OTC Markets

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Via Email Only

North American Securities Administrators Association, Inc.
Corporation Finance Section
Small Business/Limited Offerings Project Group
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RE: Notice of Request for Comment Regarding The Uniform Securities Act Manual Exemption

OTC Markets Group Inc. ("OTC Markets Group")[1] respectfully submits this comment letter in response to the North American Securities Administrators Association's ("NASAA") notice requesting comment regarding the Uniform Securities Act Manual Exemption (the "Notice").[2]

Our markets serve an important function within the capital markets landscape, offering U.S. investors a regulated public market to buy and sell securities of companies that are not listed on a U.S. stock exchange. Companies that meet the recognized standards on our top two market tiers – OTCQX and OTCQB – are required to publicly disclose current information, including audited financial statements, officer and director information and ongoing material events. These robust disclosure requirements and the public availability of real-time information have led the OTCQX and OTCQB markets to be recognized as securities manuals in a majority of states.[3]

The purpose of the manual exemption is to ensure that investors have access to a baseline of current information before a broker can provide research or solicit investments in an unlisted security. Investment professionals across the country must consider compliance with the manual exemption when determining whether they can provide research or recommend OTC securities.

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[1] OTC Markets Group Inc. operates the OTCQX® Best Market, the OTCQB® Venture Market and the Pink® Open Market for 12,000 U.S. and global securities. Our OTC Link® Alternative Trading Systems (ATSs) provide critical market infrastructure that broker-dealers rely on to facilitate trading. Our innovative model offers companies more efficient access to the U.S. financial markets. OTC Link ATS, OTC Link ECN and OTC Link NQB are SEC regulated ATSs, operated by OTC Link LLC, member FINRA/SIPC.

[2] Unif. Sec. Act of 2002 § 202(2) (Nat'l Conf. of Comm'r on Unif. State L.)

[3] *Blue Sky,* OTC Markets Group Inc., https://www.otcmarkets.com/corporate-services/products/blue-sky. The OTCQX and OTCQB markets are exempt from Blue Sky laws in 38 states and one U.S territory: Alaska, Arkansas, Colorado, Connecticut, Delaware, Georgia, Hawaii, Idaho (OTCQX only), Indiana, Iowa, Kansas (OTCQX only), Kentucky, Louisiana, Maine, Michigan, Minnesota, Mississippi, Missouri, Nebraska, New Jersey, New Mexico, North Dakota, Ohio, Oklahoma, Oregon, Pennsylvania, Puerto Rico, Rhode Island, South Carolina, South Dakota, Tennessee, Texas, Utah, Vermont (OTCQX only), Virginia (OTCQX only), Washington, West Virginia, Wisconsin, and Wyoming. The OTCQX and OTCQB markets are exempt in certain states under other exemptions for non-issuer transactions.

The manual exemption has historically recognized traditional, printed securities manuals, such as Mergent, which publish reference books containing financial information about unlisted companies. These manuals track the minimum disclosure requirements under the Uniform Securities Act. They are generally published in a physical book or PDF format and are only available to paid subscribers or at certain libraries.

Beginning in 2016, states began recognizing the information made available on www.otcmarkets.com for companies on the OTCQX and OTCQB markets for the purposes of the manual exemption. Today, these markets are exempt under secondary trading rules in 38 states and Puerto Rico. In a world where investing continues to move online, this recognition represents ***the continuing trend of states recognizing <u>modern</u> securities manuals with information that is updated in real-time and available for free to all investors***.

Modern securities manuals provide more robust investor protection. Today's financial markets move at lightning speed, quickly rendering information stale. To adapt, it is imperative that modern securities manuals take account of real-time information. For example, in addition to required periodic disclosure and financial information, each company profile page for OTCQX and OTCQB issuers contains real-time pricing data, security details (e.g., public float, shares outstanding), news releases, contact information, and a list of all company officers, directors, 10% shareholders and service providers. This information is dynamic and updated in real-time.

Traditional printed securities manuals, such as Mergent, are typically published once a year, with semi-annual supplements containing changes to the annual publication. As long as the company information is published in the printed manual, the exemption is effective. By contrast, OTC Markets Group analyzes compliance with the OTCQX and OTCQB requirements on a *daily* basis. Companies that fail to file timely disclosure or meet the applicable financial requirements are removed from these markets immediately and accordingly lose the applicable exemption.

