

Over-the Counter “Pink Sheet” Securities and the Threat they Pose as a Money Laundering Vehicle to Broker-Dealers

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Introduction: An Outline of the Issues

Financial crimes investigators (FCI's) occasionally encounter over-the counter (OTC) "Pink Sheet" listed securities as a physical share certificate. The financial industry calls them "Pink Sheets" in recognition of the actual pink paper once used to print out the stock prices. They are typically speculative stocks that should legitimately represent a share of ownership in a bona-fide company not yet listed on a public stock exchange, but due to their opaque, unregulated nature and the market in which they trade are very attractive to people who wish to launder money and defraud both investors as well as broker-dealers. The ideal means to forestall attempts by bad actors to introduce this speculative, money laundering vehicle is to identify and define the nature of Pink Sheet securities. Money launderers use Pink Sheet securities as a significant component of a money laundering scheme both as an instrument of the crime or as the objective of that crime; the methodology behind it will be clearly delineated. The impact on the broker-dealer, investing public and securities market as a whole, if steps are not taken by the FCI to combat these schemes are too damaging to ignore. Brokerage firms must exercise extreme caution when dealing with Pink Sheet securities, particularly when in physical share form in order, as such, steps an FCI should take to protect the firm from being used as a means to launder funds will be clarified. The purpose of this paper is to provide FCI's and broker-dealers a cogent solution towards identifying and preventing money laundering through the use of Pink Sheet securities at their firm; thereby promoting a securities market based on financial integrity, transparency and fairness.

The Nature of a Pink Sheet Security

The OTC Bulletin Board "Pink Sheet" market connects broker-dealers electronically and comprises securities that typically represent companies that are speculative in nature. Unlike the OTC Bulletin Board or "OTCBB," which is a quotation service operated by the Financial Industry Regulatory Authority (FINRA) which requires OTCBB issuers to register with the Securities Exchange Commission (SEC) and adhere to stricter ongoing listing standards,¹ Pink

¹ Microcap Stock: A Guide for Investors (www.sec.gov/investor/pubs/microcapstock.htm,2014),p2.

Sheet companies have no such requirement to be listed. In fact, it can be considered to be “an open marketplace for a broad spectrum of equity securities, with no financial standards or reporting requirements.”² The lack of surveillance and regulation with respect to this market make Pink Sheet securities difficult to value, illiquid, subject to market manipulation and oftentimes of dubious provenance. Being unregulated, Pink Sheet securities have no formal listing, document disclosure, accounting, or filing requirements(such as the dates of current financial statements with a national securities regulator like the Securities Exchange Commission (SEC) in the U.S.).³

The big risk associated with these kinds of microcap or “penny stock” securities relate fundamentally to a lack of readily available information to the investing public; information taken for granted when a client of a broker-dealer seeks to transact in stocks listed on a more common stock exchange, such as the New York Stock Exchange (NYSE). Concrete information as part of a normal process of due diligence that an investor should undertake when investing in a microcap stock “can be extremely difficult to find, making them more vulnerable to investment fraud schemes and making it less likely that quoted prices in the market will be based on full and complete information about the company.”⁴ Due to their low market capitalization, often ranging between \$50 million and \$300 million⁵ (but sometimes of little or no value whatsoever) make the Pink Sheet security a hazardous product best avoided notwithstanding aggressive attempts made by unscrupulous stock promoters that promise huge short-term returns on invested capital.

Furthermore, as Pink Sheet securities typically trade infrequently, they often become controlled by a small number of shareholders who will try to work in concert to manipulate the price of the stock. Given this illiquidity an FCI must consider them a high-risk investment product both to the

² Ibid., p3.

³ OTC Markets: Official site of the OTCQX, OTCQB & OTC Pink Sheet Marketplaces (www.otcmartets.com/learn/otc-company-overview, 2015) p1,2.

⁴ Microcap Stock: A Guide for Investors (www.sec.gov/investor/pubs/microcapstock.htm,2014), p3.

⁵ The Lowdown on Penny Stocks, NASDAQ.com (www.nasdaq.com/investing/lowdown-on-penny-stocks.stm), 2015, p1.

broker-dealer, but also to those clients who seek to trade them, or more seriously, try to introduce them into the brokerage firm by way of a physical share certificate deposit.

