

**NOTICE OF REQUEST FOR PUBLIC COMMENTS REGARDING A  
PROPOSED MODEL RULE TO DESIGNATE NATIONALLY  
RECOGNIZED SECURITIES MANUALS FOR PURPOSE OF THE  
MANUAL EXEMPTION AND A PROPOSED MODEL RULE TO EXEMPT  
SECONDARY TRADING IN SECURITIES ISSUED BY REGULATION A –  
TIER 2 ISSUERS**

**July 19, 2018**

The North American Securities Administrators Association, Inc. (“NASAA”) is requesting public comments regarding two proposed model rules that would facilitate secondary trading in securities of issuers about which there is certain publicly available information about the issuer.

The first proposed model rule would designate certain sources as nationally recognized securities manuals or their electronic equivalent for purposes of the so-called “manual exemption” from registration under state law. This proposed model rule is intended to address issues that have arisen as a result of the discontinuation of the manual previously published by Standard & Poor’s.

The second proposed model rule would provide two alternative options for providing an exemption for secondary trading in securities of issuers that have previously sold securities in an offering under Tier 2 of Regulation A and that remain current in their ongoing reporting requirements under federal law. The second proposal is designed to facilitate secondary trading in securities of Regulation A - Tier 2 issuers.

Comments on the proposed model rules are due by **August 20, 2018**. To facilitate consideration of comments, please send comments to William Beatty ([bbeatty@dfi.wa.gov](mailto:bbeatty@dfi.wa.gov)), Chair of the Corporation Finance Section; Faith Anderson ([faith.anderson@dfi.wa.gov](mailto:faith.anderson@dfi.wa.gov)), Chair of the Small Business/Limited Offerings Project Group; Christopher Staley ([nasaacomment@nasaa.org](mailto:nasaacomment@nasaa.org)), Assistant General Counsel, NASAA; and Mark Stewart ([nasaacomment@nasaa.org](mailto:nasaacomment@nasaa.org)), Counsel, NASAA. We encourage, but do not require, comments to be submitted by e-mail. Hard copy comments may be submitted at the address below.

NASAA Legal Department  
Mark Stewart, Counsel  
NASAA  
750 First Street, NE, Suite 1140  
Washington, DC 20002

**Note:** After the comment period has closed, NASAA will post to its website the comments it receives as submitted by the authors. Parties should therefore only submit information that they wish to make publicly available. Further, the following notice will appear on NASAA’s website where comments are posted: NASAA, its agents, and employees accept no responsibility for the content of the comments posted on this Web page. The views, expressions, and opinions expressed in the comments are solely those of the author(s).

## Background

The so-called “manual exemption” is of “ancient vintage.”<sup>1</sup> The manual exemption is available to resales of securities of issuers about which there is publicly available information although the issuer is not necessarily a public reporting company. When the USA (1956) was drafted, several states had already adopted manual exemptions. The manual exemption contained in the USA (1956) exempted:

any non-issuer distribution of an outstanding security if a recognized securities manual contains the names of the issuer’s officer and directors, a balance sheet of the issuer as of a date within eighteen months, and a profit and loss statement for either the fiscal year preceding that date or the most recent fiscal year of operations.<sup>2</sup>

The draftsmen noted the various protections to which the manual exemption was subject:

- The exemption could be denied or revoked by the Administrator;
- The term “recognized securities manual” could be defined by the Administrator by rule;
- Exempt transactions were subject to anti-fraud provisions;
- Broker-dealers and representatives were required to register;
- The Administrator could require registered broker-dealers to keep lists of securities sold under this exemption.<sup>3</sup>

Further, the draftsmen noted that although not required by the uniform manual exemption, some states restricted the exemption “to sales by registered dealers, or require[d] that the sale be at a price ‘reasonably related to the current market price,’” or otherwise restricted the exemption.<sup>4</sup>

The Revised Uniform Securities Act of 1986 (RUSA (1986)) included a manual exemption similar to that contained in the USA (1956) but that was further conditioned on the security having been outstanding in the hands of the public for at least 90 days.<sup>5</sup> This change was advocated to “bar immediate secondary trading of nonregistered IPO securities.”<sup>6</sup>

The Uniform Securities Act of 2002 (USA (2002)) also contains a manual exemption, but it is much more restrictive than the exemptions contained in either the USA (1956) or RUSA (1986). The manual exemption in the USA (2002) reflects recommendations made by NASAA and generally conforms to NASAA’s amendments to the USA (1956).<sup>7</sup> NASAA’s amendments include a requirement that the issuer has a class of equity securities that is either listed on a

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<sup>1</sup> Uniform Securities Act of 1956 (“USA (1956)”) Draftsmen’s Commentary to §305(i), §305(j) and Related Sections Referring to Non-Issuer Distributions.

