



Aaron K. Fox

Managing Director, Minneapolis Office

aaron.fox@ipsaintl.com

(612) 605-6046



Food for thought - Another Madoff Fraud Every Single Year....

The Pink Sheets are on track to record trading volumes this year. Annualizing their daily trading volumes places the numbers between \$150 and \$200 billion. Estimates of fraud in the Pink Sheets abound from a conservative 10-15% to a ludicrous 50-70%. If we choose a point in between, say 25%, that's \$50 billion in investments diverted from the financial markets – \$50 billion that deserving small companies won't get – \$50 billion that will not stay in the market, but instead be drained into the pockets of stock promoters and manipulators. That's almost a Madoff-scale fraud every single year...

And, it isn't a stretch of the imagination that frauds of large scale can come from the OTC markets. The hedge fund, Absolute Capital, saw significant losses a few years ago from Pink Sheet stocks that a money manager had secretly invested a number of the funds in. And, remember, Bernie Madoff started his career as an OTC market-maker, only one step up from the Pinks.

Rather than a few very wealthy people harmed by one person, fraud in the Pinks represents tens of thousands of average Americans losing a couple of thousand dollars at a time. The common retort is these folks deserve what they get for playing in this space. However, that doesn't address the question of capital available to small companies.

Some firms question whether they should even allow trading in these markets to occur through their systems. In my opinion, we need to protect and develop these markets. There is no question the economy needs small companies. Some of those small firms will need capitalization. The markets that serve small firm issuers provide that access to capital. The more important question is how can we effectively and efficiently preserve this source of capital for deserving firms and protect investors.

The 27th *SEC-Business Forum on Small Business Capital Formation* included comments by former SEC Chairman, Christopher Cox, which really put the importance of these markets in perspective. Chairman Cox noted for the past two decades, small businesses have bailed us out of every recession. Chairman Cox went on to state that small businesses have consistently generated between two-thirds and three-quarters of all net new jobs and were responsible for 100% of net new jobs after the dot-com bubble burst. You can find the 2008 report, as well as previous years [here](#).

So how do we ensure only the deserving companies continue to access capital? Detecting, investigating and refusing to participate in potentially fraudulent distributions is a start. Many firms have implemented policies and procedures to ensure they identify issues with low-priced securities and the parties who trade them as soon as they hit the door. Look to your peers for ideas on how to develop these processes. The folks who have “been through the fire” are extremely valuable resources.

In developing your own investigative skill, you can look to publicly available resources. The work that Cromwell Coulson has done with the Pink OTC has provided a great framework for evaluating potentially fraudulent companies. The addition of the categories of types of firms as well as the Caveat Emptor status (the skull and cross bones symbol) in 2006 has been extremely helpful in identifying “at a glance” concerns.

Coulson is not one to rest on his laurels. He continues to add features to the Pink OTC that offer investors and firms efficient means to evaluate their concerns. This summer Pink OTC also added the ability to see all of the securities that a lawyer, investor relations firm or transfer agent was associated with. You can access this in two ways. For a particular lawyer, transfer agent or investor relations firm, go to the OTC Guide page and find the category titled “Service Provider Directory.” Selecting the category of interest will deliver you to an alphabetized list of providers. You can also access this information from the company information page for a particular stock. If the lawyer, transfer agent or investor relations person’s name is hot linked you can get a listing of the securities this person or entity is associated with.

And, of course, Hartley Bernstein’s old Stock Patrol documents are still out there and many are still relevant.

If you’re interested in a deeper understanding of how to research potential fraud related to low priced securities, send an email to info@ipsaintl.com. If we have enough interest, we will set up a webinar specific to this topic. You may also wish to review my previous articles on low priced securities included at our website [Customizing AML: Monitoring Low-Priced Securities for Suspicious Activity](#) and [Securities Broker-Dealers Adjust to New Post-Sanction Realities](#).

Regulatory Trends – Anecdotal Events or Calls to Action

I presented to the *SIFMA AML Committee* in July 2009 on monitoring for potentially suspicious activity in low-priced securities. As part of that presentation, I predicted sanctions for failure to supervise would replace AML as a primary concern at many firms. The day that I gave the presentation, FINRA released notice of a \$1 million fine for failure to supervise.