It is standard practice in Canada that the recognized exchanges, such as the Toronto Stock Exchange (TSE) and the TSX Venture Exchange imposes conditions “in particular, legal and financial—on companies wishing to list with them and issue securities. Companies that are unable or do not wish to meet these conditions turn to the OTC markets.”⁶ The need to first understand and become familiar with this kind of high-risk product is the best way for FCI’s to then learn how Pink Sheet securities appeal to those seeking to use them to engage in fraud and money laundering. Stock ownership, whether in electronic form or as a physical share certificate represents ownership in a corporation, however, those of the Pink Sheet variety, especially of the “shell or bearer share variety, are used to layer money laundering schemes. The shares used in such schemes are seldom those of publicly traded corporations—the type that are listed on the major exchanges.”⁷

It is the scarcity of a Pink Sheet company’s history that is advantageous to those seeking to use it as a means to assign and promote value when none exists. Companies without a track record or formerly defunct in years past can easily be hijacked by those needing a tool to commit fraud and launder money. The OTC Pink Sheet market and the securities found therein becomes akin to the “Wild West” in the investment world wherein securities issued by small companies may be legitimate or not and it is in this space where the criminal seeks to exploit opportunity. Through familiarity of what the Pink Sheet market is, as well as the lack of oversight and control of the securities that trade on it, FCI’s can then learn how it is used by money launders.

⁶ Fraud on OTC or Pink Sheets, Autorite des Marches Financiers (www.lautorite.gc.ca/en/fraud-otc-pinksheets-conso.html), 2015, p1.

⁷ John Madinger, Money Laundering, A Guide for Criminal Investigators, 3rd Ed. (CRC Press, 2012), p197.

How Pink Sheet Securities are used by Money Launderers

The vast majority of securities transactions that take place in the stock market are of a legitimate nature where attempts to initially place illicit funds can be difficult, nevertheless Pink Sheet securities present opportunity exploited by money launderers in placement, layering and integration of the proceeds of crime. Fraudsters and money launderers see this market and the securities under discussion here as a vehicle to carry out their illegal objectives. This is particularly the case with physical share certificates, including **Bearer Securities**, when the holder of such a physical “**Cert**” approaches the broker-dealer with the aim to have the firm accept them and book them into the client account. Although increasingly many jurisdictions no longer provide for physical certificates, they are still sufficiently available. For those unregistered physical securities, the bearer may sometimes not be registered as the owner of record with the transfer agent. In fact, “The Transfer of bearer securities can be as simple as handing the security over to a new owner.”⁸ These securities are very often of the **micro/nano-cap** variety, and are illiquid or even fictitious “shell” companies easily manipulated by the criminal.

It must be noted that “The anonymity and easy transferability of bearer securities presents a significant ML/TF vulnerability at all three stages of money laundering. Illicit assets can be placed in the securities industry through the purchase of bearer securities.”⁹ Once the physical or bearer share certificate is created, money launderers attempt to move them to another party without the transfer of ownership being duly recorded and then try to deposit the shares into connected brokerage accounts. The broker-dealer becomes vulnerable to ML when handling Pink Sheet shares as it becomes relatively simple to move Pink Sheet shares cross-border without knowing who the recipient client is. Frequently such actions involve non-residents transferring funds derived from spurious gains or losses associated with numerous transactions in these securities.¹⁰ Artificial value or a market manipulated price of these companies allow for the shares to be sold, funds withdrawn or wire transferred to another jurisdiction, thus accomplishing the layering and

⁸ Financial Action Task Force: Money Laundering and Terrorist Financing in the Securities Sector, 2009. p.17.

⁹ Ibid.

¹⁰ MONEYVAL, Committee of experts on the evaluation of anti-money laundering measures and the financing of terrorism, 2008, p39.

integration of assets derived from underlying predicate offences.¹¹ In some cases even the transfer agent itself is set up to facilitate or act as a physical share creation “mill” churning out shares of these bogus Pink Sheet companies to facilitate the scheme and lend credibility to the owner of the shares both in physical or electronic form.¹²

