

OVER-THE-COUNTER MARKETS AND THEIR IN ROLE IN THE FINANCIAL SYSTEM

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OTC Bulletin Board

The restructuring processes, which the over-the-counter markets also passed through in the USA, brought also a higher degree of transparency in these markets. In 1993 the Penny Stocks Reform Act was passed. This act charged the SEC with setting up an electronic system and the OTC Bulletin Board began to fulfil its task.

The OTC Bulletin Board is a regulated quotation system, which depicts in real time information on prices and volumes on the over-the-counter securities market. The OTCBB covers national, regional and foreign share issues, warrants, American Depositary Receipts (ADRs) and Direct Participation Programs (DPPs).

This system works in the way that it enables the publication of the price and information on the last sale. Since 1993 firms have been obliged to submit information on trades in all domestic securities by means of the Automatic Confirmation Transaction Service, within 90 seconds of each transaction being made.

In 1997 the Securities Commission approved the functioning of the OTCBB on a stable basis with certain modifications. It allowed DPPs to be quoted on the OTCBB. In this way all foreign securities and ADRs registered with the Commission became likewise eligible for quotation in real time. In 1998 the Securities Commission approved the so-called OTCBB Eligibility Rule. Since this time there has existed the obligation to submit current financial information for all securities that had not hitherto been quoted on the OTCBB to the Securities Commission, banking or insurance supervisory authorities for the purpose of fulfilling eligibility requirements. Companies that had not hitherto provided such information but their securities had been quoted on the OTCBB were given a transitional period for meeting the new requirements. This period lasted from July 1999 to June 2000, when the current financial information on all domestic companies quoted on the OTCBB became publicly available.

At present the OTCBB represents an over-the-counter trading system that:

- provides access to more than 3600 different securities,
- includes more than 330 participants – market makers,
- transmits information on prices, volumes and the last sale of all domestic and foreign stocks and ADRs electronically and in real time,
- gives an indication of the interest and trading activities in the past days for DPPs.

Important information from the perspective of the investor

The OTCBB is a quotation service for customers who subscribe to it and it is not a service providing quotations on a bourse for issuers. There do not exist here any minimum quantitative requirements that an issuer must fulfil in order that its stocks are quoted on the OTC BB. It must however fulfil the information requirements stipulated by the eligibility rule. In trading (purchasing, selling) securities on the OTCBB investors must contact a broker, because investors do not have direct access to this market.

Important information from the perspective of the issuer

Only market makers may request a stock quotation in the framework of the system. Issuers may contact authorised market makers with a request for sponsorship of an issue. The OTCBB does not charge issuers any fees for a quotation. The rules of NASD also prohibit market makers on the OTCBB from accepting remuneration for quoting securities.

Market information provided by means of the OTCBB

Data is disseminated by means of terminals and websites of market data sellers for customers throughout the world. This data is:

- dynamic information on the prices of the last sale and traded volumes for domestic and foreign securities and ADRs,
- information on the lowest, highest and closing price and volumes during the day for DPPs,



- the supply, demand and indicative interest displayed by specific market makers,
- indicative prices for DDPs,
- telephone numbers of market makers.

As a supplement, all subscribers to the Nasdaq Workstation II service have access to all information available on the OTCBB system without the additional charges.

A comparison of the Nasdaq market and OTCBB

The OTCBB is a medium intermediating stock quotes for their subscribers and is not a service for issuers and therefore it cannot be confused with the Nasdaq market. Stocks on the OTCBB are traded by means of a community of market-makers, who quote and announce deals via a highly sophisticated closed computer network, accessible by means of Nasdaq Workstation II terminals. The OTCBB differs from the Nasdaq Stock Market primarily in the following facts:

- it does not prescribe standards that must be fulfilled in the case of stock issues,
- it does not provide the option of the automatic realisation of instructions,
- no relations are maintained with issuers that have their stocks placed on the OTCBB,
- it does not impose the same obligations for market makers.

The above table represents a summary of the basic differences

Feature or requirements	OTCBB	Nasdaq
Minimum quantitative requirements for issue	No	Yes
Issue and maintenance fees	No	Yes
Requirements for issue or quotation	Yes*	Yes
Quotation in real time for domestic issues	Yes	Yes
Minimum period for submitting Form 211 or for processing and approval of an issue	3 days	6 – 8 weeks**

* From 4 January 1999 there arises for all securities that are to be quoted on the OTCBB the duty to submit updated financial information to the Commission, banking or insurance supervisory authorities for the purpose of fulfilling eligibility requirements.

