
SECURITIES FRAUD



Association of Certified Fraud Examiners

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II. FINANCIAL MARKETS AND INVESTMENT SECURITIES

Origins of the Financial Markets

Introduction

To conduct an effective securities fraud investigation, a fraud examiner must prioritize the information gathered from evidence and interviews and put it in the appropriate context. To do this, the examiner must understand the history and basic concepts of the financial markets.

The following material provides a historical perspective of the financial markets, and it should be a valuable resource for fraud examiners. As discussed in this chapter, most activities in financial services fall into one of the following categories:

- The extension of credit
- The payment of accounts
- Fees for services
- Compensation for risk
- Profiting from the *spread* (i.e., the difference between the bid and the offer—the ask price—of a security)
- Entitlement to the *vig* (i.e., any attempt to widen the spread between the bid and offer prices of a security can be viewed as adding vig to the trade)

The Origins of Trading

Although the American investment houses might like to suggest that they gave birth to the global financial markets with the Buttonwood Agreement of 1792, which founded what became the New York Stock Exchange, such claims would be ignoring more than eight hundred years of investment activity occurring in Europe and the Middle East.

But as with many benchmark events, there is considerable disagreement over the origin of the first financial markets. Some argue that in 11th-century Egypt, Muslim and Jewish merchants established the first market when they participated in a trading group that managed the flow of goods through the Middle East. Others suggest that during the same period, the Italian maritime merchants developed the first exchange system for credit and payment that facilitated their shipping enterprises. Likewise, around the same time in France and Belgium, there were well-organized exchanges for trading commodities. It is also a fair assumption that China likely developed some form of capital market facilities to meet the needs of its vast empire. But rather than grappling with “first arrival,” it is more important to analyze the motives for developing financial exchanges—access to credit and capital.

Access to Credit and Capital

The need to access credit and capital drives the development of complex financial markets. It is easy to appreciate the modern necessity for access to credit and capital markets, and merchants in ancient trade centers such as Cairo, Venice, and Antwerp had similar needs.

In an autocratic system, however, there is no need for a financial system. Thus, isolated feudal communities had little need for credit and capital facilities. After all, much of the work performed in such systems was done by forced labor, and, if there was a crop failure, the feudal lord could always implement additional tax burdens on the citizenry. In these systems, supply is controlled by one individual and consumer demand is of little importance.

In contrast, an active merchant society developed credit and capital facilities out of necessity to ensure a sustainable effort. These merchant exchanges evolved into modern financial markets, but the evolution was not smooth or natural. Powerful nation states soon determined that they needed access to the credit and capital markets because they had soldiers to arm, wars to wage, and empires to create—and all of this required capital.

The First Securities

Publicly Financed Enterprise

Development of 17th-century trade and settlement efforts was accompanied by intense global competition, and the Dutch East India Company, which was the first multinational corporation and the first company to issue stock, played an important role in early international trade.

During that time, many European nations were strapped for cash because of wars, and they were not always able to finance shipbuilding and other commercial trade efforts. Royal charters like the Dutch East India Company were early pioneers in the issuance of equity-related certificates of partial ownership in private enterprises, a form of joint stock ownership.

With the issuance of certificates that represented monetary value, assets were securitized, and securitization created the opportunity for what we refer to today as *securities fraud*. Like the securities issued today, the certificates issued by the Dutch East India Company could be transferred, stolen, forged, and misrepresented.

Securitization: The French Connection

One of the first examples of investment certificates can be found in 18th-century France. Early economists learned that the unbridled issuance of currency could spur rampant inflation, so France created a system of national credit through issuing *assignats*, which were certificates of indebtedness bearing 5% interest. These notes, or government IOUs, are comparable to modern-day bonds. They were backed by assets or, in some cases, prospects, such as the expected spoils from French colonization or the liquidation proceeds from church property confiscated by the French government. To differentiate them from the realm's common coin, assignats were issued in denominations larger than those issued in French currency. These IOUs were at best an assurance, but they were not a guarantee.

Jay Cooke's "Five-Twenty" Civil War Bonds

Just as the French government financed its empire with *assignats*, in the 1860s, the United States federal government needed financing to construct railroads and canals and to fund the Civil War. With the cooperation of the Secretary of the Treasury, the U.S. government issued Union government bonds, which might be referred to as junk bonds—bonds that carry a significant risk of default by the issuer, but they have a higher interest rate to compensate.

