what is suspicious about the reported activity."[50]

6. **Foreign Involvement**. Pointing to instructions in the SAR Form and SAR Narrative Guidance, the court granted summary judgment to the SEC on 289 SARs that did not disclose "foreign involvement" of various kinds, including the involvement of foreign currency, foreign persons, or a foreign jurisdiction.[51] The court rejected Alpine's arguments, including that it need only disclose information on "high-risk" foreign jurisdictions and that listing foreign addresses in other parts of the SAR filing relieved it of the duty to note foreign involvement in the SAR narrative.[52]

Finally, the SEC claimed that 295 of the 1,593 SARs alleged to have deficient narratives were defective because they did not include the basic customer information in the SAR narrative that FinCEN refers to as the Five Essential Elements. The majority of this set of SARs involved customers as to which "related litigation" information was also omitted, as discussed above. With respect to the remaining 22 SARs in this set, which involved a different customer, the SEC argued these SARs were mandatory because this customer made large LPS deposits and "frequently conducted other transactions in which the issuers of the securities had had significant regulatory or criminal actions brought against them."[53] The court, however, held that the SEC did not explain why the customer's transactions in stock issued by questionable issuers would give a broker-dealer a "reason to suspect that all of [the customer's] LPS transactions involved questionable issuers."[54] For these SARs, the court held that there was a fact question whether these SARs were mandatory, in the absence of a statement in the SAR that Alpine considered the transactions suspicious.

Deposit-and-Liquidation Patterns. In its second category of claims, the SEC sought summary judgment regarding 3,568 sales of LPS.[55] In each instance, Alpine filed a SAR reflecting a large deposit of LPS but did not file a SAR reflecting the sales that followed those deposits. The court granted summary judgment to the SEC as to 1,218 groups where Alpine failed to file a SAR reporting a customer's sales after it had made a substantial deposit of LPS in a thinly traded market.[56] As the court noted, FinCEN guidance explains that the "[s]ubstantial deposit . . . of very low-priced and thinly traded securities," followed by the "[s]ystematic sale of those low-priced securities shortly after being deposited" is suspicious and subject to reporting under Section 1023.320.[57] The court noted that the filing burden on broker-dealers was lessened by the fact that multiple sales transactions could be reported in a single SAR covering a 30-day period.[58]

Late-Filed SARS. The SEC sought summary judgment on 251 SARs that were filed long after the transactions at issue, often more than six months later. The court disagreed, finding that the SEC failed to show that Alpine had an obligation to file the SARs at issue. The SEC relied on the fact that Alpine filed the SARs to comply with a FINRA order to do so, but the court found that this is "not sufficient to establish for purposes of this lawsuit that Alpine had an independent duty to file the SARs."[59]

Failure to Maintain Support Files. Finally, the court granted summary judgment to the SEC on its claim that Alpine failed to maintain support files for 496 of its SARs as required by Section 1023.320(d).[60]

Implications

Given the priority placed on BSA compliance by the SEC, FINRA, and other enforcement agencies, the Alpine litigation and the district court's decision provide a valuable roadmap of issues that broker-dealers may wish to consider in reviewing and enhancing their SAR filing procedures. Among other things, broker-dealers may consider reviewing their practices and procedures in light of the red flags identified by the SEC and the court, as well as the various FinCEN guidance documents upon which the court relied. To the extent form templates are used for SAR narratives, broker-dealers should consider taking steps to ensure that employees have adequate training to build out these narratives to account for the particular circumstances at issue, and that quality assurance procedures are in place in addition to annual testing. Finally, it remains essential that broker-dealers file timely SARs, document their filing decisions, and maintain the required supporting information. While the Alpine litigation is unusual in various respects—and Alpine may well decide to appeal the district court's decision to the Second Circuit[61]—it nevertheless provides some useful insights for broker-dealers and others subject to SAR filing requirements.

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This memorandum is not intended to provide legal advice, and no legal or business decision should be based on its content. Questions concerning issues addressed in this memorandum should be directed to:

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[1] *See* Press Release, U.S. Sec. & Exch. Comm'n, *SEC Charges Brokerage Firm With Failing to Comply With Anti-Money Laundering Laws* (June 5, 2017), *available* here.

[2] *See U.S. Sec. & Exch. Comm'n* v. *Alpine Sec. Corp*., No. 1:17-cv-04179, 2018 WL 6528767 (S.D.N.Y Dec. 11, 2018) (December Op.), *available* here.

[3] *See U.S. Sec. & Exch. Comm'n* v. *Alpine Sec. Corp*., 308 F. Supp. 3d 775, 781 (S.D.N.Y. 2018), *reconsideration denied*, No. 1:17-cv-04179, 2018 WL 3198889 (S.D.N.Y. June 18, 2018).

[4] *See* Federal Financial Institutions Examination Council, Bank Secrecy Act / Anti-Money Laundering Examination Manual: Suspicious Activity Reporting – Overview (2014), *available* here ("The decision to file a SAR is an inherently subjective judgment . . . By their nature, SAR narratives are subjective, and examiners generally should not criticize the bank's interpretation of the facts.").

[5] *See* December Op. at 53.

