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Alert

SEC Staff Bulletin Highlights AML Risks Associated with Low-Priced Securities Trading in Omnibus Accounts

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On Nov. 12, 2020, the staff of the U.S. Securities and Exchange Commission's ("Commission") Division of Trading and Markets ("Division Staff") issued a bulletin ("Bulletin") highlighting various anti-money laundering ("AML") risks for broker-dealers effecting low-priced securities transactions through omnibus accounts maintained for foreign financial institutions.[1] Historically, FinCEN and the Division Staff have recognized that omnibus accounts are an integral part of the way in which firms do business,[2] but have also raised concerns about how such accounts can be misused.[3] This new Bulletin focuses in particular on the risks of such accounts involving foreign financial institutions and trading in low-priced securities. However, the Division Staff also noted that wrongdoers can engage in illicit activities through any means that allow a nominee account holder to conceal the identity of the ultimate beneficial owner of the account holder.

Background and Current Regulatory Framework

Over the past few years, the Commission has brought numerous enforcement actions against parties who allegedly perpetrated multi-layered schemes to defraud investors involving low-priced securities. These schemes were set up by foreign individuals or groups of individuals who obtained a controlling interest in issuers by acquiring large quantities of their low-priced securities. These individuals or groups typically held less than 5% of the controlling interest in issuers and set up nominee accounts and multiple layers of foreign financial intermediaries to conceal their actions. Given the omnibus account structures, these individuals were able to shield their identities from U.S. broker-dealers, with the U.S. broker-dealer only knowing the identity of the foreign financial institution and not the identity of the foreign financial institution's underlying customers and/or ultimate beneficial owners.

The Division Staff believes that foreign financial institutions engaged in low-priced securities trading through omnibus accounts present a high risk for illicit activities, including fraud, money laundering and unregistered securities offerings. The Bulletin articulates the Division Staff's concern that U.S. broker-dealers may be facilitating this kind of illicit activity by not sufficiently discharging their AML obligations, failing to conduct sufficient due diligence on omnibus accounts held for foreign financial institutions,

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[1] Securities and Exchange Commission, Division of Trading and Markets, *Staff Bulletin: Risks Associated with Omnibus Accounts Transacting in Low-Priced Securities* (Nov. 12, 2020), available here.

[2] *See,* e.g., Guidance from the Staffs of the Department of the Treasury and the U.S. Securities and Exchange Commission, Question and Answer Regarding the Broker-Dealer Customer Identification Program Rule ("CIP Q/A Guidance") (31 CFR 103.122) (Oct. 1, 2003), available here; *see also* Customer Due Diligence Requirements for Financial Institutions, 79 Fed. Reg. 45151, 45161 (Aug. 4, 2014).

[3] *See,* e.g., SEC Office of Compliance Inspections and Examinations, National Exam Risk Alert, Master/Sub-accounts, Volume 1, Issue 1 (Sept. 29, 2011), available here.

and ignoring (or failing to report) red flags associated with illicit or suspected suspicious activity conducted through these accounts.

The Bulletin also reminds broker-dealers of their existing obligations under the Bank Secrecy Act[4] ("BSA"), Rule 17a-8 of the Exchange Act, and Section 5 of the Securities Act of 1933 ("Securities Act"), as well as FINRA rules, with respect to AML compliance when effecting low-priced securities transactions through omnibus accounts maintained for foreign financial institutions.

Analysis

Broker-dealers are advised to consider three key AML obligations when engaging in transactions in low-priced securities effected through omnibus accounts, especially when those accounts are maintained for foreign financial institutions.

First, the BSA requires broker-dealers to establish a risk-based, written AML program with policies, procedures and internal controls reasonably designed to detect and report suspicious activities, including a relatively new fifth-pillar of the AML program.[5]

Second, as part of their AML program, broker-dealers must establish a risk-based, written due diligence program for "correspondent accounts"[6] held for a foreign financial institution, including omnibus accounts associated with low-priced securities transactions, as part of their obligations under Section 312 of the USA PATRIOT Act[7] ("Special Due Diligence Program"). In high-risk situations involving any correspondent account, an AML program should include provisions for obtaining any necessary and appropriate information about the customers underlying such an account.