These bonds, however, were different from those issued today. How would securities regulators react to using thousands of unlicensed agents to solicit bond investments from uneducated and naïve miners in isolated towns? How would they react if the scheme also included efforts to pressure the media to publish favorable articles on the loan program? What if the issuer had a relatively poor balance sheet and had failed in an earlier attempt to sell the same bonds? While this situation clearly appears rife with potential for fraud, it happened in the United States.

Financing at reasonable terms was in strong demand, but lines of credit were rare. Early in Lincoln's administration, Congress attempted to issue \$500 million in bonds. However, the effort failed.

Jay Cooke, a gifted financier from Sandusky, Ohio, came to the rescue. Cooke had established himself through a successful career as a private banker in Philadelphia, and with the help of Washington insiders, Cooke was appointed as the official agent to market "five-twenty" bonds (i.e., bonds that became callable—capable of being redeemed before maturity—in five years and that matured in twenty). From 1862–1865, Cooke was able to place \$830 million in bonds, which was an unimaginable feat. (See Figure 1 on the following page.)

Figure 1: Newspaper Advertisement for Jay Cooke's "Five-Twenty" Bonds from 1863

SPECIAL NOTICE.

The sales of the
United States SIX per cent. Loan,
called
5-20's
have amounted for many weeks past to
over Two Millions of Dollars daily.
The First of July
is rapidly approaching, when the public will no longer have the
right to Subscribe at Par for this desirable Loan, the principal
and interest of which is payable **IN GOLD.**

All parties contemplating investing in these Six per cent.
Bonds, should at once forward their money through any of the local
agencies, or direct, to

JAY COOKE,
Subscription Agent,
114 South Third Street, Philad'a.

A FIVE-TWENTY ADVERTISEMENT SENT TO NEWSPAPERS IN ALL PARTS OF THE
COUNTRY IN 1863

Shared Interests

The tangible securitization of participation in commercial markets was a leap for society that went beyond the limits imposed on bartering for physical goods. Formal systems of credits, payments, access to capital, risk management, and partial ownership became realities. The securitization of assets must be understood as enabling the concept of shared interests:

- An *investor* in promissory notes (including bonds and IOUs) can benefit from the extension of credit, which satisfies the need for investment cash flow.
- The *borrower*, or issuer of the bond, has a source of discretionary capital and a viable alternative to a bank loan.
- The *sole owner* of the enterprise, in exchange for benefiting from the sale of equity ownership, diversifies by placing some of the risk on other shareholders.
- *Equity owners* potentially benefit from an enterprise that they did not create and may not have the ability to manage themselves.

Shared interests through securitization therefore spread the wealth, risk, and ultimately the opportunity for what is known today as securities fraud.

Organized Exchange Trading

Securities

Simply put, *securities* are fungible, negotiable instruments that represent an interest or a right in something else. The Securities Act of 1933 and the Securities Exchange Act of 1934, however, provide a more detailed definition of a security: “any note, stock, treasury stock, security future, bond, debenture, evidence of indebtedness, certificate of interest or participation in any profit-sharing agreement, ... investment contract, ... or, in general, any interest or instrument commonly known as a security, ... or any ... guarantee of, or warrant or right to subscribe to or purchase, any of the foregoing.”

This is a broad definition, and under it, many types of instruments may be classified as securities.

Types of Securities

Although specific types of securities are fully described later in this course, some basic definitions might be helpful. Some common types of securities include:

- *Equity or common stock*: Equity or common stock indicates ownership in an enterprise and generally entails voting rights. In the event of bankruptcy or liquidation, equity investors are not creditors and rank last in the distribution of corporate assets.
- *Preferred stock*: Preferred stock is a special equity security that has properties of equity and a debt instrument; therefore, it is described by some as a hybrid security. Preferred stock generally means

an owner has no voting rights and, in the event of bankruptcy or liquidation, has a preferred position above that of the equity owner.

