

Managing the Risks of Master/ Sub-Account Relationships

I. INTRODUCTION

The Securities and Exchange Commission (“SEC”) has issued a National Exam Risk Alert to alert registered broker-dealers that the master/sub-account trading model can be used to further violations of the AML rules, the federal securities laws, and other laws and regulations.¹ The SEC has stated that the misuse of this account structure raises significant regulatory concerns for (i) money laundering; (ii) insider trading; (iii) market manipulation; (iv) account intrusions; (v) information security; (vi) unregistered broker-dealers; and (vii) excessive leverage (e.g. inadequate minimum equity for pattern day traders).²

A master account, typically an LLC or an LLP, opens an account with a registered broker-dealer that permits the master to have subordinate accounts (or “sub-accounts”) for different trading activities. Master/sub-account structures can permit customers to avoid or minimize regulatory obligations and oversight because often the registered broker-dealer obtains and maintains information only with respect to the owner of the master account and the firm may not know the actual identity of the underlying traders. The lack of information about the underlying sub-account traders can expose the broker-dealer to significant legal and reputational risk.

Sub-account traders often execute trades via trading systems or other platforms provided by the master account customer/owner using the Market Participant Symbol (“MPID”) of the registered broker-dealer. The broker-dealer may not know who is utilizing its MPID and trading in the sub-accounts. The SEC has promulgated new Rule 15c3-5 to address these risks by requiring broker-dealers who provide market access to establish, document and maintain a system of risk management controls and supervisory procedures that are reasonably designed to ensure compliance with all applicable regulatory requirements.

CONTACTS »

Ellen Zimiles
646.227.4612
ellen.zimiles@navigant.com

Alma Angotti
202.481.8398
alma.angotti@navigant.com

Jay Perlman
202.973.3220
jay.perlman@navigant.com

www.navigant.com/anticorruption



¹ National Exam Risk Alert, Volume I, Issue 1 (September 29, 2011)

² Id at 1.

II. INCREASED EXAMINATION FOCUS AND ENFORCEMENT

Both the Financial Industry Regulatory Authority (“FINRA”) and the SEC have announced that master/sub-account relationships and the regulatory issues arising out of direct market access are examination priorities.³ Particularly in the AML area, the account structures raise a host of regulatory and risk management concerns including those related to the customer identification program (“CIP”), customer due diligence (“CDD”), and transaction monitoring. The SEC, FINRA and the Financial Crimes Enforcement Network (“FinCEN”) have all sanctioned broker-dealers for AML and other violations arising from its master/sub-accounts.⁴

III. WHAT YOUR FIRM CAN DO

Broker-dealers in securities that have master/sub-account trading structures should analyze their accounts, transaction monitoring systems and internal controls to ensure that they comply with all applicable laws and regulations and address the risk presented by their customers. Firms that provide customers or other persons with market access are required under new Rule 15c3-5 to have controls and procedures reasonably designed to manage the associated financial, regulatory and other risks of these arrangements. Firms that permit market access should pay particular attention to their customers with master/sub-accounts structures.

A. Analyze the structure of the master/sub-accounts for CIP

Not all master/sub-account relationships are structured the same way and different structures can present very different regulatory obligations. For example, in the *Pinnacle Capital Markets* case, FINRA found

that in some, but not all of the master/sub-accounts, the sub-accounts were customers of the firm and the firm should have identified and verified the identity of the underlying sub-account holder. The firm should first determine if the sub-account holder is the technical “customer” of the firm for CIP purposes. CIP applicability will typically depend, among other things, on whether the sub-account holder has direct control of the transactions effected in the account.

B. Analyze the risk of the master account and perform appropriate due diligence

Other AML obligations may require a broker-dealer to obtain information on the sub-account holders whether or not formal CIP obligations apply. Master/sub-account structures can present sufficient risk to require the firm to conduct due diligence on the sub-account holders. A firm should establish customer due diligence procedures for sub-accounts, based on the firm’s evaluation of risks presented by the master account.

C. Transaction monitoring

It is important for firms to monitor transactions at both the master account and the sub-account levels for indications of manipulations, insider trading and other suspicious activity, and to file suspicious activity reports (“SARs”) as appropriate. In addition, firms may need to obtain information about the sub-account holders in connection with the review of potentially suspicious transactions and SAR filing.

D. Written supervisory controls and training

Firms should design written supervisory controls to ensure appropriate due diligence and monitoring of master/sub-account relationships and regularly review the effectiveness of these controls and procedures. Broker-dealers should also ensure that they adequately train traders who have access to the firm’s trading system and technology, including, where appropriate, market trading rules and credit.

³ 2011 FINRA Examination Priority Letter, <http://www.finra.org/web/groups/industry/@ip/@reg/@guide/documents/industry/p122863.pdf>; Speech at SIFMA Anti-Money Laundering Seminar, by Carlo V. de Florio, Director, Office of Compliance Inspections and Examinations, U.S. Securities and Exchange Commission, (March 2, 2011) <http://www.sec.gov/news/speech/2011/spch030311cvd.htm>.

⁴ See *In the Matter of Pinnacle Capital Markets, LLC*, FinCEN Matter No. 2010-4 (Sept. 1, 2010) (BSA violations); *In the Matter of Pinnacle Capital Markets LLC and Michael A. Paciorek*, Exchange Act Release No. 62811 (Sept. 1, 2010) (BSA violations); *In the Matter of Pinnacle Capital Markets, LLC*, # 2006006637101 (Feb. 010) (FINRA AML rule violations); *In the Matter of Tuco Trading, LLC and Douglas G. Frederic*, Litigation Release No. 20500 (Mar. 18, 2008) (master account acting as an unregistered broker-dealer and excessive leverage issues); *In the Matter of Warrior Fund, LLC*, Exchange Act Release No. 61625 (Mar. 2, 2010) (master account acting as an unregistered broker-dealer and excessive leverage issues).

E. Information Security

The SEC has noted that a master/sub-account structure poses a greater risk of hacking because there is a larger population of persons with access to a broker-dealer's trading systems and the firm may not have information on the identity of these traders. Broker-dealers that permit master/sub-account arrangements must take reasonable measures to address this risk. Firms should consider applying information security parameters and triggers to limit the additional operational risk resulting from trading activity and volume flowing through the master account. The firm should also consider when to require the master account owners to implement controls to prevent the use of the trading platform for inappropriate purposes.

ABOUT NAVIGANT

Navigant (NYSE: NCI) is a specialized, global expert services firm dedicated to assisting clients in creating and protecting value in the face of critical business risks and opportunities. Through senior level engagement with clients, Navigant professionals combine technical expertise in Disputes and Investigations, Economics, Financial Advisory and Management Consulting, with business pragmatism in the highly regulated Construction, Energy, Financial Services and Healthcare industries to support clients in addressing their most critical business needs.

Our Global Investigations & Compliance practice has unparalleled AML, antibribery and corruption expertise. Our professionals conduct investigations and assess and enhance compliance programs, including internal controls systems, develop and implement training programs and deploy proprietary technological and investigative due diligence protocols for some of the world's largest companies.



DISPUTES & INVESTIGATIONS • ECONOMICS • FINANCIAL ADVISORY • MANAGEMENT CONSULTING

© 2011 Navigant Consulting, Inc. All rights reserved. Navigant Consulting is not a certified public accounting firm and does not provide audit, attest, or public accounting services.

See www.navigantconsulting.com/licensing for a complete listing of private investigator licenses.