



BC Notice 2007/24

BCSC Response to Abusive Practices in British Columbia Involving US Over-the-Counter Markets

1. The Problem

Some market participants with connections to British Columbia engage in abusive market activities through the over-the-counter markets in the United States. These US OTC markets consist of the OTC Bulletin Board (OTCBB) and Pink Sheets quotation systems. These markets are legal and are home to many legitimate businesses, but they are vulnerable to abuse because the requirements issuers must meet to be quoted are not onerous, and the level of regulatory scrutiny is low¹.

The abuses consist of illegal, manipulative activities. Unscrupulous promoters, through deceptive means, gain control of a public company, 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.

Unfortunately, a disproportionate number of these promoters operate from British Columbia.²

Most of the victims of the market abuses carried out by BC-based promoters are not resident in British Columbia, but the promoters' visible connections to the province damage our market's reputation. This in turn harms legitimate issuers, investment dealers and other British Columbia capital market participants.

¹ Unlike stock exchanges that choose the issuers they will list, the OTCBB and the Pink Sheets are quotations systems for inter-broker trading. Therefore:

- They do not have minimum thresholds for assets, working capital, or size of public float.
- They do not review director or officer suitability.
- They do not oversee issuer disclosure or material transactions, nor can they sanction issuers or impose trading halts.
- The Pink Sheets does not require Issuers quoted on its system to be subject to any reporting requirements or to have an auditor.

² BC-based issuers represent about 45% of all TSX-Venture exchange issuers, yet they represent 70% of all Canadian-based OTCBB issuers and 15% of OTCBB issuers overall. These statistics measure the BC connection in the US OTCBB market generally, and reflect both legitimate and abusive activity. However, our anecdotal experience leads us to believe that the level of abusive activity with BC connections is disproportionate to a similar degree as BC's overall connection to these markets.

2. The BCSC Response

What market abusers need to succeed

We have identified five things that those who abuse US OTC markets from British Columbia need to succeed.

Easily-acquired control positions

Promoters need to be able to acquire large stock positions at low cost.

Weak continuous disclosure requirements

The companies promoters seek to control must have few continuous disclosure requirements. This facilitates use of aggressive news releases, spam and direct mail campaigns to implement the promotion.

Access to shell companies

Promoters use US OTC “shell” companies from BC-based shell manufacturers. These are a means for promoters to obtain control of what appears to be a public company to use in the promotion.

The shell manufacturers create companies that have met US “going public” requirements and appear to have a start-up business. The shell has a small public float, usually created by distributing shares to BC residents, purportedly using private placement exemptions.

Once the shell is assigned an OTC ticker symbol, the shell manufacturer gathers the shares privately placed with British Columbia investors, purportedly using exemptions from the take-over bid requirements, and transfers them to the promoters buying the shell. The promoters thus end up with virtually all of the outstanding so-called “publicly-held”, shares of the company. The value of these shell companies is reflected in the high six-figure prices that promoters pay for them, even though the cost to set one up is a fraction of that amount.

The promoters then vend in a business for shares, cancel any other outstanding shares, and abandon the shell’s ostensible original business. The rest of the promotion then unfolds as described above.

BC-based dealers to facilitate insider sales

Promoters use BC-based investment dealers to gather stock and to sell their holdings into the US OTC market as the promotion unfolds.

Professional advisers to help promoted companies appear legitimate

Promoters need the services of lawyers, accountants, geologists, and other professionals to form shell companies and meet what few regulatory requirements apply.

Goal and objectives

Our overall goal is to reduce British Columbia's attractiveness as a place to engage in this abusive market activity.

