

## Heightened Threat of Fraud

### FINRA Alerts Firms to Recent Trend in Small-Capitalization IPOs

#### Summary

FINRA alerts members to an emerging threat to customers and members, where FINRA, NASDAQ and NYSE have observed initial public offerings (IPOs) for certain small capitalization (small-cap) issuers listed on U.S. stock exchanges that may be the subject of pump-and-dump-like schemes (sometimes referred to as “ramp-and-dump” schemes in other jurisdictions),<sup>1</sup> FINRA has observed significant unusual price increases on the day of or shortly after the IPOs of certain small-cap issuers, most of which involve issuers with operations in other countries. FINRA has concerns regarding potential nominee accounts<sup>2</sup> that invest in the small-cap IPOs and subsequently engage in apparent manipulative limit order and trading activity. Some of the investors harmed by ramp-and-dump schemes appear to be victims of social media scams. This *Notice* addresses concerns similar to those previously raised in the Anti-Money Laundering sections of the [2022](#) and [2021](#) Reports on FINRA’s Examination and Risk Monitoring Program.<sup>3</sup>

This *Notice* does not create new legal or regulatory requirements or new interpretations of existing requirements, nor does it relieve firms of any existing obligations under federal securities laws and regulations and under FINRA rules. Members may consider the information in this *Notice* in developing new, or modifying existing, practices that are reasonably designed to achieve compliance with applicable regulatory obligations based on the member’s size and business model.

Questions regarding this *Notice* should be directed to Blake Snyder, Senior Director, Financial Intelligence Unit, at (561) 443-8051 or by email at [Blake.Snyder@finra.org](mailto:Blake.Snyder@finra.org).

#### Background and Discussion

FINRA has observed instances where IPOs<sup>4</sup> have been affected by manipulative ramp-and-dump schemes. Such instances have involved some of the following elements, but the threat continues to evolve, and bad actors may continue to adapt their approach over time.

November 17, 2022

#### Notice Type

- ▶ Special Alert

#### Suggested Routing

- ▶ Anti-Money Laundering
- ▶ Compliance
- ▶ Equity Capital Markets
- ▶ Financial Crimes
- ▶ Fraud
- ▶ Internal Audit
- ▶ Investment Banking
- ▶ Legal
- ▶ Operations
- ▶ Risk
- ▶ Senior Management
- ▶ Trading

#### Key Topics

- ▶ Anti-Money Laundering
- ▶ Capital Raising
- ▶ Fraud
- ▶ IPOs
- ▶ Trading

#### Referenced Rules & Notices

- ▶ Bank Secrecy Act
- ▶ FINRA Rules 2010, 2020, 2090, 3110, 3310, 4512, 5130 and 5131
- ▶ Regulation S-ID
- ▶ Sections 11, 12 and 17 of the Securities Act of 1933
- ▶ SEC Regulation M
- ▶ Securities Exchange Act Rule 10b-5
- ▶ Securities Exchange Act Rule 15c3-5

- ▶ **Small Market Capitalization and Limited Public Float** – Each IPO typically raised less than \$25 million and valued each issuer at less than \$100 million, with the IPO typically issuing fewer than 20 million shares.
- ▶ **Foreign Issuers** – Many issuers or their operating subsidiaries or affiliates maintained primary operations in China, but some issuers also based their operations in other countries.
- ▶ **Foreign Broker-Dealers** – Foreign broker-dealers, primarily based in Hong Kong, have allocated or been allocated significant amounts of the shares, sometimes as much as 90 percent or more of the shares. The practice of allocating a majority of the shares issued in an IPO to foreign broker-dealers may limit the supply of the public float available to the market on the day of the IPO and during the price increase phase of ramp-and-dump schemes.
- ▶ **Concentrated Allocations of IPO Shares** – Underwriters and selling group members (including foreign broker-dealers) may be allocating the majority of shares to a small number of investors, leading to a concentration of shares being held in very few hands.
- ▶ **Nominee Accounts** – Nominee accounts, primarily accounts opened for foreign nationals, have been opened at U.S. broker-dealers to invest in IPOs and later place manipulative orders and trades to inflate aftermarket prices. These accounts raise potential concerns, including:
  - ▶ account holders' possible lack of awareness that their identities were being used to open the accounts;
  - ▶ apparent contradictions between customers' trading activity and their ages, occupations, investment experience, financial status and sources of funding;
  - ▶ indicators that funding for initial IPO customer accounts are being financed, directly or indirectly, by the issuer or other third parties, including through potential loans; and
  - ▶ possible centralized control over a group of nominee accounts, which can be identified through indicators such as:
    - similar timing of account opening;
    - similar referral source or point of contact for accounts;
    - similar customer contact information;
    - similar bank account information;
    - similar IP addresses;
    - similar initial account funding amounts;
    - similar amounts of indications of interest for IPOs; and

