IBDC-RIAC SPOTLIGHT SERIES

THE CHALLENGES OF IDENTIFYING AND DEFENDING SELLING AWAY AND MONEY LAUNDERING

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ABOUT IBDC-RIAC

IBDC-RIAC is a cooperative organization created to aggregate the talents and resources of legal, insurance, compliance, regulatory, cyber security and technology experts who provide services to independent broker-dealers, registered investment advisors and insurance agents. A network of professionals who share the common goal of working with these financial communities to preserve and grow their businesses.

Lilian Morvay, the founder of IBDC-RIAC, has over 25 years experience in the legal and insurance industries working with broker dealers, RIAs and insurance agents.

SELLING AWAY AND MONEY LAUNDERING DISCUSSION POINTS

- What is selling away and money laundering?
- What are the broker-dealer's duties to prevent and identify selling away and money laundering?
- How may an external consultant assist a broker-dealer with its annually required internal investigation to discover selling away and money laundering?
- How may the right expert assist defense counsel in defending selling away and money laundering claims?
- As an insurance underwriter, what are important questions to ask broker-dealers is assessing their risk for selling away and money laundering claims?

Governing Rules: Selling Away

- FINRA Rule 3270 – Outside business activities.
- FINRA Rule 3280 – Private securities transactions.
- FINRA Rule 3110 – Supervision.

Theories of Liability

- Vicarious liability.
- Apparent authority.
- Negligent supervision.
- Control person.

Vicarious Liability / *Respondeat Superior*

- Derivative of broker's primary liability.
  - Violation of statute or common law duty.

    vs.
  - Industry rules / firm policies.
    - No private right of action.
    - *Vennittilli v. Primerica*, 943 F. Supp. 793, 798 (E.D. Mich., 1996).
    - *Craighead v. E.F. Hutton*, 899 F.2d 485, 493 (6th Cir., 1990).

- Defenses.
  - Broker acted outside the scope of his or her association or duties.
  - Broker acted for his or her own purpose.
  - Firm was unaware.
    - Brokerage firm not obligated to repay personal loan broker solicited from customer.
      - *Smith v. Merrill Lynch,155 Mich. App. 230, 399 N.W.2d 481 (1986).*
  - Can't logically be acting on behalf of firm if conduct violates industry rules and firm policies.

Apparent Authority

- Merely alleging an employment relationship is not enough.

- Apparent authority must be traceable to the principal and cannot be established by the acts and conduct of the agent.
  - *Meretta v. Peach*, 195 Mich. App. 695, 698-699; 491 N.W.2d 278 (1992).

Apparent Authority

- Practice pointers.
  - Demonstrate firm's policies and procedures limit the scope of a broker's sales activities.
  - Demonstrate the investor's belief that the sale was thorough and approved by the firm was not reasonable.
  - *Harrison v. Dean Witter Reynolds*, 974 F.2d 873, 891 (7th Cir, 1992).
    - No "reasonably prudent person [could] naturally suppose [the broker] possessed the authority."
  - *Carsten v. North Bridge Holdings*, 2006 Mich. App. LEXIS 230 (Jan. 24, 2006).
    - Investor did not reasonably rely on the brokerage firm when she signed a blank piece of paper authorizing an unexplained transaction.
  - *Kohn v. Optik*, 1993 U.S. Dist. LEXIS 7298 (C.D. Calf., March 30, 1993).
    - Investor didn't (1) open a regular account, (2) send checks to the firm, (3) receive a receipt, statement or other communication from the firm. The irregularity of the transaction put the investor on notice that the broker was acting outside the scope of his employment.
  - Force the investor to come forward with evidence to show:
    - Firm was aware.
    - Firm was involved.
    - Firm benefitted.

Negligent Supervision

- Two guiding concepts – FINRA's rules and common law negligence.

