NATIONAL EXAM PROGRAM
RISK ALERT

By the Office of Compliance Inspections and Examinations ("OCIE")[1]

Volume IV, Issue 3 **October 9, 2014**

This Risk Alert summarizes deficiencies that OCIE staff observed in the controls that certain broker-dealers put in place to comply with obligations related to sales of the securities of microcap companies, including to (1) perform a "reasonable inquiry" in connection with unregistered sales of securities in reliance on Section 4(a)(4) of the Securities Act, and (2) respond to suspicious activity in connection with such sales. A discussion of certain types of accounts that OCIE staff observed as being frequently associated with "dumping" of microcap securities is also included.

BROKER-DEALER CONTROLS REGARDING CUSTOMER SALES OF MICROCAP SECURITIES

I. Introduction

OCIE's National Examination Program staff (the "Staff"), examined 22 broker-dealers (the "broker-dealers" or "firms") that the Staff had identified as being frequently involved in the sale of the securities of microcap companies. The examinations assessed these firms' compliance with certain provisions of the Securities Act of 1933 ("Securities Act") and the rules thereunder, as well as anti-money laundering ("AML") requirements under the Bank Secrecy Act[2] and the Securities Exchange Act of 1934 ("Exchange Act"). Specifically, the Staff evaluated compliance with the firms' obligations to (1) perform a "reasonable inquiry" in connection with customers' unregistered sales of securities when the firms are relying on the exemption set forth in Section 4(a)(4) of the Securities Act, and (2) file suspicious activity reports, as required under the Bank Secrecy Act and the Exchange Act, in response to "red flags" related to such sales.

Of the 22 firms examined, more than 80% were issued letters of deficiency for material control weaknesses and/or potential violations of law. The overwhelming majority of the firms examined were also referred to the Division of Enforcement or another regulatory agency for further consideration of whether violations of law occurred.[3]

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1 The views expressed herein are those of the staff of OCIE, in coordination with other staff of the Securities and Exchange Commission ("SEC" or "Commission"), including the Division of Trading and Markets. The Commission has expressed no view on the contents of this Risk Alert. This document was prepared by the SEC staff and is not legal advice.

2 The Bank Secrecy Act is the name commonly used for the Currency and Financial Transactions Reporting Act of 1970, 12 USC §1829b, 12 USC §§1951-1959, and 31 USC §§5311-5330.

3 Today, the Commission issued an order in another matter involving violations of Section 5 of the Securities Act. *See In the Matter of E*Trade Securities, LLC, and G1 Execution Services, LLC*, Securities Act Release No. 9662, *available at*: http://www.sec.gov/litigation/admin/2014/33-9662.pdf.

II. Overview of Broker-Dealer Obligations Regarding Proposed Customer Sales

A. Reasonable Inquiry under Securities Act Section 4(a)(4)

Sections 5(a) and 5(c) of the Securities Act generally provide that it is unlawful for any person, either directly or indirectly, to use the mails or interstate means to sell any security unless a registration statement is in effect or to offer to sell any security unless a registration statement has been filed with the Commission, unless an exemption from the registration provisions applies. Section 4(a)(4) of the Securities Act provides such an exemption for "brokers' transactions executed upon customers' orders on any exchange or in the over-the-counter market but not the solicitation of such orders."[4] Reliance on Section 4(a)(4) is unavailable, however, for example, when a broker-dealer knows or has reasonable grounds to believe that the selling customer's part of the transaction is not exempt from Section 5 of the Securities Act.[5] The Commission and the courts have held that a broker-dealer may claim the Section 4(a)(4) exemption if, after reasonable inquiry, the broker-dealer is not aware of circumstances indicating that the customer would be violating Section 5, such as when the customer is an underwriter with respect to the securities or that the transaction is a part of a distribution of securities of the issuer.[6] In conducting the reasonable inquiry under Section 4(a)(4), broker-dealers may consider the matters set forth in Note (ii) to Rule 144(g)(4).[7] Simultaneously with the issuance of this Risk Alert, the Division of Trading and Markets is issuing Frequently Asked Questions regarding the obligations of a broker-dealer to conduct a reasonable inquiry when engaging in unregistered resales of securities in reliance on Section 4(a)(4).[8] This guidance should be consulted for more detail on the availability of the Section 4(a)(4) exemption. FINRA has also issued its Notice to Members 09-05 addressing these obligations and providing guidance.[9]

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4 Broker-dealers may also potentially rely on the exemption provided by Section 4(a)(3) of the Securities Act, which generally exempts "transactions by a dealer," but that exemption is unavailable for certain transactions, including those involving an underwriter. *See In the Matter of Owen V. Kane*, Exchange Act Release No. 23827 (Nov. 20, 1986) (Commission opinion), aff'd, 842 F.2d 194 (8th Cir. 1988).

