IMPACT OF THE PROPOSED NATIONAL MARKET SYSTEM ON SMALL AND MEDIUM-SIZE FIRMS

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Summary and Conclusions
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Chapter 1
Introduction

During the past five years, the government has exhibited considerable concern for the problems of small business. In the securities area, small business has had to rely primarily on equity for public financing and yet has only limited access to this area of the market. Accordingly, the Securities and Exchange Commission (SEC) has modified the rules which regulate small companies that seek to raise money from the public to ease the costs and constraints imposed on them.

The Regulatory Paradox

Despite this concern with facilitating the public financing capability of small business, when the broad spectrum of securities regulation policy is viewed, a paradox becomes apparent between the policies designed for big and small businesses. Thus the SEC has expended significant effort and resources to develop the national market system (NMS) which was mandated by Congress in the Securities Acts Amendments of 1975. This system, intended to enhance the pricing efficiency and liquidity of the constituent stocks, establishes admission standards, the effect of which is to permit the entry of only a small number of relatively large corporations. In contrast, securities regulation policy towards small business has focused almost entirely on the primary market.

Granted that the NMS is desirable "to reduce the cost of capital. . . and increase the likelihood that capital will be channeled to most productive uses," as one prominent market scholar has observed, for big companies, then is not such a system at least
equally desirable for the much larger number of small companies? 1

Or, if it is believed that the methods of trading stocks in the
NMS are inappropriate for smaller companies, are there not
alternative measures that could be taken by the government, the
securities industry, or both to improve the trading markets in
the securities of these companies and contribute to a reduction
in their cost of capital?

The OTC Lag

Historically, the attention given to the over-the-counter
(OTC) market, where the preponderance of small-company shares
are traded, has tended to lag behind that given to the listed
market. Such a lag is understandable in the period when the
initial securities acts were passed and the SEC was learning the
business. At that time relatively little was known about the OTC
market. The lag is no longer justifiable, however, since both
Congress and the SEC have gained considerable knowledge of and
insights into OTC trading practices.

The Significance of Liquidity

Liquidity is often the big factor in determining whether
or not a company can tap the primary market for equity to obtain
the capital that it needs to grow. Based on the current structure
of U. S. securities markets, the shares of small companies are
most likely to experience problems of liquidity. Indeed, in a
study conducted for the National Association of Securities
Dealers (NASD), the self-regulatory organization of the OTC
market, by Price, Waterhouse & Co., 153 out of 233 institutional
investors identified "lack of liquidity" as the "principal reason"
for not investing in the securities of companies with a capitalization
under $50 million. 2

ii.
The Approach of the Study

The current project was undertaken to gain a better understanding of this paradox, represented by the considerable attention given by government and industry officials to the trading markets of the securities of big companies, manifest in the efforts to develop the NMS, and the lack of attention for the trading markets of the securities of small companies. For this purpose, interviews were held with the participants in the equity markets of small companies. These participants included the executives of small companies that had sold securities, underwriters who handled the offerings, and the dealers who made secondary markets in them.

Chapter 2

Government Policy and Small Business Financing

The more rapid expansion of government regulation compared with economic growth has exerted particular pressures on small business. Accordingly, in the past five years, both Congress and the regulatory agencies have sought to ameliorate this condition by modifying the regulations on small business.

Congressional Action

Two major areas where Congress has acted to ease the financing problems of small business are taxation and pension-fund investment. The reduction of the capital gains tax, particularly, has encouraged the flow of capital to small companies. Amendments to the Employment Retirement Income Security Act of 1974 (ERISA) permit pension-fund dollars to enter the small business venture and capital markets without violating the "prudent man rule."
The Securities and Exchange Commission

In addition to relaxing the rules (described in the text of this report) for issuing securities in the primary market, the SEC has created an Office of Small Business Policy in the Division of Corporation Finance and has undertaken a joint study with the Small Business Administration (SBA) on first public offerings of corporate common stock. Thus far most of the measures of the SEC concerned with small business have been addressed to facilitate financing in the primary market. There is little in the horizon at present to suggest that this focus will change in the foreseeable future. Indeed, its action to reduce disclosure requirements for certain small companies, which probably will have a negative effect on the secondary markets of these companies' stocks, suggests that the Commission is more concerned with reporting burden than with the quality of the secondary market of these companies' stocks.

The Report of the SBA Task Force on Venture and Equity Capital

In 1975, the capital raising activity of small business fell to a trough. Alarmed by this situation, the SBA impanelled a special Task Force on Venture and Equity Capital for Small Business and appointed the former SEC Chairman, William J. Casey as its chairman. The Task Force made various recommendations, a number of which have been adopted. In his Congressional testimony, Chairman Casey emphasized the importance of liquidity in the secondary market and pointed to the limiting effect of a particular SEC rule governing the sale of restricted stock.

Eventually, the SEC modified their rule, one of the few instances where the Commission has taken action that could help the secondary market for small company stock. The general disregard of this market, however, creates a serious imbalance.
between government policies towards the secondary markets of big and small companies.

Chapter 3
Background and Characteristics of the OTC Market

The OTC market may be divided into two segments. In one, trading is done through the National Association of Securities Dealers' Automated Quotation (NASDAQ) System. In the other, the basis of trading is a compilation of quotations submitted by dealers that appears in sheets colored pink (accordingly, it is often described as the "pink-sheet" market).

The OTC's Heterogeneous Character

The OTC market embraces the largest number of publicly traded companies of any defined securities market in the U. S. It includes a substantial number of corporate, federal, state and local government debt securities. Some of the nation's primary industrial corporations have opted to remain in the OTC market but the typical company is significantly smaller.

The total scope and size of the OTC market are, in the words of one executive vice-president of a trading firm, "unknown quantities." There are 3,400 or so stocks included in the NASDAQ System. It is difficult to gauge the size of the non-NASDAQ sector because of the ease of entry and exit of the market makers and the lax method of trading and of reporting prices. An estimate of 25,000 stocks is commonly used. It is in the "pink-sheet" market that the great bulk of the securities of small companies are traded.
Role of the Market-Maker

Each OTC stock has, in effect, as many markets as it has market-makers willing to make two-sided quotations. Market-makers provide liquidity by standing ready to buy or sell a security.

Market-makers who specialize in small companies are likely to deal in a large number of different stocks. On the other hand, market-makers who concentrate on the stocks of relatively big companies usually are involved in much fewer issues. As a result, it is more difficult for the market-makers of the small companies to keep abreast of developments in or have any communication with the companies whose stocks they handle.

Like other businessmen, market-makers are interested in the money they earn. In general, the sponsorship they provide for corporate securities is predicated on the profit opportunities available in each security. When it ceases to be profitable to trade a stock, -- usually because of its inactivity, extreme volatility, or competition from other dealers -- market-makers tend to drop out of the market for that stock and seek more fertile outlets for committing their capital.

The NASD has issued rules to provide stability and structure to market-making for NASDAQ securities. No such effort has been undertaken for the "pink-sheet" market.

Development of the OTC Market

The heterogeneous, diffuse character of the OTC market makes it difficult to formulate and implement regulations which are simultaneously uniform, appropriate and fair to all the participants. This condition was particularly true in the pre-
NASDAQ era, and one vice-president of a securities firm told us, "It's hard to believe the Dark Ages were here only ten years ago".

With respect to the "pink-sheet" market, the reference to the "dark ages" is apt.

Chapter 4: The Linkage Between the OTC Market and the NMS

In striking contrast to their neglect of the OTC market when the Securities Exchange Act of 1934 was adopted and the relatively casual review during the several decades that followed, both Congress and the SEC revealed much concern with the OTC market in introducing the principle of an NMS. The SEC's 1972 Policy Statement, representing the government's first attempt to define the NMS refers "...to a system of communications by which various elements of the marketplace, be they exchanges or over-the-counter markets, are tied together." The House NMS report, issued shortly thereafter agreed with the concept of a system that would bring together the elements of both the exchange and OTC secondary markets. The Senate report, issued the following year, made reference to the "pink-sheet" as well as the NASDAQ sectors of the OTC market and asserted "...that all investors in publicly-held companies are entitled to the best market available given the characteristics of that particular stock."

The General Character of the OTC Securities to be Included in the NMS

During the early years of NMS development, despite their general interest in embracing the OTC market into the system neither the SEC nor Congress gave much attention to the specific standards for including OTC stocks. It was clear, however, that they both had in mind stocks that were actively traded and represented relatively big companies.
Thus, in describing the elements of the marketplace to be linked together in the NMS, the SEC refers to the OTC in terms of the third-market. This market comprises exchange-stocks traded over-the-counter, which tend to represent relatively big companies since the stocks must meet exchange listing standards. Continuing to reflect the notion that the NMS would include the stocks of big companies, the Commission issued a statement in January 1978, indicating that "...a number of equity securities currently traded exclusively in the over-the-counter market generally possess characteristics which justify their inclusion in the 'qualified' category." Limiting the NMS to the stocks of companies currently traded exclusively in the over-the-counter market that possessed qualifying characteristics meant that only a handful of the 28,000 or so OTC companies would be eligible for the NMS.

The position of Congress during the formative years of the NMS was much the same as that of the SEC. It was believed that the securities appropriate for inclusion in the NMS should be actively traded and represent relatively large companies.

The Move To Specific Standards

A year and a half after the January, 1978 statement on July 22, 1979, the SEC proposed Rule 11 Aa 2-1 which paved the way for specific standards. This rule provided for two quantitatively different sets of criteria to determine which stocks should be designated an NMS security, thereby creating a two-tier system. Under this system, securities which meet certain minimum standards (tier 1 securities) would automatically be included in the NMS; securities which meet a less restrictive set of standards (tier 2 securities), on the other hand, would be eligible for inclusion in the NMS, but the choice of whether or not to enter the system would be left, in part, to company management.
After obtaining the opinions of various interested parties including the NASD, the American Society of Corporate Secretaries, the stock exchanges, and the National Securities Traders Association (NSTA), the SEC, on February 17, 1981, adopted Rule 11 Aa 2-1. The two-tier designation approach was utilized because the Commission considered it to be the process by which the various legitimate diverse concerns that such a process raises could best be accommodated. The immediate result was the automatic designation of approximately 40 tier 1 stocks as NMS securities and the designation of some 450 additional tier 2 OTC stocks as "potential NMS securities." The Commission decided to leave the choice of the inclusion of potential NMS securities to the issuers, for the present, despite the fact that this decrease did not fully jibe with the congressional mandate, because of the experimental nature of the new secondary market. A subsequent modification would have the effect of increasing the number of tier 2 stocks to 1,450.

The specific criteria are listed below:

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<thead>
<tr>
<th>Criteria</th>
<th>Tier 1</th>
<th>Tier 2</th>
</tr>
</thead>
<tbody>
<tr>
<td>Net Tangible Assets</td>
<td>$3,000,000</td>
<td>$2,000,000</td>
</tr>
<tr>
<td>Capital and Surplus</td>
<td>$1,000,000</td>
<td>$1,000,000</td>
</tr>
<tr>
<td>Number of Shareholders of 100 Shares or More</td>
<td>1200 holders</td>
<td>400 holders</td>
</tr>
<tr>
<td>Size of Public Float</td>
<td>500,000 shares</td>
<td>250,000 shares</td>
</tr>
<tr>
<td>Market Value of Public Float</td>
<td>$5,000,000</td>
<td>$3,000,000</td>
</tr>
<tr>
<td>Minimum Price Per Share</td>
<td>$10</td>
<td>$5</td>
</tr>
<tr>
<td>Average Monthly Volume</td>
<td>600,000 shares</td>
<td>100,000 shares</td>
</tr>
<tr>
<td>Minimum Number of NASDAQ Market-Makers</td>
<td>4 dealers</td>
<td>4 dealers</td>
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The Commission decided that the most important criterion was national investor interest and so its average monthly volume requirement is the most restrictive. Based on these standards, a relatively small company with a very active trading market could
be included while a relatively large company with an inactive trading market would not be (there is likely, however, to be a relationship between the size of a company and the trading activity of its stock).

Other Areas of Linkage

In the process of linking the OTC market with the NMS, the SEC has retained certain traditional barriers between the stock-exchange and OTC markets.

