Summary of Comments and Responses

Investment Dealers that Trade in the U.S. Over-the-Counter Markets

General comments and suggestions

Six commenters out of nine who commented on the conditions support the BCSC's efforts to use conditions of registration to reduce the risk of inappropriate trading activity in U.S. over-the-counter bulletin board and pink sheets markets (OTC market).

One of the commenters suggested the rulemaking process would have been more appropriate. The Commission considered carefully what regulatory tool to use before deciding to propose conditions of registration. The process we used was as transparent as the rulemaking process would have been. We consulted in person with industry and published the conditions of registration for comment. We are satisfied that we have appropriately taken into consideration market participants' views in finalizing the conditions. We are also satisfied that conditions of registration, with their greater flexibility, is a more appropriate tool than rulemaking, which is less flexible.

Two commenters questioned whether the conditions were necessary or would be effective. For the reasons described in BC Notice 2007/33, we think they are, and they will be.

Effectively managing the risks of OTC trading

The first proposed condition is stated in an outcomes-based way – dealers must effectively manage the risks of trading OTC securities through their supervision and compliance systems.

One commenter thought the Commission should balance the risks of abusive trading in the OTC markets against the interests of investors. In finalizing the conditions, we think we have achieved that balance and imposed a fair burden on dealers proportional to their activity levels in the OTC markets.

Three commenters asked that we describe the risks that dealers are required to manage. BC Notice 2007/33, describes those risks.

Two commenters pointed us to IDA rules (including Regulation 1300, Policies 2 and 3, and By-law 29.1), suggesting that these are adequate to manage the risks of trading in the OTC markets. These rules require investment dealers to have effective supervisory systems and controls. However, those rules do not require dealers to know who the ultimate, individual beneficial owner of OTC securities is. The heart of the proposed conditions necessitates that dealers know this information before they can sell OTC securities.

Monitoring, recordkeeping, and reporting
One commenter asked us to clarify that introducing brokers are not responsible for these conditions. We have clarified, in guidance, that carrying brokers bear this responsibility in an introducing relationship.

Another commenter asked that the Commission publish a list of OTC issuers caught by the conditions. We think the definition of OTC issuer in the conditions is clear enough to allow dealers to easily determine whether a given issuer is an OTC issuer, so there is no need to publish a list. Note that BC Instrument 51-509 applies to OTC issuers with a significant connection to BC, while the conditions apply to all OTC issuers.

One commenter suggested that the UMIR gatekeeper obligation in 10.16 already covers suspected manipulative and deceptive activity, making the monitoring, recordkeeping, and reporting requirements unnecessary. UMIR only applies to trading on Canadian marketplaces, so it does not address trading in OTC markets. Even if it did, it does not spell out clearly the fundamental obligation in these conditions – that dealers must know who the ultimate, individual beneficial owner of OTC securities is before selling them.

Record quarterly OTC commissions
We were asked to clarify in guidance that the conditions do not apply to OTC trading by salespersons or through offices outside British Columbia. We have included this clarification in guidance.

One commenter observed that dealers would need to make significant system enhancements to identify commissions earned by security as opposed to asset class or sales code, separating OTC and Pink Sheet issuers on separate blotters. We appreciate that dealers will incur costs to comply with these conditions. We think that the benefits of addressing the problem outweigh the costs to dealers and are a reasonable consequence in our collective efforts to ensure British Columbia is not a gateway for abusive trading in the OTC markets.

One commenter wondered why the conditions require that commissions be recorded and reported instead of trading volume. The Commission's initial consultations with industry posed both choices for measuring. The feedback we received clearly favoured commissions as the best measure.

Record quarterly proportion of OTC commissions against all equity trading commissions
We were asked to explain how reporting total commissions earned would prevent manipulative trading. It won't. Reporting commissions will help the Commission measure the success of the substantive requirements in the conditions that dealers manage the risks of OTC trading and know the ultimate, individual beneficiaries when selling OTC securities on an agency basis.

We were also asked if the Commission is primarily concerned with sellers of OTC securities rather than buyers. We are primarily concerned with sellers, and we have clarified the conditions accordingly.

Record quarterly OTC deposits by insiders, control persons, founders, or persons involved in investor relations activities for the OTC issuer

We were asked to clarify whether "deposits" covers electronic, physical or both kinds of delivery. In guidance, we have clarified that it covers both. Note Condition 8 applies only to physical deposits.