Specifically, we have designed a set of initiatives to remove the conditions that these unscrupulous promoters need to succeed. Our initiatives have these objectives:

1. Improve disclosure and compliance by US OTC issuers with significant connections to British Columbia
2. Discourage the manufacture and sale of US OTC shell companies for abusive purposes
3. Disrupt abusive promotions
4. Hold dealers responsible for their trading activities in the US OTC market
5. Discourage the participation by lawyers, accountants, geologists and other professionals who facilitate abusive market activities

We expect most of the initiatives to be implemented this fall. Before we implement these initiatives, we will seek public comment on our proposals and will consult with stakeholders.

Many initiatives are aimed at "BC OTC issuers". These are issuers that have significant connections to British Columbia, and whose securities are quoted on US OTC markets excluding issuers whose securities also trade on a more senior market or exchange, such as the New York Stock Exchange, the American Stock Exchange, the NASDAQ Stock Market, the Toronto Stock Exchange or the TSX Venture Exchange. Factors that determine a significant connection to British Columbia include the presence in British Columbia of the issuer's directors and officers, shareholders, administration, capital raising or investor relations activities.

3. The Initiatives

Improving disclosure and compliance by BC OTC issuers

New disclosure requirements

We propose to require BC OTC issuers to comply with British Columbia's continuous disclosure requirements for reporting issuers, including timely disclosure of material changes. We will also introduce a requirement for directors and officers of BC OTC issuers to file personal information forms disclosing their qualifications and backgrounds.

BC OTC issuers that report under the US *Securities Exchange Act of 1934* will be able to use the documents they file with the U.S. Securities and Exchange Commission to satisfy

most of the continuous disclosure requirements. BC OTC Pink Sheet issuers that do not report under the 1934 Act will be required to comply with British Columbia audit and other reporting requirements if they wish their shares to trade in British Columbia.

Expanded compliance reviews

Once the new disclosure requirements are in force, we will carry out continuous disclosure reviews of BC OTC issuers. When we find significant non-compliance we will likely cease trade the issuer's securities. An example of significant non-compliance would be an issuer's failure to disclose the regulatory history of an issuer's management and investor relations personnel.

We already cease trade BC OTC mining issuers that we notice have announced mineral resources or mineral reserves but have not filed a technical report required under National Instrument 43-101 *Disclosure Standards for Mineral Projects*. We have begun a review of all BC OTC mining issuers, and we will cease trade issuers that have not filed required technical reports.

Discouraging the manufacture and sale of US OTC shell companies for abusive purposes

Early investigations and focused enforcement action

US issuers that issue shares outside the United States in reliance on an exemption from US registration requirements must file with the SEC a Form SB-2 Registration Statement or other form to register those shares to make them free-trading. We ask BC OTC issuers who have filed Form SB-2s to provide a list of their shareholders and to identify the exemptions the issuer relied upon to issue the shares in British Columbia. In some cases, we also ask to see subscription agreements and payment particulars.

We will now be investigating all of these issuers to determine whether they met the requirements to use the exemptions. If not, we are likely to cease trade the issuer until it files a prospectus.

In appropriate cases, we will take enforcement action against the issuer and its principals for conducting an illegal distribution.

Restrictions on use of exemptions

We propose to impose resale restrictions on British Columbia residents that buy shares of a BC OTC issuer before the issuer goes public. They will be allowed to sell those shares only:

- through a dealer
- from accounts in their own name, and
- into the public market.

We propose to restrict the use of take-over bid exemptions for BC OTC issuers to prevent shell manufacturers from gathering up the registered “free-trading” shares for delivery to the promoter buying the shell without complying with formal take-over bid procedures. Where a directors’ circular is required and the directors of the BC OTC issuer do not deliver one, we will likely cease trade the securities of the BC OTC issuer. We may also take other enforcement action against the shell manufacturer and the promoter who bought the shell for their participation in the illegal take-over bid.

Disrupting abusive promotions

SpamWatch

Last month we began imposing three-day trading halts on securities of BC OTC issuers that are the subject of a spam campaign, and publishing the information on our website. We also follow up with the issuer regarding the spam, requesting information as to the issuer’s relationship with the spammer and the issue of a news release commenting on the spam. We maintain a list of issuers that are the subject of known spam campaigns on our investor education website.