The Competition Between Stock Exchanges and Non-Member Firms

The traditional barriers that stock exchanges have erected between member and non-member trading have been pierced by SEC Rule 19c-3, adopted in June 1980. On the date when Rule 19c-3 became effective, July 18, 1980, there were 87 Rule 19c-3 securities. As of March 1, 1982, there were 299 Rule 19c-3 securities. This rule exempts from all OTC-related exchange restrictions any stock listed after April 26, 1979, the date the Rule was originally proposed, or which is traded on an exchange on that date but fails to remain listed for any period of time thereafter. The thrust of this provision is that, with respect to the relatively small number of stocks involved, member firms may engage in principal transactions with non-members and may also arrange agency crosses within their own firms.

The rule has potentially important implications for the structure of the nation's securities markets. While it breaks down barriers between the stock-exchange and OTC markets, it applies only to stocks that meet exchange listing requirements. Moreover, the firms, within the scope of this exemption, are likely to have relatively active stocks. The rule, therefore, probably will not have much effect on the stocks of small companies.
The Integration of Stock Exchange and OTC Trading

Impelled by a mandated requirement for an NMS, the various stock exchanges have developed the Intermarket Trading System (ITS) which provides an electronic linkage among market centers. When originally established, the ITS did not include NASDAQ. Reflecting the headway made by the ITS in the upgrading of NASDAQ, the SEC, on April 21, 1981, announced that it would proceed with the implementation of an Automated Interface between the ITS and an enhanced NASDAQ system, a Computer Automated Execution System (CAES) with such capabilities as order-routing and automatic execution.

There are also 49 OTC stocks that were included on June 1, 1982 in a federally mandated system of disclosing last sale and high and low prices. Despite these measures, the SEC has not manifest a current inclination to increase participation in the NMS and market linkage facilities beyond those provided by the indicated eligibility standards. Officials of the Commission, nevertheless, recognize that the capability to expand significantly the number of securities which can participate exists and will be in place.

"The Forgotten Stocks"

The foregoing SEC actions have the potential of revolutionizing the nation's secondary markets. After great expenditure of time and effort, the SEC has made definitive progress in achieving a key objective of the 1975 Amendments - the modernization of the secondary markets and providing for a linkage between auction and dealer markets.
Nevertheless, the proportion of OTC companies eligible to participate in the NMS is relatively small, probably no more than 1,500 out of some 28,000. Thus, the great bulk of OTC stocks will remain outside the NMS and even an expanded NASDAQ. These are "the forgotten stocks" that represent most of the country's small businesses. Many of these companies are sound enterprises that would benefit considerably by the availability of a public-financing route. This availability would be enhanced by an effective secondary market for their shares. It is to the method whereby most of these stocks are traded that we now turn our attention.

Chapter 5: The "Pink-Sheet" OTC Market

Trading in the great bulk of the nation's stocks, representing primarily small companies, is conducted in the non-NASDAQ sector of the OTC market through a cumbersome process that has remained essentially unchanged for the past 50 years. The basis of this trading is a package of sheets that show the dealers making a market in each stock and their current quotations. As stated previously, it is customary to apply the designation "pink-sheet" market to this non-NASDAQ sector of the OTC market.

These sheets are published each trading day by the National Quotation Bureau, a wholly-owned subsidiary of Commerce Clearing House, Inc. Until NASDAQ was established in 1971, the pink sheets constituted the sole publicly available mechanism for conducting transactions in the entire OTC market. Since 1971, they have continued to serve the same function for the non-NASDAQ OTC stocks.

The Trading Environment

The current method of trading in the "pink-sheet" market was developed prior to the advent of automation. Accordingly, it
is an archaic market that relies on old-fashioned procedures.

An investor who desires to buy or sell a non-NASDAQ stock will approach his or her broker-dealer, who must rely upon the "pink-sheets" for quotation information. The broker-dealer will check the sheets, ascertain the range of quotations and the sponsoring market-makers. Presumably, the customer's broker-dealer will then call several of these market-makers to verify the quotations, the amounts of stock available for purchase or sale, and negotiate a price. This method of trading has serious shortcomings including: prices may be fictitious; the market is illiquid; and thus trading is time-consuming one-sided and work-out markets are common; and transaction price or volume data are largely unavailable.

The Nature of the Market

During 1980, the National Quotation Bureau estimated that about 16,000 stocks had been quoted in the sheets, although some of these might have appeared for only a few days during the year. As mentioned previously, higher estimates have been made for the total non-NASDAQ sector.

There are a great variety of stocks traded ranging from those representing essentially "shell" companies to those of financially strong enterprises with good growth prospects. The manager of an equity fund specializing in small companies indicated to us that prices in the "pink-sheet" market often do not measure underlying values. It is appropriate to ask why this situation exists, especially at a time when many securities market theoreticians embrace the concept of an efficient market, where, it is contended, prices reflect the information available about a company's stock at any given moment. In part, the explanation lies in the belief of company management and the market-makers in their stocks that
they can exploit the inefficiencies of "pink-sheet" trading to their own advantage.

**Investor Protection and Market Surveillance**

While the gap in efficiency between the trading methods in NASDAQ and "pink-sheet" stocks is wide, the gap in self-regulatory surveillance is just as wide. The NASD has largely overlooked the "pink-sheet" area. Investors, therefore, approach these stocks gingerly, not simply because of the limited disclosure, but also because of the limited amount of regulatory supervision. This attitude, in turn, impairs liquidity and makes it more difficult for these small companies to obtain public financing.

At the present time, the new NASDAQ machine, built by the Harris Corporation, is being installed in trading rooms around the country. This machine, with increased capacity, greatly strengthens the potential of NASDAQ. Several dealers we interviewed suggested that the resulting enhanced capacity could be utilized by including "pink-sheet" stocks with two or more market-makers willing to make a two-sided market in them. Such an expansion of NASDAQ would, of course, facilitate surveillance of the added securities.

**Chapter 6: The Interview Approach and the Sample**

The basic source of information in the study was the interview. Two types were conducted. The first was held with the executives of small publicly-held companies. This provided the data base used in the analysis. The second was with dealers of stocks and investment bankers which provided insights into important issues but did not lend itself to statistical summarization.

The company interviews, conducted over a seven-month period,
from March through September, 1980, covered 70 companies in Connecticut, New York and New Jersey. The project's budget did not permit a national survey. Sixty-five of these interviews are included in the statistical analysis. The remaining five were deemed inappropriate because the responses were not meaningful or the companies had either gone private or were in the process of doing so.

The interviews sought three types of information. One was factual concerning the companies and the trading markets for their stocks. Another was attitudinal - specifically, the opinions of the company executives and securities dealers about the present and future structure of the trading market in the companies' stocks. The third type of information sought dealt with actual company experience in going public and raising capital.

The Character of the Sample

No precise standard of size was employed. Since all the companies in the sample had to be public and the securities markets are generally not receptive to offerings of marginal enterprises, the companies in our sample are established economic entities. Still, they are small relative to other public companies.

The bulk of the sample, or 75%, is composed of companies with total revenues under $20 million. When assets, rather than sales, are used as the measuring standard, the distribution range is narrower; 90% of the 65 companies had assets under $20 million.

While the sample includes a number of different industries, all the companies, reflecting their generally small size, either provide services or are engaged in light industry. Companies of this type tend to have much lower asset sales ratios than those
in heavy industry. This differentiation, to a large extent, probably explains the narrower asset rather than sales distribution of the companies in our sample.

Most of the companies were relatively young; about two-thirds were started within the past 20 years. Moreover, many were still managed by their founders.

Chapter 7: Analysis of the Interviews

In this chapter, the results of the interviews, which are summarized in tabular form in Appendix B, are analyzed:

A Basic Question: Why the Lack of Interest in the Secondary Markets of Small Companies

It is understandable that the concern with the secondary markets should initially focus on the stocks of a small group of large companies. It is odd, however, that it has taken so long for this concern about the secondary markets to extend to the stocks of small companies. Presumably, if improved secondary markets are helpful to large companies and their shareholders, they should also be helpful to small companies and their shareholders.

A Partial Explanation: Management Attitudes Towards the Market-Making Function

Our analysis indicates that the management of small companies tend to be immersed in day-to-day operational problems. They are likely to be more concerned about their ownership and control position in the company than the status of the investor in their stock. The market-maker, in turn, who has an affinity for the status quo and an instinctive aversion to change, is likely to avoid stocks in which he does not see immediate profit opportunities. Accordingly, it is unlikely that either the managements of small companies or the market-makers of their securities will take the initiative in developing a better secondary market for these securities.

xvi.
We explored this area further by examining how the attitudes of management and the market-maker might be affected by the characteristics of the particular stocks and their trading markets.

**The Influence of Liquidity**

Liquidity is obviously an important characteristic. It affects both a stock's value and the company's ability to raise capital by selling securities. An important determinant of liquidity is the number of shares in the hands of the public.

The companies in our sample had relatively modest public floats; in 41 out of 65 cases, or 63.1%, the public had less than 600,000 shares. Moreover, many of the companies were still being run by their founders or the founders' families, often like a personal fiefdom. This concentration of control and much of ownership contributed to dampen management's interest in the trading market of their stocks. Overall, 41% of the responding companies expressed indifference to the performance of their market-makers. Some even confessed to apathy.*

Still the public was involved, holding 40% or more of the outstanding shares in 39, or 60%, of the companies. And the degree of public participation did have an effect on management's attitude. For example, 12 of the 18 companies that expressed satisfaction

*The final report of the joint SEC/SBA study of initial public offerings (IPO) of common stock, released in August 1981, shows that 65% of 85 IPO issuers responding to a survey rated their markets "excellent" or "good". This outcome is different from that indicated in our study, where, as stated in the text above, 41% of the managements expressed indifference concerning the performance of their market makers and only 30% were "very satisfied" or "somewhat satisfied." This difference could be accounted for, at least in part, by differences in the composition of the samples used in the two studies. For example, as indicated in the text, when we refine our sample to include only companies that had stocks with public floats over 600,000 shares, 67% of the respondents expressed satisfaction with the performance of the market-makers, a figure that is in line with the SEC/SBA results. Our tabulations were recorded by the interviewer as a result of a personal interrogation, which permitted the reference to "apathy" mentioned in the text. The SEC/SBA tabulations were based on responses to distributed questionnaires.

xvii.
with the performance of their market-makers, or 66.7%, had a public float over 600,000 shares. Conversely, 14 of the 18 companies that expressed dissatisfaction with the performance of their market-makers, or 77.8%, had a public float of 600,000 shares or less. This tendency for managements' attitudes to their market-makers to be influenced by the degree of public participation was confirmed by other quantitative relationships.

The picture that emerges is one where there is simultaneously a significant degree of insider control and a substantial public ownership of the stocks of small public companies. This situation creates difficulties for both insiders and public stockholders. The public often suffers from the inability of company management to reconcile multiple, conflicting objectives. It also suffers from the inability of the companies and their market-makers to communicate with each other. At the same time, management is constantly compelled to take into consideration the implications of being public whenever they make decisions. Many respondents thought their companies incurred all the costs of being public without gaining any of the benefits.

The Influence of Market-Price Action

Another factor that influenced management's attitude towards its market-makers was the actual price action of the stock. To gauge market-price action, we used as a measure the relationship between market value of a company's total outstanding common stock divided by its book value. Only 16 of the 51 companies for which the data were available expressed satisfaction with their market-makers' performance. Nine of these 16 companies (56%), however, had stock with a market value which was greater than its book value.
Conversely, 14 of the 51 companies expressed dissatisfaction with their market-makers and nine of these 14 (64%) had stock prices which were below their book value.

It would be a mistake to conclude from this analysis that company executives hold their market-makers responsible for the price of their stock. Yet, their attitude towards their market-makers is, in part, a reflection of their attitude towards their market and it is easier for a company whose stock is priced above net worth to be satisfied with its market than it is for a company whose stock is priced below its net worth. This issue can be more fully understood if it is examined from the perspective of the market-maker.