One commenter thought that monitoring volume of trading would be more effective than monitoring deposits, but deposit activity is a clearer indicator of risk of abusive OTC trading.

Some commenters thought that the concept of being "involved" in investor relations activities was too broad. We agree. Our goal was to ensure that those who act behind the scenes directing investor relations activities are covered by the conditions. New wording makes it clear that those who conduct investor relations activities or who cause it to be conducted are caught.

Other commenters asked for definitions of the concepts "investor relations activities" and "founder". These concepts are already defined in securities regulation. In the guidance, we direct readers to the sources for these definitions.

Record quarterly total OTC deposits refused under Condition 8

Commenters asked what we meant by "refused" and whether a dealer with a general policy not to accept delivery of physical OTC certificates has "refused".

A dealer that does not accept deposits of OTC securities in any form is not subject to these conditions. A dealer that accepts deposits of OTC securities in other forms but has a general policy of refusing delivery of physical OTC certificates has "refused" delivery under this condition. The dealer should report the general policy in response to this condition on the first quarterly report after it occurs. The dealer need not report further instances of such "refusals" subsequently unless its general policy changes in a way that materially affects compliance with this condition.

Report quarterly

Three commenters were concerned about whether dealers can have their systems changes ready by the time the conditions come into effect. One commenter thought the recording and reporting requirements would be labour intensive, manual and error prone. These commenters warned that initial reports might be approximate rather than precise.

We recognize dealers will experience challenges as they prepare and adjust their systems. However, we cannot assess whether the risk of abusive trading in the OTC markets is increasing or decreasing, and whether these conditions are effective or ineffective without this information.

Dealers should be prepared to meet Conditions 3(a), (b) and (c) when they come into effect. However, if a dealer has not yet fully implemented systems to provide precise, automated calculations, we will accept, for the first two reporting periods, reasonable good faith estimates, for Conditions 3(a) and (b), based on the information available to the dealer, if the dealer explains its plan to ensure the required data will be provided as soon as possible.

Establishing beneficial ownership
We had several thoughtful comments about this aspect of the conditions.

One commenter pointed out that dealers will have difficulty obtaining beneficial ownership information from institutional clients in secrecy jurisdictions. These same commenters suggested that this condition unfairly focuses on BC dealers and is at odds with approaches taken by other regulators.

Commenters offered various alternatives, but none of them would prevent the problem we are trying to address – abusive OTC trading. BC has a unique market problem and so, the BCSC has taken a unique regulatory approach designed to reduce or eliminate the risk of abusive OTC trading.

Refusing orders to trade if beneficial ownership not established
Some commenters asked that we consider changing the trigger for this requirement from "trading" (which encompasses both purchases and sales) to "selling". We have made that change, as that is the activity we intend to capture.

Two commenters asked if representations from the account holder would satisfy the requirement that the dealer form a reasonable belief that it knows the identity of the beneficial owner. Account holder representations can form the basis for a reasonable belief, unless they are unreasonable on their face. We have provided guidance on this issue.

Three commenters identified that Depository Trust Company (DTC) deposits cannot be identified prior to receipt unless delivery is refused. The dealer, in that case, could be exposed to liability due to delay. They suggested that DTC receipts be reviewed and beneficial owners identified after receipt.

We agree with this suggestion. The guidance covers this situation and emphasizes that beneficial ownership must be known before any sale of DTC deposited securities can be made.

One commenter was concerned with the process for approving securities received through the Delivery Against Payment (DAP) process. In those cases, securities are delivered after an order is executed.

In this situation, dealers must determine beneficial ownership before the order is executed, even though the securities are not wired in until after execution. If the dealer is not able to determine beneficial ownership, the order must be refused and the incident reported.

Determining whether the beneficial owner is an insider, control person, founder, or involved in investor relations activities for the OTC issuer

Three commenters noted that there was no concept of reasonable belief in this condition, though there is in the condition requiring the dealer to determine beneficial ownership. They thought the same standard should apply to both conditions.

We agree. The wording of the condition has been revised to reflect our agreement. It is important to note that the concept of reasonableness in both cases includes an assumption that the dealer will regularly test the effectiveness of its policies and procedures and, if those policies and procedures are not proving effective, will revise them to make them more effective. In other words, the dealer's reasonableness standard itself, requires testing and revision.

