

2010 Mid-Atlantic Money Laundering Conference

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Master-Sub Account Arrangements

- **General Structure: One master account with various sub-accounts underneath.**
- **Several Variations on this theme:**
 - Different structures
 - Different Labels
 - Different regulatory consequences
- **Frequently involve day-traders**
 - Arrangement appears to be attractive to day-traders, because they are not required to maintain a minimum account equity balance and their buying power may exceed the individual 4:1 margin-to-equity ration required of accounts held directly at a broker-dealer.

Master-sub Account Arrangements

■ Risks: CIP, 312 and Suspicious Activity

- Sub-accounts may or may not trigger CIP obligations depending on the specific arrangement
 - see Treasury/SEC Q&A on omnibus accounts 10/1/03
- If Master account is a foreign financial institution Section 312 obligations.
- Monitoring for suspicious activity among sub-accounts is required.
 - If you don't know the underlying sub-account holder, it is difficult to determine what is suspicious.
 - We are seeing patterns of wash trading and apparent manipulative trading activities among sub-accounts under master accounts.

Master-Sub Account Arrangements

■ Aiding and abetting an unregistered broker-dealer

- SEC Release No. 60764 in the Matter of GLB Trading, Inc. and Robert A. Lechman
- GLB and Lechman aided, abetted and caused Tuco Trading's violation of acting as unregistered broker-dealer. Tuco Trading was a Nevada LLC providing day-trading capabilities to customer.
- GLB censured and registration revoked. GLB and Lechman, jointly and severally, ordered to pay disgorgement of and prejudgment interest totaling \$220,670. Lechman was also barred from association with any broker or dealer, with a right to reapply for association after three years from the date of the Order, and has been ordered to pay a \$75,000 civil penalty.

Direct Market Access/Sponsored Access Firms

Direct Market Access (DMA) refers to electronic facilities that allow buy side firms to more directly access liquidity for financial securities they may wish to buy or sell. Using DMA, the firms still use the infrastructure of sell side firms but take over more of the control over the way a transaction ("trade") is executed.

- Firms have to report suspicious transactions, including securities transactions, conducted "by, at or through" the firm pursuant to 31 CFR 103.19, and FINRA Rule 3310(a) requires they have procedures and systems in place for this.
- These requirements apply to DMA/Sponsored Access firms, and, due to the volume of transactions effected through the firms, they may need to implement automated monitoring. Suspicious transactions can include manipulation, wash or prearranged trading, and insider trading.

Pinnacle

- **Online business providing direct access to US securities markets to foreign customers.**
- **Firm used cookie-cutter procedures that didn't fit the firm's business – because these procedures were impractical as well as inadequate – they were ignored.**
 - Procedures required a driver's license for foreign customers opening account on line
 - Procedures required "tax id number" for foreign financial institution customers who didn't have tax id numbers.
 - Relied on clearing firm to verify the customer identify using a database that was not designed to verify foreign investors and so was of little value.

Pinnacle

- **Failed to adopt specific risk-based procedures to verify customer identify for those customer residing in higher risk foreign jurisdictions.**
 - Some were traditional omnibus accounts
 - Others were multi-tiered “mater-sub” arrangements where beneficial subaccounts owners independently directed and controlled account activity via online access without any participation by the master.
 - The financial institution master account owners were in high risk jurisdictions in Africa, Asia, North and South America, the Middle East and Europe.

Pinnacle (cont.)

- **For the Master/sub accounts – failed to identify the beneficial owner of the subaccount who had direct trading access to the firm.**
- **Failed to adopt effective procedure for reviewing accounts for suspicious activity.**
 - Procedures included a list of red flags but no guidance on how to identify and examine for suspicious activity.
 - Red flags and procedures failed to address the master/sub structures – for example, it did not review journal and wire transactions between subaccounts.
- **Failed to identify and report suspicious activity in several accounts such as :**
 - Possible manipulation
 - Irregular money movements in excess of customer's reported liquid and total net worth

Sale of Unregistered Securities

■ Regulatory Notice 09-05: Reminds Firms of Their Obligations to Determine Whether Securities are Eligible for Public Sale

- Firms must have procedures reasonably designed to avoid becoming participants in an unregistered distribution of securities.
- Firms may not rely solely on others such as transfer agents, clearing firms or issuer's counsel.
- The nature of those procedures and the required level of firm inquiry concerning the customer and the source of the securities will depend on the particular circumstances.

Sale of Unregistered Securities

Red Flags that Signal an Unregistered Distribution:

- 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;

Sale of Unregistered Securities

- **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;**

Sale of Unregistered 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;
- The issuer's SEC filings are not current, are incomplete, or nonexistent.

Sale of Unregistered Securities

- Firms fail to take steps to determine:
 - When or how their customers had received the share certificates at issue,
 - whether their customers were control persons of the issuers
 - what percentage of the outstanding shares of these companies their customers owned

Sale of Unregistered Securities

■ Recent Cases (SEC & FINRA):

- Firms that participated in unregistered resales of restricted securities also may have ignored a number of red flags that indicate not only that the resale was part of an unregistered distribution, but also that action may have been required under AML reporting requirements.
- Failure to conduct appropriate inquiry and respond to red flags may have consequences under both the federal securities laws and AML requirements.

Leonard & Co. Fined \$225,000 for Sale of Unregistered Securities and AML (01/09)

Key Allegations

- By selling more than two million shares of unregistered Shallbetter stock into the public markets for control persons of Shallbetter, RR and Leonard & Co. violated the registration provisions of federal securities laws. RR and Leonard & Co. failed to conduct an adequate review of Shallbetter before recommending its purchase to customers of the firm. FINRA further found that Cole participated in a scheme to manipulate the price of Shallbetter stock, purchased and recommended purchases of Shallbetter stock while in possession of material nonpublic information and sent numerous emails to customers that inappropriately touted various stocks, including Shallbetter.
- Failure to implement an adequate AMLP and failure to timely file suspicious activity reports in connection with certain activities, including liquidation of a large position of a thinly traded unregistered penny stock at the direction of a corporate insider; the wiring of proceeds to third parties, some of whom were overseas; and the accountholder's refusal to provide requested information about an entity to which he proposed to transfer funds.

Barron Moore, Inc. Expelled for Illegal Sales of Unregistered Securities and AML (09/08)

Key Allegations

- Sold more than 6.75 million shares of unregistered stock of three companies, on behalf of seven customers, resulting in unlawful proceeds of more than \$975,000. Barron Moore opened accounts for numerous customers who repeatedly deposited large numbers of unregistered shares of thinly-traded securities into those accounts, sold those securities and then wired the proceeds out of the accounts. Neither the representatives nor the supervisors took appropriate steps to determine whether the securities could be sold without violating the registration requirements of the federal securities laws. The conduct occurred despite the presence of numerous red flags indicating that illegal stock distributions might be taking place
- Failure to detect and report suspicious activities by a convicted money launderer as well as in accounts ostensibly controlled by a 20-year-old who washed and detailed the cars of Barron Moore employees.

Questions

