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SEC's Recent AML Enforcement Actions: No Need for CCOs to Panic

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In a recent speech, Securities and Exchange Commission (SEC) Commissioner Hester Peirce urged the commission to “take great care in imposing liability on chief compliance officers” (CCOs) and not “second-guess [their] good faith decisions” because the commission wants “firms to hire good CCOs.” Less than a week later, on May 16, 2018, the SEC published a settled administrative enforcement proceeding against a broker-dealer firm’s CCO/AML compliance officer, his employing firm (an introducing broker), and that firm’s clearing broker for failure to file suspicious activity reports (SARs) for seven firm customers’ trading activity in penny stocks over a nine-month period.

The Introducing Firm’s Failure to File SARs

The seven customers, which were onboarded by introducing firm Chardan Capital Markets LLC in late 2013, routinely deposited and promptly sold billions of shares of thinly traded penny stocks that the customers primarily obtained by converting debentures into shares of microcap issuers. The customers deposited these shares with a custodian and then sold them through Chardan via DVP/RVP accounts. These sales, which totaled more than 12.5 billion shares of penny stocks, regularly accounted for significant percentages of the daily trading volumes of the stocks (e.g., each of the seven customers engaged in at least one transaction involving sales of more than 50 percent of the day’s trading volume in a particular stock, and four of them engaged in at least one transaction where the sales exceeded 70 percent of the day’s trading volume in a stock) and often occurred after or as promotions of the penny stocks were occurring.

Among the numerous red flags that Chardan should have identified involving the customers and trading at issue under its anti-money laundering (AML) policies and procedures were the questionable background of the customers, trading that constitutes a substantial portion of all trading for the day in a particular security and heavy trading in low-priced securities, two or more accounts trading an illiquid stock suddenly and simultaneously, the receipt of law enforcement subpoenas regarding the customers’ activities, and the customers’ request to liquidate penny stock shares, which may also represent engaging in an unregistered distribution of penny stocks. In addition, Chardan’s policies specifically identified as red flags of suspicious activity the trading in stocks of penny stock issuers that:

- Have no business, no revenues, and no product.
- Have experienced frequent or continuous changes to their business structure.
- Have officers who are associated with multiple penny stock issuers.
- Undergo frequent material changes in business strategy or its line of business.
- Have been the subject of a prior trading suspension.

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According to the SEC's order, Chardan discovered past criminal and regulatory issues with an entity these seven customers were associated with; after executing the trades, Chardan received numerous regulatory inquiries into certain of the penny stocks these customers had traded in; and, according to the SEC, Chardan knew, or should have known, that the SEC had suspended trading in three securities shortly after the securities had been sold by certain of its seven customers. The SEC found that Chardan's monitoring of its customers' trading was insufficient to identify suspicious activity and that it failed to comply with its own AML policies and failed to file SARs as required under the Bank Secrecy Act. Consequently, Chardan was subject to a cease-and-desist order, censured, and fined \$1 million.

The Clearing Firm's Failure to File SARs

Industrial and Commercial Bank of China Financial Services LLC (ICBCFS), the clearing firm that cleared and settled the trades of the seven Chardan customers, was similarly found to have failed to file required SARs. According to the SEC, while ICBCFS took some steps to stop Chardan's customers' suspicious trading activity at certain points during the relevant period, including ceasing to clear penny stock trades in June 2014, it never filed a SAR for any of the trading activity of Chardan customers. For instance, at one point ICBCFS requested that Chardan have a customer stop trading sub-penny stocks, but the customer continued that activity and no SAR was filed by ICBCFS. Likewise, on another occasion ICBCFS threatened Chardan that it would close a customer's account unless Chardan provided a sufficient description of the customer's transactions and background; ICBCFS did close the account, but it did not file a SAR. ICBCFS further asked Chardan for information about numerous trades by customers trading low-priced securities but failed to file related SARs for any of them. In addition, ICBCFS personnel were aware that certain accounts at a firm specializing in low-priced securities that had previously been shut down by ICBCFS had migrated to Chardan, but ICBCFS failed to investigate these customers' trading activity and failed to file any related SARs. Consequently, ICBCFS was subject to a cease-and-desist order, censured, and fined \$860,000.

In the related Financial Industry Regulatory Authority (FINRA) enforcement action against ICBCFS, FINRA found that, despite clearing and settling billions of penny stock shares for introducing firms starting in 2012, ICBCFS failed to have in place a reasonably designed AML program to detect and cause the reporting of potentially suspicious transactions, particularly those involving penny stocks. Not only did ICBCFS not have surveillance reports that monitored potentially suspicious penny stock liquidations until June 2014, but it also did not require its employees to document their review of the surveillance reports it did have in place. In addition, ICBCFS did not have systems and procedures to monitor whether certain business activities were unusual for any given customer, despite the firm's written AML procedures specifically identifying such activity as red flags requiring monitoring; and because the firm assigned critical suspicious activity monitoring duties to a nonexistent employee title, no such monitoring was effectively conducted.

As a consequence, FINRA found that ICBCFS failed to detect or reasonably investigate red flags of potentially suspicious activity involving penny stock transactions run through the firm. Furthermore, after being informed through an SEC examination that its customers were engaged in potentially suspicious penny stock trading that the firm did not detect or report, ICBCFS failed to amend its AML program to address those shortcomings and also failed to inform its AML independent auditor of the issues. In addition, ICBCFS's compliance testing of its AML program was inadequate because it failed to uncover any of the deficiencies in the firm's trade monitoring. In settling the FINRA action, ICBCFS paid a fine of \$5.3 million (which was in addition to the \$860,000 fine imposed against the firm in the SEC action).