- FINRA Rule 3110.
  - Establish
  - Implement
  - Maintain

  } A System

- System must be reasonably designed to achieve compliance with securities laws, rules and regulations.
  - "The standard of 'reasonableness' is determined based upon the circumstances of each case…. The burden is on the staff to show that respondent's procedures and conduct were not reasonable…..It is not enough to demonstrate that an individual is less than a model supervisor or that the supervision could have been better."
    - *In re William Lobb*, NASD Compl. No. 07960105, p 5 (Apr. 6, 2000).

- Reasonableness standard is desirable for several reasons.
  - Allows consideration of facts and circumstances in each case (size of broker-dealer, type of business conducted, operational staff, compliance oversight, etc.).
  - Balances the cost to investors to conduct business with the broker-dealer. Supervisory costs necessarily are reflected in brokerage firm fees and commissions.

Negligent Supervision

- Common law negligence.
  - Duty.
    - Flows from relationship.
    - What duties are owed to customers?
    - What duties, if any, are owed to non-customers?
  - Breach.
    - Distinguish between acts of commission and acts of omission.
  - Proximate Cause.
    - Two types of causation.
    - Transaction causation and loss causation.
  - Injury

Control Person Liability

- As a general rule, a broker-dealer controls its registered representatives, whether directly or indirectly.
  - But courts do recognize that a broker's conduct is not always within the firm's control.
    - *Hauser v. Farrell*, 14 F.3d 1338 (9th Cir, 1994).

- Governing statutes build in a "good faith" defense.
  - Burden of proof on broker-dealer.
  - Must show it did not know (subjective standard) and, in the exercise of reasonable care, could not have known (objective standard) of the misconduct.

- Good faith defense sustained if:
  - Reasonable written supervisory procedures established, implemented diligently enforced, and maintained.
  - Broker-dealer did not directly or indirectly induce the misconduct.
  - No red flags or, if there were red flags, the broker-dealer was vigilant in discovering, investigating, and promptly and appropriately responding.

Outside Business Activities

- FINRA Rule 3270.
  - Business activity outside the scope of the relationship with the firm is prohibited, unless the broker has provided prior written notice to the firm.

- Supplementary material to FINRA Rule 3270 - .01 Obligations of Member Receiving Notice.
  - Upon receipt of written notice, the firm must consider whether the proposed activity will: (1) interfere with or otherwise compromise the broker's responsibilities to the firm and/or customers, or (2) be viewed by customers or the public as part of the firm's business based upon, among other factors, the nature of the proposed activity and the manner in which it will be offered.
  - The firm must evaluate the advisability of imposing specific conditions or limitations on a broker's outside business activity, including, where circumstances warrant, prohibiting the activity.
  - The firm also must evaluate the proposed activity to determine whether the activity properly is characterized as an outside business activity or whether it should be treated as an outside securities activity subject to the requirements of Rule 3280.
  - The firm must keep a record of its compliance with these obligations with respect to each written notice received and must preserve this record for the period of time and accessibility specified in SEA Rule 17a-4(e)(1).