As stocks on the Pink Sheet system fall in an unregulated grey area they are an ideal haven for shell companies. Shell companies “generally refers to limited liability companies and other business entities with no significant assets or ongoing business activities....typically have no physical presence other than a mailing address, employ no one, and produce little to no independent economic value.”¹³ Money launderers find shell companies attractive to carry out illicit activity in relation to Pink Sheet securities trading because some can be run anonymously, have little to no reporting requirements, be owned by almost anyone and be an easy vehicle for the transfer of funds between third parties and the owners of the limited liability shell company.¹⁴ It must be mentioned that bad actors, “[i]n particular, individuals or entities in high-risk areas/jurisdictions or conflict zones can disguise their true identities through a series of shell companies located in various jurisdictions to participate in a financial system that they otherwise would not be able to access.”¹⁵

The four most common fraudulent securities market activity found in brokerage accounts opened in the name of an acquired shell company towards facilitation of laundering funds will now be explained in detail. These are: reverse acquisition, trading Pink Sheet securities at off-market and fictitious prices, the use of a brokerage account at the initial placement stage and the “Offshore Scam.”

¹¹Ibid, p 18.

¹² Ontario Securities Commission, In the Matter of the Securities Act, R.S.O. 1990, c.S5, as Amended and in the Matter of J.Wong, D.Watson, N.Rogers, A.Giles, J. Sparrow, K. Findlay, Leasemart Inc.,Advanced Growing Systems, Inc., Pharm Control Ltd., The Bithub.com,Inc.,Universal Seismic Associates Inc., Pocketop Corporation, Asia Telecom Ltd., International Energy Ltd., Cambridge Resources Corporation, Nutrione Corporation and Select American Transfer Co., 2013.

¹³ Department of the Treasury Financial Crimes Enforcement Network, The Roll of Domestic Shell Companies in Financial Crime and Money Laundering: Limited Liability Companies, 2006, p. 4.

¹⁴ Ibid, p 10.

¹⁵ Financial Action Task Force: Money Laundering and Terrorist Financing in the Securities Sector, 2009. p.39.

Reverse Acquisition

The reverse acquisition or reverse stock split of a defunct company on the Pink Sheets is a common procedure in which the once active, publicly traded company is acquired often through the use of shares from the private company as consideration. Ideally, the shell is one which has been dormant for some time with any former list of shareholders difficult to locate. Once majority controlled by the private company, the name of the old public company is changed and the old shares consolidated by the new owners, such as for every one thousand old shares now replaced with one new share, reducing any residual shareholder influence in the public company and effectively taking the private company public. The next step would be an amendment to permit the share float in the “new” public company to increase allowing this newly “hijacked” company to issue shares to whomever it chooses.¹⁶ At this point the basic offenses for ML and the link to the Pink Sheet security come together specifically, market manipulation, fraud and insider trading. The Pink Sheet company, now controlled by the criminal group, often will use the “**Pump and Dump**” scheme to integrate funds in the ML process.

The “Pump and Dump” scheme works as follows: with the criminal syndicate holding the cheap shares, paid promoters are used to issue press releases, Internet bulletin boards, chat rooms and spam to communicate highly optimistic information that is either completely false or very loosely based on fact about the company. They work to promote the thinly traded company by controlling liquidity to ensure there is a scarcity of shares which forces buyers to pay ever higher prices. The unsuspecting public buys the higher priced penny stock from the fraudster who, once he has sold or “dumped” his shares ceases the promotion resulting in the rapid decline of the price of the security.¹⁷

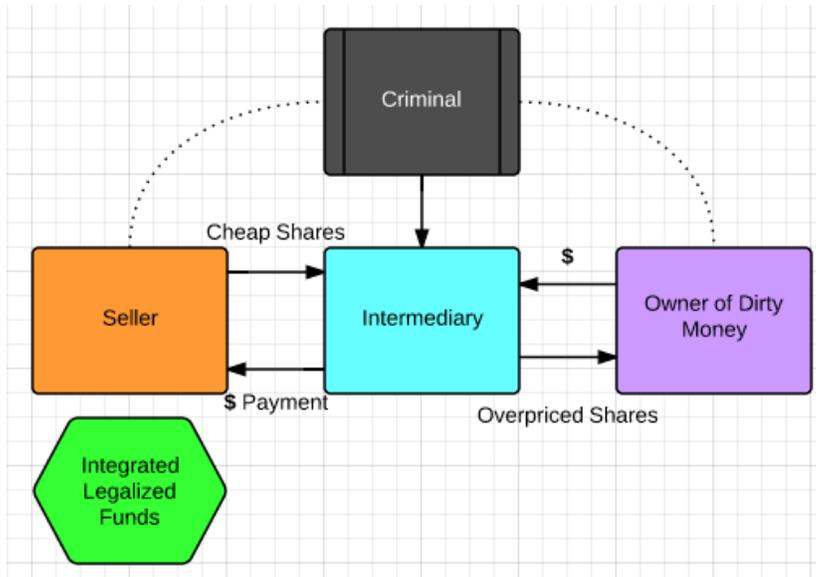
Trading Pink Sheet Securities at Off-Market and Fictitious Prices