[6] *See* Press Release, U.S. Dep't of Justice, *Manhattan U.S. Attorney Announces Bank Secrecy Act Charges Against Kansas Broker Dealer* (Dec. 19, 2018), *available* here. The SEC brought a parallel cease-and-desist proceeding against the same broker-dealer. *See* U.S. Sec. & Exch. Comm'n, Order Instituting Administrative and Cease-and-Desist Proceedings, Pursuant to Sections 15(B) and 21c of the Securities Exchange Act of 1934 and Section 203(E) of the Investment Advisers Act of 1940 Making Findings, and Imposing Remedial Sanctions and a Cease-and-Desist Order (Dec. 19, 2018), *available* here.

[7] 31 C.F.R. § 1010.810(a).

[8] 31 C.F.R. § 1010.810(b)(6).

[9] 31 C.F.R. § 1010.810(d).

[10] For example, in 2018 the SEC reached resolutions with Chardan Capital Markets LLC and its clearing firm, Industrial and Commercial Bank of China Limited, for failures to file SARs related to microcap sales. *See* U.S. Sec. & Exch. Comm'n, Order Instituting Administrative and Cease-and-Desist Proceedings, Pursuant to Sections 15(b) and 21C of the Securities Exchange Act of 1934, Making Findings, and Imposing Remedial Sanctions and a Cease-and-Desist Order, In the Matter of Chardan Capital Markets, LLC (May 16, 2018), *available* here; U.S. Sec. & Exch. Comm'n, Order Instituting Administrative and Cease-and-Desist Proceedings, Pursuant to Sections 15(b) and 21C of the Securities Exchange Act of 1934, Making Findings, and Imposing Remedial Sanctions and a Cease-and-Desist Order, In the Matter of Industrial and Commercial Bank of China Financial Services, LLC (May 16, 2018), *available* here. For a discussion of other recent anti-money laundering enforcement actions by the SEC, *see* Paul, Weiss Memorandum, "Economic Sanctions and Anti-Money Laundering Developments: 2017 Year in Review" (Jan. 23, 2018), *available* here.

[11] 17 C.F.R. § 240.17a-8.

[12] *See* Complaint, *U.S. Sec. & Exch. Comm'n* v. *Alpine Sec. Corp*. (S.D.N.Y. June 5, 2017), *available* here.

[13] December Op. at 30-31.

[14] *See id.*

[15] *Id*. at 35.

[16] *Id.*

[17] *Id*. at 36.

[18] *Id.*

[19] *Id.* at 32 (citing 2002 SAR Form at 3). The court noted that the 2012 SAR form was materially similar.

[20] *Id.*

[21] *Id.* at 33. *See also* FinCEN, Guidance on Preparing a Complete & Sufficient Suspicious Activity Report Narrative 4-6 (Nov. 2003), *available* here.

[22] December Op. at 25. The court followed FinCEN's lead in calling these six elements the Five Essential Elements of a SAR. *See id.* at 25 n.22; FinCEN, Guidance on Preparing a Complete & Sufficient Suspicious Activity Report Narrative 3 (Nov. 2003), *available* here.

[23] December Op. at 33.

[24] *Id.* at 13-14, 44.

[25] 2002 SAR Form at 3, *available* here.

[26] December Op. at 46.

[27] *Id.* at 45.

[28] *Id.* at 47.

[29] *Id.* at 52. *See also* FinCEN, 2002 SAR Form, *available* here; FinCEN, FinCEN Suspicious Activity Report (FinCEN SAR) Electronic Filing Instructions (Oct. 2012), *available* here; and FinCEN, Guidance on Preparing a Complete & Sufficient Suspicious Activity Report Narrative 3 (Nov. 2003), *available* here.

[30] *See* December Op. at 32.

[31] *Id.* at 54 (citing 2002 SAR form at 3).

[32] *Id.* at 66.

[33] *Id.* at 54-55.

[34] *Id.* at 62-63.

[35] *See id.* at 65.

[36] *Id.* at 67.

[37] *Id. See also* FinCEN, FIN–2006–G014, Potential Money Laundering Risks Related to Shell Companies (Nov. 9, 2006), available here; FinCEN, Guidance on Preparing a Complete & Sufficient Suspicious Activity Report Narrative 3 (Nov. 2003), *available* here.

[38] December Op. at 69-70.

[39] *Id.* at 70.

[40] *Id.*

[41] *Id.* at 72.

[42] *Id.* at 75.

[43] *Id.* at 74-75.

[44] *Id.* at 75.

[45] *Id.* at 79.

[46] *Id.* at 79.

[47] *Id.* at 78-79 (citing SAR Activity Review, Issue 22, at 39).

[48] *Id.* at 81.

[49] *Id.* at 82.

[50] *Id.* at 83 (citing 2002 SAR form at 3).

51 *Id.*

52 *See id.* at 85-86.

53 *Id.* at 88.

54 *Id.*

55 *Id.* at 89.

56 *Id.*

57 *Id.* at 90 (citing SAR Activity Review, Issue 15, at 24).

58 *Id.* at 91-92.

59 *Id. at* 97.

60 *Id.* at 99.

61 Alpine had previously attempted to seek mandamus on the issue of the SEC's enforcement authority. *See In re Alpine Sec. Corp.*, No. 18-1875 (2d Cir. Aug. 7, 2018).