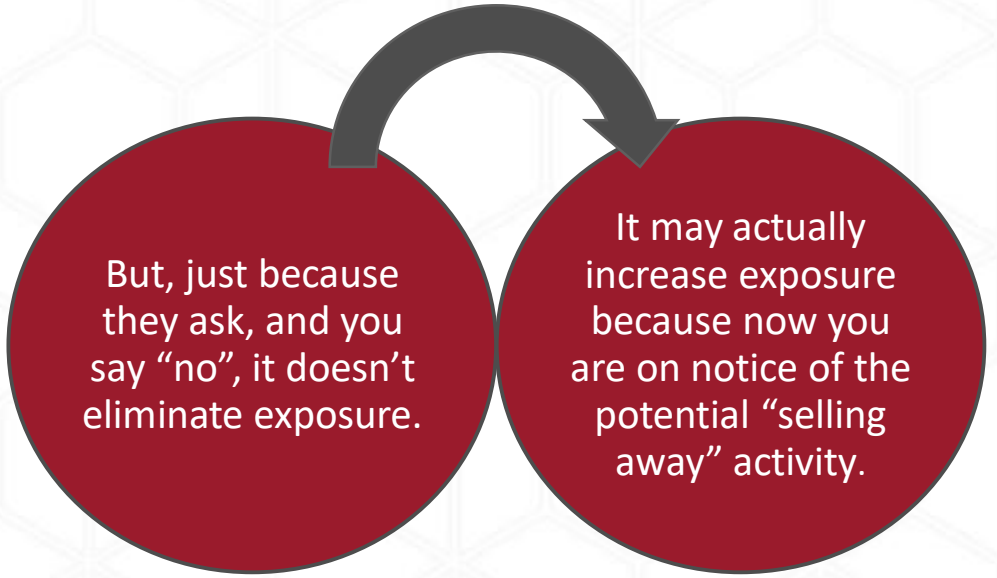
Private Securities Transactions

- FINRA Rule 3280.
  - **(a) Applicability.**
    - No person associated with a member shall participate in any manner in a private securities transaction except in accordance with the requirements of this Rule.
  - **(b) Written Notice.**
    - Prior to participating in any private securities transaction, an associated person shall provide written notice to the member with which he is associated describing in detail the proposed transaction and the person's proposed role therein and stating whether he has received or may receive selling compensation in connection with the transaction; provided however that, in the case of a series of related transactions in which no selling compensation has been or will be received, an associated person may provide a single written notice.
  - **(c) Transactions for Compensation.**
    - (1) In the case of a transaction in which an associated person has received or may receive selling compensation, a member which has received notice pursuant to paragraph (b) shall advise the associated person in writing stating whether the member: (A) **approves** the person's participation in the proposed transaction; or (B) **disapproves** the person's participation in the proposed transaction.
    - (2) If the member approves a person's participation in a transaction pursuant to paragraph (c)(1), the transaction shall be recorded on the books and records of the member and the member shall supervise the person's participation in the transaction as if the transaction were executed on behalf of the member.
    - (3) If the member disapproves a person's participation pursuant to paragraph (c)(1), the person shall not participate in the transaction in any manner, directly or indirectly.

Takeaways from Rule 3280

- Essentially, if after receiving written notification of a possible securities transaction, a broker-dealer approves such a transaction, that broker-dealer must supervise the transaction as if it is a product of the broker-dealer.

- If the broker-dealer rejects the request for approval, the broker cannot participate in the transaction.



So what happens when individual investors seek to arbitrate claims against a broker-dealer but they lack any formal affiliation with the firm?

- i.e., they aren't traditional "customers."

Do broker-dealers have to arbitrate these "selling away" claims?

When registered representatives go rogue and sell unapproved products to investors who aren't technically customers of the broker-dealer, one would think that a broker-dealer could avoid arbitration.

Not necessarily…

An agreement to arbitrate exists within the meaning of the mandatory arbitration rule only if it is required by a written agreement or a customer requests arbitration from a member.

- **FINRA Rule 12200:**
  - Requires FINRA members to arbitrate disputes:
    - "between a customer and a member or associated person of a member" if arbitration is "requested by the customer" or "required by a written agreement" and the dispute "arises in connection with the business activities of the member or associated person...."

SO, WHO IS A CUSTOMER?

WHETHER INVESTORS ARE CUSTOMERS OF A FINRA MEMBER, SUCH THAT INVESTORS COULD INVOKE FINRA'S MANDATORY ARBITRATION RULE, RELATES TO THE EXISTENCE OF A CONTRACT TO ARBITRATE, NOT THE SCOPE OF THAT POTENTIAL AGREEMENT.

UBS FINANCIAL SERVICES V. CARILION CLINIC, 706 F.3D 319 (4TH CIR., 2013).