We have issued five trading halts since SpamWatch started last month.

Investor education

We are including in our investor education programs information about the US OTC market to caution investors of the risks of that market, and to provide relevant information to the investing public as the initiatives proceed.

Holding dealers responsible for their trading activities in the US OTC market

New compliance system requirements for dealers

We propose to impose new requirements on BC-based investment dealers that are actively trading in the US OTC market, or that are vulnerable to having OTC trading activity migrate to them. These will require the dealer to have a compliance system that:

- monitors trading volumes in the US OTC markets of the dealer and each of its brokers,
- monitors the dealer’s proportion of buys to sells in the US OTC market,
- requires identification of the beneficial owner of the US OTC market securities, and information about the owner’s relationship to the issuer and how the owner acquired the securities,
- monitors the delivery of insider US OTC market stock, and
- requires the dealer’s UDP (ultimate designated person) to approve all insider sales of US OTC market stock in companies that are not inter-listed on a more senior exchange.

Discouraging the participation by lawyers, accountants, geologists and other professionals who facilitate abusive market activities

Cooperation with professional governing bodies

We will work with professional associations and industry groups to build awareness campaigns about abuses of the US OTC markets conducted from British Columbia. We will also make referrals to professional self-regulatory associations for disciplinary purposes when appropriate.

We have had preliminary discussions with some professional associations. We expect to carry out this initiative throughout the consultation period. We will make disciplinary referrals as appropriate cases arise.

4. Minimizing interference with legitimate US OTC business

The US OTC market is a legal marketplace. We do not intend to unreasonably interfere with legitimate capital raising activities and the liquidity that the US OTC market provides for issuers engaged in lawful activity.

Many initiatives will affect only those who are not in compliance with securities law requirements. Some initiatives will affect all BC OTC companies, and some of the individuals associated with them, including those who have not failed to comply with requirements. We do not think these initiatives will unduly interfere with legitimate activity:

- BC OTC issuers that are quoted on the OTCBB will be able to use their SEC documents to comply with most of the new disclosure requirements.
- Given that companies already issue news releases to announce material changes, the new requirement to file that news release and a related material change report will not be onerous.
- Individuals who are suitable to act as directors and officers of a public company will not be adversely affected by the requirement to file personal information about their qualification and background.
- The new resale restrictions on private placees will not interfere with the opportunity for bona fide investors to profit from their investment.
- The new compliance system requirements for dealers will not interfere with legitimate US OTC trading.

The new disclosure requirements will impose a burden on BC OTC Pink Sheet issuers that currently have no auditor or reporting obligations. However, our regime of securities regulation is based on the principle that public companies comply with continuous disclosure requirements.

Measuring success

We will measure the success of these initiatives by monitoring various indicators, including:

- the ratio of BC OTC issuers that comply with the new disclosure requirements to those issuers with higher risk factors (e.g., problem directors, suspicious trading) that cease operations or leave British Columbia (a growing ratio may indicate success)
- the percentage of directors and officers of BC OTC issuers who have criminal or regulatory histories (a decrease may indicate success)
- the number of BC OTC issuers that are the subject of spam campaigns (a decrease may indicate success)
- the number of BC OTC issuers that graduate by becoming listed or inter-listed on a more senior exchange (an increase may indicate success)

We do not expect to eliminate completely all BC-based abuses of US OTC markets, but if as a result of these initiatives, British Columbia's share of abusive US OTC market activity is no longer disproportionate, that will be a significant success. It will also be a first step to the ultimate goal of reducing our share of this activity to a disproportionately low level.

June 25, 2007

Douglas M. Hyndman
Chair

This Notice refers 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. . For a list of stocks that have been subject to spam campaigns and to see the halt trade orders to date, visit the Commission's investor education website at www.investright.org.