Finally, broker-dealers should consider whether a transaction conducted or attempted by, at, or through a broker-dealer that involves, individually or in aggregate, funds or other assets of at least $5,000, requires reporting to FinCEN on a suspicious activity report ("SAR").[8]

Intersection with CIP and CDD Obligations

FinCEN and the Commission have previously issued joint guidance clarifying that in circumstances associated with omnibus account relationships, the broker-dealer's "customer," for purposes of the customer identification program ("CIP") and customer due diligence ("CDD") rules, would be the financial institution intermediary and not the financial institution's underlying customer and/or the ultimate beneficial owner of the securities.[9] The Bulletin cautions, though, that "it is critical for broker-

[4] Codified at 12 U.S.C. § 1829b, 12 U.S.C. §§ 1951-1959, and 31 U.S.C. §§ 5311-5314 and 5316-5332, with implementing regulations at 31 C.F.R. Chapter X.

[5] 31 C.F.R. § 1023.210(b)(5) ("Appropriate risk-based procedures for conducting ongoing customer due diligence, to include, but not be limited to: (i) understanding the nature and purpose of customer relationships for the purpose of developing a customer risk profile; and (ii) conducting ongoing monitoring to identify and report suspicious transactions and, on a risk basis, to maintain and update customer information.").

[6] *See* 31 C.F.R. § 1010.605(c)(1)(i) (defining a "correspondent account" as, *inter alia*, "an account established for a foreign financial institution to receive deposits from, or to make payments or other disbursements on behalf of, the foreign financial institution, or to handle other financial transactions related to such foreign financial institution.").

[7] Codified at 31 C.F.R.§ 1010.610.

[8] *See* 31 C.F.R. § 1023.320.

[9] *See,* e.g., CIP Q/A Guidance.

dealers to remember that even when the ultimate beneficial owner is not a broker-dealer's 'customer' for CIP and CDD purposes, there are circumstances where the characteristics of that ultimate beneficial owner would need to be considered as part of the broker-dealer's broader AML obligations" and that "broker-dealers may determine that a foreign financial institution presents a higher-risk profile and, accordingly, collect additional information to better understand the customer relationship."

Division Staff Views Regarding Application of AML Obligations to Foreign Omnibus Accounts

Notwithstanding the existing CIP and CDD guidance regarding omnibus accounts, broker-dealers should be aware that the Division Staff considers an inability to obtain information identifying the ultimate beneficial owners of funds and securities held in an omnibus account engaging in higher-risk transactions (such as low-priced securities transactions) to significantly increase the AML and other legal and compliance risks of the foreign omnibus account associated with those transactions. The Bulletin suggests that broker-dealers should consider obtaining information regarding the characteristics of ultimate beneficial owners of funds and securities, including their identities, when due diligence procedures identify those transactions or entities as posing a heightened risk. If a broker-dealer determines that such inquiries fail to appropriately manage the risk, then they should consider refusing to open (or closing) omnibus accounts, or restricting or rejecting transactions where necessary to mitigate that risk. The Bulletin reminds broker-dealers that "nothing under the federal securities laws or FINRA rules obligates [broker-dealers] to accept an order where they believe that the associated compliance or legal risks are unacceptable."

The Bulletin also provides an illustrative example fact pattern, typifying the chain of events that groups have used to engage in illicit activities involving low-priced securities. The Division Staff notes that this pattern varies and includes various combinations of the following components and others:

- **Obtain Controlling Interest in an Issuer**
    - First, an individual or group of individuals ("Control Group") obtains a controlling interest in an issuer through the purchasing of a large quantity of low-priced securities without a restrictive legend.
- **Transfer to Nominees**
    - Next, the low-priced securities are transferred to offshore entity nominees with foreign ownership, that have no apparent purpose other than concealing the Control Group. The securities are then distributed such that no nominee holds account-level positions of 5% of the total issued and outstanding securities, to evade detection and identification of the Control Group.
- **The Accounts are Layered Through "Nested" Account Relationships**
    - The Control Group opens multiple accounts on behalf of the nominees at a series of foreign intermediaries. The foreign intermediaries use omnibus accounts in their names at other foreign intermediaries to execute trades as instructed by, and for the benefit of, the Control Group.
    - There may be multiple layers of foreign intermediaries handling the order flow through successive account relationships prior to the trades being consolidated and executed with a U.S. broker-dealer.