<sup>2</sup> USA (1956) § 402(b)(2).

<sup>3</sup> USA (1956) Draftsmen’s Commentary to §305(i), §305(j) and Related Sections Referring to Non-Issuer Distributions.

<sup>4</sup> *Id.*

<sup>5</sup> RUSA (1986) § 402(3).

<sup>6</sup> RUSA (1986) Comment to § 402.

<sup>7</sup> USA (2002) Official Comments to § 202.

national exchange or that is quoted on the NASDAQ unless certain other requirements are met. This requirement was “designed specifically to address the problem of penny stock fraud.”<sup>8</sup>

The manual exemption contained in the USA (2002) generally exempts “a nonissuer transaction by or through a broker-dealer registered, or exempt from registration...and a resale transaction by a sponsor of a unit investment trust registered under the Investment Company Act of 1940, in a security of a class that has been outstanding in the hands of the public for at least 90 days” provided all of the following conditions are satisfied:

- The issuer is not in the organizational stage and is not a blank check, blind pool or shell company with no specific business plan;
- The security is sold at a price reasonably related to its current market price;
- The security is not part of an underwritten offering;
- A nationally recognized securities manual that is publicly available or a document filed with the SEC through EDGAR contains:
  - A description of the business and operations of the issuer;
  - The names of the issuer’s executive officers and the names of the issuer’s directors, if any;
  - An audited balance sheet of the issuer dated within 18 months of the transaction; and
  - An audited income statement for the past two fiscal years.<sup>9</sup>
- One of the following requirements is met:
  - The issuer has a class of equity securities listed on a national exchange or designated for trading on the NASDAQ;
  - The issuer is a unit investment trust registered under the Investment Company Act of 1940;
  - The issuer has been engaged in continuous business for at least 3 years; or
  - The issuer has total assets of at least \$2,000,000 based on an audited balance sheet dated within 18 months prior to the transaction.<sup>10</sup>

Most states have adopted some form of the manual exemption.<sup>11</sup>

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<sup>8</sup> USA (1956) as amended by NASAA, 1996 NASAA Comment.

<sup>9</sup> This information is more limited than the information that is available about an issuer that files public reports under the Exchange Act of 1934. Public reporting companies are generally required to file annual reports (including audited financial statements) on Form 10-K within 60-90 days of the fiscal year end, quarterly reports on Form 10-Q within 40-45 days from the end of the quarter, and current reports on Form 8-K within four days of a material event.

<sup>10</sup> USA (2002) § 202(2).

<sup>11</sup> According to a recent recommendation of the SEC’s Advisory Committee on Small and Emerging Companies, 39 of 54 U.S. jurisdictions have adopted some form of the manual exemption. Recommendation Regarding Secondary Market Liquidity for Regulation A, Tier 2 Securities, Advisory Committee on Small and Emerging Companies, May 15, 2017, available at <https://www.sec.gov/info/smallbus/acsec/acsec-recommendation-051517-secondary-liquidity-recommendation.pdf> [hereinafter Recommendation of ACSEC].

## First Proposed Model Rule: Recognition of Current Information Sources for Purposes of the Manual Exemption

States have typically recognized the following manuals for purposes of the manual exemption:

- Standard & Poor's Corporation Records;
- Fitch Investors Service; and
- Mergent's Investor Service (formerly known as Moody's).

In 2016, however, Standard & Poor's discontinued the publication of its manual. Because many companies quoted on the OTC Markets, Inc. ("OTC") website had relied on their listing in the Standard & Poor's Corporation Records for purposes of the manual exemption, the OTC began seeking recognition of its website as a source of the requisite information for purposes of the manual exemption.