We believe that the OTCQX and OTCQB markets should be recognized in any revision of the manual exemption. To the extent that NASAA is seeking to enhance the existing framework, it should continue to take a disclosure-based approach and allow each state to determine which securities manuals it chooses to recognize. Our experience in bringing to life a modern securities manual puts us in a unique position to provide the following comments and recommendations in response to the Notice.

1. **The Notice makes misleading statements and comes to flawed conclusions based on dated studies**

The Notice acknowledges that a majority of U.S. states have recognized the OTCQX and OTCQB markets for the purpose of the manual exemption. It then goes on to state that "[o]ther states have not granted such recognition based on concerns about the securities traded on the over-the-counter marketplace." This statement is misleading and implies that the remaining 15 states have declined to approve these markets based on investor protection concerns. In fact, to our knowledge, Massachusetts is the only state that has specifically declined to update their manual exemption to recognize these markets. OTC Markets Group continues to work with many of the 15 US jurisdictions that have not yet updated their manual exemption. A number of these jurisdictions have indicated an intent to include OTCQX and OTCQB, some continue to evaluate, some are non-responsive, and several jurisdictions have not adopted the manual exemption in any form.[4]

[4] California, Illinois, New York, Alabama, and Montana have not adopted either of the 1956 or 2002 Uniform Securities Act versions of the manual exemption.

The Notice compounds its misleading inferences by citing to a 2016 SEC white paper as evidence of the risks related to investing in OTC stocks. The reliance on this study is misplaced for several reasons. First, the Notice incorrectly asserts that the paper "analyzed the OTC marketplace and found 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.'" In fact, these were not the paper's findings but rather a synthesis of existing literature, all of which is between seven and 26 years-old.[5] Second, a careful reading reveals that the paper was intended to explore "the relationship between OTC investor returns and stock promotions, company transparency, and investor demographics."[6] Accordingly, the study largely focuses on a sample group composed of "Blue Sheet" securities — i.e., securities that were subject to a regulatory inquiry — which the author admits is a dataset "potentially biased towards lower quality OTC stocks." It is likely that many of the companies included in this study would not even qualify for the OTCQX or OTCQB markets. Third, the Blue Sheet sample dataset is nearly ten years old.[7] Since that time, the OTC market has transformed dramatically, most notably following the adoption of amended Rule 15c2-11 by the Securities and Exchange Commission (SEC) in 2021. Finally, the sample used in the paper consists only of domestic issuers, which further undermines NASAA's citing of the paper as an indictment of the OTC market as a whole.[8] Approximately 75% of all OTC issuers are established international companies listed on a non-U.S. stock exchange, such as Roche, Adidas and Heineken.[9] NASAA's purported concerns regarding the stated risks related to OTC securities are misguided and should not inform the discussion around updating the manual exemption.

2. Instead, NASAA should look to the SEC's recently updated Rule 15c2-11

There is, of course, risk in all investing, including on the OTC market. However, rather than attempting to limit the opportunities available to investors by creating investor qualifications, NASAA should follow the lead of the SEC and focus on the availability of current disclosure in line with the recently amended Rule 15c2-11 under the Exchange Act.

In September 2021, the SEC modernized Rule 15c2-11, a longstanding Exchange Act rule that governs when a broker-dealer can publish quotations in OTC equity securities. The investor protection achievements of the amendments are summarized in the SEC's final rule press release:

> Recognizing the ease with which information sharing takes place today, the amendments [to Rule 15c2-11] generally prohibit broker-dealers from publishing quotations for an issuer's security when issuer information is not current and publicly available, subject to certain exceptions. Investors who have access to current and publicly available issuer information are better equipped to make informed decisions about how to allocate their capital and to counteract misinformation that can proliferate through promotions and other channels.[10]

[5] *See* Joshua T. White, *Outcomes of Investing in OTC Stocks* 1,1 (Abstract) (Dec. 16, 2016), https://www.sec.gov/files/White_OutcomesOTCinvesting.pdf.
[6] *Id.* at 16.
[7] *Id.* The sample is limited to 2014 data.
[8] *See id.*
[9] *See* Matt Fuchs, *2022 Market Data Annual Review*, OTC Markets Group Inc. (Feb. 24, 2023), https://blog.otcmarkets.com/2023/02/24/2022-market-data-annual-review/; *see also OTCQX International Index*, https://www.otcmarkets.com/index/.OTCQXINT.
[10] Press Release, Sec. Exch. Comm'n, SEC Adopts Amendments to Enhance Retail Investor Protections and Modernize the Rule Governing Quotations for Over-the-Counter Securities (Sept. 16, 2020), https://www.sec.gov/news/press-release/2020-212.