5 *In the Matter of John A. Carley*, Exchange Act Release No. 57246, 2008 WL 268598, *8 (Jan. 31, 2008) (Commission opinion). *See* also *In the Matter of Jacob Wonsover*, Exchange Act Release No. 41123 (Mar. 1, 1999) (Commission opinion), *aff'd*, 205 F.3d 408 (D.C. Cir. 2000); *In the Matter of Quinn and Co., Inc.*, Exchange Act Release No. 9062 (Jan. 25, 1971) (Commission Opinion).

6 17 C.F.R. § 230.144(g). *See, e.g., World Trade Financial Corp. v. S.E.C.*, 739 F.3d 1243, 1248 (9th Cir. 2014) (agreeing with the D.C. Circuit's decision in *Wonsover v. S.E.C.* and the Commission "that a broker is not merely an 'order taker,' and must conduct a reasonable inquiry into the circumstances surrounding the transaction before the broker may claim the protection of the Section 4(4) brokers' exemption.") (citation omitted); *In the Matter of Midas Securities, LLC and Jay S. Lee*, Exchange Act Release No. 66200, at 19 (Jan. 20, 2012).

7 *See* "Frequently Asked Questions about a Broker-dealer's Duties When Relying on the Securities Act Section 4(a)(4) Exemption to Execute Customer Orders," SEC's Division of Trading and Markets (Oct. 9, 2014), *available at*: http://www.sec.gov/divisions/marketreg/mrfaq.htm (herein "TM FAQ"), at Question No. 2.

8 *See* TM FAQ, supra note 7.

9 FINRA Notice to Members 09-05, "Unregistered Resales of Restricted Securities," (Jan. 2009), *available at*: http://www.finra.org/web/groups/industry/@ip/@reg/@notice/documents/notices/p117716.pdf. ("Firms

B. Obligations under the Bank Secrecy Act and Exchange Act

Exchange Act Section 17(a) and Rule 17a-8 thereunder require broker-dealers to comply with the recordkeeping, record retention, and reporting obligations of the Bank Secrecy Act and the regulations thereunder.[10] These regulations mandate, among other things, that broker-dealers file a Suspicious Activity Report ("SAR") with the Financial Crimes Enforcement Network ("FinCEN") to report any transaction (or a pattern of transactions of which the transaction is a part) by, at, or through the broker-dealer involving or aggregating funds or other assets of at least $5,000 that it "knows, suspects, or has reason to suspect": (1) involves funds derived from illegal activity or is conducted to disguise funds derived from illegal activities; (2) is designed to evade any requirements of the Bank Secrecy Act; (3) has no business or apparent lawful purpose and the broker-dealer knows of no reasonable explanation for the transaction after examining the available facts; or (4) involves use of the broker-dealer to facilitate criminal activity.[11] The failure of a broker-dealer to file a SAR, as required by these regulations, is a violation of Exchange Act Section 17(a) and Rule 17a-8.

III. Examination Observations

A. Examinations

In conducting the 22 examinations, the Staff assessed: (1) the controls the broker-dealers had implemented regarding the unregistered sale of securities when relying on the Section 4(a)(4)

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that do not adequately supervise or manage their role in such distributions run the risk of participating in an illegal, unregistered distribution.") This Notice to Members, which includes a discussion of the requirement that broker-dealers establish a supervisory system and corresponding written supervisory procedures to avoid becoming participants in potential unregistered distributions of securities, offers the following examples of red flags that firms could consider:

