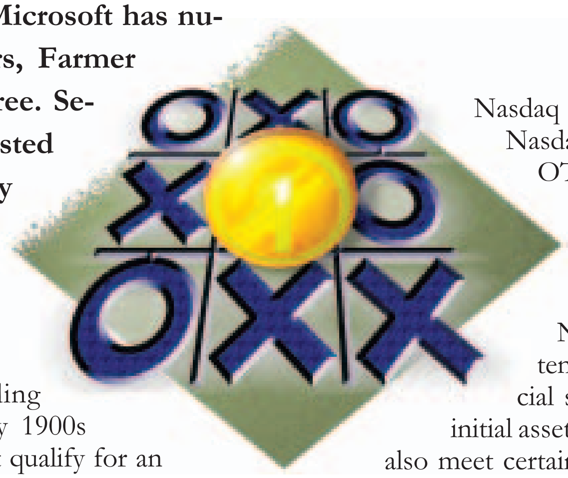
The Basics: What Is the Over-the-Counter Market?

By John E. Deysher

"Over-the-counter", or OTC, is a term loosely applied to securities that aren't listed on an organized exchange—such as the New York, American, Midwest, Boston, Pacific or Philadelphia exchange. OTC securities are traded through at least two, but often numerous "market makers" who maintain bids and offers for the securities they trade. Microsoft has numerous market makers, Farmer Brothers has about three. Securities that trade on a listed exchange are quoted by a solo "specialist" who is charged with maintaining orderly trading in a security.



Over-the-counter trading traces its roots to the early 1900s when small firms that didn't qualify for an exchange listing were traded informally among brokers. The term refers to the actual countertops used by dealers to handle transactions.

Up until about 30 years ago, volume on the exchanges dwarfed the OTC market. But in the mid-1970s, the OTC market began to pick up steam. Since then, the explosion of initial public offerings and subsequent OTC listings make it the biggest market in the world:

	No. of Issues*
New York Stock Exchange	2,800
American Stock Exchange	700
Over the Counter	11,200

**As of 12/03.*

The OTC market consists of four basic units, each with different qualification standards:

	No. of Issues*
Nasdaq National Market (NNM)	3,500
Nasdaq SmallCap	700
OTC Bulletin Board	3,300
Pink Sheets	3,700

**As of 12/03.*

Once included in either the Nasdaq National Market or Nasdaq SmallCap system, a company must maintain certain financial standards generally equal to about half the initial asset and capitalization requirements. They must also meet certain governance requirements including: publishing annual and quarterly reports, conducting annual meetings and maintaining independent directors.

Trading in all Nasdaq securities is overseen by the National Association of Securities Dealers (NASD) and all Nasdaq firms must submit regular reports for SEC (Securities and Exchange Commission) review.

But the majority of companies whose shares are traded over the counter don't meet current Nasdaq requirements.

The OTCBB

The OTCBB is an electronic quotation system that displays real-time quotes, last-sale prices, and volume information for many OTC securities that are not listed on the Nasdaq stock market or a national securities exchange. Although the NASD oversees the OTCBB, it is not part of the Nasdaq stock market.

In 1999, the SEC approved an NASD rule allowing the NASD to require that all OTCBB companies file updated financial reports with the SEC or with their banking or insurance regulators. Beginning in June 2000, the rule applied to all companies on the OTCBB. Since then, any companies that have refused to file timely reports with the SEC or their banking or insurance regulators have been removed from the OTCBB.

When an OTCBB company fails to file its reports on time, the NASD will add a fifth letter "E" to its four-letter stock symbol. The company then has 30 days to file with the SEC or 60 days to file with its banking or insurance regulator. If it's still delinquent after the grace period, the company will be removed from the OTCBB. You'll find a list of securities that have been removed from the OTCBB at www.otcbb.com.

These non-Nasdaq issues include small and large domestic and international companies that can't or don't wish to comply with Nasdaq's listing requirements. They trade on either the OTC Bulletin Board or in the Pink Sheets.