- **Foreign Financial Institutions Execute Trades at U.S. Broker-Dealer(s)**
    - Finally, the foreign financial institutions execute trades through their omnibus accounts at U.S. broker-dealers. To reduce scrutiny, and avoid raising red flags, the Control Group may use a network of foreign financial institutions and U.S. broker-dealers such that no entity has complete visibility into the amount of securities deposited, trading volume and activity, timing of wire transfers, etc.

Thus, through layering the accounts and spreading the trading activity, the Control Group is able to obfuscate the ultimate beneficial owners' identities and engage in fraudulent schemes (e.g., coordinated manipulative trading, fraudulent stock promotion, "pump and dump" schemes, etc.) undetected.

Other Risks and Related Broker-Dealer Obligations

The Bulletin also reminds broker-dealers of their obligations (1) to conduct a reasonable inquiry when selling securities in an unregistered transaction in reliance on Section 4(a)(4) of the Securities Act; and (2) pursuant to sanctions imposed by OFAC.

With regard to reasonable inquiry, Section 5 of the Securities Act requires all offers and sales of securities in interstate commerce to be registered, absent an applicable exemption. 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."[10] However, in order to claim this exemption, broker-dealers must conduct a reasonable inquiry to ensure that the account's owner is not an underwriter of the securities and that the transaction is not part of an issuer's distribution.[11] Because of the risks associated with transactions in low-priced securities effected through omnibus accounts maintained for foreign financial institutions, the Bulletin suggests that broker-dealers should consider whether to obtain identifying information as to the ultimate beneficial owners of funds and securities. If a broker-dealer determines that obtaining this identifying information is appropriate but is unable to obtain it, then that broker-dealer should consider whether to proceed with the transaction.

With regard to OFAC, the Bulletin reminds broker-dealers of their sanctions-related obligations, including the requirements related to the (i) blocking of accounts and other property interests of entities and individuals appearing on sanctions lists, including of entities owned (directly or indirectly) 50% or more by blocked persons; (ii) country-based sanctions prohibitions; and (iii) rejecting of prohibited transactions. In addition, it provides that OFAC maintains several sanctions programs that prohibit U.S. persons, including broker-dealers, from dealing in equity and debt of, and extension of credit to, certain sanctions targets.

Lastly, the Bulletin highlights a nonexclusive list of key red flags for broker-dealers from FINRA Regulatory Notice 19-18, including, among others:

[10] Codified at 15 U.S.C. § 77d(a)(4).

[11] *See World Trade Financial Corporation v. SEC*, 739 F.3d 1243, 1248 (9th Cir. 2014).

- Accounts opened in the name of foreign financial institutions that sell shares of stock on an unregistered basis on behalf of customers;
- Sudden spike in investor demand for, coupled with a rising price in, a thinly traded or low-priced security; and
- Customers domiciled in, doing business in or regularly transacting with counterparties in a jurisdiction that is known as a bank secrecy haven, tax shelter, high-risk geographic location or conflict zone.[12]

Conclusion

Issues relating to omnibus accounts continue to raise concerns with the SEC and now FinCEN. As noted above, prior guidance and prior enforcement actions have demonstrated that concern. Going forward, firms will have to tread carefully when applying the omnibus guidance in the context of low-priced securities. Managing the particular issues presented in heightened risk activities may require evaluating or modifying existing AML compliance programs, as well as accounting for the additional risks posed by transactions routed through multiple layers of accounts.

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If you have any questions concerning this *Alert*, please contact your attorney at Schulte Roth & Zabel or one of the authors.

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[12] FINRA Provides Guidance to Firms Regarding Suspicious Activity Monitoring and Reporting Obligations, Reg. Notice 19-18, FINRA (May 6, 2019) ("Regulatory Notice 19-18"), available here.