- a customer opens a new account and delivers physical certificates representing a large block of thinly traded or low-priced securities;
- a customer has a pattern of depositing physical share certificates, immediately selling the shares and then wiring out the proceeds of the resale;
- a customer deposits share certificates that are recently issued or represent a large percentage of the float for the security;
- share certificates reference a company or customer name that has been changed or that does not match the name on the account;
- the lack of a restrictive legend on deposited shares seems inconsistent with the date the customer acquired the securities or the nature of the transaction in which the securities were acquired;
- there is a sudden spike in investor demand for, coupled with a rising price in, a thinly traded or low-priced security;
- the company was a shell company when it issued the shares;
- a customer with limited or no other assets under management at the firm receives an electronic transfer or journal transactions of large amounts of low-priced, unlisted securities;
- the issuer has been through several recent name changes, business combinations or recapitalizations, or the company's officers are also officers of numerous similar companies; and
- the issuer's SEC filings are not current, are incomplete, or nonexistent.

[10] Self-regulatory organizations' rules also contain AML requirements. *See, e.g.*, FINRA Rule 3310.

[11] *See* 31 CFR §1023.320.

exemption and the filing of SARs in response to "red flags" associated with unregistered sales; and (2) whether those controls operated effectively such that each broker-dealer's activity complied with existing legal requirements.

In particular, the Staff scrutinized the broker-dealers' liquidations of large blocks of shares of microcap issuers that were also the subject of significant promotional efforts.

B. Observations

1. Reasonable Inquiry under Securities Act Section 4(a)(4)

While the majority of the examined broker-dealers had adopted supervisory policies and procedures regarding conducting a reasonable inquiry when relying on the Section 4(a)(4) exemption, the Staff observed deficiencies in their design or implementation, including:

- Some firms' policies and procedures did not contain sufficient detail to assist the firms' employees in their efforts to effectively monitor and identify situations where facts and circumstances suggest the customer may not have had a claimed exemption. For example, some firms' policies and procedures merely stated that a reasonable inquiry should be conducted, without providing any additional discussion of potential red flags that could indicate a possible Section 5 violation, protocols that the staff should follow when encountering red flags, or supervisory reviews that should be conducted to determine whether the securities were resold in compliance with an available exemption;[12]
- Some firms relied, without further inquiry, on the absence of restrictive legends on stock certificates to conclude that the securities could be resold in unregistered transactions.[13]

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[12] The SEC has found similar written supervisory policies and procedures to be deficient. *See, e.g.*, *Midas Securities, LLC*, supra note 6, at 12 ("The minimal written procedures the Firm had lacked meaningful guidance setting forth "reasonable inquiry" procedures for registered representatives to follow when customers sought to sell large amounts of an unknown stock to the public without registration. As Applicants admitted, the written procedures included no specific risk factors alerting registered representatives to the possibility that a proposed transaction might be part of an unlawful distribution—such as the classic warning signs of an obscure issuer, a thinly traded security, and the deposit of stock certificates in a large volume of shares. The procedures also lacked any guidance to registered representatives about how to determine whether a proposed sale was exempt from registration, including asking their customer how, when, and under what circumstances the customer acquired the stock. Because of these deficiencies, the written procedures also failed to provide the supervisors with a reliable mechanism for identifying securities sales that should be investigated or halted for violating the Securities Act.")

[13] The certificates of securities acquired in a nonpublic transaction usually bear a restrictive legend, which indicates that the securities cannot be resold without registration or compliance with an exemption. However, the Staff has observed a number of instances at several broker-dealers in which the firms relied on the absence of a restrictive legend as a basis for believing that the deposited shares were unrestricted, without conducting a further inquiry. The SEC has found such reliance to be inadequate. *See, e.g.*, *Quinn and Co*., supra note 5 (stating that the failure of an issuer to place a restrictive legend on the stock cannot relieve a broker-dealer from its duty as a professional in the securities business to make a reasonable inquiry into facts known to it indicating that it is participating in an illegal unregistered sale of securities).