The Bulletin Board (OTCBB)

Founded in 1990, the Bulletin Board is a network of electronically linked market makers who trade shares of small companies. Unlike the totally unregulated Pink Sheets, the Bulletin Board is overseen by the SEC and the NASD. Bulletin Board companies must file audited financial statements with the SEC and comply with federal securities laws. Many companies end up here after being thrown off an exchange or Nasdaq for failing to meet financial or governance listing standards.

But *caveat emptor:*

- Although Bulletin Board companies are required to file annual and quarterly reports, proxies and insider trades with the SEC, neither the SEC nor NASD verifies the filings as factual.
- There are no minimums either—a company may have no assets, sales or earnings, but as long as they make timely SEC filings they'll continue to be listed.
- There are also no governance standards, independent audit committees or independent directors like those applied to listed and Nasdaq companies.

All this makes fraud and other corporate malfeasance much easier to commit on the Bulletin Board.

However, there are some larger, conservatively financed companies that have been around a long time and trade actively on the Bulletin Board. These include: Bresler & Reiner, Bulova, Monarch Cement, Erie Family Life and New Ulm Telecom.

The Pink Sheets

Finally, we come to the Pink Sheets, a dwelling place for companies that are not required to make SEC filings (usually because they have less than 300 shareholders) and are thus regulation-free.

There is often minimal disclosure, with some companies issuing nothing more than audited financial statements once a year.

Liquidity is often minimal, with some issues trading only a few shares

Useful OTC On-Line Resources

www.sec.gov
Access to 10-Ks, 10-Qs, 8-Ks, proxies, etc., of all SEC-filing companies.

www.nasdaq.com
Quotes, data and information on all Nasdaq-traded companies.

www.nasdaqnews.com
Market news, statistics, recent additions and deletions.

www.nasdaqtrader.com
Market news, Nasdaq indexes, broker-dealer information.

www.otcbb.com
Quotes, data and information on Bulletin Board–traded companies.

www.pinksheets.com
Quotes, data and information on Pink Sheet–traded companies.

www.otcquote.com
Semi-current Level II quotes on Pink Sheet issues for a monthly fee.

www.walkersmanual.com
Information on Bulletin Board, Pink Sheet and thinly traded issues.

www.stockpatrol.com
Alerts investors to potential fraud in penny stocks.

per month (or year).

The Pinks are strewn with the shares of near worthless issuers, such as bankrupt companies that are in reorganization or liquidation and have not made timely SEC filings. There's a lot of junk here, as well as the increased risk of fraud and malfeasance.

But there are also some very good companies trading here and their number is growing.

One of the consequences of the Sarbanes-Oxley Act of 2002 and tougher corporate disclosure laws is the choice by many companies to deregister their securities. Under the rules, any company that can show it has less than 300 "owners of record" can deregister, meaning it is no longer a "public company," is no longer required to make SEC filings and is exempt from regulatory oversight. Many small companies estimate the cost of complying with Sarbanes-Oxley—in terms of higher insurance, audit and legal fees—can easily exceed $1 million annually. Their shares now trade in the Pinks, but the savings can be significant.

Indeed, in 2003 about 718 companies deregistered—up from 675 in 2002.

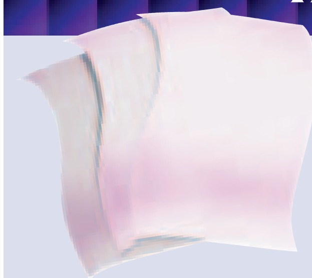
Many companies that deregister continue to make public earnings announcements, file annual and quarterly reports and hold annual shareholder meetings. When a company announces it is deregistering, the shares usually fall significantly, as investors run for the exits, not wishing to continue to own shares of a non-reporting company. Over time, though, the share price reflects the operating fundamentals as it does for listed or Nasdaq securities.

Some Pink Sheet issues with conservative balance sheets, long and generally profitable operating histories and limited analyst coverage include: Ash Grove Cement, Burnham Holdings, Central Steel & Wire, Goodheart-Wilcox and Lexcom.