- *Notes and bonds:* Notes and bonds are securities that have a stated interest rate that is paid semi-annually until maturity. What differentiates notes and bonds are the terms to maturity; the difference between the two types of securities does not lie in who issues them. Notes are short-term promissory IOUs, while bonds have a longer maturity than notes. Bondholders have no equity interest in the enterprise, but they are first among the investors to be paid in the event of a bankruptcy or liquidation. Bonds are relatively priced based on the par value, which is \$100. For example, \$98.50 is a discount bond, while \$106.50 is a premium-price bond. *Select bonds*—those with no coupons or unique features upon maturity—may be priced at a deep discount to par, such as \$23.
- *Warrant:* A warrant gives the holder the right—but not the obligation—to purchase securities in the future. That is, a warrant gives the holder the right to purchase securities (usually equity) underlying the warrant from the issuer within a certain period. Traditionally, warrants are attached as “sweeteners” to securities offerings to make the investment more attractive. To be traded on an exchange, warrants must be stripped from the underlying security.
- *Option:* There are listed options that trade on organized exchanges such as the Chicago Board Options Exchange (CBOE), and over-the-counter (OTC) options that trade among broker-dealers or through an electronic exchange. The owner of an option has the right, but not the obligation, to sell or buy a security at a set price for a specific time period. The seller of an option contract has the obligation to buy or sell a security at a set price for a specific time period.
- *Futures contract:* Similar to an option, futures contracts can trade on an exchange such as the Chicago Board of Trade (CBOT) or over the counter. Also, like an option, a futures contract has a preestablished price and a set time period. A futures contract, however, involves an obligation, not a right, for both the buyer and seller.
- *Variable annuity contracts:* A variable annuity contract is a long-term contract between an annuity owner and their insurance company. The SEC defines a variable annuity as “a contract between [the annuity owner] and an insurance company, under which the insurer agrees to make periodic payments to [the annuity owner], beginning either immediately or at some future date.”¹¹ These instruments are registered securities products that are controlled by the SEC.

In terms of securitization, some equities, preferred stocks, warrants, and bonds are still available in certificated form and can be physically issued. However, options and futures contracts are only available in a book-entry format.

¹¹ U.S. Securities and Exchange Commission, “Variable Annuities: What You Should Know,” www.sec.gov/investor/pubs/varannty.htm.

Securities Markets

Securities markets are the markets in which securities are traded.

Primary Markets Versus Secondary Markets

Basically, securities fraud occurs in either the primary market or the secondary market. The *primary market* deals with the issuance of new securities, and the *secondary market* is where previously issued securities and financial instruments are bought and sold. When new stock is issued in the primary market, the sale is an initial public offering (IPO). That is, the *IPO* is the first sale of a company's stock to the public. In contrast, secondary markets (e.g., the New York Stock Exchange, the American Stock Exchange (AMEX), and over-the-counter markets) are used for trading stocks between entities that might purchase them.

Listed Versus Over-the-Counter Markets

Stock markets in the United States can be classified into one of two basic types:

- Physical markets
- Over-the-counter markets

PHYSICAL MARKETS

Listed markets are tangible physical entities; they include the New York Stock Exchange, the American Stock Exchange (AMEX), and several regional exchanges, such as the Philadelphia Stock Exchange and the Chicago Stock Exchange. The prices of stocks listed on these exchanges are determined by auction processes in which investors bid for stocks through their brokers. More specifically, an auction market is “[a] market in which buyers and sellers meet through a single specialist, who, in a centralized location or “floor,” matches incoming orders to buy and sell each stock. Specialists use the capital of their firm to represent a stock, but they are not allowed to provide research or retail sales support.”¹²

For a stock to be traded on an exchange, it must be listed, and each exchange has its own listing requirements that specify the features that a firm must have to be listed; that is, they must be accepted for trading purposes.

Among the physical markets, the New York Stock Exchange (NYSE) deserves additional focus. The NYSE was established in 1792 when New York merchants signed the Buttonwood Agreement. In short, the NYSE provides a means for buyers and sellers to trade shares of stock in companies registered for public trading.

¹²NASDAQ, “Market Mechanics: A Guide to U.S. Stock Markets.”

Trading on the NYSE includes security interests in both stocks and bonds. Although the NYSE has always been a physical exchange, NYSE stocks can be traded via its electronic Hybrid Market. Also, the NYSE has listing and verifiable financial disclosure requirements for securities that are traded by brokers.