"WHEN PARTIES HAVE AGREED TO ARBITRATE, COURTS ENFORCE THOSE AGREEMENTS VIGOROUSLY TO PROTECT THE PARTIES' JUSTIFIED EXPECTATIONS CONCERNING THEIR CHOICE OF DISPUTE RESOLUTION MECHANISMS AND THEIR POTENTIAL EXPOSURE TO LIABILITY."

RAYMOND JAMES FINANCIAL SERVICES, INC. V. CARY, 709 F.3D 382 (4TH CIR., 2013).

"Customer" as used in the FINRA mandatory arbitration rule generally refers to an entity that is not a broker or dealer, who purchases commodities or securities from a FINRA member in the course of a member's business activities, namely the activities of investment banking and the securities business.

UBS Fin. Servs., Inc. v. Carilion Clinic, 706 F.3d 319, 325 (4th Cir., 2013).

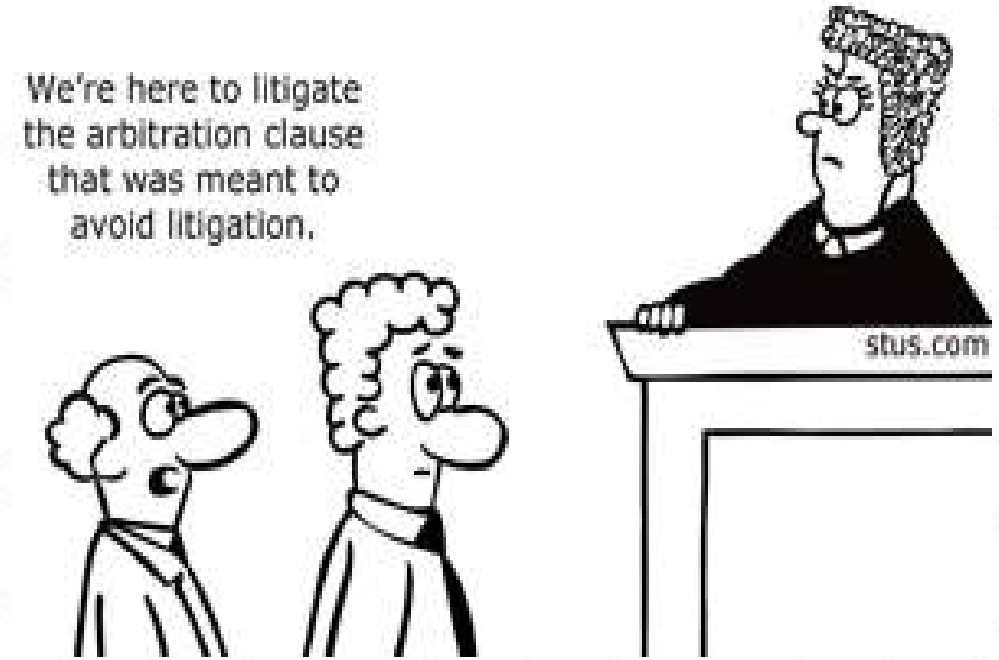
FINRA has endorsed the view that its members are required to arbitrate disputes with its "customers: or the "customers" of its "associated persons" by explaining in a procedural rule change proposal to the SEC, that it views "selling away" claims as arbitrable against a member.

See, Order Approving Proposed Rule Change, 74 Fed. Reg. 731, 736 N.37 (Jan. 7, 2009).