Another scheme that facilitates the integration of funds is done by trading Pink Sheet securities at “**off-market**” prices. In this unofficial market the criminal will buy the shares at a cheap price

¹⁶ Department of the Treasury Financial Crimes Enforcement Network, The Roll of Domestic Shell Companies in Financial Crime and Money Laundering: Limited Liability Companies, 2006, p. 4..

¹⁷ Financial Action Task Force: Money Laundering and Terrorist Financing in the Securities Sector, 2009. p.40.

and then resell them “in an agreed transaction via an intermediary, at an artificially inflated price, to the person holding illicit funds.”¹⁸ The profit made from this sale of shares then has the appearance of being legitimately obtained.

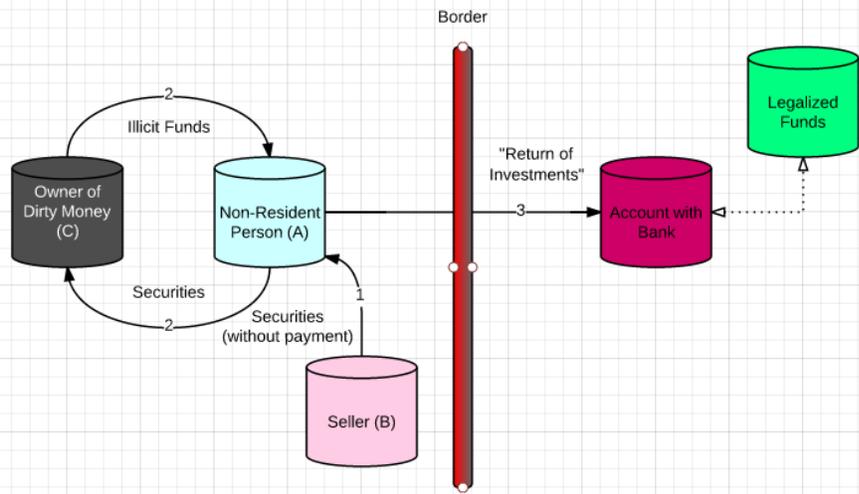


Source Reference Moneyval2008

In the case of fraud associated with Pink Sheet Securities, often fictitious transactions are involved where a non-resident, party “A” agrees to purchase the shares from the “seller” Party “B.” Party “A” does not pay for the shares and once received from “Party B” then sells the shares to Party “C” in exchange for dirty money. The funds are then moved outside the country to non-resident Party “A” under the guise of a gain on investment.¹⁹

¹⁸ MONEYVAL, Committee of experts on the evaluation of anti-money laundering measures and the financing of terrorism, 2008, p42.

¹⁹ Ibid, 45.



Source Reference Moneyval2008

The Use of a Brokerage Account at the Initial Placement Stage

Another example of securities chicanery involves the use of a brokerage account at the initial placement stage by the money launderer to transfer in Pink Sheet shares which would have been used as a **form of payment**, or representative of money acquired through criminal activities elsewhere. The account holder would then execute numerous buy and sell trades in the account on this security to create the impression the stock is actively traded, so as to attract interest from gullible investors. It does not matter if all the trades are profitable, so long as the shares brought in are sold to another in exchange for cash. The funds are eventually transferred out by the unsuspecting broker-dealer, sometimes as a bank draft to an associated third party.²⁰

For **insider trading**, which involves the principals of the public company acting on material non-public information, a breach of fiduciary duty in its own right, "The illicit assets generated by insider trading can be laundered through the securities industry....The most common example of laundering would be the simple transfer of illicit proceeds to a bank account."²¹

²⁰ Ibid 49 & Financial Action Task Force: Money Laundering and Terrorist Financing in the Securities Sector, 2009. p.27.

²¹ Financial Action Task Force: Money Laundering and Terrorist Financing in the Securities Sector, 2009. p.48.

