

IIROC NOTICE

Rules Notice Request for Comments

Dealer Member Rules

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Trading in Securities of U.S. OTC Issuers - Proposed Amendments to Dealer Member Rule 1300.1

Summary of nature and purpose of proposed Rule

On April 30, 2009, the Board of Directors (“the Board”) of the Investment Industry Regulatory Organization of Canada (“IIROC”) approved the publication for comment of proposed amendments to the Dealer Member Rules (“the Rules”) in relation to trading in securities of U.S. over-the-counter (“OTC”) issuers. The proposed amendments will introduce a new requirement for Dealer Members to ascertain the identity of the ultimate, individual beneficial owner of U.S. OTC securities before such securities are sold.



Specifically, the proposed amendments will:

- Prohibit a Dealer Member from accepting an order to sell the securities of a U.S. OTC issuer until the Dealer Member has formed a reasonable belief as to the true identity of the beneficial owner of those securities, including the identity of every natural person who controls the beneficial owner where the beneficial owner is not a natural person;
- Provide an exemption for American Depository Receipts and for any OTC securities for which the issuer has a class of securities listed or quoted on the TSX Venture Exchange, The Toronto Stock Exchange, the Canadian National Stock Exchange, the New York Stock Exchange, the American Stock Exchange or the NASDAQ Stock Market; and
- Provide an isolated trade exemption from identification requirements.

The primary objective of the proposed amendments is to discourage abusive and illegal OTC market activity, and prevent such activity from migrating to other parts of Canada as a result of similar requirements imposed by the British Columbia Securities Commissions (“BCSC”).

Issues and specific proposed amendments

U.S. OTC issuers have often been a source of scandal with links to Canada, and British Columbia (“BC”) in particular. The U.S. OTC market is composed of the Over-the-Counter Bulletin Board and the Pink Sheets. A disproportionate number of the players in these U.S. OTC markets who engage in abusive activities have visible connections to BC. As a result of the actual harm and reputational damage to BC’s capital markets, the BCSC has implemented measures to prevent further abusive activities.

BCSC conditions of registration

The measures implemented by the BCSC include conditions of registration (“conditions”) for all BC investment dealers that trade in securities of U.S. OTC issuers through an office in BC. The conditions took effect on June 13, 2008, and will expire on December 31, 2011.

The BCSC conditions can be grouped into three general categories:

- Beneficial ownership identification requirements prior to the sale of securities of an OTC issuer
- Detailed reporting requirements with respect to securities of OTC issuers traded and held in the accounts of Dealer Members
- Designated person responsibility for certification of procedures relating to OTC trading, approval of deposits of securities of OTC issuers, and compliance with the conditions



Undertaking and isolated trade exemption

The conditions do not apply to a BC registered dealer that files an undertaking acknowledging that the dealer will not trade securities of an OTC issuer until December 31, 2011 for its own account or the account of any other person. However, a firm that has filed an undertaking may make an isolated trade in securities of an OTC issuer if the trade is on behalf of a client that does not trade in securities of OTC issuers, either generally or occasionally, and if the firm records the relevant details of the isolated trade. Guidance provided by the BCSC indicates that the relevant details of the trade which must be recorded include the name of the issuer, the number of securities traded, the date of the trade, the price, and the circumstances that the firm believed brought the trade within the exception. A firm that has filed an undertaking may later withdraw it by providing the BCSC with 10 days notice before making any trades in securities of an OTC issuer.

The conditions imposed by the BCSC are intended to address abusive and illegal market activity, while having a minimum impact on legitimate trading. It was recognized that the BCSC conditions may cause abusive market activity to move elsewhere within Canada. The adoption of similar requirements by IIROC is intended to discourage and prevent the illegal OTC market activity from migrating to other parts of Canada. The IIROC requirements will also standardize rules targeting illegal OTC market activity for all IIROC Dealer Members, although Dealer Members operating out of BC will have to continue to comply with the BC conditions so long as those conditions are in place.

IIROC Dealer Member Rule 1300 currently sets out requirements for Dealer Members to learn and remain informed of the essential facts relative to every customer and to every order or account accepted. Pursuant to IIROC Dealer Member Rule 1300.1, Dealer Members are required to ascertain and verify the identity of any natural person who is a beneficial owner, directly or indirectly, of more than 10% of a corporation or similar entity, or a trust. The proposed amendments will be a new requirement in addition to the existing identification requirements set out in Dealer Member Rule 1300.