Many market-makers we interviewed thought activity was a function of investors' perception of value and that the more valuable a company was considered, the more likely it was that the company's stock would have an active market and thus attract the interest of the trading community. A comparison of the number of market-makers in a company's stock with its market value/book value ratio supported this hypothesis. Fourteen of the 19 companies in the analysis (74%) with market values greater than their book values had five or more market-makers. In contrast, 20 of the 32 companies with market values below book values (63%) had four or fewer market-makers. This relationship was confirmed by other quantitative checks. In effect, the market-makers are followers rather than leaders, tending to show interest in the stocks of companies in which there is active investor interest rather than in those companies which do not have an investor following.
The Inefficiency of the Secondary Markets of the Stocks of Small Companies

It is widely held that the U.S. securities markets are efficient. The Efficient Market Hypothesis holds that stock prices are usually in equilibrium because they have taken into account all the available information which affects the companies' outlooks. Such markets are considered fair because all investors, with the exception of insiders, have equal access to the same information. In these markets, where prices reflect appropriate underlying values, capital flows to the companies with the most promising futures. As a result, a nation's financial resources are efficiently allocated thereby contributing to healthy economic growth.

These conditions do not exist for the bulk of the stocks of small companies. As described previously, these stocks are traded through the "pink-sheets" which, in the words of one high-technology company president, represent "an archaic, antiquated and ridiculous method given today's technological capabilities." Moreover, in many cases, it is questionable if there is sufficient information on which to base rational decisions, an indispensable requirement for market efficiency. This paucity of adequate securities research available on smaller corporations was confirmed by means of various statistics in the SEC/SBA study of initial offerings of common stock. In view of the importance of information for investors, the decision of the SEC to exempt a class of smaller issuers from the registration and reporting requirements of the Securities Exchange Act suggests that it is more concerned about reporting pressures on small companies than the quality of the secondary market in their stocks.
Certain strategic steps taken by various securities firms indicate that they are aware of the inefficiencies in the markets of small public companies and believe that these inefficiencies can be profitably exploited. Eventually, such actions will lead to more research on and better analysis of the stocks of small companies which should help improve the market for these stocks. While enhanced research is a step in the right direction, it cannot compensate for the archaic structure of the secondary markets in "pink-sheet" securities, where transactions are hindered by use of cumbersome, time-worn methods.

To the extent that the stocks of small, publicly-held companies are traded in inefficient markets, a handicap is placed on investors who cannot readily buy and sell these stocks; on the companies, which are limited in their financing opportunities; and on the national economy which does not receive the benefit of effective allocation of its financial resources.

The Relationship of the Secondary Markets to the Primary Markets

Throughout the interviews, managements were asked about the effect of the secondary market on their companies' ability to raise money in the primary market. The reactions varied.

Some companies did not give consideration to the primary market, because they either sought financial self-sufficiency or relied principally upon banks. Others preferred to avoid the primary market for such reasons as reluctance to dilute ownership, the increased possibility of a takeover by a larger corporation, or apprehension of depressing their stock's price. Still others recognized the importance of the secondary market but felt that their stock was too inactive and illiquid for an offering to be feasible, or its price was too low for one to be desirable. On
the other hand, various companies in the sample confirmed the observations made by executives in the securities industry, who stressed the importance of liquidity and noted that the larger public float and stronger balance sheet, which follows from a new public offering, would help produce this liquidity.

While the companies' responses indicated some awareness of the interdependence between the primary and secondary markets, their general lack of sophistication with regard to the whole spectrum of alternative financial instruments was apparent. This lack of sophistication on the part of most respondents was highlighted by the creativity of the few who were successful in obtaining financing from both the primary market and other sources. A pointed observation came from an executive who had done a successful offering. He commented, "After we did the primary two years ago, our stock became more liquid, our stock price rose and suddenly a broad range of financial options became available to us."

The NMS and Small Public Companies

Our interviews were largely conducted prior to the adoption of the final SEC Rule for admitting stocks to the NMS and therefore they relate to the original proposal. We do not believe, however, that this difference is significant since our interest was in principles rather than in specific standards.

The management of only 38, or 59%, of the 65 companies in our sample had heard of the NMS, and therefore it was necessary to explain the system. Subsequently, the managements were asked if they agreed with the principle of the SEC and members of the securities industry determining which securities are qualified for inclusion. Twenty-four of the 65 respondents (37%) indicated concurrence with this principle.

xxii.
and seven (11%) expressed no opinion.

The majority (52%) disagreed primarily because they thought the business community should have more and the SEC less voice. Some of the respondents questioned whether there should be any selection process at all, suggesting that the NMS should be open to any OTC company that wanted to be included and was willing to comply with the system's regulations and pay costs.

Overall, the majority of respondents thought that inclusion in the NMS would provide a positive incentive to the market-makers in their stocks and would improve the quality of the markets. In general, it was felt that the resulting greater liquidity, exposure and prestige of their stock would make investors more eager to buy it and this benefit would more than offset the effects of increased competition on their market-makers. Only eight respondents (13%) gave more weight to the possibility that greater competition would make trading less profitable and therefore lead to a fall-off in market-maker sponsorship.

Of particular interest was the responses of the OTC-NASDAQ companies whose stocks were ineligible for the NMS, thirty-five, or 86%, said that inclusion would improve their market. These companies had experienced the transition from the "pink-sheets" to NASDAQ, and thought it was, in the words of one respondent, "a miracle compared to what we had before." To many of these respondents, the concept of the NMS appeared to be a natural evolution from the NASDAQ system, and having experienced the benefits of NASDAQ, they instinctively wanted to be able to participate in further advances in market structure.

xxiii.
In response to the query about how inclusion in the NMS would affect their ability to raise capital from the public, 48 of the 64 responding companies (75%) thought it would be easier. The main reason advanced for this opinion was that underwriters would experience less difficulty in distributing their stock to the public because of the prestige associated with the NMS; also, the modernized electronic facilities of the system would facilitate handling a sudden rise in volume that might follow an increase in the public float.

On the same point but from a somewhat different point of view, the respondents were asked what effect they thought exclusion from the NMS would have on their ability to sell stock in the primary market. Thirty-six of the 61 responding companies (59%) thought it would be more difficult to raise money from the public, while 20 (33%) thought it would have no influence. Most of the 36 respondents who thought that exclusion would impair their ability to raise capital said that their new offering would be stigmatized because of exclusion and its liquidity would be hampered. The 20 respondents who thought exclusion would have no effect on their capital-raising ability claimed the key determinants of an offering's success were the timing, the underwriter and the company's past history.

An almost overwhelming reaction came to the question of what management could do if it had the choice of entering the NMS. Fifty-two of the 65 executives (80%) said they would accept. An additional 8 (15%) explained an uncertain response by stating they would place the issue before the companies' boards of directors for consideration. Only five respondents (8%) gave a negative answer.
Most of those who stated they would enter the NMS indicated greater exposure and stock liquidity as the reasons for their decision. They also cited the enhanced prestige that would be achieved. The small minority of executives who said they would not enter the NMS were more concerned about the additional regulations and expenses that might be incurred than they were encouraged by possible market benefits.

Chapter 8: Possible Courses of Action

The progress made in the OTC-NASDAQ and NMS secondary markets, embracing only a small percentage of the country's publicly traded stocks, is in stark contrast to the lack of movement in the rest of the OTC market, where most of the stocks of small companies are traded. The reasons for taking action to improve the non-NASDAQ OTC market are compelling. The technological backwardness and inefficiency of this market ultimately impair the allocation of the nation's financial resources. Modernization could have particularly positive results in view of the primitive condition of this sector of the nation's securities markets and the related illiquidity of many of its stocks. The absence of a centralized interface leads to fragmentation which discourages market-makers from supplying liquidity and investors from purchasing the stocks of the companies which are traded in it. The extremely positive attitude displayed by the corporate executives in our sample towards entering the NMS if they had the choice represented not so much an interest to become part of the NMS, in particular, but rather a general desire to obtain improved trading markets for their stocks.
The Alternative Routes

Accordingly, in our judgment, it is imperative that a program be launched now to modernize the non-NASDAQ sector of the OTC market. The SEC's relaxation of the original standards to permit the inclusion of additional OTC stocks still covers only a small fraction of all OTC stocks. Therefore, with respect to that large overlooked segment, it is a "do nothing" policy which merely continues the absence of progress that has characterized the market for these companies' stocks for the past 50 years.

The First Steps

The development of two major ongoing programs affords a useful learning experience. Efforts to automate the over-the-counter market were started by the SEC when, in the early 1960's, its Special Study invited private industry to submit proposals towards that end. Some ten years later, under the continuing guidance of the NASD, automation of the active portion of the OTC market finally emerged in the form of NASDAQ. The idea for the NMS also emanated from the SEC, in 1971, as an outcome of its Institutional Investor Study. The elements of that system are still being put into place some ten years later. This experience leads to two important conclusions. One is that the SEC can be an effective initiating agency, but is not likely to undertake the technical job of implementation. The other conclusion is that even after a program is initiated, a long time will be required for implementation because of the primitive state and huge size of the non-NASDAQ sector of the OTC market.

Accordingly, it is urgent to start now. For this purpose, it seems reasonable for the SEC, as the top regulator in the area, to form a committee composed of representatives from the government, small business, and the securities industry. The xxvi.
purpose of the committee would be to determine how best to tackle the problem, devise a program that defines the scope of possible actions, and obtain the participants. Thus, the committee would provide the triggering action. Actual implementation would be left to private industry.

Introduction of a suitable operating structure into the huge non-NASDAQ sector of the OTC market could generate considerable trading activity. The resulting profit potential is likely to attract competitive interest on the part of private industry. The NASD, as the self-regulatory agency for the OTC market might have monitoring responsibility to guide actual implementation by private industry. As in the case of NASDAQ and the NMS, the actual elements of the new system to provide an effective secondary market for the stocks of small firms could be modified as deemed necessary as implementation experience is gained.
The Text
Chapter 1: Introduction

Over the past five years, the government has exhibited considerable concern for the problems of small business. This concern has been prompted by several factors. They include the effect of stagflation on small business; recognition of the contribution which small companies have made towards the achievement of many vital national goals, such as job creation and technological innovation; and the simultaneous discovery by the government that many of its policies have been discriminatory towards these companies. The Congress and the various departments and agencies of the federal government have undertaken reviews of their policies towards small business in such areas as regulation, taxation, innovation and financing. Some of these reviews have culminated in actual legislation. For example, the Small Business Impact of 1979 requires regulatory agencies of the government to consider the effect of proposed regulations on small business before adoption. Another measure, the Regulatory Flexibility Act of 1980, directs the agencies to relax, for small business, regulations which were designed for application to big corporations but have been applied uniformly to all businesses.

Small Business Financing and the Capital Markets

Big business has been able to employ different forms of short and long-term debt instruments, as well as equity, to raise capital. Although small business has at times made extensive use of public capital markets, it has characteristically done so by means of equity. For debt financing, small business usually must go to private sources, such as banks and insurance companies.
In general, business firms have issued much more debt than equity in the public markets. Thus, between 1971 and 1980, approximately $379.4 billion of underwritten securities were issued to the public. Of this total, bonds accounted for about $275.7 billion, or 72.7%. Common stock, on the other hand, accounted for only $80.1 billion, or 21.1%, while preferred stock offerings totaled $23.6 billion, or 6.2%. While this trend away from equity and towards debt raises serious questions about the overall capital structure of the nation's corporations, it has special implications for the financing of small business.

According to the President's first annual report on the state of small business and competition, small business (those employing less than 500 persons) produce 38% of the nation's gross national product. Yet, as indicated in the prior data, small business has had access to an equity market which comprised only 21% of the nation's public financing over the past ten years. This limited availability of equity capital for small business has contributed to the formulation of governmental policies intended to ease the public financing burden of small business. The numerous changes alleviating regulatory costs and constraints in the Securities and Exchange Commission (SEC) rules governing small companies that seek to raise money from the public illustrate this intention.

The Regulatory Paradox

Despite this concern with facilitating the public financing capability of small companies, when the broad spectrum of securities regulation policy is viewed, a dichotomy becomes apparent between policies towards big and small business. The SEC has expended
significant effort and resources to develop the National Market System (NMS) which was mandated by Congress in the Securities Acts Amendments of 1975. (The development of the NMS is discussed in appendix A.) The component facilities which will comprise the NMS, a significant portion of which are already in place, are intended to enhance the trading efficiency and improve the liquidity of the stocks that will be included in the system. The standards that the Commission has adopted for eligibility in the NMS are described in Chapter 4. These criteria, as modified, would be met by approximately 1,500 of the 28,000 Over-The-Counter (OTC) stocks traded in the U.S. Accordingly, the focus of securities regulation policy towards big business has been to improve the trading mechanism of the markets in these securities.