The “Offshore Scam”

Related to insider schemes is lastly the “**Offshore Scam.**” Under a Securities and Exchange Commission (SEC) rule known as “Regulation S,” companies that sell shares outside the U.S. to offshore investors are not required to register them with the SEC. The insiders who control the Pink Sheet microcap shares sell them at a very low price to unscrupulous stock promoters who acting as legitimate foreign investors re-sell them to U.S. investors at a much higher price. The resultant profit is split between the insider and promoter. Once this wave of unregistered shares enters the U.S. market, the price collapses due to oversupply, leaving the victimized investor with substantial losses on his or her “investment.”²² It has been clearly demonstrated for the benefit of the FIC that Pink Sheet securities, based on the detailed methodologies discussed above, are used by money launderers as a tool to facilitate movement of funds derived from predicate offences.

Impact of ML on the Broker-Dealer via Pink Sheet Securities

To the FIC the impact Pink Sheet securities have on the broker-dealer, its staff and the securities market, when they are used as part of a ML enterprise, are significant. Failure to comply with AML regulations cost the firm fines, staff punishments, client losses and serious reputational damage.

Law enforcement such as the Royal Canadian Mounted Police (RCMP) note the appeal such criminal controlled companies have and the threat Pink Sheet securities pose to capital markets. Known to the RCMP’s Integrated Market Enforcement Team (IMET) as “Criminalized Professionals”—lawyers, accountants, investment bankers, advisors or anyone with a professional designation or certification that may be participating in capital markets with the intent to commit fraud.”²³ These professionally organized criminal groups gravitate towards Pink Sheet companies as a means to make money quickly and subsequently attempt to introduce such

²² Microcap Stock: A Guide for Investors (www.sec.gov/investor/pubs/microcapstock.htm,2014),p9.

²³, Mallory Proconier, Criminalized professionals create new challenges, www.rcmp-grc.gc.ca/gazette/vol75no1/cover-dossier/imet-eipmf-eng.htm., 2013, p1.

funds into the banking system. Companies controlled and manipulated by organized crime are in the main confined to the manipulation of securities that fall under the Pink Sheet variety, according to the U.S. Securities and Exchange Commission, “The Commission’s experience shows that the activities of organized crime have been confined to the “microcap” securities market and taint only a small fraction of that sector.”²⁴ Nevertheless, AML deficiencies on the part of the broker-dealer or the FIC to stay this kind of illegal activity result in penalties levied on the firm and its employees. According to FINRA Rule 3310 “The anti-money laundering programs required by this Rule shall, at a minimum, (a) Establish and implement policies and procedures that can be reasonably expected to detect and cause the reporting of transactions required under 31 U.S.C. 5318(g) and the implementing regulations thereunder.”²⁵ Transactions covered under this requirement include the buying and selling of stocks, including those on the Pink Sheets.

In the FINRA case of DOE v. Meeting Street Brokerage it was found that the brokerage firm, through its AML compliance officer should have recognized red flags requiring further AML scrutiny. However, customer activities in Pink Sheet traded securities, which served as the basis of market manipulation were deliberately not investigated, with **Suspicious Activity Reports** (SARs) not documented or filed. As a result, Meeting Street Brokerage and its principals were charged with acting in a scheme designed to increase or artificially maintain the price and volume of Relay Capital, a Pink Sheet security. Furthermore, the AML compliance officer did not research other customer accounts and their Pink Sheet trading activity which appeared suspicious, including the depositing and journaling of these shares, especially those clients who had been disciplined or barred by FINRA or another regulator in the past. The penalties levied by FINRA on Meeting Street Brokerage for not filing SARs resulted in the firm being expelled from FINRA membership. For the AML compliance officer, he was fined \$15,000, suspended from the association with a FINRA member for 90 days and suspended from the association with any FINRA member in a principal capacity for two years.²⁶

²⁴ Richard H. Walker, U.S. Securities and Exchange Commission, Testimony Concerning The Involvement of Organized Crime on Wall Street, www.sec.gov/news/testimony/ts142000.htm, 2000, p1.

²⁵ Financial Industry Regulatory Authority, http://www.sifma.org/uploadedfiles/events/2013/anti-money_laundering_and_financial_crimes_conference/finra-3310.pdf, p1.

²⁶ Ibid <http://www.finra.org/Newsroom/NewsReleases/2009/P120509>, p1.