UDP responsibilities

Three commenters thought that the UDP might not necessarily be the most appropriate person to approve physical deposits of OTC security certificates. In addition, several commenters pointed out that the dealer is in the best position to determine who will be the most appropriate and effective person to approve these deposits.

We agree. This condition has been changed to permit dealers to choose a director or officer to approve deposits.

Two commenters thought that requiring the UDP to "ensure" compliance with the conditions is an unrealistically high standard. They pointed out that human intervention is required in processes to implement these conditions, which may involve some possibility of error. Instead, they asked us to consider a standard requiring the UDP to confirm that the policies and procedures adopted by the dealer are reasonably designed to achieve compliance with the conditions.

We think that the standard must go beyond the design of a dealer's policies and procedures. After they are designed and implemented, the designated person must ensure they are supported by effective ongoing monitoring, review and where appropriate, improvement. That is what we intend when we ask that the designated person ensure compliance with the conditions. The guidance includes this information.

Several commenters pointed out that dealers already have corporate governance structures that require approval and review under IDA By-law 38. We were asked to amend this condition to require that policies and procedures for compliance with these conditions either be approved under this structure or that we remove the condition.

We have not removed or changed the requirement. These conditions go, and are intended to go, beyond existing IDA requirements.

Expiry date
Two commenters thought that a review of the need for BC Instrument 51-509 and its effectiveness ought to be conducted before setting an end date or determining whether the conditions should be continued.

We propose the conditions will expire at the end of 2011. This will provide the Commission with 14 reporting periods of information and three years of IDA compliance examination results. We will work with dealers for the first two reporting periods to ensure they can create accurate and reliable reports. We expect reports for the remaining 12 reporting periods to be full and complete. We will monitor the effect of the conditions on an ongoing basis and be prepared to modify the end date as appropriate based on the data we collect.

Miscellaneous comments
Several commenters were concerned about implementing these conditions in only our jurisdiction.

The market problem the Commission is attacking is regional. If the problem migrates to other jurisdictions, we will be satisfied that it indicates the conditions are effective. The CSA is monitoring developments here and other jurisdictions can adopt similar conditions if necessary.

Some commenters were concerned that dealers without a physical presence in British Columbia are exempt.

This is an initiative aimed at abusive conduct in British Columbia. Confining the conditions to dealers with a BC presence allows us to better monitor their impact and make adjustments if necessary.

One commenter suggested that the BCSC should simply cooperate with the IDA to focus on activities of promoters, insiders, and persons and issuers of interest instead of imposing these conditions.

We do not think that cooperation without legally binding requirements would be as effective. Dealers that facilitate sales, in particular, are vulnerable to being used for OTC abuse because they are necessary intermediaries to get OTC securities into the public market.

One commenter thought we should take a risk-based approach and limit requirements to criteria such as offshore accounts, transactions of a certain size, or clients not otherwise exempt from IDA or AML regulations.

We will review the information we receive from the reporting requirements and from IDA sales compliance examinations carefully. We will consider, as that data comes in, whether it is appropriate to revise the conditions in a risk-based way, as suggested.

One commenter suggested we replace "OTC issuer securities" with "OTC quoted securities of OTC issuers" to avoid capturing securities of OTC issuers trading on markets other than the OTCBB and Pink Sheets. We think the definition of "OTC issuer" captures the appropriate set of issuers.

De minimis exemption
One commenter suggested that a *de minimis* exemption be provided to provide relief to dealers that are rarely intermediaries for OTC trading. We were also asked to consider allowing dealers to review deposits only if they exceed a certain size or to allow dealers to incorporate exemption thresholds into their own policies. We addressed these comments by offering dealers who make only isolated trades the opportunity to file an undertaking in order not to have to comply with the conditions.

Spam
Three commenters suggested that we increase investor education or host a website where investors can report issuers sending spam email.

We already have the "SpamWatch" program. Please see the link on our InvestRight website: http://www.investright.org/spamwatch.aspx

Legitimate issuers
Three commenters suggested that large issuers listed on exchanges outside North America should be exempt.

We considered this suggestion, but were unable to identify any such issuers that were not also listed on one of the North American exchanges that would serve to exclude them from the definition of "OTC issuer".

Cost-benefit analysis
One commenter suggested that a cost-benefit analysis be undertaken.

There is no doubt that a serious market problem in this area has existed in BC for some time. We have considered the costs, but believe the problem is so significant that focussed and determined action is required.