For the purposes of this course, it is important to understand the NYSE because:

- Unlike citizens of many European countries, most Americans' wealth consists of financial assets directly affected by the activity on the NYSE.
- U.S. central banks and government agencies make many policy decisions based on the health of the financial markets as reflected by the NYSE.
- The NYSE is a major marketplace, drawing together companies and investors from around the globe. (Although the NYSE is based in the United States and is associated with major U.S.-based corporations, companies from any country can trade on the NYSE, and many foreign entities trade on the NYSE as American Depositary Receipts).
- For the NYSE, orderly conduct, price transparency, and a respect for fair practices are ongoing priorities.
- Research related to price history and trading activity for NYSE-listed securities is readily available.

For the examiner, if a questionable transaction involves the NYSE, it is very likely that a detailed record of the activity exists, and that the transaction was governed by a long-standing regulation. Additionally, the exchange's leadership can be relied upon for any necessary clarification. Chapter VII provides a more detailed discussion of the regulated options and futures markets, but it should be noted that many NYSE-traded stocks are also the underlying securities for options and futures contracts. Therefore, a trading pattern (for example) related to market manipulation should be examined on both the underlying security exchange and all other derivative exchanges.

OVER-THE-COUNTER MARKETS

A stock that does not trade on a major exchange is said to trade over the counter (OTC). Securities sold in the OTC market include unregistered securities and securities registered with the SEC.

Unlike the NYSE's floor trading in a physical exchange, OTC trading is conducted electronically, through direct contact with a market maker, or through communication among professional buyers and sellers. Operationally, any transaction that occurs off the floor is considered over the counter. This includes traditional securities, such as stocks and bonds, and derivatives and special-purpose synthetics that were created for a limited market.

The National Association of Securities Dealers Automated Quotations (NASDAQ) is an OTC market, or dealer market, as opposed to an auction market, and this means that it is “[a] market in which many competing dealers, called market makers, use their own capital, research, retail, and/or systems resources to represent a stock.”¹³

To be listed on NASDAQ, companies must meet stringent listing requirements. But even though the NASDAQ listing requirements are stringent, with trading controls arguably equivalent to the NYSE, there are well-meaning skeptics who associate all OTC trading with high-risk and less-than-trustworthy operations.

Stocks of companies not listed on a national exchange or market like NASDAQ are traded over the counter (OTC). And often, companies not listed will trade OTC through pink sheet listings published by OTC Link LLC (which is owned by OTC Markets Group, Inc., formerly known as Pink OTC Markets Inc.), or the OTC Bulletin Board (OTCBB).

The SEC provides the following information about OTC Link LLC:

OTC Link LLC (OTC Link) is an electronic inter-dealer quotation system that displays quotes, last-sale prices, and volume information in exchange-listed securities, OTC equity securities, foreign equity securities and certain corporate debt securities. In addition to publishing quotes, OTC Link provides, among other things, subscribers the ability to send and receive trade messages, allowing them to communicate for the purpose of negotiating trades.

*All subscribers to OTC Link are broker-dealers that are members of FINRA. Subscribers are permitted to quote any OTC equity security eligible for quoting under Exchange Act Rule 15c2-11 or the applicable exemptions to Rule 15c2-11. OTC Link does not require companies whose securities are quoted on its system to meet any eligibility requirements. With the exception of some foreign issuers, the companies quoted on OTC Link tend to be closely held, very small and/or thinly traded. Most issuers do not meet the minimum listing requirements for trading on a national securities exchange. Many of these companies do not file periodic reports or audited financial statements with the SEC, making it difficult for the public to find current, reliable information about those companies.*¹⁴

Like OTC Link, the OTCBB is an electronic inter-dealer quotation system. The OTCBB system “displays quotes, last-sale prices, and volume information for many OTC equity securities that are not listed on a national securities exchange.”¹⁵ And “companies that want to have their securities quoted on

¹³ NASDAQ, “Market Mechanics: A Guide to U.S. Stock Markets.”

¹⁴ U.S. Securities and Exchange Commission, “Over-the-Counter Market,” www.sec.gov/answers/pink.htm.

¹⁵ U.S. Securities and Exchange Commission, “Over-the-Counter Market.”

the OTCBB must seek the sponsorship of a market maker as well as file current financial reports with the SEC or with their banking or insurance regulator.”¹⁶ FINRA oversees the OTCBB.

For the examiner, the most problematic securities are those traded in the OTC markets through the OTCBB and through pink sheet listings. OTCBB securities have SEC reporting requirements, while pink sheet listings are not registered with the SEC.