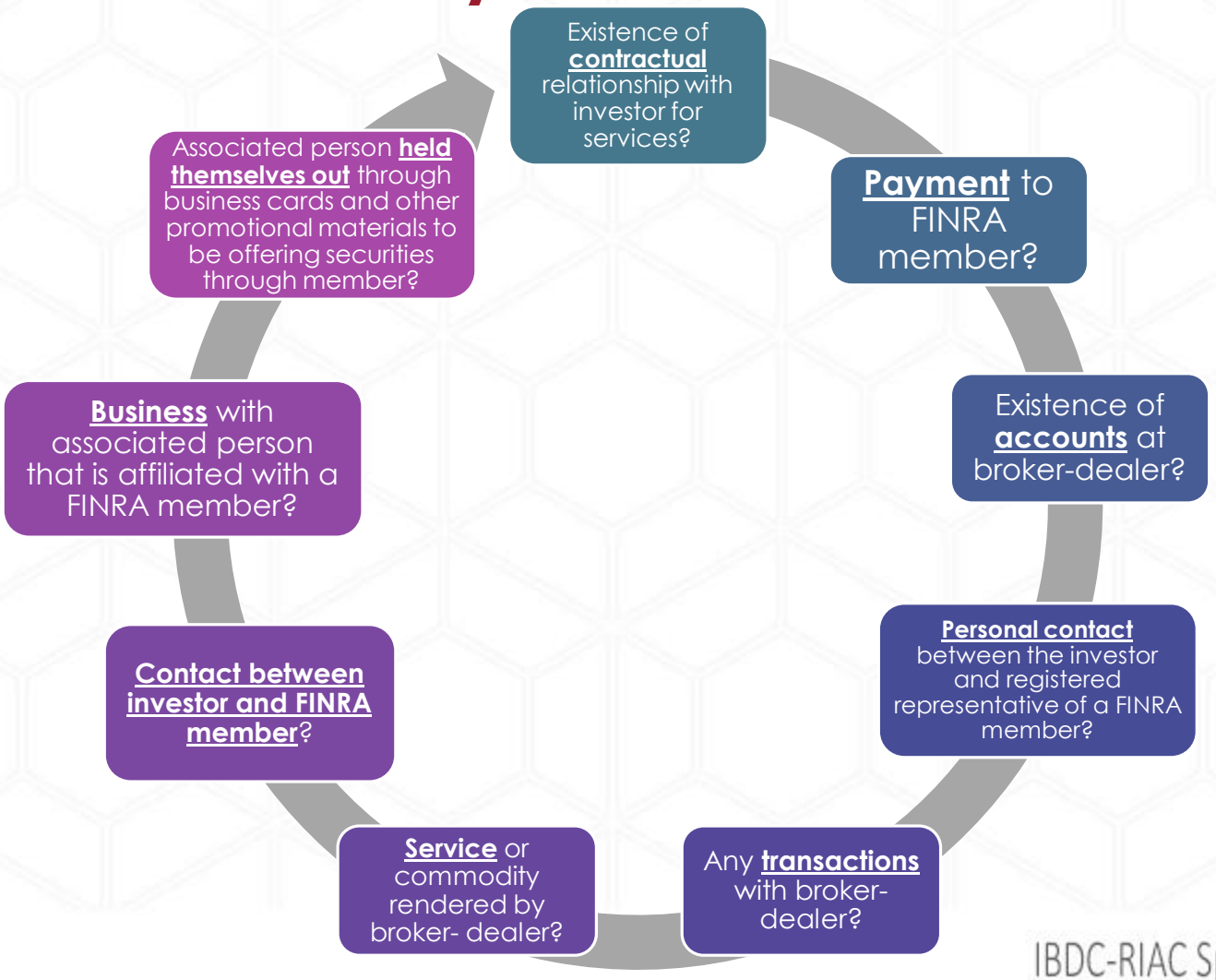
Common Defense Strategy

- Courts decide "customer question."

- File a federal court action seeking declaratory and injunctive relief barring arbitration of the claim on the basis that the claimant is not a customer of the firm as contemplated by FINRA Rule 12200.