In contrast, securities regulation policy towards small business has focused almost entirely on the primary market. The SEC has established an Office of Small Business Policy and has energetically effected changes in policy designed to reduce the burden of regulation on small companies which seek to raise money from the public. The Commission has modified existing rules, developed simplified registration forms, and created new exemptions with the purpose of increasing the accessibility of the nation's primary markets to these companies. (These changes are discussed in greater detail in Chapter 2).

Various conditions have contributed to this regulatory paradox, represented by the contrasting policies of government towards big business and small business in the securities markets. The stage
for the concentration of policy towards small business on the primary market was set in the mid-1970's when it became virtually impossible for a small company to raise money from the public. Pressure was added by the rapidly escalating cost of regulatory compliance associated with small new offerings.

Simultaneously, a major reason that policy towards big business focused on the secondary markets and helped create the impetus for the NMS was concern with the efficiency of those markets. Indeed, one well-known scholar, Professor James Lorie, described them as being "in disarray". Stating the rationale for the NMS, Lorie wrote "The overriding objective of public policy is to make our capital markets function more equitably and efficiently so as to reduce the cost of capital for American enterprise and increase the likelihood that capital will be channeled into its most productive uses." 3

While these factors help explain, they do not justify the paradox in securities regulation policy. If the government thinks that the NMS is desirable "to reduce the cost of capital ... and increase the likelihood that capital would be channeled into its most productive uses," then why limit the system to large enterprises, which is the outcome of present policies. If such a system is desirable for big companies, is it not at least equally desirable for small companies? Indeed, if the trading markets of New York Stock Exchange (NYSE) companies were "in disarray" in 1973-74, as Professor Lorie put it, such a characterization would have significantly understated the condition of the trading markets of many OTC stocks for which there was suddenly no market whatsoever.
Or, if it is believed that the methods of trading stocks in the
IS are inappropriate for smaller companies, are there not alternative
measures that could be taken by the government, or the securities
industry, or both, to improve the trading markets in the securities
of these companies and contribute to a reduction in their cost of
capital? Despite the attention that has been riveted on the
problems of small business, such issues have been neglected.

The OTC Lag

Historically, the attention given to the OTC market, where
the preponderance of small-company shares are traded, has tended
to lag behind that given to the listed market. For example, the
Securities Exchange Act of 1934, which is addressed to the trading
markets of the national exchanges, overlooked the OTC market.
It was not recognized until 1938 when Congress passed the Maloney Act and the
National Association of Securities Dealers (NASD) was created and
given the power and authority to control OTC trading practices.
Establishment, in 1971, of the National Association of Securities
Dealers Automated Quotation System (NASDAQ), which for the first
time gave formal structure to trading in some OTC securities, only
came after initial investigations of the SEC Special Study of
Securities Markets in the early 1960's.

This historical lag is understandable in light of the lack
of awareness about the OTC market when the initial Securities Acts
were passed and during the early years of the SEC's development.
At the present time, however, both Congress and the SEC have
achieved considerable sophistication with regard to trading practices and
have gained valuable insights into them. The NASD is an effective
and well-recognized regulatory body. Accordingly, there is little
justification for continuing the historical lag in the attention
given to the OTC market.

The Significance of Liquidity

A major aspect of efficiently functioning capital markets
is the liquidity of the securities traded. While the term may be
described in different ways, a common definition is the cost of
buying or selling a security "in a hurry." This attribute is a
function of many factors, including: 1) the activity of the
particular security and the market as a whole; 2) the supply of
that security, normally measured as the number of shares outstanding
in the hands of the public as opposed to insiders such as officers
and directors (i.e. the public float); 3) the demand for the security,
possibly expressed as the investor's estimate of the company's
future outlook; 4) the volatility of the security in relation to
other securities. Of particular importance are the public float
and activity. Because these characteristics tend to be less
favorable for small than for big companies, the securities of the
smaller companies tend to be less liquid and possess bid/asked spreads which
tend to be larger as a percentage of the securities' total price.

Liquidity is often a key factor in determining whether or
not a company can go to the equity market and find the capital that
it needs to grow. In other words, a company desiring to do an
equity offering must either have a trading market already in place
which is relatively orderly and active or it must have investment
bankers who think they can create one. Yet, the securities of
small companies are most likely to experience problems of illiquidity.
Indeed, in a survey conducted for the NASD by Price, Waterhouse & Co.,
153 out of 223 institutional investors (68.6%) identified "lack
of liquidity" as the "principal reason" they did not invest in
the securities of companies with a capitalization of under $50
million.

The Purpose and Methodology of the Study

This project was undertaken to gain a better understanding
of this paradox represented by the considerable attention being
given by government officials to the trading markets of the
securities of big companies, manifest in the efforts to develop
an NMS, and the virtual lack of consideration to the trading
markets of the securities of small companies. To gain such an
understanding, interviews were held with the participants in
the equity markets of small companies. These participants included
the executives of small companies that had sold securities,
underwriters who handled the offerings, and the market-makers in
the secondary market. The great bulk of companies in our sample
had annual revenues which fell within a range of $5 million to
$25 million.

The OTC market is where the vast majority of small publicly-
held companies are traded. While the list of American Stock
Exchange includes some of the larger small companies in the nation,
the OTC market is the place where well over 90% of the nation's
small publicly-held businesses are located. As a result, the
sample was composed almost completely of OTC companies, though
a few American Stock Exchange listed companies were included to
obtain balance and perspective.

The methodology employed in the study and the characteristics
of the sample companies are discussed in greater detail in Chapter 6.
Initially, however, we examine some background issues.
Chapter 2: Government Policy and Small Business Financing

Despite the lags in economic growth in the past ten years, government regulations have increased at exponential rates. To some extent, big business has been able to modify the effect of this regulatory expansion by developing economics of scale in regulation compliance. Small business, on the other hand, lacks the resources to exploit these economies. Investment bankers estimate that the cost of a small primary offering in the late 1970's was almost double the cost of a similar offering ten years before. While part of this increase is attributable to factors which are exogenous to government policy, such as rising legal and accounting fees, some of it can only be explained by the growth in the amount of information required with such an offering.

Accordingly, in the past five years, many branches of the U. S. government have devoted their attention to the problems of small businesses that seek to raise capital from the public. These endeavors have led to the implementation of policies of deregulation and reregulation which have been achieved through the creation of special exemptions and new rules designed to alleviate the burden of the numerous federal regulations and laws which govern the capital-raising process for small companies.

This trend in government policy has been motivated by a concern about the capital shortage for small business and a desire by the government to redress this problem. Several factors have coalesced to explain this trend in policy. The continuing economic phenomenon of "stagflation" has placed tight financial constraints on all companies, but these constraints have had a particularly severe effect on small companies which lack access to the myriad long and
short-term debt instruments that big corporations have at their disposal, such as international bond issues and commercial paper.

Another factor has been the increased activity of small business trade associations. These associations have become increasingly well-organized and have presented the Congress with numerous studies which have graphically detailed the pre-eminent role played by small companies in the achievement of national goals, such as job creation and technological innovation. These studies also demonstrated the fact that many federal laws and regulations benefit large corporations disproportionately. Thus, Congress and the regulatory agencies have sought ways to compensate small business by means of exemptions from and amendments to existing regulations.

The Report of the SBA Task Force on Venture and Equity Capital

In 1975, the capital-raising activity of small business fell to a trough. During that year, there were only four firm underwritings for companies with a net worth of under $5 million and only 24 initial public offerings. Alarmed by this situation, the Small Business Administration (SBA) impaneled a Special Task Force on Venture and Equity Capital for Small Business and appointed the former SEC Chairman, William J. Casey, as its chairman. The Task Force, composed of small businessmen, commercial and investment bankers, institutional investors and venture capitalists, made use of information and advice supplied by officials of the SBA, the SEC, the Internal Revenue Service (IRS) and the Treasury Department.
Summarizing the findings of the Task Force's Report, Chairman Casey told the House Committee on Small Business that this "stagnation in small business financing arises from a set of general conditions which have developed in the American economy and from specific impediments which can be discerned in our tax structure, in the restrictions on the pension funds which have been imposed by the ERISA statute, and in SEC regulations governing the issuance and resale of securities." Among the general conditions Casey listed were the tendency of public policy to encourage consumption at the expense of savings and investment, the trend towards debt financing and away from equity financing, well-intentioned attempts to protect investors which "inadvertently place small companies at a disadvantage in competing for available funds," and the contraction in the securities industry which reduces the network of institutions which are able to mobilize capital.

The Task Force also made several specific recommendations. They included: a deferral of taxes on capital gains derived from the sale of the stock of small companies provided that those gains were reinvested in other small businesses (similar to the principle applied to gains derived from the sale of a house); amendment of ERISA legislation to allow pension-funds, within the "prudent man rule," to invest a portion of their assets in small companies; and allowance of greater flexibility to small business in writing off the first $200,000 in depreciable assets to increase their internal financial capabilities.

In his congressional testimony, Chairman Casey emphasized the importance of liquidity in the secondary markets and commented that the limitations "that the SEC has developed on the secondary sale of securities are probably more damaging to small business
financing in the public securities markets than the high cost of registration and the near disappearance of the private offering exemption. If the kind of risk money that goes into growing businesses cannot be readily recycled, it is usually not invested...this (lack of liquidity) leads to the liquidation of investments through takeovers by large corporations instead of by sales in the public securities markets."4

Casey noted that Rule 144, which governs restricted securities owned by officers and directors, was particularly inhibitive of liquidity and that this liquidity in the secondary markets was often a primary cause of inactivity in the primary market and others types of venture capital investing. This, in turn, reduced competition and promoted concentration. Furthermore, the quantitative limitations on the number of shares which can be sold in any six-month period often produced consequences, such as illiquidity, which proved to be contrary to the principle that the limitation was intended to advance, in this case, investor protection. Rule 144 compelled venture capital managers to become more risk averse because the "restricted pace at which they were able to liquidate their investments contributes, substantially to the trend to stay away from young companies and to restrict venture capital to companies who have matured or seem to be on the verge of maturing." Interestingly enough, despite this justifiable concern with liquidity in the secondary market, Casey gave little attention to the illiquidity caused by the inadequate trading structure of the market where the bulk of the stocks of small companies are traded.
The Task Force's Report became a catalyst of government action in many areas affecting small business, especially the primary market. Some of the suggestions contained in the report were enacted into law. Other suggestions were heeded by regulatory agencies, notably the SEC, and resulted in amendments to certain existing rules (including Rule 144) and in the relaxation of specific regulations. Still other suggestions are being debated by the parties involved. In general, the work of the Task Force was significant because it identified many of the problems surrounding small business financing and led to efforts at redressing these problems by government deregulation and re-regulation. Nevertheless, the report's reference to liquidity stopped at Rule 144 and did not address the trading markets which, for many small companies, are actually archaic.

Congressional Action

Two major areas where Congress has acted to ease the financing problems of small business are taxation and pension-fund investment.

Taxation

The Revenue Act of 1978 reduced the capital gains tax substantially. The maximum tax rate was reduced from 49.1% to 28%. It was applied across the board to all capital gains rather than being targeted specifically at gains from investments in small companies, as in the deferral plan that the SBA's Task Force outlined. The reduction meant that an investor could keep at least 72% of any long-term gain as opposed to 50.9%, an increase of over 40%. This increase made riskier investments, such as the stocks of small companies, more attractive because of the higher potential after-tax return.
One of the major goals of the capital gains tax reduction was to stimulate the flow of capital to small companies. It is largely successful in this objective. The amount of equity capital raised by companies with a net worth of less than $5 million more than tripled to $181.5 million in the twelve months ending the third quarter of 1979 from $56.1 million a year earlier, and an improving tendency continued. While part of this increase may be attributable to other factors such as the cyclical nature of the small business stock market, the capital gains tax reduction very likely influenced this mobilization of capital.

The Economic Recovery Act of 1981 further reduced the maximum capital gains rate to 20% thereby, presumably, paving the way for still greater interest in riskier stocks, in which category, as mentioned above, the stocks of small companies tend to fall. Another provision of the Act, aimed at small companies, was the increase in the permitted number of shareholders of Subchapter S corporations from 15 to 25 (Subchapter S rules allow a corporation engaged in an active trade or business to elect to be treated for income tax purposes in a manner similar to that accorded partnerships).