- multiple customers or accounts placing layered buy limit orders at or around the same time, at prices higher than the IPO price, and frequently in odd-lot amounts or other “red flags” of pre-arranged or coordinated trading.
- ▶ **Foreign Omnibus Accounts** – Omnibus accounts at U.S. broker-dealers maintained for foreign financial institutions, including foreign broker-dealers, have been observed liquidating large amounts of shares of the small-cap issuers at the peak of price spikes associated with suspected ramp-and-dump schemes. In some cases, the accounts in question did not trade the securities at all until significant price increases occurred and appeared to time their sales for when the stock price peaked.
- ▶ **Significant Price Spikes and Drops** – Most shares of issuers that are the subject of suspected ramp-and-dump schemes experienced significant price increases in the opening trade on an exchange and in continuous trading on the day of, or days immediately following, the listing. These price increases did not appear to be driven by news or material events. After the spike, the price quickly declined to a level at or below the offering price.
- ▶ **Allegations of Social Media Scams** – Investors in securities that are the subject of suspected ramp-and-dump schemes (including investors in the IPOs) have complained about investing in a ramp-and-dump scheme through so-called “pig butchering.” These schemes sometimes begin with a seemingly misdirected text message or message on a social media messaging application leading to a relationship (sometimes romantic in nature) between victims and bad actors. After a relationship is established, the bad actor will make a recommendation to the victim to place limit orders in certain securities at a specific time and price.

As noted above, the schemes are evolving, and members should pay close attention to suspicious trends in the marketplace and how they may affect members’ obligations. FINRA encourages members to continuously evaluate and adapt their supervisory systems as well as compliance and risk management programs to ensure that they are monitoring for and addressing this threat.

Firms that act as underwriters in offerings of securities serve as the “link in the distribution of securities from issuers to investors,” and underwriters perform an important role as “gatekeepers to the public markets.”<sup>5</sup> This role subjects underwriters to potential liability under Sections 11 and 12 of the Securities Act of 1933, providing a strong incentive for underwriters to help ensure the accuracy of disclosures in registration statements.<sup>6</sup>

Underwriters can raise a “due diligence” defense offering protection against such liability only if they establish that, after reasonable investigation, they had reasonable grounds to believe the statements made in the registration statement were true and that there were no omissions of material facts.<sup>7</sup> As part of establishing a due diligence defense, underwriters must show that they exercised “reasonable care in verifying the statements in the registration statement.”<sup>8</sup> Underwriters thus should be “motivated to take the investigative steps necessary to establish the ‘due diligence’ defense.”<sup>9</sup> Because of underwriters’ important role, the investing public relies on underwriters to “screen the multitude of issuers seeking access to the capital markets’ and expects them to verify the accuracy of the information in the registration statement.”<sup>10</sup> There are, of course, also important reputational concerns that give underwriters incentives beyond these legal obligations.

As these ramp-and-dump schemes evolve, there may be varied attempts to inappropriately influence the IPO process. Underwriters, as gatekeepers, must continue to be vigilant in this regard, particularly when dealing with offshore participants in the underwriting and foreign broker-dealers receiving allocations of shares.

The federal securities laws and regulations and FINRA rules place various other gatekeeping obligations on firms, including firms that are not involved in the underwriting of an offering. For instance, firms are subject to important obligations regarding the opening and handling of customers’ securities accounts, which are among those noted below.

In the context of ramp-and-dump schemes, moreover, members should consider their obligations under the Bank Secrecy Act (BSA), its implementing regulations and FINRA Rule [3310](#) (Anti-Money Laundering Compliance Program), including to:

- ▶ maintain customer identification programs to verify the identity of each customer;<sup>11</sup>
- ▶ verify the identity of the beneficial owners of legal entity customers;<sup>12</sup>
- ▶ establish due diligence programs for correspondent accounts for foreign financial institutions, including omnibus accounts held for foreign financial institutions;<sup>13</sup>
- ▶ establish and implement policies and procedures that can be reasonably expected to detect and cause the reporting of suspicious transactions conducted or attempted by, at, or through U.S. broker-dealers to the U.S. Treasury Department’s Financial Crimes Enforcement Network (FinCEN);<sup>14</sup> and
- ▶ implement appropriate risk-based procedures for conducting ongoing customer due diligence, including to understand the nature and purpose of customer relationships for the purpose of developing a customer risk profile, and to conduct ongoing monitoring to identify and report suspicious transactions.<sup>15</sup>

