



INVESTMENT INDUSTRY ASSOCIATION OF CANADA
ASSOCIATION CANADIENNE DU COMMERCE DES VALEURS MOBILIÈRES

MEMORANDUM

TO: IIAC Compliance and OTCBB Committees
FROM: Susan Copland
DATE: May 25, 2009
RE: Proposed IIROC OTCBB Rule

On May 22, 2009, IIROC published Notice 09-0153, *Trading in Securities of US OTC Issuers – Proposed Amendments to Dealer Member Rule 1300.1*. The proposed rule introduces a new requirement for dealers to ascertain the identity of the ultimate, individual beneficial owner of US OTC securities before such securities are sold.

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 Commission (“BCSC”).

The amendments are based on the BCSC requirements, enacted in 2008, but unlike the BCSC rules, do not include detailed reporting requirements or the designation of a person responsible for certification of procedures relating to several aspects of OTC trading. The IIROC requirements will also standardize rules targeting illegal OTC market activity for all IIROC Dealers, although Dealers operating out of BC will have to continue to comply with the applicable BC conditions.

Specifically, the proposed amendments:

- Prohibit dealers from accepting an order to sell the securities of a U.S. OTC issuer until the dealer has formed a reasonable belief as to the true identity of the beneficial owner of those securities, including the identity of **every** (100%) natural person who controls the beneficial owner;
- Provide an exemption for American Depositary 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.

Current rules

The proposed amendments will be a new requirement in addition to the existing identification requirements set out in Dealer Member Rule 1300, which require dealers to learn and remain informed of the essential facts relative to every customer and to every order or account accepted 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.

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.

Proposed rules

One of the key requirements set by the BCSC conditions is the dealer'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 is required to determine the identity of every individual who is a beneficial owner of the securities. This requirement is intended to target 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, dealers will be prohibited from accepting an order to sell securities of an OTC issuer until the dealer 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 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 dealers 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 can not obtain the required information, then the dealer 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 dealers to file an undertaking with IIROC. However, like the BCSC isolated trade exemption, the IIROC exemption is only available in instances where a dealer 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 dealers 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.

Differences from BCSC Rule

IIROC does not propose the adoption of rules similar to the BCSC conditions with respect to reporting requirements and designated person responsibilities as IIROC Dealer Member Rules already require the designation of an Ultimate Designated Person, and dealers are required to have procedures in place to properly supervise their accounts.

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 dealers 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.

Questions for Members

- Q1: Are the existing IIROC reporting, UDP and supervisory requirements sufficient to address the concerns that are covered by the BCSC requirements for specific reporting, designated person, and supervision? If so, should we ask the BCSC to exempt IIROC dealers from such requirements?**
- Q2: Is the BCSC requirement 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”**

important in achieving the objective of the Rule? Should it be adopted by IIROC or should the BCSC be asked to remove that provision?

- Q3: Will the proposed Rule impose undue costs or restrictions on the activities of market participants (including IIROC dealers and non-IIROC dealers) that are disproportionate to the goals of the regulatory objectives sought to be realized.**
- Q4: Are there significant technological implications for dealers as a result of the proposed amendments?**
- Q5: How do members deal with publicly traded corporations in establishing beneficial ownership?**