At the time I was preparing for the presentation to the SIFMA committee, I was uncertain if my interest in issues surrounding low-priced securities was coloring my impressions or if there was truly a trend in regulatory actions. I set out to discover if my sense of increased actions was supported by fact. I used a very unscientific process to come up with the answer to my hypothesis. I ran specific terms through the search engine at www.sec.gov and limited my search

to the litigation and regulatory action categories. The terms that I chose were: unregistered distributions, failure to supervise and penny stock bar. When graphed, the results were impressive. For the time frame July 2004 through July 2008, the trend was steady but low. July 2008 through July 2009 took a heavy turn to the north.

But the trend continues. There have been multiple additional failure to supervise actions since that time. The October report of Enforcement actions by FINRA listed five firms with failure to supervise actions and four with AML actions. View the action [here](#).

AML has not fallen off the radar; it just seems to have become a component of other actions. Failure to supervise appears to be the new overarching theme to organize various types of perceived compliance failures under.

It is particularly interesting to note the progression of events related to the Ferris Baker Watts AML sanction. The firm was sanctioned for failure to supervise and failure to file suspicious activity reports in February of 2009 and fined \$500,000 in addition to disgorgement with interest of approximately \$300,000. The sanctions stemmed from Ferris's failure to identify the fraudulent conduct of some of their employees related to a market manipulation. In August and September of 2009, the SEC followed these actions with direct complaints of failure to supervise against two senior officers and the general counsel of Ferris Baker Watts. If you would like to read these complaints, they can be found at the following links: [Complaint 1](#), [Complaint 2](#), [Complaint 3](#), [Complaint 4](#), [Complaint 5](#).

Preventing Sanctions

Double-checking how you manage and decision events flowing from the supervisory processes into General and AML Compliance is probably a good idea. This approach can also be used to leverage existing processes to alert AML and/or execute activities that support an AML investigation. For example, the Security Transfer and Receipt department or Margins can be used to execute standard due diligence on securities that meet certain parameters.

AML In The News

Regulators continue to focus on failures to detect, investigate and report potentially suspicious activity related to trading activity. In the most recent case, Scottrade was fined \$600,000 for failures to adequately monitor for suspicious activity. Read the FINRA Release [here](#).

"Each firm's AML program must be tailored to its business model, including the technological environment in which the firm operates," said Susan L. Merrill, FINRA Executive Vice President and Chief of Enforcement. "In this case, despite the large volume of on-line trading at Scottrade, the firm failed to establish any systematic or automated surveillance until 2005. Then, the automated system the firm implemented remained inadequate because it focused only on suspicious trading that was accompanied by suspicious money movement."

This is not a new message. Both FINRA and the SEC have repeatedly advised firms that in designing their AML program they should consider factors such as size, location, business activities, types of accounts they maintain and the types of transactions in which their customers engage. The continuing message is that an AML program must be customized to the risk of the business. And, I would add, the current trends of concern.

One of the continuing trends of concern is unregistered distributions. Shares issued under Rule 504 and Rule 506 seem particularly prone to fraud.

Many significant AML sanctions are tied to failure to detect and investigate potentially suspicious activity in low-priced securities. FINRA also has instructed on-line firms such as Scottrade and E*Trade to consider conducting computerized surveillance of account activity to detect suspicious transactions. They note that it is just not possible to efficiently conduct these reviews manually. As previously mentioned, relying on peers can be extremely beneficial E*Trade has shared some of how they have addressed this issue. I am hopeful that Scottrade will share similar information with their peers. While it is extremely difficult to be the firm at the center of the regulatory storm, the work that these firms undertake to resolve the issues is of great assistance to the rest of us. The firms that share their experiences with the rest of us are to be commended; they make our lives easier.

Addressing Unregistered Distributions

As far as how firms might address the issue of unregistered distributions, FINRA has offered specific guidance. In January 2009, FINRA issued Regulatory Notice 09-05 Unregistered Resales of Restricted Securities. This document outlines not only red flags specific to unregistered distributions but firms' responsibilities to make reasonable inquiries regarding whether the securities are eligible for sale and supervisory procedures and controls related to unregistered distributions. This document is a roadmap for updating your red flags related to newly issued securities and double-checking your supervisory controls. The document can be accessed [here](#).

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