



BC Interpretation Note 33-705

Conditions of Registration for Investment Dealers with a BC Office that Trade in the U.S. Over-the-Counter Markets

On October 28, 2009, 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.

1. Interpretation

A term that is defined in the *Securities Act* (Act), National Instrument 31-103 *Registration Requirements, Exemptions and Ongoing Registrant Obligations* (NI 31-103) or National Instrument 45-106 *Prospectus and Registration Exemptions* (NI 45-106) has the same meaning in the conditions. For example:

- The Act defines “director”, “officer”, “insider”, “control person” and “investor relations activities”.
- NI 31-103 defines “investment dealer” and “ultimate designated person”.
- NI 45-106 defines “founder”.

2. Application

The conditions do not apply to dealers that provide the Commission with an undertaking not to trade in securities of OTC issuers through a BC office for as long as the conditions are in force. They expire on December 31, 2014.

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 through a BC office. 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.

Depending on the circumstances of the trade, there may be additional information that is also relevant to creating an audit trail demonstrating that the trade fits within the exception.

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

3. Risk management

Condition 2 requires dealers to manage the risks of trading securities of OTC issuers through a BC office.

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 placements.

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.

4. Monitoring, recordkeeping and reporting

(a) Requirement

Condition 3 requires dealers to record and report data related to trading in securities of OTC issuers through a BC office. 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 through a BC office. For example, it may help dealers detect disproportionate or anomalous trading in those securities.

(b) Risk indicator

A primary indicator of risk is the deposit of shares of OTC issuers by insiders, control persons, founders and persons 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 made through a BC office must be recorded and reported under the conditions.

(c) *Refused deposits of OTC issuer securities*

Condition 3(d) requires dealers to record the number of deposits of OTC issuer securities they refuse under condition 9. For each refused deposit, dealers must report in Form B all relevant information about the securities and the reason the deposit was refused. Relevant information includes:

- the date of the attempted deposit,
- the name of the issuer,
- the number of securities, and
- the name of the client.

Depending on the circumstances, there may be additional information that is also relevant.

(d) *Obligations of introducing and carrying brokers*

Where an introducing broker is in a relationship with a carrying broker, the introducing broker is responsible for monitoring, recording and reporting OTC trading activity through BC offices. The carrying broker should assist the introducing broker in gathering the information necessary for the introducing broker to comply with the conditions. If the introducing broker is not subject to the conditions (because, for example, it is located outside British Columbia), but the carrying broker is subject to the conditions, the carrying broker is responsible for monitoring, recording and reporting OTC trading activity through BC offices.

(e) *Derivatives*

When calculating commissions under condition 3, dealers should not include commissions earned from derivatives since the reports required under the conditions relate to equity securities, rather than derivative securities.

(f) *Fee-based accounts*

The conditions require affected dealers to report commissions earned by the dealer from trading OTC issuer securities through a BC office. Where clients trade OTC issuer securities through fee-based accounts, dealers should report either:

- (a) the pro-rated portion of all fees earned during the reporting period based on the proportional value of OTC issuer securities traded in the fee-based account as follows:
 - (i) calculate the total value of all OTC issuer securities traded in the fee-based account for the quarter,
 - (ii) calculate the total value of all securities, including OTC issuer securities, traded in the fee-based account for the quarter,

- (iii) divide (i) by (ii) to calculate the proportional value of OTC issuer securities traded in the fee based account, and
- (iv) multiply (iii) with the fees earned from the fee-based account for the quarter,

or

- (b) the total fees collected from one or more segregated accounts created for the purpose of trading OTC issuer securities.

(g) *Joint commissions*

If a dealing representative has joint or shared commissions with another dealing representative, dealers should specify in the Form B the amount of commissions that each dealing representative receives from the dealer.

(h) *Salaried dealing representatives*

If a dealing representative receives a salary from the dealer, rather than commissions, the dealer may include the Chief Compliance Officer's name in item 3 of the Form B (rather than the dealing representative's names) along with the commissions earned from trading OTC issuer securities through BC offices.

The Form B that the dealer submits should state in the "Additional comments" section that dealing representatives receive salaries from the dealer rather than commissions.

(i) *Submitting reports*

The Commission encourages dealers to submit the Form B electronically through BCSC e-services, rather than through fax, mail or e-mail. If dealers are not able to submit the Form B electronically, dealers should submit the Form B to the Commission, Attention: Capital Markets Regulation Division - Manager, Registration and Compliance.

(j) *Nil report*

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

5. *Establishing beneficial ownership*

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

(a) *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 show that a holding company, or some other

entity other than an individual, is 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 for ensuring 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 through a BC office.

(b) Obligations of custodians for omnibus or institutional client accounts

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

If the account holder is a dealer subject to the requirements of the conditions, the dealer in its capacity as custodian should enter into an agreement with the account holder stating that the account holder agrees to be responsible for meeting the requirements of the conditions.

The Form B that the custodian submits should identify the account holder and state that the account holder has agreed to be responsible for meeting the requirements of the conditions for that account. The custodian may provide this information in the “Additional comments” section of the Form B.

(c) Accounts of foreign institutions

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, because 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.

(d) 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.

6. Responsibility of designated individual

Conditions 6, 8, and 9 impose obligations on the dealer's designated individual.

A dealer may choose the most appropriate individual to appoint as its designated individual to manage and enforce the conditions, provided that the individual has the qualifications set out in condition 7.

A dealer must not accept physical deposits of securities of an OTC issuer through a BC office without the approval of the designated individual. 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 through a BC office, a dealer should ensure that the designated individual makes all the inquiries required under conditions 2, 4 and 5.

A dealer's supervision and compliance system should identify those who will act as alternates in the absence of the designated individual. The designated individual remains responsible for the activities of any delegate and should ensure the delegate has adequate knowledge and experience to perform the role of the designated individual.

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Ref: Conditions of Registration - Investment Dealers with a BC Office that Trade in the U.S. Over-the-Counter Markets

This Interpretation Note 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.