In another FINRA case dated August 2013, the prestigious broker-dealer Oppenheimer agreed to pay \$1.425 million in fines relating to the firm selling unregistered Pink Sheet penny stocks and failed to have adequate controls against ML. Over a period from 2008 to 2010, seven Oppenheimer brokers in the U.S. sold more than 1 billion shares in 20 unregistered penny stocks. Some of the Oppenheimer clients had close ties to the Pink Sheet companies and its traded shares; one customer in Boca Raton, Florida, owned nearly 40 percent of one such company's outstanding shares! Given the tremendous share volume involved, Oppenheimer should have escalated this activity to its FCI unit and investigated both the brokers and clients under an AML mandate. This was not done, with the result that Oppenheimer was required by the regulator to hire an independent consultant to review internal company policies and procedures relating to knowing your client accounts at its own expense.²⁷

In a more recent development made on January 27, 2015, Oppenheimer is to pay \$10 million in a civil settlement with the SEC and \$10 million in settlement with the U.S. Treasury Department's Financial Crimes Enforcement Network (FinCEN) related to continued failure to adequately police suspicious trading in penny stocks and maintain adequate AML controls.²⁸

It can become a challenge for a broker-dealer seeking to increase revenue against the resources needed to abide by AML regulations "[b]ecause the volume of trading in stocks, bonds, mutual funds, and options is so heavy, suspicious transactions can be difficult to detect,"²⁹ but failing to do so carries with it tangible penalties.

Our final case, courtesy of the U.S. Attorneys' Office Eastern District of New York will illustrate the damage done to market integrity when ML is involved on such a grand scale. Six corporate executives, of the U.S., Canada and Belize and the Bahamas along with six corporate entities, three of which were offshore brokerage firms in Belize (Titan International Securities Inc., Legacy Global Markets S.A. and Unicorn International Securities LLC) aided over one hundred corrupt

²⁷ Ibid <http://www.finra.org/web/groups/industry/@ip/@enf/@ad/documents/industry/p315930.pdf>

²⁸ Marcy Gordon, The Associated Press, Jan 2015.

²⁹ John Madinger, Money Laundering, A Guide for Criminal Investigators, 3rd Ed. (CRC Press, 2012), p197.

U.S. clients to launder \$500 million dollars between January 2009 and September 2014. The defendants helped the clients conceal ownership of large amounts of thinly traded Pink Sheet securities from reporting a 5 percent or greater holding to the SEC by creating anonymous foreign entities that relied on nominee officers and dividing up the shares until below the threshold. These clients hence remained unknown both to the SEC and to the U.S. Internal Revenue Services (IRS) for tax reporting requirements. Dozens of penny stocks were involved and actively promoted for sale at higher prices as part of “Pump and Dump” schemes. Furthermore, to aid the funds flow back to the U.S. the defendants would furnish clients’ prepaid credit cards holding up to \$50,000 a month to launder the illicit proceeds. This widespread practice hurts the capital market and investor alike, “(S)tated United States Attorney Lynch. ‘Today’s sweeping indictment, charging the individuals and companies responsible for this \$500 million scheme, closes this fraudulent offshore safe haven and sends a strong message to those who seek to abuse the financial markets in order to enrich themselves that we will investigate and prosecute them no matter where they set up shop.’”³⁰

As it has been demonstrated above, proper AML controls which the FCI must advocate within the broker-dealer, are to be in place to maintain the integrity of the securities market -the monetary and reputational damages are too great to ignore.

AML Strategies the FCI Must Promote to Protect the Broker-Dealer

Broker-dealers must adopt a direct yet multifaceted strategy to protect the firm in the fight against ML when handling Pink Sheet securities, particularly those in physical share certificate form. The FCI can promote several methods as the basis of its overall risk-based AML strategy in the firm. These include: KYC verification process, solid record keeping, staff training, effective escalation when a risk has been identified and the prompt filing of the SAR to the authorities.

³⁰ The United States Attorneys office Eastern District of New York, www.justice.gov/usao/nye/pr/september14/2014sep9.php Sep 2014.p.1-3.