Any enhancements to the manual exemption should focus on the availability of current information to ensure that investors, regulators, and market intermediaries can make (and monitor) informed decisions. Notably, Rule 15c2-11 and the manual exemption set forth the *minimum* disclosure requirements under federal and state law, respectively. The OTCQX and OTCQB markets impose *additional* disclosure responsibilities and issuer qualifications on top of these baseline requirements. For example, OTCQX and OTCQB companies are required to have audited financials and have at least two independent board members.

3. **NASAA should not impose any requirements on the investor or purchaser**

The Notice sets forth a list of "possible revisions to the manual exemption to mitigate investor risks," which includes investor-based qualifications such as limiting purchases to accredited investors, establishing investor suitability standards, or requiring the issuer to sign acknowledgements before investing. These suggestions fly in the face of generally accepted securities regulation practice and principles of property law.

Federal and state regulations impose purchaser restrictions at the time of initial offering (e.g., private placements are limited to accredited investors). By contrast, transactions subject to the manual exemption are secondary trades occurring through regulated broker-dealers. Imposing restrictions on the secondary *purchases*, but not sales, will eliminate a secondary market for these investors. By artificially limiting the number of available purchasers, such a restriction would materially depress the value of the stock for shareholders and those investors that wish to sell their shares.

Any such investor qualifications would also be duplicative of (and potentially conflict with) the existing obligations of broker-dealers handling transactions in these securities. All secondary transactions made in reliance on the existing 2002 manual exemption — and all transactions conducted on our markets — are made through FINRA-regulated broker-dealers subject to applicable FINRA and SEC Rules. These rules include comprehensive suitability requirements and Regulation Best Interest.

Imposing restrictions on certain investors or purchasers of securities would be unworkable for broker-dealers and would prevent broker-dealers and clearing firms from processing and settling trades in these securities. In practice, purchaser qualifications would act as a ban on OTC securities for retail investors, senselessly wiping out countless millions in existing shareholder value.

4. **Any enhancements to the manual exemption should follow the OTCQX and OTCQB requirement for issuers**

If NASAA determines to further restrict the manual exemption, any additional substantive requirements should be imposed on the issuer and should look to the requirements for OTCQX and OTCQB companies. As mentioned above, OTCQX and OTCQB companies must meet *additional* disclosure, financial, and corporate governance requirements to be eligible for these markets. These requirements include:

- Publishing audited financials;
- Disclosing material news within three days;
- Updating officer, director, and company information upon any changes and verifying every six months;
- Maintaining an SEC-regulated transfer agent;
- Having a board of directors that includes at least two independent directors;
- Having an audit committee, a majority of the members of which are independent directors; and
- Being exempt under the SEC's Penny Stock Rule (OTCQX companies only), which includes minimum assets and revenue requirements.

These standards are well understood within the industry, with many broker-dealer compliance departments maintaining processes that recognize companies that meet these standards.

5. **Failure to appropriately modernize the manual exemption may result in federal preemption**

If NASAA fails to make progress on modernizing and standardizing the manual exemption, federal preemption may be the only means of providing a coherent compliance regime for companies, investors, brokers, and regulators. This approach would codify what a majority of states have already done by modernizing their secondary trading rules to align with current market practice. Federal rules governing secondary trading would help all issuers understand what is expected of them, help investors evaluate potential trading decisions on a level, understandable playing field regardless of where they live, and allow broker-dealers and investment advisers to provide consistent compliance advice.

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OTC Markets Group appreciates the opportunity to comment on the Notice. We welcome the opportunity to discuss our comments with NASAA.

Very truly yours,

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