** The submission of Form 211 is not obligatory in the case of an issue on the Nasdaq market. However, the average time for issue approval is 6 – 8 weeks.

Pink Sheets

The origin of Pink Sheets stretches back to 1904, when they were in the form of a publication and represented a dealers' quotation service connecting mutually competing market makers on over-the-counter stock markets throughout the country. The name of this market is derived from the pink-coloured papers, since they are shares that are still today not quoted on the Nasdaq computer system. Information on these shares is published by means of the pink-coloured papers of the National Daily Quotation Services and the National Quotation Bureau (NQB), which issues daily a summary of OTC shares and cheap shares (the Daily Quotation Pink Sheets). Since the year 2000 NQB has taken on the official name Pink Sheets.

Since this time Pink Sheets has been the central source of information for share and bond trading on OTC markets. Today, this service has been transformed through exploiting the possibilities of the Internet and progress achieved in the field of network technologies with the aim of raising quality, speed and the value of the information and products provided. These factors represent potential for the development of what was once considered a forgotten segment of the stock market.

Pink sheets LLC is the leading provider of pricing and financial information for over-the-counter markets in the USA. It is a private company registered in New York. It provides products and services that increase the transparency of information available on OTC markets, whereby they become more efficient

for all market participants. The centralised information network includes services aimed at supporting market makers, issuers, brokers and investors on OTC markets. In practice this information raises the efficiency of over-the-counter trading, providing the opportunity of better realisation for investors and improving the process of acquiring capital for issuers.

In summer 1999 the National Association of Securities Dealers began a process of eliminating more than 3000 companies from the OTC Bulletin Board system. This made many over-the-counter shares practically invisible on stock markets. In response to this, the company Pink Sheets in September 1999 introduced its



Electronic Quotation Service, an Internet-based real-time quotation system intended for market makers and brokers for dealing in over-the-counter shares and bonds. This system is not a bourse, but a system utilising the latest technology, by means of which mutually competing market makers display prices and the potential liquidity of thousands of domestic shares in real time. Currently it is used by more than 700 brokers and dealers.

These enter and move the market by means of an instrument called the OTC Dealer. This is a Java application, which gives brokers and dealers full access to the Electronic Quotation System. Market makers can also use an Internet version of the OTC Dealer application for managing and gaining an overview prices in real time. A further application, OTCQuote.com, offers access to all information in real time. It is possible to subscribe to this service and use it by means of a standard Internet browser. Protection is ensured via a password.

In June 2000 the Internet portal www.pinksheets.com was launched. Here can be found information on share prices, financial reports and information on companies issuing their shares on the OTC market. This information is provided free of charge with a 15-minute delay. Likewise, issuers incur no expenses for providing the information.

Important information from the aspect of the investor

Price quotations are provided by market makers and information on companies by the companies themselves. Pink Sheets, nevertheless, is not a stock exchange or otherwise regulated institution. Therefore, investors should be aware of the fact that the accuracy and completeness of such information has not been verified by the company Pink Sheets or any supervisory authority.

Pink Sheets is a quotation service for customers who must subscribe to it and it is not a service ensuring a quotation on a bourse for issuers. Concurrently there are no quantitative standards that an issuer need fulfil in order for its shares to be quoted by means of the Pink Sheets.

In contrast to the OTC Bulletin Board, issuers do not have to submit reports to the Securities Commission. Through an issue there arise no obligations either to the Commission or the Association of Securities Dealers.

For the purpose of buying or selling shares investors must contact a broker / dealer. Investors do not have the option of executing trades directly by means of the system itself, i.e. direct trading.

Issuers are not obliged to maintain an address and contact information in the framework of the Pink Sheets system, nevertheless such information is accessible in the case of most issuers. The National Stock Summary contains information on the majority of issues quoted in Pink Sheets.

Important information from the aspect of the issuer

Since issuers do not have a notification obligation in respect of the Securities Commission it is recommended in their own interest to make information on their companies available for shareholders and market participants in a timely and transparent manner.