Moreover, stocks trade on OTC markets using pink sheets, and in many cases, stocks traded on OTC markets are traded for a few cents per share, they are less transparent, and they are often the basis for *pump and dump* schemes. (Pump and dump schemes are discussed in Chapter VII.)

Ticker Symbols and Identifying a Trading Venue

A *ticker symbol* (or stock symbol) is a short abbreviation used to identify the stock of a publicly traded company in the stock market. Every listed stock has a unique ticker symbol, and a ticker symbol may consist of letters, numbers, or a combination of both. Ticker symbols serve a variety of functions, including:

- They identify companies trading on exchanges.
- Investors use them to place trade orders.
- Investors use them to look up the current quote of a stock.
- They can identify which exchange stocks trade on.

U.S. stock exchanges use letters for ticker symbols, and it may be possible to identify where a stock is traded by looking at the length of its ticker symbol. Below are some characteristics of the ticker symbols of U.S. exchanges:

- Stocks listed on the NYSE have one to three characters, but the majority of stocks listed on the NYSE have one- or two-letter ticker symbols (e.g., the ticker symbol for Verizon Communications is VZ, the ticker symbol for the Bank of America Corporation is BAC, and the ticker symbol for Harley-Davidson is HOG).
- Stocks listed on the NASDAQ typically have four letters, but they may have five letters (e.g., the ticker symbol for Google, which is listed on NASDAQ, is GOOG).
- Stocks listed on the OTC Bulletin Board typically have four letters (e.g., the ticker symbol for DC Brands International, Inc. is DCBR).
- Stocks listed on OTC pink sheets typically have five or more characters (e.g., Gazprom OAO is traded on the OTC markets using pink sheets under the symbol OGZPY).

¹⁶ U.S. Securities and Exchange Commission, “Over-the-Counter Markets.”

Also, companies whose stock is traded on OTC markets using pink sheets often have a “.PK” following their stock ticker symbols, and companies whose stock is traded in electronic OTC markets often have an “.OB” following their stock ticker symbols.

Moreover, to reduce investor confusion and avoid processing risks, the NYSE, NASDAQ, and other exchanges participate in the National Market System Symbology Plan for the selection and use of 1–5-character root symbols.

Options and Futures Exchanges

Additionally, there are several active futures and options exchanges in the United States. Some of the more active exchanges include:

- *The Chicago Board Options Exchange (CBOE)*: The CBOE is the premier options exchange market in the world. It specializes in trading options on individual stocks, stock indexes, interest rate futures, and a vast array of specialized products.
- *The CME Group*: In 2007, the Chicago Mercantile Exchange (CME) and the Chicago Board of Trade (CBOT) merged to create the CME Group. The CME Group specializes in trading futures and options based on interest rates, equity indexes, foreign exchange, energy, agricultural commodities, metals, weather, and real estate.

While technology has transformed many of the options and futures markets, some have retained the verbal bidding and use of hand signals of the “open outcry” trading activity that is often associated with exchange markets. However, with the use of wireless technology and portable electronic-trading technology, much of the colorful floor drama has been muted.

Possible fraudulent activity associated with the options and futures markets will be discussed in Chapter VII, but it is important to reinforce the concept that, like stocks and bonds, the spread is a central issue for options and futures because it can affect the price at which a purchase or sale is made. (The spread is discussed in the next section.)

The Potential for Profit and Fraud

Fraud Involving the Bid/Offer Spread

Definition of the Bid/Offer Spread

In most financial markets, there are always two different prices for a financial instrument at one given time. These prices are known as the bid price and the offer price (also known as the *ask price*). The *bid* price indicates the amount offered; it is the highest price a buyer will pay for a security (e.g., shares, bonds, contracts, or options). The *offer* price is the amount at which a dealer will sell a particular security

to an investor; it is the best price (lowest on the exchange) at which a dealer will sell a particular security to an investor. The offer is heavily influenced by the volume of shares available.

The *bid/offer spread* (also known as *the spread*, *the bid/ask*, or the *buy/sell spread*) refers to the difference between the bid price and the ask price for a particular security.

In general, low-volume, higher-risk securities generally have a spread greater than securities of companies with high-trading volume and a well-established business model. This is illustrated in the examples provided in the following table.