The Amendments to ERISA Legislation

Some observers of the investment world thought that few acts of government in this decade had a more negative impact on the ability of small companies to raise equity capital than the Employment Retirement Income Security Act of 1974 (ERISA). The legal context in which ERISA defined the "prudent man rule" virtually ensured that large institutional investors would stay away from venture capital and direct investment in small firms. By preventing, in effect, the nearly one-third of all U. S. equity
capital held by these institutions in 1977, or over $200 billion, from being placed in small and medium-sized businesses, the impact of ERISA rubbed off on other investors and discouraged them from investing in such companies.

Title III of the Capital, Investment and Business Opportunity Act of 1978 amended ERISA, permitting pension-fund dollars to re-enter the small business venture and equity capital markets without violating the "prudent man rule." Despite this amendment, institutional investors, as they indicated in the survey conducted for the NASD by Price, Waterhouse & Co. (cited in Chapter 1), are likely to continue to be averse to investing in small companies unless they think these investments have an adequately liquid secondary market.

Action by the Securities and Exchange Commission

Reflecting the current mood of government, the SEC has become increasingly active in the area of small business, mainly through relaxing its requirements for issuing securities in the primary market.

The SEC Office of Small Business Policy

In March, 1978, the Commission announced that it would conduct an examination of the impact of its policies on small business. According to then-SEC Commissioner Roberta S. Karmel, "Many disturbing questions were raised. In general, it appears: 1) that we lack enough information to know what effect the Commission has on small business; 2) that if we have an effect, it may be in terms of voluminous registration and filing requirements or discouragement of venture capital formation." The Commission decided to conduct several studies to collect more information with which to make decisions and to re-examine its
filing, registration and reporting requirements and their effects on capital formation.

In 1979, the SEC decided to create an Office of Small Business Policy in the Division of Corporation Finance. Many of the new rules and forms the Commission has developed, and many of the modifications of existing rules it has implemented, have resulted from the efforts of the Office. As mentioned above, with only few exceptions, these efforts have focused on areas of capital formation and the primary market.

Regulation A

Regulation A makes possible the issuance of small securities offerings without the complicated registration filing requirements of Form S-1. In 1979, the Commission lifted the maximum ceiling on the amount of money which could be raised under a Regulation A offering from $500,000 to $1.5 million. The rise in underwriting expenses and registration costs had made the $500,000 offering ceiling seem hardly worthwhile to potential offerers. According to the NASD, the cost of a Regulation A offering is approximately $100,000, thereby making it virtually impractical for many small companies to use this type of offering under the former ceiling. By significantly increasing the net proceeds a company may receive, use of Regulation A offerings has become more feasible.

In addition to raising the Regulation A ceiling, the SEC has sought to ease the marketing of such offerings. Between 1973 and 1978 the number of underwritten Regulation A offerings declined from 49% to 23% of all such offerings. Thus, the Commission has allowed underwriters, under certain circumstances, to use a re-selling document, or "red herring" as it is called, to solicit indications of investor interest in an attempt to gauge the potential market for the offering.
Another measure taken by the SEC has been the adoption of Form S-18, a simplified registration form that was introduced in April, 1979. Before Form S-18 was adopted, issuers were faced with a choice between Regulation A and the extensive registration filing procedure of Form S-1. Under S-18, a non-reporting issuing company is permitted to make a registered public offering of up to $5 million, using less extensive and detailed information than that required under S-1.

Testifying before the Senate Select Committee on Small Business, former SEC Chairman Harold Williams described the reasoning behind the S-18 approach, saying, "An issuer not subject to the reporting requirements of the Commission at the time the registration statement is filed under the Securities Act (a first time market company) may, consistent with protection of investors, raise a limited amount of capital without immediately incurring the full range of disclosure and reporting requirements imposed on other issuers." 8

In March 1981, the SEC issued a report on Form S-18 and the results of the first 18 months of its use. Between April, 1979 and September, 1980, 111 companies were able to raise $236,394,000 from the public. The report noted that Form S-18 "appeared to have substantially displaced Form S-1 as a means of registering smaller initial public offerings of common stock." 9 Over the 18 months that the study was conducted, there were more than six effective Form S-18 registrations for every "comparable Form S-1 effective registration." 10 Nearly half the companies which used Form S-18 were "start-up" companies with less than $50,000 in revenue in their latest fiscal year. The report indicated that
by most measurements the SEC's newly adopted form was remarkably successful in achieving its purpose.

**Form S-16**

The Commission has also taken action to amend its existing Form S-16. The amendments permit issuers to use a simplified and shorter Form S-16 for the registration of certain primary offerings of securities, provided that these offerings are made pursuant to a firm commitment underwriting. The S-16 form seeks to coordinate and integrate the disclosure system for companies subject to the Securities Acts and, in doing so, eliminate what, for many issuers, is little more than needless and costly duplication.

**Regulation D**

In March, 1982, the SEC approved the adoption of six rules (Rules 501-506) which it designated as Regulation D. In general, these rules raise the dollar ceiling and relax and redefine certain other criteria of offerings that qualify for exemption from registration requirements.

**Rule 504 (replacing Rule 240)** - This Rule raises to $500,000 from $100,000 the amount of exempt securities that can be sold in any 12-month period. It also eliminates the previous ceiling on the number of investors, the prohibition on payment of commissions, and mandated disclosure requirements.

**Rule 505 (replacing Rule 242)** - As previously, this Rule applies to any number of "accredited investors" and to no more than 35 "non-accredited investors. It raises to $5 million from $2 million the amount of securities that may be sold to such investors in any 12-month period, up from six months previously. "Accredited investors" include individuals who earned $200,000 or more annually over the previous two years, those with net worths of at least $1,000,000, and investors who buy at least $150,000, up from
$100,000, of securities payable within five years. The "accredited investors" are expected to collect on their own whatever information they deem necessary which the issuer is willing to provide. "Non-accredited investors" must be supplied information that is similar to that required by Form S-18.

In December, 1980, the Commission released a report on Rule 242 and the first six months of its use. The report found that 62 issuers were able to raise $38,058,704 under the Rule, of which 79% represented equity, 15% convertible debentures, and 6% debt securities. Over half of these companies had less than $1,000,000 of revenues and assets and reported either "zero or negative net income" in their latest fiscal year. Over half the issuers had been incorporated since the beginning of 1977. The average cost of issuing and distributing securities under Rule 242 was 2.5% of the amount the companies intended to raise. This compared with 13.9% of the "registered offering amounted associated with a sample of small public offerings." The Commission attributed this difference to lower distribution costs, primarily from sales commissions.

Rule 506 (replacing Rule 146) - Continuing controversy over the definition of a private placement caused the SEC to adopt Rule 146 in 1974. This Rule stipulated that transactions by an issuer involving the sale of securities shall be deemed not to involve any public offering within the meaning of Section 4(2) of the Securities Act and are therefore exempt from registration if certain conditions are met. Rule 506 provides the exemption for offerings of unlimited amounts to any number of accredited investors and to no more than 35 non-accredited investors. With respect to these offerings, the issuer must make a subjective determination that the purchaser or his representative has sufficient sophistication to be able to evaluate the merits and risks of the offering.
Rule 144

Unlike the rules discussed previously, Rule 144 is concerned with the secondary markets. In 1978, the Commission also decided to modify significantly this rule along the lines proposed by SBA Task Force Chairman Casey. Many commentators had argued that this provision had severely curtailed the ability of small companies to raise capital because of the length of the minimum time holding period limitations which made these securities effectively less liquid. The Rule was amended to increase the amount of restricted stock that could be resold to one percent of the class outstanding or the average weekly trading volume during a three month period, whichever is greater. This amendment was intended to facilitate the resale of many securities sold by small issuers in unregistered private placements. The Rule was also amended to permit individuals who have held securities covered by the Rule for a five-year period to sell them without any limitations on volume, provided that these individuals are non-affiliates of the issuers.

An Apparent Trend

With the exception of these amendments to Rule 144, all of the other measures addressed to the primary market. And it should be noted that Rule 144 is only concerned with liquidity and the secondary market indirectly, through the medium of restricted stock. While the Commission is continuing to examine many issues surrounding small business, there is little reason to believe that their focus will not remain on the primary market for the foreseeable future.

Apparently, the direction of the SEC's policy will be towards easing the reporting requirements on small companies even at the expense of deteriorating the secondary market for their securities. Pointing in this direction is the action it took in April 1982 when
the SEC adopted a rule and rule amendments which provided that a company will not have to register under Section 12(g) of the Securities Exchange Act, which is applicable to the secondary market, until the company has 500 or more holders of a single class of securities and it has total assets of $3 million or more. Moreover, a registered company may deregister at any time that it has less than 500 holders of the class and its total assets drop to less than $3 million at the end of each of its last three fiscal years.

Since the Commission is fully aware that information is essential to permit rational investment, it apparently took this step recognizing that the result would be to worsen the trading market in the shares of such companies. Indeed, in its release adopting the rule and amendments, the Commission specifically noted that the rules governing NASDAQ, the automated sector of the over-the-counter market, require that an issuer of securities registered for trading on that system must be a reporting company under the Securities Exchange Act of 1934.

**Other Developments and Trends in Government Policy**

In the fall of 1979, the SEC announced that it was undertaking a joint study with the SBA on initial public offerings (IPO's) of corporate common stock. Phase I of the study, released in March, 1980, confirmed the generally accepted belief that regional firms are the principal underwriters of the initial offerings of corporations. Phase II of the study, released in August, 1981, further showed that regional firms, as market-makers in initial public offering stocks, are also the leading providers of secondary market liquidity to initial public offering issuers. This is particularly true for smaller issuers which generally have fewer market-makers.
The Congress has been considering a bill, H.R. 5829, which would provide for the creation of a $1,000,000, five-year, tax-deferred "profit" reserve for market-makers for the purpose of market-making activities in stocks of companies with a total capitalization of not more than $50 million. This provision emerged from a recommendation in the NASD study, Small Business Financing, published in 1979, and is one of the few potential acts of government to address itself directly to the problem of the liquidity of the secondary markets of small companies. It provides explicit economic incentives for market-makers to maintain liquid markets in the stocks of small companies. Our study confirms the desirability of providing such incentives to the market-makers of the stocks of small companies.

The Importance of a Balanced Perspective

The general response to the attempts of the SEC and other government agencies to reduce the burden of regulations on small companies has been highly favorable. The reasons why the SEC has concentrated on the primary market have been understandable. The primary market collapse of the mid-1970's appeared to have disastrous implications. Also, many of the complaints about government regulation have centered on the voluminous paperwork which these regulations generate. In the field of securities regulation, the primary market produces much more paperwork for small companies than the secondary market and thus it was natural target for deregulation.

The actions taken by the SEC concerning small business financing, however, have not been without their critics. Some have said that these actions are not really deregulation, but rather re-regulation. To this criticism, former Commissioner Karmel responded that "a radical departure from prior regulatory approaches" would involve
a "more fundamental change" that would require "Congressional action." Others perceiving political motivations behind the Commission's activities, have regarded them as constituting affirmative action for small businesses for the undue burden which regulation compliance has caused them.

At the same time, there appears to be a serious imbalance developing between government policies towards the primary and secondary markets. A policy which acts to stimulate the primary market without simultaneously strengthening the secondary market obstructs the interdependent relationship between the two markets. As a result, a flood of new issues could ensue which would have little support in the after-market. Such a consequence would be detrimental to investors.

One investment banker we interviewed, when asked about this paradox in securities regulation policy towards small business, commented,

"While I certainly approve of this trend towards regulation relaxation in the new issues market and think that they are long overdue, I also think that the securities industry in particular should take certain actions of its own which would improve the efficiency of the trading markets with the consent of the SEC, of course. It may take time but it is inevitable. I think it may eventually be brought about by the industry itself because the government ignores these trading markets. If they are not strengthened and the boom in the new issues market continues there might be a situation similar to the sixties when a lot of companies that shouldn't have gone public did go public and eventually the market couldn't support them. In 1974, there were hundreds, no thousands, of small OTC companies for whom no trading market existed. Stocks could not be sold or bought for more than 25¢ a share in so many cases and even then it was very difficult to make a trade."