- Some firms relied, without further inquiry, on the delivery of the shares into a customer's account in electronic form through a transfer from the Depository Trust and Clearing Corporation ("DTCC") or the issuer's transfer agent as a basis for believing either that the shares were not restricted securities or that no further inquiry regarding the customer was necessary;[14] and
- Some firms did not collect information from the customer about how large blocks of shares, deposited into the customer's account that the customer requested the broker-dealer to sell, had been acquired, despite the fact that the firms did not know how the customer had acquired the shares.[15]

Additionally, in interviews with the Staff, compliance staff and senior management at some of the examined firms appeared to be unaware of their firms' obligation to conduct a reasonable inquiry, when relying on the Section 4(a)(4) exemption, particularly before executing large sales orders involving shares of thinly traded issuers.[16] Also, the Staff observed that some firms failed to enforce their policies and procedures related to conducting a reasonable inquiry in connection with handling unsolicited customer orders.

2. Failure to Respond to Suspicious Activity

The Staff observed that some firms failed to file SARs, as required by the Bank Secrecy Act and the firms' policies and procedures, when encountering unusual or suspicious activity in connection with customers' sales of microcap securities. Some indications of this activity were actually known by the examined broker-dealers, including the following examples:[17]

- Atypical trading patterns in the issuers' securities, including trading involving sudden spikes in price and volume;
- Certain patterns of trading activity being common to several customers, including, but not limited to the sales of large quantities of the shares of multiple issuers by the customers;
- Notifications received from the broker-dealers' clearing firms that the clearing firms had identified potentially suspicious activity in the securities of certain

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14 The SEC has found such reliance to be inadequate. *See, e.g.*, *In the Matter of the Application of ACAP Financial, Inc. and Gary Hume*, Exchange Act Release No. 70046 (July 26, 2013) (Commission Opinion) ("[W]e have repeatedly explained that where … there are indicia of an illegal distribution, a broker cannot claim that its sales of a security were exempt from registration simply because the stock certificates lack a restrictive legend or a clearing firm or transfer agent raises no objections to the sales."), *available at* http://www.sec.gov/litigation/opinions/2013/34-70046.pdf.

15 *See* TM FAQ, supra note 7, at Question No. 2 ("the Commission has stated that the reasonable inquiry under Rule 144(g)(4) should include... the nature of the transaction in which the securities were acquired by the customer[.]")

16 *Id.*

17 The Staff does not contend that the existence of any of these examples, which may indicate suspicious activity, necessarily triggers the broker-dealer's obligation to file a SAR. Whether the broker-dealer has such an obligation depends on the totality of facts and circumstances in a particular situation.

issuers or certain of the broker-dealers' customer accounts. Such notifications took the form of alerts, expressions of concern, or actions taken by the clearing firms to restrict trading in certain issuers' securities and/or certain customer accounts;

- The involvement of certain types of accounts, including those that provide anonymity to the beneficial owners (such as the accounts described in Section III.B.3 herein), in the liquidation of the shares of the microcap issuers; and
- Requests received from FINRA for information relating to certain issuers and the broker-dealers' customer accounts.

Other indications of suspicious activity were readily discoverable by the broker-dealer staff, including:[18]

- Certain types of issuer information, such as nominal assets and low operating revenue, and frequent changes to the type of activity in which the business was engaged, the name of the corporate entity, directors, and/or management; and
- Sales through the broker-dealer by individuals known throughout the industry to be stock promoters.[19]

3. Types of Accounts Used to Dump Microcap Stock

As part of the examination initiative, the Staff identified certain types of accounts that appeared to be frequently associated with the unregistered sale of large quantities of the illiquid shares of microcap issuers, including sales of restricted securities on behalf of corporate insiders. They included certain omnibus accounts, which can be used to disguise the trading activity of the accounts' beneficial owners by commingling securities and funds from several beneficial owners.[20] Examples of such omnibus accounts included, but were not limited to:

- Accounts of purported stock loan companies, which may hold the restricted securities of corporate insiders who have pledged the securities as collateral for, and then defaulted on, purported loans, after which the securities are sold on an unregistered basis;[21]
- Accounts held in the name of a corporate entity (or LLC), either for the company's own use or as a third-party custodian on behalf of other beneficial shareholders or customers, which disguise the unregistered sales of securities

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18 *See* note 17 supra.

19 *See* TM FAQ, supra note 7, at Question No. 3.

20 Generally, omnibus accounts are those in which money or securities for more than one beneficial owner are commingled by a custodian or a sub-custodian.