Upon detection of red flags related to ramp-and-dump schemes through monitoring, members should consider whether additional investigation, customer due diligence measures or a Suspicious Activity Report (SAR) filing may be warranted. Members also should consider whether, depending on the facts and circumstances, other obligations may be implicated, including, but not limited to the following:

- ▶ Exchange Act Rule 10b-5; Securities Act, Section 17(a); and FINRA Rule [2020](#) (Use of Manipulative, Deceptive or Other Fraudulent Devices);
- ▶ FINRA Rule [2010](#) (Standards of Commercial Honor and Principles of Trade);
- ▶ FINRA Rule [2090](#) (Know Your Customer);
- ▶ FINRA Rule [3110](#) (Supervision);
- ▶ FINRA Rule [4512](#) (Customer Account Information);
- ▶ FINRA Rule [5130](#) (Restrictions on the Purchase and Sale of Initial Equity Public Offerings);
- ▶ FINRA Rule [5131](#) (New Issue Allocations and Distributions);
- ▶ SEC Regulation M;
- ▶ SEC Market Access Rule, Securities Exchange Act Rule 15c3-5; and
- ▶ SEC Identity Theft Red Flags Rule, Regulation S-ID.

### Reporting Fraud

In addition to filing any required SARs through the BSA E-Filing system, FINRA also encourages members to immediately report potential fraud to:

- ▶ FINRA using the [Regulatory Tip Form](#) found on [FINRA.org](#);
- ▶ U.S. Securities and Exchange Commission's tips, complaints, and referral system (TCRs) or by phone at (202) 551-4790;
- ▶ the Federal Bureau of Investigation's tip line at 800-CALLFBI (225-5324) or a local FBI office; and
- ▶ local state securities regulators.<sup>16</sup>

In situations that require immediate attention, such as terrorist financing or ongoing money laundering schemes, members should immediately notify by telephone an appropriate law enforcement authority.<sup>17</sup>

Investors may consider [reporting fraud to FINRA](#) and reviewing the FINRA Investor Education Foundation's [Recovery Checklist for Victims of Investment Fraud](#).

## Endnotes

1. On May 20, 2021, the Hong Kong Securities and Futures Commission and the Stock Exchange of Hong Kong issued a joint [statement](#) on IPO-related misconduct in which they, among other things, describe features of ramp-and-dump schemes.
2. As used in this *Notice*, the phrase “nominee accounts” refers to nominee brokerage accounts that may be opened in the names of individuals but are controlled by an undisclosed person or group. Nominee accounts may also be involved with placing apparently manipulative orders and trades that did not specifically invest in the IPO.
3. See also [ViewTrade Securities, FINRA Letter of Acceptance, Waiver and Consent No. 2018058605501](#) (Aug. 23, 2022); [MM Global Securities, Inc., FINRA Letter of Acceptance, Waiver and Consent No. 2019062623001](#) (Sept. 9, 2022).
4. Most schemes involve IPOs, but these schemes also have included up-listings to exchanges.
5. See SEC Release on Proposed Rules for Special Purpose Acquisition Companies, Shell Companies, and Projections, Release Nos. 33-11048, 34-94546, IC-34549, File No. S7-13-22 (March 30, 2022).
6. *Id.*
7. *Id.*
8. *Id.*
9. *Id.*
10. *Id.*
11. See FINRA Rule 3310(b) and 31 C.F.R. § 1023.220.
12. See FINRA Rule 3310(f)(ii) and 31 C.F.R. §1010.230.
13. See FINRA Rule 3310(b) and 31 C.F.R. § 1010.610; *c.f.* SEC Staff Bulletin: Risks Associated with Omnibus Accounts Transacting in Low-Priced Securities, <https://www.sec.gov/tm/risks-omnibus-accounts-transacting-low-priced-securities>.
14. See FINRA Rule 3310(a) and 31 C.F.R. § 1023.320.
15. See FINRA Rule 3310(f) and 31 C.F.R. § 1023.210(a)(5).
16. See NASAA, [Contact Your Regulator](#) (providing contact information for state securities, provincial securities regulators and other resources provided by those agencies).
17. Members may call FinCEN's Hotline at (866) 556-3974.

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