The Ultimate Landmine: Apparent Authority



EXAMPLES OF CASES WHERE INVESTOR WAS FOUND **TO BE** A "CUSTOMER"

***AXA Advisors, LLC. v. Lee,* 2016 WL 335852 (D.Idaho, 2016).**	• The Lees invested over a million dollars in investments made through Douglas Roberts, a representative of AXA at the time. The court held that the Lees were customers of AXA because they purchased investments from Roberts when he was a representative of AXA. The Lees dealt exclusively with Roberts and never opened an account with AXA or purchased any securities from AXA.
***Triad Advisors, Inc. v. Siev,* 60 F. Supp. 3d 395 (E.D.N.Y., 2014).**	• A real estate investment was recommended to defendants and facilitated by one of plaintiff's "associated persons," an investment advisor, who then received a finder's fee. The court held that the investors were customers because they purchased a "service" from Triad Advisors, which was from the referral on one of their associated persons to purchase investments from another firm. Triad did not receive any compensation, they were not mentioned in any disclosure or agreements, and the Defendants did not hold an account with Triad. The decision turned on the receipt of investment advice and introduction to investments. The source of compensation was irrelevant.
***O.N. Equity Sales Co. v. Stephens,* 2008 WL 835808 (N.D. Fla., 2008).**	• Lancaster was a registered representative with ONESCO when he released a private placement memorandum, which included a subscription agreement for Lancorp. Scott purchased 18 shares of Lancorp. The court held that Scott was a customer of the member (ONESCO) because she was working with the member's agent or representative. This is a classic "selling away" case.
***MONY Securities Corp. v. Bornstein*, 390 F.3d 1340 (11th Cir., 2004).**	• Keller worked in the financial-planning business and he had affiliations with MONY. The Bornsteins, on the advice of Keller, invested in five contracts through a company unrelated to MONY. The court held that the investors were MONY customers because Keller was an associated person with MONY and he had direct connections with the Bornsteins. The claim was arbitrable solely based on the relationship between the MONY- affiliated investment advisor and the investors.
***Multi-Financial Securities Corp. v. King,* 386 F.3d 1364 (11th Cir., 2004).**	• Following the advice of Micciche, a registered representative of IFG, King and her late husband entered into a trust agreement with Intrados. The court held that King is a customer as long as she is not a broker or dealer; nothing in the Code directs otherwise or requires more.
***John Hancock Life Ins. Co. v. Wilson*, 254 F.3d 48 (2nd Cir., 2001).**	• Fucilo, a sales representative of John Hancock, sold fraudulent promissory notes to the Investors. The court held that investors do not need to be customers of the NASD member, it is sufficient if they are customers of an associated person. The Second Circuit declared that, the customer of a FINRA member's associated person is entitled to arbitrate against the member itself as long as the claim arises out of the associated persons business activities. The associated member does not have to represent to the customer that they are affiliated with an NASD (n/k/a FINRA) member, or have to have authority to sell certain investments (if fraudulent).

***UBS Financial Services, Inc. v. Zimmerman*, 2016 WL 3546537 (E.D.N.C., 2016).**

UBS underwrote and issued electronically traded notes which the investor purchased through Charles Schwab. The court held that because the investor did not have a UBS account or any direct contact with UBS, they could not have reasonably expected to have to arbitrate; a purchase of goods or services must be direct; an indirect or attenuated relationship will not suffice. The customer here only purchased indirect lending services.

***Sagepoint Financial, Inc. v. Small*, 2015 WL 2354330 (E.D.N.Y., 2015).**

Van Zandt, a registered representative of American General Securities, Inc., acquired by Sagepoint Financial, Inc. in 2006, operated a Ponzi scheme soliciting funds from clients, including Small, for investment in securities and real estate projects that instead were diverted for personal use or to pay antecedent investors. The court found that any customer relationship between Small and the associated member arose almost 4 years after Van Zandt ended his affiliation with AGSI, Small did not ever purchase goods or services from Sagepoint, and she never held an account with Sagepoint.

***Pershing LLC v. Bevis*, 2014 WL 1818098 (M.D. La., 2014).**

Pershing was the clearing agent for CDs sold to the investors that were later determined to be part of a Ponzi scheme. The court held that there was no direct relationship between the investor and Pershing, contractual or otherwise. The investors did not produce any client agreements or monthly account statements typical of customers, and a search of Pershing's records failed to reveal any record of accounts held by the investors. Although Pershing did produce clearing services to the party that perpetuated the Ponzi scheme, it was not directly involved with these investors.

