

SEC Charges Broker-Dealer and AML Officer for Failing To File SARs Related To Pump-And-Dump Scheme

On January 25, 2017, the Securities and Exchange Commission (“SEC”) announced administrative proceedings against New York-based brokerage firm Windsor Street Capital (“the Firm”) and its former Chief Compliance Officer (“COO”) and anti-money laundering (“AML”) officer John D. Telfer.¹ The SEC alleged that (1) the Firm facilitated the unregistered sale of hundreds of millions of penny stock shares in violation of Section 5 of the Securities Act of 1933 (the “Securities Act”) and (2) the Firm and Telfer failed to file Suspicious Activity Reports (“SARs”) relating to suspicious stock sales on behalf of customers in violation of Section 17(a) and Rule 17a-8 of the Securities Exchange Act of 1934 (the “Exchange Act”). Also on January 25, the SEC separately charged two of the customers, Raymond H. Barton and William G. Goode, with conducting an illegal pump-and-dump scheme.² Andrew M. Calamari, Director of the SEC’s New York Regional Office and Co-Chair of the Enforcement Division’s Broker-Dealer Task Force, stated that “when other brokerage firms were rejecting similar deposits by Barton and Goode, [the Firm] not only effectuated their illegal stock sales but then failed to report them as required by law.”³

I. Section 5 Violations

The SEC alleged that the Firm violated “Section 5 by engaging in [stock sales] on behalf of Barton and Goode without first performing a reasonable inquiry of whether [they] complied with Section 5.”⁴ Section 5 of the Securities Act makes it unlawful to offer or sell a security prior to the filing of a registration statement unless an exemption from registration is available.⁵ From January to October 2014, the Firm sold hundreds of millions of unregistered shares of stock issued by MedGen, Inc., Alternaturals, Inc. Manzo Pharmaceuticals, Inc. and Solpower, Inc. on behalf of Barton and Goode, receiving approximately \$120,000 in commissions.⁶ Barton and Goode falsely represented to the Firm that the sales were exempt from Section 5, and the Firm accepted their representations “at face value, without further inquiry.”⁷

II. Section 17(a) and Rule 17a-8 Violations

The SEC alleged that the Firm violated Exchange Act Section 17(a) and Rule 17a-8, and Telfer caused and aided and abetted those violations, by failing to file SARs with the United States Treasury Department’s Financial Crimes Enforcement Network (“FinCEN”), as required by the Bank Secrecy Act of 1970 (“BSA”) and

¹ See Order Instituting Administrative and Cease and-Desist Proceedings, *In the Matter of Windsor Street Capital, L.P.*, Adm. Proc. File No. 3-17813 (January 25, 2017) (the “Order”), available at <https://www.sec.gov/litigation/admin/2017/33-10293.pdf>.

² See Complaint, *SEC v. Barton*, Civil Action No. 2:17-cv-00403 (E.D.N.Y. Filed January 25, 2017), available at <https://www.sec.gov/litigation/complaints/2017/comp-pr2017-33.pdf>. Without admitting or denying the allegations, Barton, Goode and several other defendants agreed to settle the charges and consented to court orders requiring them to pay disgorgement plus interest and penalties totaling more than \$8.7 million. The litigation is still pending against one defendant. See SEC Press Release, *Brokerage Firm Charged With Gatekeeper Failures Related to Pump-and-Dump Scheme* (Jan. 25, 2017) (the “Press Release”), available at <https://www.sec.gov/news/pressrelease/2017-33.html>.

³ See Press Release.

⁴ Order at ¶ 9.

⁵ 15 U.S.C. § 77e(a), (c).

⁶ Order at ¶¶ 7-8, 11.

⁷ *Id.* at ¶ 10.

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its implementing regulations. A broker-dealer is required to file a SAR regarding any transaction conducted or attempted by, at, or through a broker-dealer involving or aggregating funds or other assets of at least \$5,000 where the broker-dealer knows, suspects, or has reason to suspect that the transaction is illegal.⁸

The Firm's written AML Policy stated that the Firm would "file [SARS] with FinCEN" as required by the BSA, and would monitor account activity for "red flags" such as (a) a customer's "[r]eluctance to provide complete information about nature and purpose of business, ... anticipated account activity, officers and directors or business location"; (b) a customer's "[b]ackground is questionable or differs from expectations based on business activities"; (c) "[t]wo or more [customer] accounts trade an illiquid stock suddenly and simultaneously"; (d) a customer's "transactions include a pattern of receiving stock in physical form or the incoming transfer of shares, selling the position and wiring out proceeds"; and (e) a customer engages in penny-stock transactions, in which the issuer "has no business, no revenues, no revenues and no product," or "undergoes frequent material changes in business strategy or its line of business."⁹ The AML Policy stated that if an employee of the Firm detected any red flags, or other suspicious activity, he or she should notify the AML officer, Telfer. Telfer then would determine whether or not and how to further investigate the matter, which could include filing a SAR.

The Firm and Telfer failed to file required SARs concerning sales of penny stocks following strong indicia of suspicious activity, including the types of red flags listed in the AML Policy. Customers like Barton and Goode allegedly deposited large blocks of penny stocks, liquidated them typically amid substantial promotional activity, and then transferred the proceeds away from the Firm. The red flags allegedly included "their nearly simultaneous trading in both customers' accounts; a pattern of depositing shares, quickly liquidating them, and wiring out the proceeds; and changes in the issuers' business plans at or about the time Barton and Goode's trading began."¹⁰ According to the SEC, a reasonable investigation would have confirmed that the activity was suspicious, warranting the filing of a SAR. The SEC pointed out that a Google search for "Barton" would have identified a post concerning him on the website "pumpsanddumps.com" and that Barton's and Goode's trading typically coincided with sensational issuer press releases.¹¹ In other cases, red flags were allegedly brought directly to Telfer's attention through notifications from the Firm's clearing firm. In all, the SEC alleged that the Firm and Telfer should have filed SARs concerning dozens of potentially illegal stock sale transactions by its customers, totaling at least \$24.8 million in proceeds.

This matter exemplifies the SEC's continuing interest in broker-dealer AML policies and compliance.

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If you have any questions about the issues addressed in this memorandum or if you would like a copy of any of the materials mentioned, please do not hesitate to call or email Bradley J. Bondi at 202.862.8910 or bbondi@cahill.com; Charles A. Gilman at 212.701.3403 or cgilman@cahill.com; Kimberly C. Petillo-Décosard at 212.701.3265 or kpetillo-decosard@cahill.com; John Schuster at 212.701.3323 or jschuster@cahill.com; or Sara Ortiz at 212.701.3368 or sortiz@cahill.com.

⁸ 31 C.F.R. § 1023.320. Exchange Act Rule 17a-8 requires broker-dealers to comply with 31 C.F.R. § 1023.320.

⁹ Order at ¶¶ 14-15.

¹⁰ *Id.* at ¶ 23.

¹¹ *Id.* at ¶ 24.