

2005 BCSECCOM 144

**LOM (Holdings) Limited, LOM Securities (Bahamas) Limited,
LOM Securities (Bermuda) Limited, LOM Securities (Cayman) Limited,
Lines Overseas Management Limited, Donald P. Lines, Brian N. Lines,
Scott G. S. Lines, Malcolm Mosely, David McNay, and J. Scott Hill**

Sections 161(1) of the *Securities Act*, RSBC 1996, c. 418

Ruling

Panel	Brent W. Aitken Robert J. Milbourne Roy Wares	Vice Chair Commissioner Commissioner
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Dates of Submissions	January 26, 31, February 3, 14, 2005
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Date of Ruling	March 4, 2005
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Appearing

Nigel Campbell David E. Gruber	For the respondents
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James Sasha Angus Douglas Muir	For the Executive Director
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Ruling

I Background

- ¶ 1 On January 12, 2005 we dismissed an application by the Executive Director for orders under sections 161(1) and 162 of the *Securities Act*, RSBC 1996, c. 418 against LOM (Holdings) Limited, LOM Securities (Bahamas) Limited, LOM Securities (Bermuda) Limited, LOM Securities (Cayman) Limited, Lines Overseas Management Limited, Donald P. Lines, Brian N. Lines, Scott G. S. Lines, Malcolm Mosely, David McNay, and J. Scott Hill (see 2005 BCSECCOM 29).
- ¶ 2 Although we dismissed the application, we noted that the evidence before us seemed to show (we made no findings on this point) that the new client application forms for some brokerage accounts in the name of Lines Overseas Management Limited at British Columbia dealers did not appear to contain the necessary “know your client” (KYC) information necessary to identify the beneficial owners for whose account Lines Overseas was trading. In 4 accounts,

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the form indicated that a person other than Lines Overseas had a financial interest in the account but the evidence before us did not include the additional information and details that are required by the form. The forms for 2 other accounts contained no information about whether others had a financial interest in the account.

- ¶ 3 We made no findings as to whether or not the dealers concerned in fact had the appropriate information, but given that Lines Overseas is very active in Canadian markets (over 10,000 trades over the previous year totalling over 800 million shares with a market value of over \$1.2 billion) we believed this issue was potentially significant.
- ¶ 4 We therefore asked the parties for submissions on this issue by January 31 and invited any party wishing to lead evidence or make oral submissions to so advise the Secretary to the Commission. Lines Overseas filed its submissions on January 26 and the Executive Director on January 31. Lines Overseas filed reply submissions on February 3 and the Executive Director filed a brief response to those on February 14. No one asked to lead evidence or to make oral submissions.

II Analysis

- ¶ 5 This is how we put the issue to the parties in our decision:

41 . . . The more significant issue surrounding [Lines Overseas], it seems to us, arises from the account opening forms described above, which appear to show that at least some of [its] trading is being done . . . on behalf of undisclosed beneficial owners. . . .

42 . . . We believe [Lines Overseas] should show cause why it would not be in the public interest for the Commission, under section 161, to order that [Lines Overseas] cease trading securities in British Columbia until it provides all dealers in British Columbia having accounts for [Lines Overseas] the appropriate know-your-client information about those having a financial interest in those accounts.

- ¶ 6 Lines Overseas says that the dealers involved have complied with KYC requirements in opening its accounts.
- ¶ 7 The Executive Director says that the dealers have not complied with KYC requirements and that it is in the public interest that we cease trade Lines Overseas until the dealers do so.

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¶ 8 The main issue is whether Lines Overseas is trading through these accounts on behalf of undisclosed beneficial owners or others with a financial interest in the accounts. To decide this issue, we need to determine three things:

1. What are the KYC requirements?
2. Do the dealers with whom Lines Overseas has accounts in British Columbia have the information mandated by those requirements?
3. Is Lines Overseas' trading being conducted in compliance with those requirements?

¶ 9 Although we used a "show cause" construction in paragraph 42 of our January decision, the onus of proving whether it is in the public interest to make a cease-trade order under section 161(1) of the Act order remains on the Executive Director.

What are the know your client requirements?