KYC

The development of a risk-based approach when fulfilling the obligation of KYC is the essential first step towards a firm being AML ready in efficiently identifying bad actors. A risk-based KYC approach means that at the beginning of the client verification process assessment of risk must be assigned according to fairly straight forward criteria. Geographic location of the customer is a key indicator, such that if the client is a non-resident of the broker-dealers country and living in a high-risk non-cooperative jurisdiction as listed by the FATF, then the firm is faced with a potentially high-risk client.³¹ The type of account and anticipated activity for that account is important, as typically the simple retail brokerage cash account of a client duly identified in a salaried occupation, such as a teacher, will be much lower risk than the margin account of a corporate entity with numerous accountholders and many third party sources of funding or securities flows. In instances like this, the broker-dealer must clearly identify all the beneficial account holders and the parties behind the party by scrutinizing the source of funds, including the “who,” “why” and “how” when Pink Sheet securities try to flow into a high-risk account such as this. It must be stressed that “With Know-Your-Client rules, the financial institution expands its role still further. It is no longer passive or even reactive, but proactive. It has, in effect, become deputized by the law enforcement apparatus as a private detective agency.”³²

Solid Record Keeping

Broker-dealers have an obligation as effective gatekeepers, to properly identify their clients through solid record keeping such as the account opening agreement, client’s signature card, valid government issued photo identification, a void or cleared cheque from a financial entity such as a bank, disclosure of accounts held at other financial institutions and search of the client being an insider or a public company is also required to know your client; this includes

³¹ Financial Action Task Force, Countries, <http://www.fatf-gafi.org/topics/high-riskandnon-cooperativejurisdictions/> 2015

³² Margaret Beare, Critical Reflections on Transnational Organized Crime, Money Laundering, and Corruption (University of Toronto Press, 2003) p.280

subsequent recording of large movements of funds into and out of the respective account.³³ If client activity involves frequent or large fund deposits, particularly cash equivalents such as bank drafts, along with substantial increases in trading in the penny stock space and the client shows indifference towards losses with monies or securities transferred out, then these red flags must require further investigation by the broker-dealing staff.

Staff Training

Protecting the investing public from ML associated with securities fraud means training not only the FCI, but sharing that skill-set with fellow employees at all levels of the firm. Establishing this infrastructure amongst staff introduces a tacit recognition that “Enforcement alone cannot deal with this problem. Cases are often complex, involve cross border activity and are hard to prove.”³⁴ So basic requirements involve front-line and administrative staff handling Pink Sheet securities to do some extra work, yet when compared to the damage done to a firm (should it not take appropriate measures) it is the logical choice. Staff should start with researching if the company has been dormant and resurrected—the SEC’s EDGAR database is a good tool to see when it last filed reports. As Pink Sheet securities trade OTC identifying the company and where the security trades (North America or offshore) can be a challenge but must be undertaken. If the research reveals that the company has had frequent name changes or the business of that company altered to reflect what is “hot” or trendy, such as today’s recent medical marijuana Pink Sheet companies debuting on the market, then that too is a risk indicator. Lastly, as touched on earlier massive reverse stock splits are a concern in addition to whether the security’s stock symbol includes as the last letter “Q” in it, as that means the firm has filed for bankruptcy, which is certainly not a ringing endorsement.³⁵ Training then becomes not only a necessity, as FINRA

³³R.Hubbard, D. Murphy, F. Odonnell, P.Defreitas, Money Laundering & Proceeds of Crime (Irwin Law Inc.,2004) p.276.

³⁴ Doug Hyndman, Effective Regulation for BC’s Capital Markets, Delivered to the Vancouver Board of Trade, June 2007, p.7.

³⁵ Securities and Exchange Commission, <http://www.sec.gov/News/PressRelease/Detail/PressRelease/1370543327365> Oct 2014, p2.

Rule 3310(e) specifies the firm must provide continuous training for relevant staff, but should also become part of a broker-dealers best practice corporate culture.³⁶

Client attempts to deposit physical share certificates must be handled on an exception basis only or not at all. The client must be clearly identified as low risk and the provenance of the physical shares determined; acceptance by the firm means documenting this information is essential. An FCI must not stand idly by if a client or group of clients demonstrate a suspicious pattern of attempting to deposit physical share certificates of Pink Sheet securities nor should the firm's sales staff make it a practice to solicit trades in such securities. The broker-dealer must act in a way that supports NASD Notice to Members 96-32, which "urged members to focus particular attention on certain rules, regulations, and best practices when dealing with customers in speculative or low-priced securities... In particular, NASD Regulation emphasized suitability, disclosure, valuations, supervision, and cold calling as areas in which members must take special care in discharging obligations to customers, especially when dealing in speculative or low-priced securities."³⁷ Proactive measures taken will therefore discourage and disrupt the proliferation of Pink Sheet securities and the bad actors associated with them who often conjoint this market segment with the laundering of funds.