Tips on Investing in the OTC Markets

1) Investigate before you invest. Since many OTC stocks have little if any analyst coverage, you will be doing much of the due diligence research yourself. Many firms have Web pages, which is a

The Pink Sheets



Although the name derives from the color of paper they were historically printed on, the "Pink Sheets" today is an electronic quotation system that displays quotes from broker-dealers for many over-the-counter (OTC) securities. Market makers and other brokers who buy and sell OTC securities can use the Pink Sheets to publish their bid and ask quotation prices. They are published by Pink Sheets LLC, a privately owned company. Pink Sheets LLC is not registered with the SEC in any way and it is not an NASD broker-dealer.

The Pink Sheets does not require companies whose securities are quoted upon its systems to meet any listing requirements. With the exception of a few foreign issuers, the companies quoted in the Pink Sheets tend to be closely held, extremely small and/or thinly traded. Most do not meet the minimum listing requirements for trading on a national securities exchange, such as the New York Stock Exchange or the Nasdaq stock market. And many of these companies do not file periodic reports or audited financial statements with the SEC, making it very difficult for investors to find reliable, unbiased information about them.

Nasdaq Listing Requirements

Nasdaq National Market companies must meet the following initial requirements:

- At least $15 million of shareholders' equity;
- At least $1 million income from continuing operations before income taxes in latest fiscal year or in two of the last three years;
- At least 1.1 million publicly held shares with a market value of $8 million or more;
- A minimum bid price of $5;
- At least three broker-dealers acting as market makers in the security; and
- At least 400 shareholders of record.

Nasdaq SmallCap issues must initially meet the following less stringent requirements:

- At least $5 million shareholder equity; or, at least $50 million of market value; or, at least $750,000 of net income from continuing operations in latest fiscal year or two of the last three fiscal years;
- At least 1 million publicly held shares with a market value of $5 million or more;
- A minimum bid price of $4;
- At least three broker-dealers acting as market makers in the security;
- At least 300 shareholders of record.

From the SEC: Micro-Cap Fraud

Information is the investor's best tool when it comes to wise investing. But accurate information about "micro-cap stocks"—low-priced stocks issued by the smallest of companies—may be difficult to find.

Many micro-cap stocks trade in the over-the-counter market and are quoted on OTC systems, such as the OTC Bulletin Board (OTCBB) or the Pink Sheets.

But many micro-cap companies do not file financial reports with the SEC, so it's hard for investors to get the facts about the company's management, products, services, and finances. And while many of the companies that don't file reports with the SEC are legitimate businesses with real products or services, the lack of reliable, readily available information about these kinds of companies can open the door to fraud.

Spreading False Information

Micro-cap fraud depends on spreading false information. Here's how this false information is often distributed:

- ***E-mail Spam:*** Fraudsters distribute junk E-mail or "spam" over the Internet to spread false information quickly and cheaply about a micro-cap company to thousands of potential investors. Spam allows the unscrupulous to target many more potential investors than cold calling or mass mailing.
- ***Internet Fraud:*** Fraudsters often use aliases on Internet bulletin boards and chat rooms to hide their identities and post messages urging investors to buy stock in micro-cap companies based on supposedly "inside" information about impending developments at the companies.
- ***Paid Promoters:*** Some micro-cap companies pay stock promoters to recommend or "tout" the micro-cap stock in supposedly independent and unbiased investment newsletters, research reports, or radio and television shows. Paid promoters are generally behind the unsolicited "junk" faxes you may receive that tout a micro-cap company. The federal securities laws require the newsletters to disclose who paid them, the amount, and the type of payment, but many fraudsters fail to do so and mislead investors into believing they are receiving independent advice.
- ***"Boiler Rooms" and Cold Calling:*** Dishonest brokers set up "boiler rooms" where a small army of high-pressure salespeople use banks of telephones to make cold calls to as many potential investors as possible. These strangers hound investors to buy "house stocks"—stocks that the firm buys or sells as a market maker or has in its inventory.
- ***Questionable Press Releases:*** Fraudsters often issue press releases that contain exaggerations or lies about the micro-cap company's sales, acquisitions, revenue projections, or new products or services. These fraudulent press releases are then disseminated through legitimate financial news portals on the Internet.