¶ 10 Section 48 of the *Securities Rules*, BC Reg. 194/97 says:

48 (1) A registrant . . . must make enquiries concerning each client

(a) to learn the essential facts relative to each client, including the identity and, if applicable, credit worthiness of the client and the reputation of the client if information known to the registrant causes doubt as to whether the client is of good business or financial reputation. . . .

¶ 11 This section embodies is commonly known as the "know your client" rule. The KYC rule is fundamental to the regulation of trading in the securities industry. It requires that dealers understand on an ongoing basis each client's identity, background, financial position and character so it can fulfil its role as a "gatekeeper" to the market. If the client is not an individual, this includes knowing the individuals that control the client, its business and its financial circumstances.

¶ 12 Under BC Instrument 32-502 *Exemption from Suitability Requirements*, a registrant who is a member of the Investment Dealers Association (IDA) is not required to comply with section 48 of the rules if it complies with the IDA's KYC requirement, which sets a similar standard in its Regulation 1300.1(a):

1300.1 (a) Each Member shall use due diligence to learn and remain informed of the essential facts relative to every customer and to every order or account opened.

¶ 13 Regulation 1300.1 also includes these provisions:

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- (b) When opening an initial account for a corporation or similar entity, the Member shall:
 - (i) ascertain the identity of any natural person who is the beneficial owner, directly or indirectly, of more than 10% of the corporation or similar entity, including the name, address, citizenship, occupation and employer of each such beneficial owner, and whether any such beneficial owner is an insider or controlling shareholder of a publicly traded corporation or similar entity; and
 - (ii) as soon as practicable, after opening the account, and in any case no later than six months after the opening of the account, verify the identity of each individual beneficial owner identified in (i) using such methods as enable the Member to form a reasonable belief that it knows the true identity of each individual and that are in compliance with any applicable legislation and regulations of the Government of Canada or any province.
- (c) Subsection (b) does not apply to:
 - (i) a corporation or similar entity that is or is an affiliate of a bank, trust or loan company, mutual fund, mutual fund management company, pension fund, securities dealer or broker, investment manager or similar financial institution subject to a satisfactory regulatory regime in the country in which it is located.

...

- ¶ 14 In this case, our concern was the potential non-compliance with these requirements. Fair and efficient securities markets depend on dealers knowing the character and financial circumstances of their clients, so that they do not unwittingly become conduits for inappropriate or abusive trading.
- ¶ 15 The application of the KYC requirements in this case involve two aspects of particular interest. First, Lines Overseas is a non-individual, foreign entity. Second, persons other than Lines Overseas appear to have a financial interest in some of its accounts.
- ¶ 16 The exemption in paragraph 1300.1(c) is relevant to the first aspect. Lines Overseas says that the exemption applies to its accounts with IDA members. For that to be so, Lines Overseas must be “subject to a satisfactory regulatory regime in the country in which it is located.” Lines Overseas is incorporated and located in Bermuda. Is Bermuda’s regulatory regime “satisfactory”?