Current Dealer Member Rule 1300.1(c) provides an exception from the above requirements where the account holder is a corporation or entity that is, or is an affiliate of, a bank, trust or loan company, securities dealer or similar financial institution subject to a satisfactory regulatory regime in the country in which it is located.



One of the key requirements set by the BCSC conditions is the Dealer Member's obligation to establish the ultimate, individual beneficial owner of OTC securities before a sale is executed. If the securities are not owned by a natural person, then the Dealer Member is required to determine the identity of every individual who is a beneficial owner of the securities. This requirement targets some of the highest risk transactions, such as abusive or illegal market trading where the identity of those trading is hidden behind offshore intermediaries. The proposed amendments adopt a similar identification requirement as an amendment to Dealer Member Rule 1300.1. Specifically, Dealer Members will be prohibited from accepting an order to sell securities of an OTC issuer until the Dealer Member has made the inquiries necessary to form a reasonable belief that it knows the true identity of every beneficial owner of those securities. Where a beneficial owner of the securities is not a natural person, the Dealer Member must make the inquiries necessary to form a reasonable belief that it knows the identity of every natural person who owns the beneficial owner.

For purposes of the proposed amendments, an "OTC issuer" is defined as an issuer that has a class of OTC-quoted securities, other than American Depositary Receipts, and no class of securities listed or quoted on the TSX Venture Exchange, The Toronto Stock Exchange, the Canadian National Stock Exchange, the New York Stock Exchange, the American Stock Exchange or the NASDAQ Stock Market; and "OTC-quoted securities" is defined as a class of securities that has been assigned a ticker symbol on the OTC Bulletin Board or the Pink Sheets. As a result, the proposed identification requirements will not apply in respect of the sale of securities of an OTC issuer with a class of securities listed or quoted on one of the specified exchanges ("the exempting exchanges").

The proposed identification requirement will not be subject to a similar exception as that set out in Dealer Member Rule 1300.1(c). The proposed provisions will require Dealer Members to identify the beneficial owner of securities of OTC issuers where the account holder is a foreign bank, securities dealer or similar financial institution. The identification of beneficial ownership of OTC issuer securities sold by all offshore accounts is critical to the effectiveness of the proposed rule. If the proposed identification requirement were subject to exceptions similar to Dealer Member Rule 1300.1(c), then securities of OTC issuers could be sold through an offshore account without establishing the identity of the seller or beneficial owner. In the case of accounts for foreign institutions subject to bank secrecy legislation, if the Dealer Member can not obtain the required information, then the Dealer Member will be prohibited from accepting an order to sell the securities.

The proposed amendments also incorporate an isolated trade exemption similar to the exception provided by the BCSC for those firms that file an undertaking under the BCSC conditions. The proposed exemption does not require Dealer Members to file an undertaking with IIROC. However, like the BCSC isolated trade exemption, the IIROC exemption is only available in instances where a Dealer Member does not make a practice of trading securities of



OTC issuers for its own account or the account of any other person. Furthermore, the exemption only applies to trades on behalf of a client that does not trade in securities of OTC issuers, either generally or occasionally, and if the firm records the relevant details of the isolated trade. Consequently, all Dealer Members will be required to comply with the IIROC identification requirements, except in those rare instances where the trade may be made under the isolated trade exemption.

IIROC is issuing a Draft Guidance Note for public comment that is intended to explain how IIROC will apply and interpret the Dealer Member Rules relating to trading in U.S. OTC securities. A copy of the Draft Guidance Note is enclosed as “Attachment C”.

The proposed amendments to IIROC Dealer Member Rule 1300.1 are enclosed as “Attachment A”. A black line copy of the same is enclosed as “Attachment B”.

IIROC staff considered all of the conditions imposed by the BCSC. IIROC does not propose the adoption of rules similar to the BCSC conditions with respect to reporting requirements and designated person responsibilities. IIROC Dealer Member Rules already require the designation of an Ultimate Designated Person, and Dealer Members are required to have procedures in place to properly supervise their accounts. IIROC staff believe that business conduct reviews of, and financial reporting by, Dealer Members currently provides satisfactory insight into the trading engaged in by firms so that the adoption at this time of reporting requirements like those in the BCSC conditions is not necessary. Similarly, IIROC staff does not propose the adoption of rules similar to the BCSC conditions requiring firms to identify whether a person is “an insider, control person, or founder of the OTC issuer, or an individual who conducts or causes to be conducted investor relations activities relating to the OTC issuer; and if so, how the beneficial owner acquired the securities.” The proposed IIROC identification requirements will relate only to the obligation of Dealer Members to identify the ultimate beneficial ownership by natural persons of OTC issuer securities that are sold.