***Citigroup Global Markets, Inc. v. Abbar*, 761 F.3d 268 (2d Cir., 2014).**

Abbar held investments with a UK affiliate of Citigroup. The court held that Abbar was not a Citigroup NY customer because the services performed by Citigroup NY were ancillary and collateral to the main transactions with the UK affiliate of Citigroup. Citigroup UK was not a FINRA Member. But, the rule requires a FINRA member to arbitrate disputes with its "customers" or the "customers" of its "associated persons." A "customer" under FINRA Rule 12200 is one who, while not a broker or dealer, either (1) purchases a good or service from a FINRA member, or (2) has an account with a FINRA member.

***Raymond James Financial Services, Inc. v. Cary*, 709 F. 3d 382 (4th Cir., 2013).**

Investors bought the securities on the advice of an attorney who was a business and personal acquaintance of an associated person of Raymond James. The court held that the investors were not customers because they did not purchase anything from Raymond James. Further, they did not have any Raymond James accounts, they did not have any personal contact with Raymond James or an associated member, there was no contractual relationship between Raymond James and the investors, no funds were ever tendered to Raymond James, they did not purchase any service or commodity from Raymond James that they sold in their course of business, and the attorney did not have any actual or apparent authority to sell or recommend securities on the firm's behalf, and the attorney never held himself out to be a representative of Raymond James.

***Credit Suisse Securities (USA) LLC v. Sims*, 2013 WL 5530827 (S.D. Tex., 2013).**

The investor bought an exchange traded note on the secondary market through a third-party broker dealer. Credit Suisse underwrote the note. The court held that because the investor did not have a contractual relationship with Credit Suisse and did not purchase the note from the broker dealer, there was no sufficient nexus between the parties. To create a "customer" based relationship. The customer did not purchase commodities or securities from a FINRA member.

***Orchard Securities, LLC v. Pavel*, 2013 WL 4010228 (D. Utah, 2013).**

The investors purchased various TICs for which Orchard served as the managing broker-dealer on the offering. The investors purchased their interests through a third party broker-dealer. The court held that although Orchard's name and logo was on some of the marketing materials for the investments and that Orchard received a placement fee, it did not sell interests in the TICs to any customers. The connections were too remote and insignificant to establish a direct customer relationship.

EXAMPLES OF CASES WHERE INVESTOR WAS FOUND **TO NOT** BE A "CUSTOMER"

Money Laundering

Engaging in acts designed to conceal or disguise the true origins of criminally derived proceeds so that proceeds appear to have derived from legitimate origins or constitute legitimate assets

FINRA Updated Small Firm Template Anti-Money Laundering (AML) Program & Compliance and Supervisory Procedures

December 26, 2018

"FINRA fines Morgan Stanley $10M for AML program, supervisory failures"

"Finra's findings were largely surrounding legacy Morgan Stanley Smith Barney systems, staffing and processes relating to the surveillance of wire transfers, and the deposit and sale of low priced securities."

InvestmentNews

Three Stages

AML Requirements Apply to These Financial Institutions

- Broker-Dealers
- Mutual Funds
- Insurance Companies
- Banks
- Not RIA's
  - Proposed Regulations

FINRA

- Examines broker-dealers for compliance with AML program requirements
- Brings more enforcement actions than any other regulatory body
- Identifies AML in 2017 Regulatory and Examination Priorities Letter

FINRA's Top 5 Fine Categories in 2017

- Anti-money laundering (AML) cases resulted in the most fines in 2017. FINRA reported 16 AML cases in 2017, which resulted in $14.6 million in fines.