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- ¶ 17 Lines Overseas cites IDA Member Regulation Notice MR0143 Revised Proceeds of Crime (Money Laundering) and Terrorist Financing Regulations (May 2002) and Deterring Money Laundering Activity – A Guide for Investment Dealers (October 2002). In these documents the IDA summarizes for its members the requirements of various federal regulations dealing with money-laundering and terrorist activity, including the requirement to obtain beneficial ownership information for accounts.
- ¶ 18 Lines Overseas says that the test used in that legislation, as outlined in these IDA instruments, is an appropriate one for determining whether Lines Overseas is subject to a “satisfactory regulatory regime in the country in which it is located” within the meaning of paragraph 1300.1(c). This position is supported by IDA Member Regulation Notice MR0294 *Amendments to Regulation 1300.1 – Identification of Beneficial Owners of Non-Individual Accounts* (June 2004), which refers to those tests in its discussion of the paragraph 1300.1(c) exemption.
- ¶ 19 The tests MR0294 refers to are the ones that MR0143 identifies as the exceptions to an IDA member’s requirement to obtain “third party information” from a foreign dealer under the anti-money-laundering and anti-terrorist legislation:
1. if the foreign dealer is in a member country of the Financial Action Task Force (FATF), or
 2. if the foreign dealer is in a country that is not an FATF Member but has implemented the FATF recommendations relating to customer identification.
- ¶ 20 The first does not apply because, according to the list provided in MR0143, Bermuda is not a member country of the FATF.
- ¶ 21 For second of these exceptions to apply, Lines Overseas must first show that Bermuda has implemented the FATF recommendations relating to customer identification. In its submissions, Lines Overseas cites excerpts from the FATF website discussing Bermuda’s compliance with the FATF recommendations. Lines Overseas also cites FATF’s discussion of compliance by The Bahamas and the Cayman Islands with the FATF recommendations – perhaps because other companies in the LOM group are incorporated and operate in The Bahamas and the Cayman Islands, although as noted above, Bermuda’s regime is the relevant one.
- ¶ 22 According to these excerpts, The Bahamas “has achieved compliance” with the FATF Recommendations” and the Cayman Islands is “substantially in compliance” with them. However, the FATF discussion of Bermuda’s status does not include these unequivocal statements. The discussion is limited to commentary on various aspects of its regime of financial regulation. It is silent as

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to Bermuda's compliance with the FATF Recommendations. That being so, we cannot conclude that Lines Overseas is "subject to a satisfactory regulatory regime in the country in which it is located", and therefore the paragraph 1300.1(c) exemption does not apply.

- ¶ 23 However, even if we were able to conclude that the exemption applied, or even that the dealers involved obtained the information required by paragraph (b) of Regulation 1300.1, that is not the complete answer. Paragraph 1300.1(b) specifies only one aspect of the general KYC requirement in paragraph (a) of Regulation 1300.1. It deals with the beneficial ownership of the corporate client opening the account. This has nothing to do with the identity of other persons having a financial interest in the account. Therefore, when a person other than the corporate account holder is identified as having a financial interest in the account, that has to mean something other than an interest by reason of that person being a shareholder of the corporate account holder.
- ¶ 24 This brings us to the second aspect of particular interest, which is the more fundamental concern we have. The issue as we framed it was not the identity and beneficial ownership of Lines Overseas, but the identity of persons other than Lines Overseas who apparently have a financial interest in its accounts. This information, it seems to us, would be one of the "essential facts" that paragraph 1300.1(a) requires members to learn, and the paragraph 1300.1(c) exemption is not relevant to it.

Do the dealers have the mandated information? Is Lines Overseas' trading in compliance with the requirements?

- ¶ 25 As noted at the outset, we made no findings in our decision about whether the dealers involved obtained the information necessary to comply with the KYC requirements. This was for good reasons.
- ¶ 26 First, the documents in the evidence that caught our attention were not entered with the parties' focus on the issue we raised. Second, there is no evidence confirming the source of these documents or relating to the circumstances of their creation. Third, because our concern is based largely on the apparent absence of information, additional evidence could potentially address it.
- ¶ 27 We therefore had no reasonable basis on which to make a finding whether the dealers involved did or did not have the information they were required to obtain. The Executive Director did not lead any new evidence on this point, and therefore we are in the same position as we were when we made our January decision.
- ¶ 28 There is also no evidence of any inappropriate trading activity. Even without such evidence, it could still be in the public interest to make the cease trade order. If

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the dealers involved did not comply with KYC requirements in opening the accounts, they might not know whether or not Lines Overseas' trading activity was appropriate. Conversely, it would not be necessary to make the order if there were no reasonable basis to find that Lines Overseas' trading activities are suspect.

III Ruling

¶ 29 Although we still hold the concern we expressed in our January decision, we have no evidence on which to make a cease-trade order under section 161(1) against Lines Overseas. As noted above, the onus of establishing that it would be in the public interest to do so rests on the Executive Director. If the Executive Director wishes to pursue the matter, the necessary evidence should be gathered and a notice of hearing issued.

¶ 30 March 4, 2005

¶ 31 **For the Commission**

Brent W. Aitken
Vice Chair

Robert J. Milbourne
Commissioner

Roy Wares
Commissioner