OTC Markets operates an SEC-registered Alternative Trading System called OTC Link® ATS, as opposed to a registered securities exchange. Securities of issuers traded on the OTC markets are thinly traded as compared to securities listed on national securities exchanges.<sup>12</sup> Issuers whose securities trade through the OTCQX and OTCQB markets must, however, provide specific disclosure through the OTC Markets website. The disclosure that is required to participate in these markets includes the information that must be published under the manual exemption and more. OTC Markets Group monitors disclosure by these issuers and will remove issuers from these markets if they become delinquent in providing the required disclosure.

A large number of states have taken action to recognize the OTC website for purposes of the manual exemption with respect to securities that are included in the OTCQX and OTCQB markets.<sup>13</sup> A path to compliance for secondary trading may remain unclear, however, in those states that have adopted a manual exemption but that do not specifically recognize the OTC website as an acceptable source of the information that must be publicly available for purposes of the manual exemption.

NASAA is proposing a model rule to encourage states to update the list of securities manuals they recognize for purposes of the manual exemption by eliminating the outdated Standard & Poor's Corporation Records manual and by including the OTC website with respect

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<sup>12</sup> A recent report by SEC staff analyzed the over-the-counter ("OTC") marketplace. The report notes in general that OTC securities "tend to be highly illiquid; are frequent targets of alleged market manipulation; generate negative and volatile investment returns on average; and rarely grow into a large company or transition to listing on a stock exchange." The report notes that "these properties tend to worsen when the OTC company has fewer disclosure-related eligibility requirements." OTC stocks, however, are not limited to stocks of issuers trading on the OTCQX and OTCQB marketplaces. The report indicates that with respect to the OTC Markets, "70% of quoted securities and 85% of dollar volume traded on the OTC Markets is concentrated in the Pink Tier." The Pink Tier is a separate market from the OTCQX and OTCQB. Issuers whose securities are included in the Pink Tier are not subject to the disclosure requirements of the OTCQX and OTCQB markets. See Joshua T. White, Outcomes of Investing in OTC Stocks, Dec. 16, 2016, available at [https://www.sec.gov/files/White\\_OutcomesOTCinvesting.pdf](https://www.sec.gov/files/White_OutcomesOTCinvesting.pdf).

<sup>13</sup> Thirty (30) jurisdictions currently recognize the OTCQX market for purposes of the manual exemption, while twenty-seven (27) jurisdictions recognize the OTCQB market for purposes of the manual exemption. See <https://www.otcm Markets.com/corporate-services/products/blue-sky>

to securities that are included in the OTCQX and OTCQB markets.<sup>14</sup> The model rule would read as:

Nationally recognized securities manual or its electronic equivalent” shall mean: Fitch Investors Service, Mergent’s Investor Service, and OTC Markets Group, Inc. with respect to securities included in the OTCQX and OTCQB markets.

## **Second Proposed Model Rule: Secondary Trading Exemption for Securities of Regulation A – Tier 2 Issuers**

Issuers that raise capital under Tier 2 of Regulation A remain subject to ongoing reporting requirements unless they elect to exit the reporting regime based on having fewer than 300 shareholders.<sup>15</sup> While these ongoing reporting requirements are not as fulsome as those required of companies subject to ongoing reporting under either Section 13 or 15(d) of the Exchange Act of 1934, these issuers must file the following reports through EDGAR:

- Annual reports on Form 1-K, including:
  - Description of the business of the issuer;
  - Management discussion and analysis of financial condition and results of operations;
  - Identification and information about the executive officers and directors of the issuer; and
  - Audited financial statements for the previous two fiscal years.
- Semiannual reports on Form 1-SA, including:
  - Management discussion and analysis of financial condition and results of operation; and
  - Unaudited financial statements for the six month interim period, including footnote disclosure.
- Current reports on Form 1-U with respect to fundamental changes and other matters.

Securities of issuers that comply with these ongoing reporting requirements can be traded in reliance on the manual exemption from registration in those states that have adopted versions of the exemption that substantially conform to that contained in Section 202(2) of the USA (2002). As noted above, however, not all states have adopted the manual exemption and some states have adopted earlier versions of the manual exemption that do not recognize EDGAR as a source of the information about the issuer that must be available. In those states, investors that want to trade securities of issuers that have sold securities under Tier 2 of Regulation A and that remain current in their ongoing reporting requirements may not have a readily available exemption from registration to effect such trades.