21 *See, e.g., SEC v. SW Argyll Investments, LLC (d/b/a Argyll Investments, LLC), et al.*, Lit. Rel. No. 22296 (March 16, 2012), *available at*: http://www.sec.gov/litigation/litreleases/2012/lr22296.htm; *see also, e.g., SEC v. Manuel M. Bello, Ayuda Equity Funding, LLC, and AmeriFund Capital Holdings, LLC*, Lit. Rel. No. 22400 (June 25, 2012), *available at*: http://www.sec.gov/litigation/litreleases/2012/lr22400.htm.

owned by corporate insiders of the company and allow for those insiders to withdraw proceeds individually;[22]

- Accounts held in the names of foreign financial institutions, such as offshore banks and/or broker-dealers that sold shares of the stock on an unregistered basis on behalf of customers, who may have been stock promoters;[23] and
- Accounts using a master/sub-structure, which allows for trading anonymity with respect to the sub-accounts' activity.[24]

The Staff observed that broker-dealers holding these types of accounts often failed to conduct reviews of the activity occurring in the accounts after encountering red flags,[25] as required by FINRA and/or Commission rules[26] or by the broker-dealer's own policies and procedures.

IV. Conclusion

In the examinations, the Staff observed that most of the examined broker-dealers have policies and procedures requiring the firm to conduct a reasonable inquiry into the facts surrounding a proposed unregistered sale to determine if the customer is an underwriter. The examinations, however, illuminated control weaknesses in the design or implementation of those policies and procedures. This Risk Alert has presented examples of certain situations where these control weaknesses have resulted in the broker-dealers failing to conduct a reasonable inquiry and/or failing to file SARs regarding suspicious sales activity.

The Staff welcomes comments and suggestions about how the Commission's examination program can better fulfill its mission to promote compliance, prevent fraud, monitor risk, and inform SEC policy. If you suspect or observe activity that may violate the federal securities laws or otherwise operates to harm investors, please notify us at http://www.sec.gov/complaint/info_tipscomplaint.shtml.

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22 *See, e.g.*, FINRA Letter of Acceptance, Waiver and Consent No. 2013035821401, RE: Brown Brothers Harriman & Co., *available at*: https://www.finra.org/web/groups/industry/@ip/@enf/@ad/documents/industry/p443448.pdf.

23 *See, e.g., SEC v. Gibraltar Global Securities, Inc. and Warren A. Davis*, Civil Action No. 13 Civ 2575 (S.D.N.Y.), *available at*: http://www.sec.gov/litigation/litreleases/2013/lr22683.htm; *see also, e.g., FINRA v. Oppenheimer & Co., Inc., Disciplinary. Proceeding No. 2009018668801* (Aug. 5, 2013), *available at*: http://www.finra.org/web/groups/industry/@ip/@enf/@ad/documents/industry/p315930.pdf.

24 Generally, in the master/sub-account trading model, a top-level customer opens an account with a registered broker-dealer (the "master account") that permits the customer to have subordinate accounts for different trading activities ("sub-account"). OCIE previously issued a Risk Alert with respect to master/sub-accounts, which more fully describes regulatory concerns and risks regarding those accounts. *See* National Exam Risk Alert on Master/Subaccounts, *available at*: http://www.sec.gov/about/offices/ocie/riskalert-mastersubaccounts.pdf.

25 *See* Section III.B.1-2 above for a discussion of red flags that the Staff noted during the examinations.

26 *See* Section II above.

This Risk Alert is intended to highlight for firms risks and issues that the Staff has identified in the course of examinations regarding broker-dealer controls regarding customer sales of microcap securities. In addition, this Risk Alert describes factors that firms may consider to (i) assess their supervisory, compliance and/or other risk management systems related to these risks, and (ii) make any changes, as may be appropriate, to address or strengthen such systems. These factors are not exhaustive, nor will they constitute a safe harbor. Other factors besides those described in this Risk Alert may be appropriate to consider, and some of the factors may not be applicable to a particular firm's business. While some of the factors discussed in this Risk Alert reflect existing regulatory requirements, they are not intended to alter such requirements. Moreover, future changes in laws or regulations may supersede some of the factors or issues raised here. The adequacy of supervisory, compliance and other risk management systems can be determined only with reference to the profile of each specific firm and other facts and circumstances.