The fact that the government's attention has been concentrated on the primary market does not necessarily mean that it is more important than the secondary market. As SBA Task Force Chairman Casey emphasized repeatedly in his Congressional testimony, the
state of the secondary market has as great an influence on the primary market as any other single factor. Yet the SEC has done little, de from the work on the amendments to Rule 144, to strengthen the secondary markets for the stocks of most small companies. Indeed, as we have pointed out, its action to reduce disclosure requirements for certain small companies will very likely have a negative effect on the secondary markets of the stocks of these companies.
Chapter 3: Background and Characteristics of the OTC Market

Professor William Sharpe, a prominent academic observer of the nation's markets, has claimed that "the over-the-counter market for stocks is the most modern marketplace in the United States." The word "modern" has different connotations such as contemporary, up-to-date, and efficient. But when Professor Sharpe speaks of the "over-the-counter market" he is referring only to the market of the 3,400 or so securities which are included in NASDAQ.

The OTC Market's Heterogeneous Character

The total scope and size of the OTC market are in the words of one executive vice-president of a trading firm, "unknown quantities." While the term, "unknown," may be an exaggeration, the imprecise method of trading which characterizes much of this market makes generalizations difficult. The OTC Market, a publication of Standard & Poor's Corporation, states that there are about 28,000 OTC stocks traded in the United States.

The market for most of the 25,000 or so non-NASDAQ stocks is not modern at all. Instead, it is a technological dinosaur which is out-of-step with the microelectronic age. It is indicative of the anonymity of this phase of the OTC market that even a recognized authority, as Sharpe, should overlook its existence.

The OTC market is difficult to conceptualize. As opposed to the centralized trading floors of the exchanges which function on the basis of auction-market principles, the OTC market comprises a complex, sprawling network of telephone lines, private wires, and, since 1971, the electronic quotation system, NASDAQ, whose securities represent only a small portion
of the market. To a large extent, a description that appeared in an im-
portant early book on the subject still holds true. "The concept of the
over-the-counter market is essentially that of an elaborate pattern of
bids and offers reflecting values for many different securities, each type
of security and each issue having its own position within the pattern." 3

The OTC market, in addition to the debt issues of many corporations
as well as federal, state, and local governments, embraces the largest
number of stocks of publicly traded domestic companies of any securities
market in the United States. It also includes the stocks of certain foreign
companies, among them the giant German conglomerate, AEG Telefunken. Until
recent years, the preponderance of the nation's banks and insurance com-
panies were traded over-the-counter. Many still are, although most of
the largest banks have opted to list on the New York Stock Exchange (NYSE).
Some of the nation's premier industrial corporations, such as Intel, have
preferred to remain in the OTC market. The typical OTC company, however,
is significantly smaller.

A number of NASDAQ and some non-NASDAQ stocks are actively traded,
but a key characteristic of the other issues is the small number of trans-
actions that take place. In many cases, this condition can be ascribed
to the inadequacy of the market's structure rather than to the security's
actual worth. Thin markets may also be indicative of special conditions.
For example, many companies that are nominally public are controlled by one
or a few individuals who own most of the shares outstanding and who have
no intention of buying or selling. Because of the small public float,
investors lack enthusiasm for the issue thereby dampening dealer interest
unless some external event provokes public attention. A classic illustra-
tian of such a company was Belridge Oil, whose shares languished in obscurity until Shell Oil suddenly made a tender offer for $3.5 billion.

Role of the Market-Maker

Each OTC security has, in effect, as many markets as it has market-makers willing to make two-sided quotations because any dealer who stands ready to buy or sell stock at his given bid or asked price performs the same function as a stock exchange. Thus, an OTC stock with several competing market-makers is similar in certain respects to an exchange-listed stock which is traded on several competing exchanges.

Market-makers provide liquidity by standing ready to buy or sell a security. By and large, they operate in two types of trading environments: 1) the firm in which trading is a primary source of revenue (these firms dominate the markets of the securities of small companies); and 2) the integrated firm for which trading is only part of a larger, diversified operation.

Firms that specialize in trading indicated to us that they provide a market in a particular stock primarily because of its money-making potential and not for any imputed responsibility, such as might motivate a stock-exchange specialist. While activity is a consideration in choosing such stocks, it usually is accompanied by greater competition from other market-makers. Accordingly, some dealers look for niches in less active stocks which their competitors may have overlooked.

Integrated firms also desire to earn a profit from trading activities but their trading departments often must satisfy the objectives of another department. These objectives may include an investment banking interest.
(the firm may desire to become the company's investment banker); a retail interest (the firm may have one or several clients who wish to purchase or sell the shares of the company); or a research interest (the firm may have a securities analyst who is recommending the stock).

A security's liquidity is often defined as the spread between the bid and asked prices. When trading in a security is active, the market-maker can earn a profit by the frequency of transactions and therefore he tends to be more willing to provide a narrow spread. As one trader put it: "Trading is like any other retailing business. The percentage mark-up on a pair of underwear of which a department store sells thousands is inevitably going to be lower than the mark-up on a $5,000 mink-coat of which it may sell only a handful. The same is true for stocks. The more active a stock is the lower its spread is because it costs traders less to carry an inventory. With an active stock you can always get out of the market, with an inactive stock you may be locked in."

On the other hand, the market-maker may want a wider spread to offset the risks of holding a volatile security. Another trader told us, "Contrary to popular belief, traders do not like to trade volatile stocks nor do they attempt to make a stock volatile. There is nothing a trader would rather do than trade a stock for months at a time at 10-10½ and watch the price never change. Needless to say this would be very easy and would require little or no skill. Often, it is when a stock suddenly becomes volatile that a trader gets burned and stops making a market. People think traders have access to all sorts of inside information, but in reality, traders are usually the last to learn and sometimes have to pay the price."

A constant criticism that emerged during many of the company interviews
was that dealers knew little or nothing about the companies whose stocks they handled. This criticism was confirmed by several heads of trading firms. One replied, "We are in business to make supply meet demand, not to analyze securities. There are enough people in this industry who are paid to perform that function." Others commented that the relationship between a company and its market-makers was a two-way street and that there were many companies who were even more ignorant about their market-makers than vice versa. One vice-president of a trading firm suggested that companies should try to get together with their market-makers once a year and discuss their companies' past performance and future prospects to give the market-makers a better feel for the company and its stock.

Development of the OTC Market

This development may be divided into the periods before and after the advent of NASDAQ.

The Pre-NASDAQ Period

Prior to 1929, the only Federal law which pertained to the regulation of the nation's securities markets was the Mail Fraud statute, which prevented a broker from using the U.S. Postal System to sell securities through methods of false representation. The decade of the 1930's witnessed the passage of the Securities Act of 1933, the Securities Exchange Act of 1934, the Public Utility Holding Act of 1935, the Trust Indenture Act of 1939, the Investment Advisors Act of 1940 and the Investment Company Act of 1940. Within the space of ten years, the securities industry was transformed from one which was practically unregulated into one of the most heavily regulated industries in the nation.
The Securities Exchange Act of 1934 focused upon trading activities on the exchanges and "only touched upon" trading in the OTC market. It was not until the Maloney Act was passed in 1938 that the concept of self-regulation was applied to the OTC market and the NASD was established to govern its practices. Viewing the initial 20 years of this regulation, one observer noted, "Expediency has at times outweighed logic in the formulation of some of the rules and regulations. Federal regulation of the over-the-counter market has in practically all instances been partial."4

The heterogeneous, diffuse character of the OTC market makes it difficult to formulate and implement regulations which are simultaneously uniform, appropriate and fair to all the participants. This condition was particularly true in the pre-NASDAQ period, when the trading firms and the traders regulated themselves in the literal sense of the word. In 1963, the SEC Special Study commented, "In general, over-the-counter trading tends to be governed by informal codes of conduct and practices evolving out of the workings of the markets themselves."5 This comment is still applicable to the non-NASDAQ sector of the OTC market.

In its "Rules of Fair Practice," the NASD developed a sophisticated code of conduct, but many of these rules proved difficult to enforce. The Special Study noted that while these "Rules of Fair Practice" required all quotations to be "bona-fide" dealers complained about the practice of "backing away" from a quotation. Some dealers accused others of giving a quotation not to display a firm's trading market but rather to solicit indications of interest and obtain information. The Special Study observed that while Section 15 (c) (2) of the Exchange Act gave the Commission authority to create rules to prevent misleading quotations, none had been
developed. Dealers whom we interviewed indicated that incidents of "backing away" still occur, but often are not reported to the NASD. For one thing, they indicate, rectification through prescribed channels would be time-consuming; then again, the speed with which word-of-mouth disseminates information in the trading community about market-makers who give bogus quotations provides some degree of control.

The Special Study was the motivating force behind the Securities Acts Amendments of 1964. These amendments imposed disclosure requirements on the larger OTC companies which were similar to those required of exchange-listed companies with respect to periodic reporting, insider trading and proxy regulation. Stronger criteria and stiffer requirements were developed to regulate entry into the securities industry. In 1965, the SEC adopted a rule stipulating that all OTC broker-dealers who were not members of the NASD take a qualifying examination administered by the Commission.

The Special Study also explored the possibility of automated quotations in the OTC markets. Automation offered the trading industry the opportunity for improved operational efficiency and, as a result, for more business. It offered the public greater trading reliability and the opportunity to
observe the workings of the OTC market more closely. These effects, it was thought, would help to remove the taint which the public tended to attach to the OTC market. NASDAQ, the outcome of the Special Study's original investigation into the automation of the OTC market, has largely accomplished this objective for the relatively small number of securities within the system.

The Advent of NASDAQ

The NASD implemented NASDAQ in February of 1971. In retrospect, the move to automated quotations was inevitable. Account executives felt they needed to get a better grasp of the market in order to serve their clients effectively. Dealers thought they needed to look at all the existing quotations in actively traded stocks, where prices could change swiftly, to maintain their competitive positions. Recalling the pre-NASDAQ era, one vice-president of a trading firm told us, "It's hard to believe the Dark Ages were here only ten years ago." The NASD also believed it was necessary to create some standards and prevent the widespread trading of "shell" companies, because there had been a number of abuses in this area during the late 1960's.

The NASDAQ system functions on three levels. Dealers who subscribe to Level III have the ability to enter firm quotations of bid and asked quotations in any stock in which they want to make a market. When they do so, they must be ready to buy or sell a minimum unit, usually 100 shares, at their quoted prices. As soon as a trader enters a bid and asked price into the system it is transmitted to a central computer file and immediately relayed to the terminals of all other subscribers. Until the dealer enters a new price quotation or drops out of the market he can be "hit" at the
indicated quote and forced to make a transaction.

Level II of NASDAQ is used primarily by brokerage firms in their trading rooms. From Level II they can get quotations on all stocks in the NASDAQ system. The bid quotations appear in descending order and the asks appear in ascending order while the market-makers are listed beside their quotations. The key difference between Levels III and II is that Level III allows its subscribers to key into the system and enter their quotations.

Level I is designed primarily for registered representatives. Initially it provided them with the "representative bid and asked" quotation. The representative bid was simply the median bid price of all market-makers; the "representative asked" was tabulated by adding the median bid/asked spread of all the market-makers to the median bid. In 1980, the NASD decided to expose quotations of the "inside markets," i.e. the highest bid and the lowest asked, on Level I NASDAQ terminals and to publish these "inside markets" in the newspapers. The NASD's president, Gordon Macklin, has said that the exposure of these "inside markets" has contributed significantly to the growth of OTC volume.

The qualification standards for enabling an issue to be traded in the NASDAQ system are not complex. They include registration of the stock under Section 12 (g) of the Securities Exchange Act of 1934; two registered market-makers in this issue; 500 public shareholders of record; a public float of at least 100,000 shares; and that the underlying company have assets of at least $1 million and capital and surplus of at least $100,000. If these requirements are not maintained or if prompt disclosure of "material information" is not made to the public or to any state or federal agency requiring the disclosure, the stock may be suspended.
NASDAQ has substantially altered the image and character of the OTC market. The system was successful in part because it was able to capture the minority of the OTC market around which the majority of the investment community's interest was centered. In late 1980, there were some 335 market-makers handling the 2,900 stocks traded in NASDAQ. Since then, about 500 more companies have entered the system. A major achievement of the system was the improved efficiency of information which has unquestionably contributed to the growth of trading volume in the OTC market in the past decade.