In recognition of this issue, the Advisory Committee on Small and Emerging Companies recently made a formal recommendation<sup>16</sup> that the Securities and Exchange Commission:

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<sup>14</sup> The proposed model rule would not provide any relief with respect to securities of issuers included in the Pink Tier of the OTC Markets.

<sup>15</sup> 17 CFR §230.257(d).

<sup>16</sup> Recommendation of ACSEC, *supra* note 11.

1. Take steps to help reduce friction in secondary trading by holders of Tier 2 Regulation A securities where the issuer is current in its ongoing reports.
2. Collaborate with NASAA in this endeavor.
3. Use its authority under Section 18 of the Securities Act to preempt from state regulation the secondary trading in securities of Tier 2 Regulation A issuers that are current in their ongoing reports.<sup>17</sup>

The Corporation Finance Section's primary recommendation to states is to either adopt the version of the manual exemption contained in Sec. 202(2) of the USA (2002), as amended by NASAA (below), or to conform existing exemptions to Sec. 202(2). Some states may, however, prefer to provide a more limited exemption narrowly tailored to issuers that are current in their ongoing reporting requirements under Tier 2 of Regulation A. In that vein, two alternative exemptions are being proposed that would permit secondary trading of securities by such issuers.

The first proposed option includes language that could be adopted by statute or rule to specifically provide for a transactional exemption from registration for securities of issuers current in their ongoing reporting requirements under Tier 2 of Regulation A provided that the transaction otherwise complies with the terms of the manual exemption adopted elsewhere in statute or rule:

Secondary sales of securities of an issuer that previously sold securities in an offering qualified under Tier 2 of Regulation A provided that the issuer is current in its ongoing reporting requirements under 17 CFR §230.257(b) at the time of the sale and complies with the terms of the exemption from registration in [code citation to manual exemption].

This language is intended to be included in an existing list of securities transactions exempt from registration.

The second option proposed is a narrowly tailored version of the manual exemption (for those states that do not have a version of the manual exemption similar to that contained in Section 202(2)) drafted specifically with respect to securities of issuers that have previously sold securities in an offering qualified under Tier 2 of Regulation A provided that the issuer is current in its ongoing reporting requirements.

## **Conclusion**

Comments on the proposal are due by **August 20, 2018**. The following documents are attached to this proposal:

- Manual Exemption from Section 202(2) of the USA (2002) as amended by NASAA – *Exhibit A*
- Proposed Model Rule to Designate Nationally Recognized Securities Manuals for Purpose of the Manual Exemption from Registration – *Exhibit B*
- Proposed Model Rule to Provide a Transactional Exemption from Registration for Transactions in Securities of Issuers That Comply with Ongoing Reporting Requirements Under Tier 2 of Regulation A – *Exhibit C*

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<sup>17</sup> *Id.*

# **Exhibit A**

## **Manual Exemption from USA (2002) as amended by NASAA**

- (2) Any non-issuer transaction by a registered agent of a registered broker-dealer, and any resale transaction by a sponsor of a unit investment trust registered under the Investment Company Act of 1940, in a security of a class that has been outstanding in the hands of the public for at least 90 days provided, at the time of the transaction:
- (A) The issuer of the security is actually engaged in business and not in the organizational stage or in bankruptcy or receivership and is not a blank check, blind pool or shell company whose primary plan of business is to engage in a merger or combination of the business with, or an acquisition of, an unidentified person or persons; and
  - (B) The security is sold at a price reasonably related to the current market price of the security;
  - (C) The security does not constitute the whole or part of an unsold allotment to, or a subscription or participation by, the broker-dealer as an underwriter of the security;
  - (D) A nationally recognized securities manual designated by rule or order of the Administrator or a document filed with the U.S. Securities & Exchange Commission (SEC) which is publicly available through the SEC's Electronic Data Gathering and Retrieval System (EDGAR) and contains:
    - (i) A description of the business and operations of the issuer,
    - (ii) The names of the issuer's officers and the names of the issuer's directors, if any, or, in the case of a non-U.S. issuer, the corporate equivalents of such persons in the issuer's country of domicile,
    - (iii) An audited balance sheet of the issuer as of a date within 18 months, or in the case of a reorganization or merger where parties to the reorganization or merger had such audited balance sheet, a pro forma balance sheet, and
    - (iv) An audited income statement for each of the issuer's immediately preceding two fiscal years, or for the period of existence of the issuer, if in existence for less than two years or, in the case of a reorganization or merger where the parties to the reorganization or merger had such audited income statement, a pro forma income statement; and
  - (E) The issuer of the security has a class of equity securities listed on a national securities exchange registered under the Securities Exchange Act of 1934, or designated for trading on the National Association of Securities Dealers Automated Quotation System (NASDAQ), unless:
    - (i) The issuer of the security is a unit investment trust registered under the Investment Company Act of 1940, or
    - (ii) The issuer of the security has been engaged in continuous business (including predecessors) for at least three years, or
    - (iii) The issuer of the security has total assets of at least \$2,000,000 based on an audited balance sheet as of a date within 18 months or, in the case of a