Five Pillars

- Written policies and procedures
- Designation of a responsible individual
- Education and training
- Independent testing
- Ongoing customer due diligence

7 things a broker-dealer should do to avoid an AML-enforcement action

1. Consider risk
2. Know your customer
3. File a Suspicious Activity Report ("SAR") when a red flag arises
4. Monitor and investigate suspicious trading activity
5. Limit direct market access risk
6. Take regulatory inquiries seriously
7. Review your AML program annually

1) Consider risks when developing your AML program

- Implementing templates provided by FINRA and using boilerplate language is not sufficient
- AML procedures should reflect your business risks
- Monitor for high risk activities and trading abuses
- Commit adequate resources to meet risk
- Consider compliance officer's experience

2) Know your customer

- CIP programs must permit a broker-dealer to form "a reasonable belief that it knows the true identity of each customer." 31 C.F.R. 1023.220
- Verify the identity of each customer within a reasonable time
- Investigate and address inconsistent identifying information
- Avoid customers with prior regulatory issues

3) When reasonably suspicious, file a Suspicious Activity Report (SAR)

- The duty arises when the broker-dealer knows, suspects, or has reason to suspect unlawful or suspicious activity
- The SEC reviews the number of SARs filed by firms in light of their business activities, size, and regulatory history
- SARs should adequately describe why a firm believes the activity is suspicious
- Customer history may be a red flag
- Conduct and memorialize independent investigations, and consider next steps after findings are made

4) Monitor for suspicious trading activity and investigate problem trades, especially penny stock transactions

- Adequately monitor registered reps and customer activity
- Special attention is required if your firm's business handles transactions with unregistered shares or microcap securities
- Pay special attention to customers who:
  - Engage in transactions involving penny stocks, especially in large volumes
  - Open accounts to deposit large amounts of unregistered shares
  - Immediately wire funds after selling penny stocks
  - Open accounts that are maintained by multiple corporate entities
  - Use multiple accounts that may not have a legitimate business purpose

5) Identify and limit the risk created by giving a customer direct market access

- Broker-dealers that give customers access to an exchange or alternative trading system must implement risk management controls that
  - Limit the firm's financial exposure, and
  - Ensure compliance with applicable regulatory requirements
- Monitor for suspicious activities
  - Watch for manipulative trades, such as spoofing or wash trades (i.e., transactions without a change in beneficial ownership)
  - Do not rely on customers to self-monitor and report
  - Ensure that traders have one trading ID and deactivate inactive IDs

6) Take regulatory inquiries seriously and follow up internally as necessary

- Conduct internal investigations
- Responding to regulators is not enough
- Follow up internally
- Improve AML procedures

7) Conduct independent annual reviews of your AML program

- FINRA Rule 3310(c) – AML programs must "provide for annual (on a calendar-year basis) independent testing"
  - Testing by qualified firm personnel or a third-party

AML program testing may not be "independent" if:

- The firm selects the information for review by a third-party
- The third-party tester does not visit the firm's office

AML program testing may not be adequate if:

- It fails to address high-risk activities
- Was not timely
- Insufficient documentation
- Conducted by untrained personnel
- Failure to sample customer accounts
- Failure to monitor money movement activities

Consultant/Expert Value Before the Claims Hit

Consultant Audit Review:

- Independent Assessment
- Consultant's Access to other Companies' Experiences
- Identifies Areas for Improvement- Need to Address
- Determines whether safeguards consistent with regulators' findings
- Demonstrates Reasonable Process and Procedures

Considerations for Consultant Audit Review

- Consultant- must be credible with industry experience
- Consultant- must be a good witness
- Privileged Review
  - Cannot Hide Facts
  - Report- if not addressed could open liability or provide a roadmap

Consultants Role in Arbitration/ Lawsuits/Regulatory Actions

- Adds Credibility to Companies' Position
- Demonstrate that Reasonable Processes and Procedures in Place
- Demonstrate that Company has taken remedial steps, if appropriate
- Aid in assessing potential liability

QUESTIONS?

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