**NASDAQ's Implications: The Segregation of the OTC Market**

Another result of NASDAQ's advent was the segregation of the OTC market into two sectors—one comprises the relatively small number of NASDAQ-traded stocks and the other the much larger number of stocks where, as described in chapter 5, trading has remained essentially fossilized. The SEC/SBA joint study did not examine OTC trading methods in any detail but it did note a difference in the liquidity between the NASDAQ and non-NASDAQ sectors of the market. "Overall, the Regional Broker-Dealer respondents make an average of approximately 32 markets in NASDAQ stocks and 14 markets in non-NASDAQ OTC stocks. The average position held in a NASDAQ stock ($15,500), moreover, was nearly two and one half times the average position ($6,200) held in a non-NASDAQ stock. From the issuer's viewpoint, NASDAQ secondary markets are probably more liquid than non-NASDAQ OTC markets."
Not surprisingly, once dealers became accustomed to using the NASDAQ equipment, they recognized that the old methods of trading had become arcane and outmoded. As activity in the NASDAQ sector increased, therefore, a number of traders began to shift capital that had once been employed making markets in the less active non-NASDAQ sector into NASDAQ stocks, where they thought they could generate a better return on their capital.

Since 1971, the NASDAQ system has continued to make progress, so that observers like Professor Sharpe now consider it to be the most "modern" securities market in the United States. At the same time, trading practices in the rest of the OTC market continue to be conducted in much the same manner as they have for the last 50 years. The efforts to integrate NASDAQ into the NMS are discussed in the following chapter.
Chapter 4: The Linkage Between the OTC Market and the NMS

In striking contrast to their neglect of the OTC market when the Securities Exchange Act of 1934 was adopted and the relatively casual review during the several decades that followed, both Congress and the SEC revealed much concern with the OTC market in introducing the principle of an NMS. It will be recalled that Congress overlooked the OTC market in 1934 when the Securities Exchange Act was passed. After provision was made for federal supervision of the OTC market in 1938 the SEC did relatively little until the early 1960's when it initiated the action that led to the OTC regulatory provisions in the Securities Acts Amendments of 1964. On the other hand, from the very outset both Congress and the SEC made clear that the OTC market should be considered in the creation of the NMS.

The OTC Market's Role in the Concept of an NMS

The concept of an NMS evolved out of the upheavals in the late 1960's and early 1970's. A Policy Statement issued by the SEC on February 2, 1972, a year after the initial mention of a "central market system" in its letter transmitting the Institutional Investor Study, represented the first government attempt to define the NMS (then referred to as a "central market system"). In this Statement, the SEC specifically referred to integrating the
exchanges and OTC markets. Thus, the Commission observed that "the term 'central market system' refers to a system of communications by which various elements of the marketplace, be they exchanges or over-the-counter markets, are tied together. It also includes a set of rules governing the relationships which will prevail among market participants. To mandate the formation of a central market system is not to choose between an auction market and a dealer market. Both have an essential function and both must be put to work together and not separately in the new system."  

Several months after the SEC Policy Statement, the Subcommittee on Commerce and Finance of the Committee on Interstate and Foreign Commerce of the House of Representatives, in August, 1972, issued its report on the NMS. While this report did not make much reference to the OTC market, it agreed with the principle enunciated by the SEC that the system would bring together the elements of both the exchange and OTC secondary markets.

The report of the Subcommittee on Securities of the Senate Committee on Banking, Housing and Urban Affairs, issued in February of the following year, gave more explicit reference to the OTC market that incorporated reference to both the "pink-sheet" and NASDAQ stocks. The belief was expressed "... that all investors in publicly-held companies are entitled to the best market available given the characteristics of that particular stock."
The General Character of the OTC Securities to be Included In The NMS

During this early period both Congress and SEC were concerned with formulating the general concept of an NMS that included the OTC market. While they gave little attention to the specific standards which would be used to determine which stocks would be included, it was clear that they had in mind those stocks which were traded actively and represented relatively big companies.

The Position of the SEC

The SEC's 1972 definition of an NMS provided for the preservation of separate markets but proposed that the exchange and dealer markets be linked together rather than operate independently. The Commission explicitly stated that the purpose of this market linkage was to foster competition and to provide the public with better information. The Statement said this would be achieved by making "visible to the investing public, the competition which now takes place among the separate exchange markets and between all of them and the third market."

The so-called third market, whose development is chronicled in Appendix A, arose in the 1960's as a result of the wide spreads which were created by fixed minimum commission rates imposed on exchange-traded stocks. These spreads enabled OTC dealers to trade competitively in stock-exchange stocks. A contraction occurred in the third market following the elimination of fixed, minimum commissions. It still exists, however, and embraces stocks that are generally active and meet stock-exchange listing standards. Accordingly, by and large, they represent the country's relatively big companies.
It is significant that the market linkage initially envisioned in the 1972 SEC Statement encompassed only the over-the-counter market for exchange-listed stocks. The statement made only a passing reference to the great majority of companies whose stocks were traded solely in the over-the-counter market, and then brushed it aside. "While the Commission believes it is important that a tandem central market also evolve for unlisted securities, and recognizes that significant strides are being made in this direction through NASDAQ, this report will concern itself only with such a system for listed securities."

The reference to a "tandem central market system for unlisted securities" suggests that the SEC at that time expected eventually to move in that direction. It has not done so. Rather, the Commission has continued to follow the policy of excluding from the NMS most of the stocks traded in the OTC market. Thus, in a statement issued on January 26, 1978, the SEC articulated its belief that "listed equity securities included in the consolidated system and a number of equity securities currently traded exclusively in the over-the-counter market generally possess characteristics (including, in most cases, national investor interest and substantial assets and earnings histories) which justify their inclusion in the 'qualified' category." The phrase "a number of equity securities currently traded exclusively in the over-the-counter market" indicates that the Commission still intended to include only a handful of the 28,000 or so OTC companies in the NMS.
While the Commission knew at that time that it wanted to include only the relatively elite OTC stocks in the NMS it apparently was reluctant to formulate the specific standards for that purpose until more progress had been made in putting together the components of the system. Indicative of this attitude, in the January 1978 Statement, the Commission said that the designation of eligible OTC securities for the NMS would be predicated upon "the implementation of those technical elements of a national market system necessary to assure that trading in those securities occurs under competitively fair circumstances and in a manner consonant with the principles of national market system."

The Position of Congress

The position of Congress, during the formative years of designing the concept of an NMS, was much the same as that of the SEC. It was believed that the securities appropriate for inclusion in the NMS should be actively traded and represent relatively large companies.

The 1972 Statement of the House Subcommittee, like that of the SEC, indicated that the NMS "would consist of a multiplicity of different exchanges together with the third market."

The Senate Subcommittee, despite its awareness of the "pink-sheet" market, was also primarily concerned with the stocks of substantial companies capable of meeting the listing requirements of the major exchanges. "The Subcommittee intends, therefore," the 1973 Report states, "simultaneously with the implementation of the combined auction-dealer market in presently
listed securities, to consider proposals for the establishment of procedures by which exchange trading could be commenced in presently unlisted securities.\(^8\)

The Move to Specific Standards

As indicated previously, at the time the SEC issued the January 1978 Statement, it apparently did not yet feel ready to formulate specific standards for defining NMS-eligible securities. It was, however, prepared to move in that direction. Accordingly, after considering the views of various parties, the Commission, a year and a half later, on July 22, 1979, issued Proposed Rule 11 Aa2-1. This rule, stated that two quantitatively different sets of criteria should be utilized in determining which stocks would be designated an NMS security thereby providing for a two-tier system. Under this system, securities which meet certain minimum standards (tier 1 securities) would automatically be included in the NMS while securities which meet a less restrictive set of standards (tier 2 securities) would be eligible for inclusion in the NMS but, in these cases, the choice of whether or not to enter the system would be left, in part, to company management.

The decision of the SEC to propose this two-tier system was a compromise between the Commission and various commentators, such as the NASD, the National Securities Traders Association and the National Association of OTC Companies. These self-
regulatory organizations and trade associations contended that the management of companies whose securities met the standards of the NMS should be allowed to choose whether their securities are included in the NMS. The SEC disagreed, however, and noted that this was contrary to the intent of the Congressional legislation, and remarked, "The Commission believes that the benefits to be obtained from a national market system should be affordable to investors in all securities with suitable characteristics and should not be solely dependent on the desire of corporate management."

The SEC's initial compromise stipulated that a tier 2 security would only be eligible for inclusion in the NMS "upon application of the issuer or two or more market centers or prospective market centers for that security." A "market center" was defined to be any exchange on which a security is listed or admitted to unlisted trading privileges and on which continuous two-sided quotations are available, or the OTC market where the market maker is willing to perform a similar function.

The Variations of Opinions

Proposed Rule 11Aa2-1 did not set forth specific criteria but instead gave general guidelines about them. The Commission declared that, in consonance with Congressional intent, the criteria would be applied uniformly to both exchange and OTC securities. This was later changed when the rule was adopted.
to apply only to OTC securities. Before developing specific criteria for inclusion in the NMS, the Commission asked various interested parties such as the NASD, the NSTA and the American Society of Corporate Secretaries for any thoughts they might have as to what those criteria should be.

Most of the commentators agreed, that the Commission should develop a single set of standards for uniform application to all securities and that OTC securities should not be included in NMS facilities until the appropriate technology was in place. The commentators, however, tended to emphasize different features.

The National Association of Securities Dealers

The National Association of Securities Dealers (NASD) stated that "we believe that primary emphasis should be placed on standards which are indicative of national investor interest e.g. number of shareholders, trading volume and size of public float, rather than standards that relate to the investment merit of a security, e.g., earnings. The Association supports the utilization of total assets, shares publicly held and market value of shares publicly held as appropriate criteria.10" The NASD also proposed that average dollar volume be employed as a criterion because it was a meaningful indicator of both price and volume. The Association criticized the proposed rule because it did not allow the companies "a meaningful voice in the designation of the manner in which their securities will be traded" and because they claimed the two-tier system was inappropriate and would be difficult to administer and implement.11
The American Society of Corporate Secretaries

Commenting on behalf of the nation's industries, the Society remarked, "Our basic concern is that there may be negative implications as to those issuers whose shares may not qualify for trading in this market. This will be the national system and will carry the imprimatur of Congress and the SEC. As such, under the assumption that this system provides the advantages envisioned by Congress and the SEC, it should attract the most investor interest. We are concerned that those issuers whose shares do not qualify for inclusion in this system may experience a limitation on their access to capital and their ability to generate sufficient market-making in their securities." Yet the Society also recognized that the securities included in the NMS should "meet certain standards as to quality of issuer and market interest" and proposed that the listing requirements of the American Stock Exchange be used as minimum criteria.

The National Securities Traders Association

The NSTA disagreed with the SEC's notion of a two-tier system and called it "cumbersome and unnecessary." This organization, representing OTC traders, also strongly criticized the Commission's position that the issuer's consent should not be required as a prerequisite for inclusion in the NMS, saying,
"We feel this is wrong.\textsuperscript{14} Unlike the NASD, the NSTA claimed that the criteria should include "substantial assets and earnings histories," and submitted a list of criteria which included 1200 round lot shareholders, a public float of 600,000 shares, net tangible assets of $6,000,000, after-tax earnings of $600,000 shares. The NSTA also stated its concern that inclusion of OTC stocks in NMS facilities might have a negative impact on the willingness of traders to continue to make markets in those securities because of the increased competition due to enforced information disclosure.

The Stock Exchanges

The New York Stock Exchange (NYSE) and the Boston Stock Exchange (BSE) advocated the use of the Composite Tape Association (CTA) requirements (the listing standards for the AMEX) as criteria for inclusion of OTC securities in the NMS. The NYSE commented that the SEC's Proposed Rule 11Aa2-1 raised a number of problems, "perhaps the most serious of which is that the suggested criteria appear too exclusionary.\textsuperscript{15} The AMEX and the SIA (Securities Industry Association) generally endorsed the CTA standards as appropriate for exchange-traded securities and called for further study to determine what standards should be applied to OTC securities."
Rule 11Aa2-1

On February 17, 1981 Rule 11Aa2-1 was finally adopted by the SEC. It established specific criteria for the inclusion of OTC securities in the NMS. The two-tier designation approach was utilized because the Commission considered it to be the process by which the various legitimate, diverse concerns that such a process raises could best be accommodated. The immediate result would be the automatic designation of approximately 40 tier 1 OTC stocks as NMS securities and the designation of an additional 454 tier 2 OTC stocks as "potential NMS securities." A subsequent modification would have the effect of increasing the number of tier 2 stocks to 1,450.

