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Microcap Securities – Reasonable Inquiries and AML Considerations

A Q&A Regarding Microcap Security Red Flags and How Your Organization Can Be Prepared

Under the most normal of circumstances, trading microcap securities comes with risk. Risk primarily due to the lack of publicly available information, making these securities more susceptible to price manipulation. Under the “new normal”, fraudsters are looking to exploit the over-leveraged and less-market-savvy risk takers promising big wins on COVID-19 tangent products and services.

FTI Consulting Managing Directors Kyle Daddio (former FBI and broker-dealer Chief AML Officer), Michael Buffardi (former FinCEN Special Advisor & SEC Senior Attorney), and Stephanie Fauerbach (former Big Four practitioner), address certain red flag indicators that institutions should consider when delving into the microcap securities market and how compliance programs can be prepared.

Q: Under the current pandemic environment, what is the regulatory landscape as it relates to microcap securities?

Stephanie Fauerbach: I recently attended the Securities Enforcement Forum West. The Securities and Exchange Commission (SEC), specifically Steven Peikin, Co-Director SEC Division of Enforcement, reinforced that individuals and companies may be looking to capitalize on the COVID-19 crisis for personal gain. In fact, the SECs considers the risk being so great they have created an internal COVID-19 Investment Scams Task Force, dedicating substantial resources to the issue. One way the SEC is seeing this greed is through the alleged manipulation of microcap stocks. In fact, through May 26, 2020, the SEC has issued trading suspensions on thirty-two microcap stocks, including formally charging three issuers. FINRA as well continues to pursue disciplinary actions against registered representatives and broker-dealers alleged to have violated securities regulations related to microcap.

Q: What are the areas of risk a regulator would probe when reviewing firms that accepted over-the-counter (OTC) microcap securities?

Michael Buffardi: A microcap examination will generally focus on two areas: first, a review to determine if there were Section 5 violations for any unregistered distributions of securities and then AML to determine if the firm's policies and procedures were reasonably designed to detect and report any illicit microcap activity. For better or worse, examiners have the benefit of hindsight when it comes to sampling for both issues. For efficiency, they will likely sample customer accounts with large deposits of microcap shares obtained through private securities transactions, especially if there are multiple accounts involved. The rhetorical question I always had in the back of my mind during these reviews was: "Does this look like an investment or is this person depositing only to sell in the open market?" A solid and documented reasonable inquiry on the part of a broker-dealer tends to provide clarity to that question.

Q: How would an organization ensure its AML compliance program is prepared to answer the rhetorical question Michael posed?

Kyle Daddio: As Michael pointed out, as the broker-dealer involved in the transaction, first-and-foremost you want to make sure you have a strong understanding of the type of customer making the request – have you satisfied the reasonable inquiry threshold. The questions you should be asking include: Is the requestor an individual or institutional client? Is this something they have done previously? Does this align with the typical transactional and trading activity of this customer type at your firm? The broker-dealer should be considering, at minimum, the following, i) manner/rationale in which account holder received shares, and if rationale aligns with account holder's business purpose; ii) customers who repeatedly obtain blocks of shares for consideration well below the then-trading price; iii) an individual receiving large lots from several sources consolidating the shares; iv) a private security sale to account holder when shares are eligible for open market sale. The broker-dealer should diligently review the information provided by the customer, focusing on whether the information satisfies internal policy requirements and regulatory expectations and if it conflicts with any information from other sources.

Q: When you are determining if a Rule 144 exemption is applicable for unregistered securities and whether the company was a shell company at any point in time, what tips or techniques do you recommend for firms performing these lookbacks?

Stephanie Fauerbach: Firms should have a general understanding of what third-party resources are available to find information to corroborate documentation provided by the customer. Websites like otcmarkets.com can be a good first-step to obtain documentation for non-reporting issuers, including financial statements and news reports of any reverse-mergers that indicate previous ticker symbols or businesses. Since the 144 exemption requires a non-reporting company to never have been a shell company, any loose threads publicly available information should be pulled until the most vivid picture of the company's past has been tracked down. Firms should also review any financials produced by the issuer to determine if, in the past, the companies' listed assets and liabilities indicate it was a shell. Since many non-reporting issuers produce unaudited financials, any accounting red flags should also be recognized and mitigated.

Q: What are some issues financial institutions should address to help ensure the procedures are being properly executed within an organization?

Kyle Daddio: Staffing and training are typically the most overlooked and last implemented parts of a compliance program but can be the most detrimental if left unaddressed. You can have the best systems, but if you don't have enough staff or they're not properly trained, your program may be vulnerable. You are not gaining the full benefit of the systems you spent time and money to implement. It is more difficult to hire staff with requisite microcap and trade surveillance knowledge, so there should be an emphasis on developing training. Someone with a strong understanding of the rules and regulations around microcap securities, either a senior compliance official and/or former regulator with the firm, or third-party firm, could lead the effort of developing training. I would also ensure that the training program is considered in the firm's annual audit and review of the compliance program, and that the third party conducting the review has staff with the requisite backgrounds to provide feedback and recommendations for enhancing the training program.

Q: Recently we have seen significant volatility in the market due to the COVID-19 pandemic. Given microcap securities are typically higher risk products, during times of increased market volatility, what are some red flags institutions should be aware of related to microcap securities?

Michael Buffardi: Market volatility can create chaos based on changes in trading volume alone. Microcap fraudsters may seek to hide sudden spikes in thinly-traded securities within the broader market fluctuations. A firm should determine what exactly is triggering volatility specifically within that issuer. One red flag would be if there's a simultaneous increase in promotional activity for the stock, especially if the activity is comprised of self-issued press releases or releases issued by a third-party promoter identified as being paid for services characterized as "shareholder communication initiative." Another significant red flag is whether an issuer has recently changed its business model or company name to something related to the cause of the market volatility. Problematic microcap issuers will often track popular trends or events to capitalize on investor interest. I'd be on the lookout for a company that was, for example, a drilling/mining company in 2013, switched to a cannabis company in 2017, and is now a biotech company advertising COVID-19 treatments or medical supplies. A company like that could be completely legitimate. It could also not be.

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