

33-705 Conditions of Registration for Investment Dealers that Trade in the U.S. Over-the-Counter Markets [BCIN - Lapsed]

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Amendments: Amended June 13, 2008 to include date Conditions of Registration were imposed. Amended February 20, 2009 to revise references to certain condition numbers.

Concurrently Published

- [BCN 2008/24 Notice of Conditions of Registration for Investment Dealers that Trade in the U.S. Over-the-Counter Markets \[BCN\]](#)

On June 13, 2008, the Director, Capital Markets Regulation imposed Conditions of Registration for all British Columbia investment dealers that trade in securities of OTC issuers through an office in British Columbia.

This interpretation note explains how the Commission interprets and applies the Conditions.

Application

The Conditions do not apply to dealers that provide the Commission with an undertaking not to trade in securities of OTC issuers for as long as the Conditions are in force. They expire on December 31, 2011.

On occasion, a client of a dealer that has filed an undertaking with the Commission may wish to make an isolated trade in securities of an OTC issuer. To accommodate these circumstances, the undertaking includes an exception. If a dealer wants to rely on the exception, it must record the relevant details of the trade, including the name of the issuer, the number of securities traded, the date of the trade, the price, and the circumstances that the dealer believed brought the trade within the exception.

Dealers who file an undertaking and later decide to withdraw it, must provide the Commission 10 days' advance written notice before they can trade in securities of OTC issuers.

Risks of trading securities of OTC issuers

Condition 2 requires dealers to manage the risks of trading securities of OTC issuers.

The risks are those associated with trading by market participants who engage in illegal, manipulative market activities through the over-the-counter markets in the United States.

A typical scenario involves unscrupulous promoters who, through deceptive means, gain control of an OTC issuer, then promote it by making misleading disclosure. After the stock price rises significantly, the promoters sell their shares into the market to unsuspecting investors. Since the company has no legitimate business or prospects, the stock soon becomes worthless. The promoters walk away with profits and the new investors lose their investment.

A primary indicator of risk is the acquisition by an individual closely connected to the issuer of large quantities of securities from private placees.

We expect dealers to implement systems that are effective in managing these risks. An effective system would include regular monitoring to ensure it is working as intended.

Recording and reporting

Condition 3 requires dealers to record and report data related to trading in securities of OTC issuers. The Commission will use this data to monitor the impact of the Conditions on trading in those securities.

Some of the data may also be useful to dealers as part of the systems they use to manage the risks associated with trading in securities of OTC issuers. For example, it may help dealers detect disproportionate or anomalous trading in those securities.

A primary indicator of risk is the deposit of shares of OTC issuers by insiders, control persons, founders and individuals who conduct or cause to be conducted investor relations activities relating to the OTC issuer (closely-related persons). These deposits can enable a closely-related person to sell the securities to public investors at inflated prices through the US OTC markets. Both electronic deposits and physical deliveries must be recorded and reported under the Conditions.

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.

Where a carrying broker is in a relationship with an introducer, the carrying broker is responsible for monitoring, recording and reporting the OTC trading activity.

We do not require a report for any quarter in which the dealer has not traded any securities of OTC issuers.

Dealers should deliver reports in Form B to the Conditions to the Commission, attention: Capital Markets Regulation - Manager, Registration and Compliance.

Identifying beneficial owners and related individuals

Conditions 4 and 5 require dealers to identify the beneficial owner of securities of an OTC issuer a client seeks to sell, and to determine that person's relationship with the issuer.

Terminology

"Director", "officer", "insider", "control person" and "investor relations activities" are defined in the *Securities Act*.

"Founder" is defined in National Instrument 45-106, *Prospectus and Registration Exemptions*.

"Designated person" is defined in IDA By-law No. 1.

Dealer's responsibility

The Commission relies on dealers to act as gatekeepers of the markets, to help prevent illegitimate and abusive market activity. In part, this means that dealers must be able to form a reasonable belief that they know the true identity of each beneficial owner of the OTC issuer securities. If a dealer's inquiries lead to a holding company, or some other entity other than an individual, being the beneficial owner, the Conditions require the dealer to make further inquiries to establish the identities of the individuals who control that entity.

We expect dealers to use reasonable and reliable methods to determine beneficial ownership and the relationship between the beneficial owner (or person who gives trading instructions on the account) and the OTC issuer. This might include for example,

- if the client is not the beneficial owner, direct contact with those the client has identified as the beneficial owner;
- a review of account activity;
- confirmation of information with the OTC issuer;
- making independent inquiries with third parties.

Ultimately, dealers are responsible to ensure that the desired outcome is achieved - to identify the beneficial owner (and those who control non-individual beneficial owners) of the OTC issuer securities to be traded.

To comply with the Conditions for omnibus or institutional client accounts, a dealer will have to apply the requirements of the Conditions for the beneficial owner associated with each deposit.

To comply with the Conditions for accounts of foreign institutions, a dealer will have to delve beyond agency relationships to identify the actual beneficial owner. If, as a result of bank secrecy or similar legislation, the dealer cannot satisfy itself of the information required by the Conditions, the Conditions prohibit the dealer from selling the securities.

Previous inquiries

If a dealer has already made inquiries of a client under Conditions 4 and 5 about the client's ownership of securities of a particular OTC issuer and the client's relationship to it, the dealer is not required to make those inquiries again in the absence of indications that the circumstances have changed. We expect dealers to apply their judgment about whether these indications are present. For example, significant changes in trading volume or frequency, or unusual deposits of securities into the client account may suggest that circumstances have changed sufficiently for the dealer to make further inquiries.

Responsibilities of designated persons

Conditions 6, 7 and 8 impose obligations on the dealer's designated person.

A dealer may choose the most appropriate person to appoint as its designated person to manage and enforce the Conditions, provided that the person is a director or officer of the dealer.

A dealer must not accept physical deposits of securities of an OTC issuer without the approval of the designated person. A dealer can accept other forms of transfers of securities of OTC issuers, such as Depository Trust Company transfers and delivery against payment orders, but cannot execute orders to sell those securities until it complies with Conditions 4 and 5.

A physical deposit of securities of an OTC issuer is a primary indicator of risk. Before accepting a physical deposit of securities of an OTC issuer, a dealer should ensure that the designated person makes all the inquiries required under Conditions 2, 4 and 5.

May 13, 2008

Brenda M. Leong
Executive Director

Ref: Conditions of Registration - Investment Dealer that Trade in the U.S. Over-the-Counter Markets

This Notice may refer to other documents. These documents can be found at the B.C. Securities Commission public website at www.bcsc.bc.ca in the section Securities Law & Policy: Policies & Instruments.