

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

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Specific features of the over-the-counter market

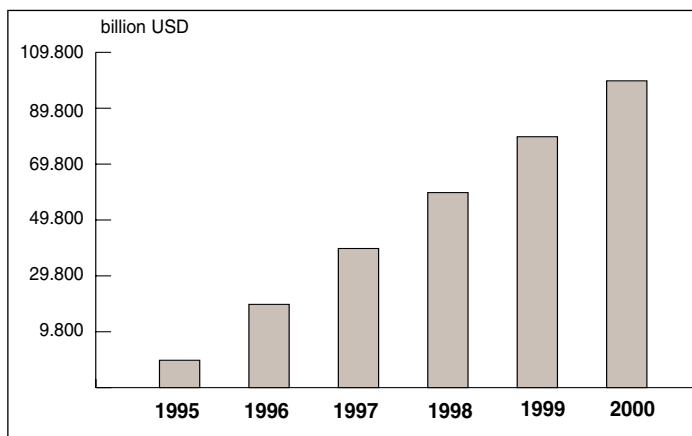
Nowadays numerous features are connected with the term over-the-counter market. We can include here the following points:

- as derives from its name, it is a market outside a stock exchange, i.e. it does not have any reserved centralised physical location, where traders or specialists gather as in the case of classic courses,
- often they are also termed “off board” markets, on which buyers and sellers are not physically present,
- it is a network of independent traders (stockbrokers), who between themselves perform purchase and sales transactions via a telephone or computer network without intermediaries,
- its name over-the-counter (OTC) market – a market across a counter is historically derived from the fact that most of these trades were made over banks’ counters
- it allows the registration of securities also of small and new companies that do not meet the demanding criteria of courses,
- the current level of electronic facilities allows 24-hour trading, which is indisputably an advantage in comparison with a bourse and in the case of time shifts between continents does not cause traders any problems.

The over-the-counter market has taken on a huge dimension especially in the USA, because there it has given room for other often also high risk issuers to enter the market, something which would have been impossible for them on a bourse. The placing of issues on a bourse has, as far as fees are concerned, become also financially demanding. The size of bourse fees deters many investors and traders from trading on a bourse.

The shift of many traders to the over-the-counter market is documented also by the fact that today already 13 times more trades are made on OTC markets than on the largest bourse, the New York Stock Exchange. This fact is depicted in the following graph, showing the historical volume of trades since 1995.

Volume of shares traded (1995 – 2000) ¹



Source:
http://www.otcbb.com/dynamic/trading_data/sharedollarvolume/share.htm

¹ Stated data concern only the OTC market (number of shares traded).

Development of over-the-counter markets and its structure in the USA

Historically over-the-counter markets were established at the beginning of the 20th century. The market was however significantly fragmented and inefficient. Bond houses, investors, investment dealers and brokers traded via announcements in financial publications or the daily press. Likewise they distributed circulars with offers to their clients and other investment firms. In 1904 Roger W Babson founded a statistical organisation aimed at gathering such information, registered in Wellesley Hills, Massachusetts. These statistics were systematised and issued by means of a monthly journal.

In 1911 Arthur F Elliot, a publisher of financial publications in Boston, set up in Manhattan the first service for providing reports on daily quotes of investment dealers and brokers on the over-the-counter market. Both these services supplemented one another and their subsequent combination was a natural step forward. Through their consolidation in October 1913 the National Quotation Bureau (NQB) was established.

At the time reports on market quotes of firms in five cities on the Eastern Seaboard were provided daily. Exploiting the latest telecommunications and printing technologies, the NQB after a couple of years expanded its services to more than 50 towns between both



seaboards. The privilege of issuing quotations had always been reserved for registered brokers and dealers. These had to fulfil standards relating to financial stability and transparency. The establishment of the Securities Commission through the Securities Act in 1933, the Securities Exchange Act in 1934 and the establishment of the National Association of Securities Dealers by means of the Maloney Bill to the Exchange Act in 1938 created a system of regulation and supervision over brokers, dealers and the OTC markets. The NQB first introduced higher standards for OTC market makers than did the Securities and Exchange Commission (SEC) or the National Association of Securities Dealers, Inc. (NASD). At the start of the Sixties this quotation service was opened up to any broker / dealer registered with the Commission and subsequently to any NASD member.

In 1963 the NQB was bought out by the conglomerate, the Commerce Clearing House. The CCH was a reference book publisher and perceived NQB's products in the same manner, i.e. as literary publications and therefore did not wish to invest in new technologies. For this reason, and in connection with the needs of this market, NASD founded a stock market (the Nasdaq Stock Market), a real-time system. Through using technology with the aim of improving market efficiency Nasdaq met with great success. NQB continued in its activity as a publisher of paper publications, where its output declined yearly.

In 1997 NQB passed into the hands of new management, which supported the use of the latest technologies and an improvement in the services offered to customers. As a result of these efforts NQB in September 1999 presented its Electronic Quotations Service system, based on the internet and real-time trading, for stocks and bonds traded on over-the-counter markets. In June 2000 NQB changed its name to Pink Sheets LLC and then presented the first financial web portal with information on OTC Securities and issuers.

Currently over-the-counter trades in the USA are divided mainly into:

- dealers and brokers, who are grouped in a national association and use the Nasdaq automatic quotation system,
- participants in the over-the-counter Bulletin Board (OTCBB)
 - the Pink Sheets market,
 - the Grey market (other markets for stocks that are not located in the above mentioned markets).

Nasdaq

With regard to the fact that shares of various companies not listed on a stock exchange are traded quite

unrestrainedly on OTC markets, the American government charged the SEC to draw up an analysis of the capital market, the result of which was a recommendation for the automation of the OTC market. This task was assigned to the already-functioning National Association of Securities Dealers (NASD), which in 1971 introduced an automated system of trading and quotation for over-the-counter trades, the National Association of Securities Dealers Automated Quotation – NASDAQ.

The main task of this system is to develop and manage systems, services and products for various stock markets. It bears responsibility also for the formulation of regulatory policies, regulations and registration criteria for all the markets it operates. It also administers a complex technological infrastructure for the gathering, processing and distribution of trading and exchange rate information. It has introduced an on-line MarketWatch department, which is responsible also for the halting trading. It operates the largest stock market under the Nasdaq stock market. Besides securities, which are a component of the over-the-counter market, Nasdaq today registers and trades more than half the companies quoted on bourses. The varied level and quality of stocks has led to two independent stock markets having been created in the framework of Nasdaq, namely:

- The Nasdaq National Market - Nasdaq NM, where the largest worldwide companies are registered. Besides the traditional sectors, there are also found here new, quickly growing and prospering firms in a wide variety of industrial sectors,
- The Nasdaq SmallCap Market – Nasdaq SCM, a component of which are in particular new firms with small market shares. In the case of improving its market position and if a company fulfils also the other required criteria, it may move to the qualitatively higher level, the Nasdaq NM.

Whereas in the past rules for trading, the control and regulation mechanism, as well as the legislative framework for the over-the-counter market's functioning were much more liberal, today the differences between trading on the Nasdaq and the New York Stock Exchange are vanishing. Therefore nowadays Nasdaq is termed in many professional papers a bourse, despite organising and realising the largest share of over-the-counter trades in the world.

In terms of globalisation processes Nasdaq's aim is to create and expand live local markets in individual regions around the world. The effort is thus to create a single global market. For this reason Nasdaq has set up representative offices in Asia, Canada and Europe.

To be continued in issue 11/2003