Only brokers /dealers registered with the Securities Commission may quote shares in Pink Sheets. Issuers may contact them with a request for so-called sponsorship of their securities in the Pink Sheets system. A market maker must then fill out and submit a form 211 to the NASD OTC Compliance Unit. Quotation is permitted only following approval by this unit.

NASD rules prohibit market makers from receiving any remuneration for quotation of securities in Pink Sheets. Similarly the company Pink Sheets does not charge issuers fees for services connected with quotation.

Direct-access trading on over-the-counter markets

The volumes of trades realised by means of direct-access trading, i.e. directly without brokers or dealers intermediating are slowly growing in line with the decline in costs and growth in the advantages that this method of trading brings.

Direct access - a fast and a low-cost trading technology, which became known as the phenomenon of "day trading" in the Nineties, is making headway also among institutional investors. Despite the fact that precise information on the usage of direct-access trading is unavailable, sources from the investment world confirm that the percentage volume of such trades on the main bourses and Electronic Crossing Networks ranges between 10% – 12%.

Direct-access software electronically consolidates data on trades and enables traders to automatically direct orders to various destinations without using the services of a broker. This high-speed method of trading is gaining favour among institutional investors, who are influenced by the requirements of performance and the changing business environment. Direct-access trades are realised in the course of several seconds and commission fees represent



mostly a half to one-third of the expenses connected with trading via brokers, where trades are performed without using a telephone or other manual activity.

Direct-access trading is growing also, since at present the costs of electronic components have dropped significantly and, thereby, also the costs of transmission media*. On the other hand, people and their trust in the new technologies are changing at a slower pace. Expenses in the case of direct-access trading in shares represent approximately 0.5 to 2 cents per share, thus decreasing significantly trading costs. Despite this fact, up to 80% of the activity on Electronic Crossing Networks comprises traditional brokers and dealers, who charge their institutional clients 5 to 6 cents per share.

The main advantage of direct-access trading remains the fact that it enables access from one point to several trading centres, as well as the speed of finding a trading counterparty, which can take only a matter of seconds. The advantages of direct-access trading may be seen also in the fact that at present in the USA six to seven main Electronic Crossing Networks and three main bourses exist. Thus, for buyers as well as sellers it is becoming ever more difficult to gain an overview of the whole market at once. Direct access enables traders to input an instruction and specifications. This software then searches in one go the whole market as well as centres bringing together liquidity, and in a matter of seconds brings a response on the acceptance and realisation of the instruction. The whole process is strongly powered by new technologies and investors have only in recent years begun to realise the opportunities it offers.

Conclusion

Over-the-counter markets in the USA represent investment opportunities for intelligent and informed investors, but likewise bear a high degree of risk. This is connected in particular with the fact that many issuers on these markets are small companies with a short history of operation or are in an economically awkward situation. As a result, in comparison with shares quoted on a bourse they bear a higher degree of risk. Therefore, also investing on legitimate OTC markets can often lead to a complete loss of an investment.

* Today the price of a server in the USA is around USD 2 500, whereas five years ago it would have cost USD 25 000 and 10 years ago did not exist.

This conclusion has been documented also by the situation on over-the-counter markets since the year 2000, on which concentrated all high-tech companies without any history and representing a highly risky new market with low market capitalisation, but the grounds for an expected high rate of growth in the future. Investors' enormous interest in this market segment brought about a speculative bubble in equity markets, which through its price level greatly exceeded the productive possibilities of the companies. Today, these equities are shifting into the "penny" or "small" equity field with high losses for investors. Ever more often calls resound from many economists and analysts that investors should never purchase any shares before evaluating a company's underlying fundamentals, assessing its financial statements, appraising its management and other relevant data. Thus, fundamental analysis and in particular, in the case of portfolio investors, the issue of risk diversification are making a comeback. The recommendation is also made that the unsophisticated and passive investors should steer clear of OTC markets completely.

Many shares today are only relatively liquid or not very tradable. Some shares today in these markets are practically unsellable. The low liquidity of this part of the market causes high volatility in prices, which can lead again to losses for the investor. Investors today face also important challenges in the sense that they should be on guard against any sign of fraud or manipulation. Cases revealed even from the practices of the most advanced capital market of the USA have convinced us often enough of this. It may be expected that over-the-counter markets in the future as regards the mechanism of their functioning, control and regulation will encounter new measures aimed at removing the above problems.

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