Security	Exchange and Symbol	Bid	Offer	Spread
General Electric	NYSE (GE)	\$18.87	\$18.94	\$0.07
Intel Corp	NASDAQ (INTC)	\$13.60	\$13.68	\$0.08
Kingfisher (UK based)	OTC Pink Sheet (KGFHY)	\$3.58	\$3.78	\$0.20
Sterling Chemicals	OTC Bulletin Board (SCHI)	\$7.85	\$7.95	\$0.10
Lehman Bros	NYSE-Traded Corp Bond	\$10.00	\$12.50	\$2.50
(5.75% coupon, due April 2012)				

The spread between the bid and the offer for a security is more than a key concept; it is essentially the cornerstone of how trading markets function and is often used to commit securities fraud. For the broker-dealer, the bid/offer spread provides compensation for carrying costs, offsets losses due to risk factors, meets enterprise-operating needs, creates cash flow that will offset financing agreements, and should be a contributor to net profits. Thus, even though financial institutions attempt to generate somewhat predictable income from fee-based services, the trading spread is central to being able to “follow the money.”

Moreover, the spread is important because the greater the spread is, the greater the potential for fraud through misrepresentation and manipulation. A wide spread on an inexpensive stock that is traded in OTC markets, like the Kingfisher stock in the table, creates incentives for a firm or advisor to promote it and engage in misconduct. With an exchange-listed stock like the General Electric example, which trades efficiently and transparently (i.e., has a tighter bid/offer spread), there is far less incentive for misconduct.

If the firm or market maker can buy a large quantity of Kingfisher stock at \$3.58 and sell it for \$3.78, it can turn over a profit of \$0.20 (\$3.78–\$3.58) per share in a single day. That is, the bid/offer spread in Kingfisher is \$0.20. Assuming that the bid/offer spread remains constant and that there is a single transaction on each of the 260 trading days in the year, there will be a \$52.00 (\$0.20 * 260) profit from

the bid/offer spread in one year. And the \$52.00 profit is more than 14 times greater than the basic cost of the \$3.58 share ($\$52.00/\3.58). Moreover, even though the calculation assumes that there is a single transaction on each day, it is likely that a firm would make multiple trades in a single day, and if that is the case, the annualized rate of return (i.e., the return that the investment generates over a period of one year) for the Kingfisher stock would be off the charts.

Conversely, consider the General Electric stock, which is traded on an auction market that is fully transparent and for which the exchange floor specialists set the spread. For the General Electric stock, the bid/offer spread is only \$0.07 ($\$18.94-\18.87), which is much less than the spread for Kingfisher's stock. And if the bid/offer spread remains constant and that there is a single transaction on each of the 260 trading days in the year, there will be an \$18.20 ($\$0.07 * 260$) profit from the bid/offer spread in one year. The \$18.20 profit is less than the basic cost of the \$18.87 share. Moreover, with an exchange-listed security like the General Electric stock, the spread will narrow to one or two cents a share frequently. Therefore, when compared to the Kingfisher stock, the General Electric stock has a higher price and a tighter spread, and its overall profit potential is much less than the Kingfisher stock.

Calculation of the Bid/Offer Spread

As seen in the previous example, the size of the bid/offer spread has a major effect on the profits of dealers. Even though it is not a formal rule, NASD 5% Policy—the NASD policy limiting brokers and market makers from charging in excess of 5% commission on most stock transactions—discourages dealers from having an excessive spread.¹⁷ A pattern of commissions in excess of 5% is indicative of unprofessional conduct.

Originally, equity pricing was based on U.S. dollars and the English “bit,” which was expressed in fractions, such as \$16 1/4. The smallest increment was 1/16, or approximately six cents. In 2000, however, pricing switched to decimals, which narrowed the spread for actively traded securities. For example, in terms of pre-2000 spreads, a best-case scenario for an investor would be a bid of \$16 and an offer of \$16 (1/16), which would be a visible security with significant trading volume. In post-2000 spreads, the spread could be a bid of \$16 and an offer of \$16.02. In fact, FINRA Rule 6433, which provides the minimum quotation size requirements for OTC equity securities, states that “[t]he OTCBB can accept bids/offers expressed in fractions as small as 1/256 or in decimals up to six places.”¹⁸

Furthermore, the tighter spreads meant lower revenues for some financial services firms, and, as a result of these narrow spreads, it became difficult for many firms to meet their relatively high fixed costs. To make

¹⁷ NASD Conduct Rule 2440 prohibits a member from entering any retail transaction in a security at a price not reasonably related to the current market price of that security. Rule 2440 provides that a reasonable markup is generally not more than 5% over the prevailing market price. IM-2440.