ICBCFS also was found to have failed to promptly produce requested documents to the SEC during the course of its investigation and to have lost approximately 40,000 emails over a four-month period in violation of Rule 17a-4. It is impossible to determine how much of the penalty imposed was attributable to this serious violation of applicable books-and-records requirements and how much was attributable to the failure to file SARs, particularly in light of the simultaneous FINRA enforcement action in which ICBCFS was found to have committed systemic AML violations surrounding its clearance and settlement of liquidations of 33 billion penny stock shares over a three-year period and fined \$5.3 million. It is possible, however, that the comparatively smaller penalty for ICBCFS's AML violations in the SEC action reflected the fact that ICBCFS did take some steps to stop Chardan's customers' suspicious activity, even if it did not file SARs.

Liability of the CCO/AML Officer

As AML officer and CCO of Chardan, Jerard Basmagy was responsible for implementing Chardan's policies as well as filing SARs for the firm. According to the SEC's order in the administrative proceeding against him, Basmagy failed to recognize and investigate the numerous red flags arising from the significant penny stock liquidations by customers of the firm. According to the SEC's order, the large-volume penny stock transactions through the DVP/RVP accounts, together with other red flags, should have caused the firm, through Basmagy, to collect additional information about how the customers acquired their shares and how long they had held the stock.

While noting that the firm's policies did change over time to address large sales by customers of penny stocks, the SEC nevertheless found that Chardan and Basmagy failed to collect documents sufficient to show how each of the customers obtained their shares for numerous suspicious transactions. On one occasion, when Basmagy did receive documentation that he deemed insufficient such that he did not permit the customer to execute its trade, Basmagy did not file a SAR for that transaction or conduct further investigation. Basmagy also was found to have engaged in insufficient monitoring of patterns of suspicious activity, as required by Chardan's policies (e.g., he failed to look into red flags regarding issuers, their principals, or their trading volume). In addition, Basmagy failed to follow up on reports from ICBCFS about suspicious transactions by Chardan customers by either investigating the reports or filing SARs. Even after ICBCFS ceased to allow any Chardan customers to trade penny stocks through it because of concerns about the seven Chardan customers, neither Chardan nor Basmagy investigated the customers' penny stock trading or filed related SARs.

Importantly for purposes of the action against Basmagy, however, after FINRA and SEC staff investigating transactions by Chardan customers in low-priced securities (separately) requested responsive documents in Chardan's possession, custody, or control, Basmagy requested that Chardan registered representatives contact customers and obtain those documents. None of those documents had previously been obtained despite the requirements of Chardan's policies. Basmagy then produced the documents to the regulators without noting that Chardan only obtained them after it had received the regulators' requests, so that the investigative staff mistakenly believed that the documents had been in Chardan's possession at the time of the transactions at issue.

The SEC found that, as a result of its customers' trading activity, Chardan knew, suspected, or had reason to suspect that its customers were using their Chardan accounts to facilitate unlawful activity and that their deposits and subsequent liquidations of penny stocks were suspicious. Chardan was therefore required to file SARs for its customers' activity, and Basmagy, who had the responsibility to file those SARs as CCO/AML officer, was found to have willfully aided and abetted and caused Chardan's violation of Exchange Act Section 17(a) and Rule 17a-8. Basmagy was subjected to a cease-and-desist order, fined \$15,000, and subject to both an industry bar and a penny stock bar, with the right to apply for reentry after three years.

Lessons to Be Taken

It is clear that FINRA and the SEC continue to focus on AML violations as an area of enforcement priority and that firms should be sure to comply with their own AML policies that require monitoring and surveillance of customer trading activity, investigation of red flags, and reporting of suspicious trading activity through SARs. The basic takeaway from the SEC's actions is that, especially where penny stock trading is involved, firms should be particularly careful to investigate red flags and to reject customers during onboarding and reject potentially violative trades when circumstances warrant (and then file a SAR).

While regulators have demonstrated a greater willingness to bring charges against individual associated persons in enforcement actions, the fact that in this case the introducing firm's CCO/AML officer was held individually liable and barred from the securities industry should not cause compliance professionals undue concern. The noted failures of all of the named respondents in these three related actions are fairly egregious. Basmagy appears to have failed to perform the compliance tasks that he was explicitly assigned under Chardan's policies—failing to investigate obvious red flags, appropriately monitor customer trading (particularly in penny stocks), or file any SARs—even after specific information about suspicious activity involving Chardan customers was brought to his attention by ICBCFS and after ICBCFS ceased clearing any penny stock transactions for Chardan customers because of concerns about suspicious penny stock trading.

The most egregious act by Basmagy, however, may have been that he intentionally attempted to mislead the SEC's staff into thinking that certain documents had been in Chardan's files since the transactions being investigated had been executed (likely in an effort to claim that Chardan had conducted an investigation of red flags at the time), when those documents in fact had been collected years later and only after the SEC staff had requested Chardan's files. While his failure to file SARs on behalf of Chardan is clearly a serious violation of his obligations, his apparent attempt to mislead the staff and create evidence in an effort to exonerate the firm and himself is likely what led to his industry and penny stock bars. For this reason, firm compliance professionals should not be overly concerned that the SEC's action against Basmagy, and the severe penalty imposed, is indicative of heightened scrutiny of their activities.

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