The Schemes

Micro-cap fraud schemes can take a variety of forms. However, the two most common are the classic "pump and dump" scheme, and the off-shore scam.

Pump and Dump

It's common to see messages posted on the Internet that urge readers to buy a stock quickly or to sell before the price goes down, or a telemarketer will call using the same sort of pitch. Often the promoters will claim to have "inside" information about an impending development or to use an "infallible" combination of economic and stock market data to pick stocks. In reality, they may be company insiders or paid promoters who stand to gain by selling their shares after the

good place to start. Order annual reports and proxies, and review SEC filings. Do the same for the competitors. Crunch the numbers. Identify why you think this company is a worthwhile investment. What are the opportunities and risks? Upside and downside?

2) If you are interested in a bank, thrift or insurance company, check the regulatory filings of federal and state banking and insurance departments.
3) Use limit orders where a large spread exists between the bid and offer. This may be especially true with inactive Bulletin Board and Pink Sheet issues.
4) If you are interested in inactive issues (where greater price inefficiencies may exist), obtain a copy

stock price is pumped up by the buying frenzy they create.

Once these fraudsters sell their shares and stop hyping the stock, the price typically falls, and investors lose their money.

The Off-Shore Scam

Under a rule known as "Regulation S," companies do not have to register stock they sell outside the United States to foreign or "off-shore" investors.

In the typical off-shore scam, an unscrupulous micro-cap company sells unregistered Reg S stock at a deep discount to fraudsters posing as foreign investors. These fraudsters then sell the stock to U.S. investors at inflated prices, pocketing huge profits that they share with the micro-cap company insiders. The flood of unregistered stock into the U.S. eventually causes the price to plummet, leaving unsuspecting U.S. investors with enormous losses.

Red Flags

To avoid micro-cap fraud, the SEC recommends that investors watch out for these "red flags":

- ***SEC Trading Suspensions:*** The SEC has the power to suspend trading in any stock for up to 10 days when it believes that information about the company is inaccurate or unreliable. Think twice before investing in a company that's been the subject of an SEC trading suspension. You'll find information about trading suspensions on the SEC's Web site at www.sec.gov.
- ***Assets Are Large But Revenues Are Small:*** Micro-cap companies sometimes assign high values on their financial statements to assets that have nothing to do with their business. Find out whether there's a valid explanation for low revenues, especially when the company claims to have large assets.
- ***Odd Items in the Footnotes to the Financial Statements:*** Many micro-cap fraud schemes involve unusual transactions among individuals connected to the company. These can be unusual loans or the exchange of questionable assets for company stock that may be discussed in the footnotes.
- ***Unusual Auditing Issues:*** Be wary when a company's auditors have refused to certify the company's financial statements or if they've stated that the company may not have enough money to continue operating. Also question any change of accountants.
- ***Insiders Own Large Amounts of the Stock:*** In many micro-cap fraud cases—especially "pump and dump" schemes—the company's officers and promoters own significant amounts of the stock. When one person or group controls most of the stock, they can more easily manipulate the stock's price at your expense. You can ask your broker or the company whether one person or group controls most of the company's stock, but if the company is the subject of a scam, you may not get an honest answer.

Additional red flags:

High Pressure Sales Tactics: Beware of brokers who pressure you to buy before you have a chance to think about and investigate the "opportunity." Dishonest brokers may try to tell you about a "once-in-a-lifetime" opportunity or one that's based on "inside" or "confidential" information. Don't fall for brokers who promise spectacular profits or "guaranteed" returns. These are the hallmarks of fraud.

No Written Information: Don't deal with brokers who refuse to provide you with written information about the investments they're promoting. Never tell a cold caller your social security number or numbers for your banking and securities accounts. And be extra wary if someone you don't know and trust recommends foreign investments.

of Walker's Manual of Unlisted Stocks (732/431-6614). Editor Andrew Berger sifts through thousands of companies and profiles 500 thinly traded issues.

5) Stick with companies that use reputable auditors, where standards are higher.

6) You should also check out the related article on these two pages on how to avoid micro-cap fraud in the OTC markets.

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