¹⁸ FINRA Rule 6433.

up for the drop in revenues, some firms elected to take additional market risk or to focus on fee-based accounts.

Of course, the shift from fractions to decimals does little to narrow the spread of illiquid OTC stocks that are controlled by a limited number of firms.

A popular securities fraud scheme involves the use of a well-known stock, such as General Electric (GE), as the initial recommendation in a new investment account. Soon after the initial purchase of well-known stock, the broker solicits a transaction in an affinity—related to a current event, medical issue, or emotional topic—OTC pink sheet stock investment. Of course, the sales commissions are relatively low for the listed stock, but comparatively high for the OTC investment.

Any time an investment professional puts self-interest before the fiduciary duty they owe to their customers, they have potentially committed a form of fraud. Excess commissions and transactions unsuitable to the client are proven forms of misrepresentation.

To examine the nature of such activities, the examiner must use multidimensional skills as discussed in Chapter I. To conduct the analysis, the activity must be analyzed as a series (the purchase of the NYSE stock followed by a high-commission OTC pink sheet trade); it should not be analyzed as two separate and unrelated transactions. Once this sequence is identified, spreadsheet queries can quickly help determine if such practices are widespread and systematic.

The Vig

The *vig* refers to attempts to widen the bid/offer spread. While the term has negative connotations for financial services professionals, the practice of extracting as much overage commission as possible is alive and thriving. Adding a vig to a transaction is relatively simple, even in the highly regulated world of financial services. This is especially true for transactions involving exotic and seldom-traded securities, such as collateralized mortgage obligations (CMOs), options on futures contracts, or OTC pink sheet companies. It should be noted that it is unlikely that all securities of any one class (e.g., CMOs, OTC pink sheet listings, options, futures, or warrants) are uniformly toxic and unsuitable. The following example illustrates the practice of adding a vig to the trade.

EXAMPLE

After two years had passed since the initial underwriting of a \$300 million CMO issue, mortgage payments had reduced the outstanding pool to \$202 million. At this time, two large insurance companies each buy \$100 million of the remaining principal, leaving a residue of \$2 million. Because this residue, or tail, is not very interesting to institutional investors, it is sold to a retail broker-dealer at a deep discount. The broker-dealer understands that the two insurance companies, which own the two \$100

securities, will hold them in their portfolios and will not likely trade them. Therefore, the pricing services that provide evaluations for customer statements will have no trades to use as comparative models when pricing the securities.

The owner of the \$2 million residue has a security that can be priced artificially at whatever the market will bear—in some cases a markup of 20% or more. As a result, the broker-dealer makes usurious commissions, and the unsuspecting investor is down at least 20% from the outset—so far in the hole that he will never break even and will never receive a positive return on his investment.

This example raises the following question: Because a normal spread, consistent with the 5% rule, should offer sufficient profit potential for the broker-dealer, what is the rationale for the firm or trading desk structuring a guaranteed loss and gouging the investor? The answer is clear: They are reaching for the vig or the excess spread available to the opportunist. The logical extension is that if 5% is good, then more than 5% is better.

Prevention and Detection

This chapter has illustrated how the opportunity for fraud grew with the introduction of representative certificates traded on listed and OTC exchanges. But has this field of opportunity expanded beyond the possibility of detecting and preventing such fraud? If the activity is infrequent, subtle, and lacks a pattern, detecting and preventing such fraud might be difficult. The good news, however, is that fraudsters are generally not subtle or original; instead, they tend to follow long-established patterns and look for substantial return.

Although securities fraud might seem to be relentless, examiners should conduct securities fraud examinations in the following manner to segment a transaction or activity into its most organic and insightful elements:

- Determine the contextual importance of information.
- Verify its accuracy.
- Examine the spread.

Despite the appeal of shared interests, why do people invest given the numerous obstacles? Is the investor perpetually and hopelessly at a disadvantage? One might argue that the system is fatally flawed, and, as a result, the potential for gains through fraudulent behavior is too easy. Those observations would be accurate without an extensive code of conduct as mandated by securities statutes and the resolve of agencies prepared to enforce fairness and professional conduct.

The following chapter examines the legal mandates and regulatory guidelines for securities transactions.