Rapid Escalation Procedures

Identifying and escalating (notifying the FCI and senior management) high-risk activity associated with Pink Sheet securities at the broker-dealer is a vital component towards disclosing potential activity linked to ML. Two-way communication between the supervisors of the firm and its financial intelligence unit (FIU) can serve as an early warning that predicate offenses may be linked. The FIU can share reports of suspicious transactions with supervisors while supervisors facing the clients have the transactional information to lend to the FIU. Turning a blind eye or being ignorant of bad actions committed by clients of the broker-dealer is not acceptable, "The onus therefore falls on corporate officers to monitor and report suspicious activities. Any officer of a financial institution in America found guilty of being involved in money laundering risks up

³⁶ FINRA, http://complinet.com/en/display/display.html?rbid=2403&element_id=8656&print=1 2014.

³⁷ Ibid, <http://www.finra.org/Industry/Regulation/Notices/1996/P004927>, Sep 1996.

to ten years' imprisonment and /or a fine of \$500,000.”³⁸ An efficient process requires that a firm's staff provide senior management with timely notification and shared access to data.

SAR

The essential component in escalating high-risk activity of suspected ML is through the filing of a SAR. Submission of a SAR to the relevant authorities in the broker-dealers' respective jurisdiction will meet its reporting obligations to document, disclose and help prevent illegal activity. It must be noted that during this escalation process, the client of the broker-dealer under investigation in which a SAR has been filed, must never be “tipped off” that they are under scrutiny: “The financial institution and/or its staff can themselves face criminal penalties for telling a client that an STR (suspicious transaction report) is being filed.”³⁹ If there are reasonable grounds to suspect that the transaction is related to the committing of a ML offense, then escalation and reporting is mandated in the manner as prescribed in the jurisdiction of the broker-dealer. For example in the U.S. reporting would be made to the Financial Industry Regulatory Authority, and in Canada it should be made to the Financial Transactions and Reports Analysis Center (FINTRAC).⁴⁰

When the FCI and broker-dealer adopts an effective program that identifies high-risk clients, supports ongoing training of staff and implements a rapid response escalation procedure, then the firm gains the initiative while fulfilling its ongoing commitment in the fight against ML in this sphere.

Conclusion

Although OTC Pink Sheet securities are a niche segment of the securities market, the FCI will have become familiar with this high-risk product as the opportunities afforded to the criminal are particularly appealing. Knowledge and dedicated resources will help prevent the broker-dealer

³⁸ Jeffrey Robinson, *The Laundrymen, Money Laundering, The World's Third Largest Business* (Arcade Publishing, 1996), p.28.

³⁹ Margaret Beare, *Critical Reflections on Transnational Organized Crime, Money Laundering, and Corruption* (University of Toronto Press, 2003) p.280

⁴⁰ R.Hubbard, D. Murphy, F. Odonnell, P.Defreitas, *Money Laundering & Proceeds of Crime* (Irwin Law Inc.,2004) p.298.

from becoming vulnerable to furthering fraud and ML. Given that the Pink Sheet market operates in a non-regulated gray area the means at the FCI's disposal within the firm to keep this high-risk product out must be brought to bear. Through rigorous scrutiny of trading activity when Pink Sheet securities are involved, along with the questioning of funding flows associated with these clients, it is anticipated that bad actors will retreat in the face of such pressure. The methods used by money launderers has been delineated so as to better understand the techniques used in the ML process. It has been clearly demonstrated that the negative impact on the broker-dealer in monetary and reputational terms is significant—the FCI can help in a meaningful way safeguard the firm from such damages. The FCI must take an active approach within the firm to communicate a best practice culture where nebulous or “too good to be true” products are uncovered and shut down. Lastly, beyond doing what is in the firms' own self-interest, the broker-dealer, by hindering the proliferation of Pink Sheet securities, will help thwart ML/TF within capital markets both domestically, as well as globally. In this way, it is hoped this paper has served to illuminate a product segment which will aid both the FCI and broker-dealer should Pink Sheet securities be encountered within capital markets.

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