Like the BCSC conditions, the proposed amendments exempt application of the rule with respect to the sale of securities of OTC issuers that have a class of securities listed or quoted on one of the exempting exchanges. In response to comments received from IIROC advisory committees consulted during the rule development process, IIROC staff considered extending the list of exempting exchanges on the basis that there are well-established, large capitalization issuers listed on prominent exchanges such as the London Stock Exchange that may have a class of securities trading on the U.S. OTC markets that would be captured by the proposed amendments. However, IIROC’s consultation process did not produce any examples of an issuer listed on a major non-North American exchange with a class of securities trading on the U.S. OTC markets that was not also listed or quoted on one of the exempting exchanges in the proposed amendments. As a result, IIROC staff was of the view that a revision extending the list of exempting exchanges was not justified.



Proposed Rule classification

Statements have been made elsewhere as to the nature and effects of the proposed rule, as well as analysis. The purposes of the proposed rule are to:

- ensure compliance with securities laws;
- prevent fraudulent and manipulative acts and practices;
- promote just and equitable principles of trade and the duty to act fairly, honestly and in good faith;
- foster fair, equitable and ethical business standards and practices; and
- promote the protection of investors.

It is believed that the proposed amendments will discourage abusive and illegal market activity associated with securities of U.S. OTC issuers from being conducted through Dealer Members, and dissuade the illegal OTC market activity from migrating to other parts of Canada. The IIROC requirements will also standardize rules targeting illegal OTC market activity for all IIROC Dealer Members, although Dealer Members operating out of BC will have to continue to comply with the BC conditions so long as those conditions are in place.

The Board therefore has determined that the proposed amendments are not contrary to the public interest.

Due to the extent and substantive nature of the proposed amendments, they have been classified as Public Comment Rule proposals.

Effects of the proposed Rule on market structure, Dealer Members, non-Dealer Members, competition and costs of compliance

The proposed amendments do not impose any burden or constraint on competition or innovation that is not necessary or appropriate in furtherance of IIROC's regulatory objectives. They do not impose costs or restrictions on the activities of market participants (including Dealer Members and non-Dealer Members) that are disproportionate to the goals of the regulatory objectives sought to be realized. The proposed amendments will likely result in a significant reduction in the number of sale transactions in U.S. OTC securities through Dealer Members by non-individual entities.

Technological implications and implementation plan

In most instances, there should not be significant technological implications for Dealer Members as a result of the proposed amendments. Procedurally, Dealer Members are required now to supervise trading and comply with existing identity verification requirements. Some Dealer Members may feel the need to enhance their compliance monitoring systems to better detect the sale of U.S. OTC issuer securities captured by the proposed amendments.



The proposed amendments will be made effective on a date determined by IIROC staff that allows for a reasonable rule implementation period after approval is received from IIROC's recognizing regulators.

Request for public comment

Comments are sought on the proposed amendments. Comments should be made in writing. Two copies of each comment letter should be delivered by July 21, 2009 (60 days from the publication date of this notice). One copy should be addressed to the attention of:

Jamie Bulnes
Director, Member Regulation Policy
Investment Industry Regulatory Organization of Canada
Suite 1600, 121 King Street West
Toronto, ON M5H 3T9

The second copy should be addressed to the attention of:

Manager of Market Regulation
Ontario Securities Commission
19th Floor, Box 55
20 Queen Street West
Toronto, ON M5H 3S8
marketregulation@osc.gov.on.ca

Those submitting comment letters should be aware that a copy of their comment letter will be made publicly available on the IIROC website (www.iiroc.ca under the heading "IIROC Rulebook - Dealer Member Rules - Policy Proposals and Comment Letters Received").

Questions may be referred to:

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Attachments

[Attachment A – Proposed amendments to Dealer Member Rule 1300.1 regarding trading in securities of U.S. OTC issuers](#)

[Attachment B – Black line copy of IIROC Dealer Member Rule 1300.1 reflecting amendments](#)

[Attachment C – Draft Guidance Note - Trading in Securities of U.S. Over-the-Counter Issuers](#)