reorganization or merger where parties to the reorganization or merger had such audited balance sheet, a pro forma balance sheet.

# **Exhibit B**

## **Proposed Model Rule to Designate Nationally Recognized Securities Manuals for Purpose of the Manual Exemption from Registration**

Note: This model rule may be used by states that have adopted the manual exemption to designate the nationally recognized securities manual recognized by the Administrator.

### **Nationally recognized securities manual.**

"Nationally recognized securities manual or its electronic equivalent" shall mean: Fitch Investors Service, Mergent's Investor Service, and OTC Markets Group Inc. with respect to securities included in the OTCQX and OTCQB markets.

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# **Exhibit C**

## **Proposed Model Rule to Provide a Transactional Exemption from Registration for Transactions in Securities of Issuers That Comply with Ongoing Reporting Requirements Under Tier 2 of Regulation A**

### **Option 1:**

Note: The language included below may be adopted in those states that have adopted a version of the manual exemption from securities registration that does not recognize EDGAR as a source of the information that must be publicly available to investors under the exemption. This language may be adopted in statute or rule to specifically provide for a transactional exemption from registration for securities of issuers current in their ongoing reporting requirements under Tier 2 of Regulation A provided that the issuers otherwise comply with the terms of the manual exemption adopted elsewhere in statute or rule. The language is intended to be included in an existing list of securities transactions exempt from registration.

Secondary sales of securities of an issuer that previously sold securities in an offering qualified under Tier 2 of Regulation A provided that the issuer is current in its ongoing reporting requirements under 17 CFR §230.257(b) at the time of the sale and complies with the terms of the exemption from registration in [code citation to manual exemption].

### **Option 2:**

Note: The language included below may be adopted in those states that do not have a version of the manual exemption similar to that contained in Section 202(2) of the Uniform Securities Act of 2002 but that wish to provide exemptive relief specifically for transactions in securities of issuers that have previously sold securities in an offering qualified under Tier 2 of Regulation A and that are current in their ongoing reporting requirements thereunder. The language is intended to be included in an existing list of securities transactions exempt from registration.

- (2) Any non-issuer transaction by a registered agent of a registered broker-dealer in a security of a class that has been outstanding in the hands of the public for at least 90 days by an issuer that previously sold securities in an offering qualified under Tier 2 of Regulation A provided that at the time of the transaction:
  - (A) The issuer is current in its ongoing reporting requirements under 17 CFR §230.257(b);
  - (B) The issuer of the security is actually engaged in business and not in the organizational stage or in bankruptcy or receivership and is not a blank check, blind pool or shell company whose primary plan of business is to engage in a merger or combination of the business with, or an acquisition of, an unidentified person or persons;

- (C) The security is sold at a price reasonably related to the current market price of the security;
- (D) The security does not constitute the whole or part of an unsold allotment to, or a subscription or participation by, the broker-dealer as an underwriter of the security; and
- (E) The issuer of the security has a class of equity securities listed on a national securities exchange registered under the Securities Exchange Act of 1934, or designated for trading on the National Association of Securities Dealers Automated Quotation System (NASDAQ), unless:
  - (i) The issuer of the security has been engaged in continuous business (including predecessors) for at least three years, or
  - (ii) The issuer of the security has total assets of at least \$2,000,000 based on an audited balance sheet as of a date within 18 months or, in the case of a reorganization or merger where parties to the reorganization or merger had such audited balance sheet, a pro forma balance sheet.