The Commission decided to leave the choice of the inclusion of potential NMS securities to the issuers for the present time but recognized that this decision was at cross-purposes with the Congressional mandate. However, the experimental and uncertain nature of this new secondary market environment made this action seem sensible.

The eight specific criteria are listed below.

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<th>Criteria</th>
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<td>5</td>
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<tr>
<td>Average Monthly Volume (shares)</td>
<td>600,000</td>
<td>100,000</td>
</tr>
<tr>
<td>Minimum Number of NASDAQ Market-Makers</td>
<td>4</td>
<td>4</td>
</tr>
</tbody>
</table>
The standards of capital sufficiency (net tangible assets, capital and surplus) which the SEC selected were intended to insure that all NMS participants were real and not "shell" companies, i.e. companies with no assets. The Commission decided that the most important criterion was national investor interest and so its average monthly volume requirement is the most restrictive. The standards are such that a relatively small company with a very active trading market could be included while a relatively large company with an inactive trading market would not be. (There is likely, however, to be some relationship between the size of the company and the trading activity of its stock)

To a large extent, the result of the SEC's criteria was to let the individual decisions of investors, as measured by trading volume, determine which securities are eligible for the NMS. While Commission officials we interviewed acknowledged the restrictiveness of the average monthly volume requirement, they observed that at a future date this requirement could be relaxed to make NMS participation available to a broader class of securities.

Other Areas of Linkage

As indicated previously, the general philosophy under which the SEC has proceeded in developing the NMS is to integrate the NYSE, ASE, the regional stock exchanges and the more active OTC-
As the NASDAQ market into a comprehensive NMS. For this purpose, through its Rule 11Aa2-1, the Commission has established standards that provide for the inclusion of certain OTC securities in the NMS. In the process of providing for this integration, the Commission has also retained certain traditional barriers between the stock-exchange and OTC markets.

The Competition Between Stock Exchange Members and Non-Member Firms

Traditionally, the stock exchanges had rules that limited the ability of members to trade with non-members. Acting under a provision of the Securities Acts Amendments of 1975, which directed it to ascertain that the rules of the self-regulatory organizations do not restrain competition, the SEC explored the relationship between stock-exchange members and non-members. The culmination of these efforts thus far has been Rule 19c-3, adopted by the SEC in June, 1980.

This rule exempts from all OTC-related exchange restrictions any stock listed after April 26, 1979, the date the Rule was originally proposed, or which was traded on an exchange on that date but fails to remain listed for any period of time thereafter. The thrust of this provision is that, with respect to the relatively small number of stocks involved, member firms may engage in principal transactions with non-members and may also arrange agency crosses within their own firms. On the date when Rule 19c-3 became effective, July 18, 1980, there were 87 Rule 19c-3 securities. As of March 1, 1982, there were 299 Rule 19c-3 securities.
The SEC has been monitoring the effects of Rule 19c-3. The Commission is concerned that the rule could lead to the internalization of brokerage firms' operations and to increased opportunities for "over-reaching" of customers. There is also apprehension that fragmentation of exchange trading could occur if member firms opt to do much of their business away from the exchanges. Under these circumstances, such firms could, in effect, become stock exchanges in their own right. Accordingly, the Rule has potentially important implications for the structure of the nation's securities markets. While it breaks down barriers between the stock-exchange and OTC markets, it applies only to stocks that have met listing requirements. Moreover, the firms, within the scope of this exemption, are likely to have relatively active stocks. The Rule, therefore, probably will not have much effect on the stocks of small companies.

The Integration of Stock Exchange and OTC Trading

Impelled by a mandated requirement for an NMS, the various stock exchanges developed the Intermarket Trading System (ITS). This system provides an electronic linkage among market centers. As described by the NYSE, "anyone on the trading of any participating exchange can determine from a quotation montage the best bids and offers and size (as well as all bids and offers) in ITS stocks displayed by ITS participants. Based on these bids/offers, all or parts of orders can be executed in any other ITS market center."
The SEC has expressed concern about the extent to which trades-through occur (brokers executing transactions on one listed exchange who ignore better disclosed quotations from other markets) and the slowness of trading, particularly during periods of heavy volume. The NYSE has been effecting improvements in the ITS, particularly in areas criticized by the SEC, and considerable progress has been made.

When originally established, the ITS did not include NASDAQ. As the ITS has made headway and NASDAQ has been upgraded, there have been increased discussions about including NASDAQ within the ITS. Finally, on April 21, 1981, the SEC announced that it would proceed with the implementation of an Automated Interface between the ITS and an enhanced NASDAQ system with such capabilities as order-routing and a Computer Automated Execution System (CAES). This action represents the achievement of a key goal of the NMS which may ultimately revolutionize the nation's secondary markets because it increases pricing efficiency and competition and reduces market fragmentation. The Automated Interface will be able to link all markets for qualified securities through communications and data processing facilities. The SEC's announcement provoked considerable concern from various sectors of the securities industry that the outcome would encourage the practice of "internalization," or the in-house execution of retail orders without exposing those orders to other market centers. The Commission, in its release, acknowledged
the validity of those concerns but claimed they did not warrant further delay in the implementation of the Automated Interface. Thirty 19c-3 stocks have been included in a pilot ITS/CAES linkage, of which 23 are NYSE listed. On June 1, 1982, the SEC mandated that 49 OTC stocks be included in a system of disclosing last sale and high and low prices.

The SEC plans to study the experiences of this mixed bag of relationships to determine how to proceed with the full integration of OTC trading into the NMS. The Commission, however, has not indicated any current inclination to increase participation in NMS and market linkage facilities beyond those provided by the indicated eligibility standards. Nevertheless, officials at the Commission recognize that the capability to expand significantly the number of securities which can participate exists and will be in place.

"The Forgotten Stocks"

The SEC actions discussed in this chapter have the potential of revolutionizing the nation's secondary markets. By abolishing protective barriers to trading in different classes of securities, the Commission has decided to liberate capital allocated to trading and permit it to flow to its most efficient, profitable use. What specific effects this will have on the OTC companies which enter the NMS and their market-makers remains to be seen, but after great expenditures of time and effort, the SEC has made definite progress in achieving a key objective of
The 1975 Amendments, the modernization of the secondary markets and providing for a linkage between auction and dealer markets.

At the same time, it should be observed that the proportion of OTC companies eligible to participate in this system remains relatively small. Over 20,000 OTC stocks will remain outside the NMS and even an expanded NASDAQ. These are "The Forgotten Stocks" that represent a large number of the country's small businesses. Many of these companies are sound enterprises that would benefit considerably by the availability of a public-financing route. This availability, in turn, would be enhanced by an effective secondary market for their stocks. It is to the method whereby these stocks are traded, therefore, that we now turn our attention.
Chapter 5: The "Pink-Sheet" OTC Market

Trading in the great bulk of the nation's stocks, representing primarily small companies, is conducted in the non-NASDAQ sector of the OTC market through a cumbersome process that has remained essentially unchanged for the past 50 years. The basis of this trading is a package of sheets that show the dealers making a market in each stock and their current quotations. Since the sheets are colored pink, it is customary to apply the designation "pink-sheet" market to this non-NASDAQ sector of the OTC market.

These sheets are published each trading day by the National Quotation Bureau, a wholly-owned subsidiary of Commerce Clearing House, Inc. Until NASDAQ was established in 1971, the "pink-sheets" constituted the sole publicly available mechanism for conducting transactions in the entire OTC market. Since 1971, they have continued to serve the same function for the non-NASDAQ OTC stocks.

The Trading Environment

The current method of trading in the "pink-sheet" market was developed prior to the advent of automation. Accordingly it is an archaic market that relies on old-fashioned procedures. There is no centralized automated interface which provides the means of comparing simultaneously, at any given moment, all the price quotations of the various marketmakers in a given stock. Instead there are the "pink-sheets."

Each day the OTC broker-dealers who are subscribers transmit the quotations for the stocks in which they want to make a market to the National Quotation Bureau. These quotations are published in the "pink-sheets" and distributed to the subscribing broker-dealers.
An investor who desires to buy or sell a non-NASDAQ OTC stock will approach his or her broker-dealer, who must rely upon the "pink-sheets" for quotation information. The broker-dealer will check the sheets, ascertain the range of quotations and the sponsoring market-makers. Presumably, the customer's broker-dealer will then call several of these market-makers to verify the quotations, the amounts of stock available for purchase or sale, and negotiate a price. This trading approach has serious shortcomings as described below.

Quotations are Non-Credit.

The information which is compiled and disseminated through the "pink-sheets" is not current due to the logistics involved. In order for the National Quotation Bureau to be able to deliver the sheets to their customers at 10:00 A.M. in the morning, they must go to press in the middle of the previous day. As a result, what appears in the "pink-sheets" are yesterday's quotations at approximately noontime. Thus, a broker-dealer who subscribes to the sheets is forced to rely on his own resources to gather current information. The quotations in the sheets could be irrelevant to the markets of stocks whose prices tend to fluctuate.

Trading is Unreliable.

The "pink-sheets" list the various stocks in which subscribers, the OTC broker-dealers themselves, are willing to make a market and, if they so choose, quote the bid/asked spread of the previous day.
The number of stocks listed in the sheets varies from day to day. At any time, a dealer may decide that the reasons for giving a particular quotation have changed and so may modify the indicated terms. Accordingly, the broker-dealer representing a client, may find after calling the presumed market-makers that he or she has altered the bid or asked price, the number of shares available, or has ceased making a market entirely.

Prices may be Fictitious.

In 1964, the SEC's Special Study pointed out that broker-dealers sometimes use the "pink-sheets" for improper purposes, such as giving a fictitious price quotation in order to create a false appearance of trading activity and then "backing away" from the quotation when an order is received. Our interviews found that despite both SEC and NASD rules to the contrary, this practice still occasionally occurs in the trading of "pink-sheet" stocks. However, such violations ordinarily are not reported to either authority. Instead, market-makers usually spread the news and warn each other of those who give bogus quotations.

The Market is Illiquid.

Dealers are technically bound by the "better of three markets rule," which requires them to make at least three inquiries about quotations from other market-makers before they can execute an order. In periods of heavy trading, the time which this process consumes makes "pink-sheet" trading arduous and unprofitable for the traders, and, as a result, contributes to the illiquidity of many of these stocks. One executive of a trading securities firm told us, "When things get very hectic, and I'm trading both NASDAQ and "pink-sheet" stocks and I'm suddenly too busy to trade them all, I often decide to drop out of the market for the "pink-sheet" stocks because I can
execute orders so much more quickly in the NASDAQ stocks."

One symptom of the illiquidity of many "pink-sheet" securities is the wide spread which characterizes their market-maker's quotations. It is not uncommon to see a quote such as "3 1/2 bid/5 1/2 asked" in a "pink-sheet" stock. This would not be likely to happen if the security were traded in the much better organized and supervised NASDAQ market. While the NASD possesses a sophisticated system for overseeing and policing NASDAQ markets, trading in the "pink-sheets" is dependent primarily on the traders themselves to report infractions and violations of the various "Rules of Fair Practice."

One-Sided and Work-Out Market are Common.

In many stocks listed in the "pink-sheets," the broker-dealer will quote only a one-sided or a work-out market. A one-sided market is one where a broker-dealer advertises himself as only a buyer or a seller and not as both. A work-out market is one where the dealer acts like a broker and tries to find a buyer or seller on the other side of the transaction. In some stocks, market-makers will refuse to quote either a bid or an asked price and will only use the "pink-sheets" to identify themselves and indicate their interest without specifying what type of market, if any, they are willing to make.

Price or Volume Data Are Largely Unavailable.

The "pink-sheets" simply list alphabetically the stocks in which subscribers provide information. This information will include the name of the broker-dealer and the bid/asked quotation provided that a two-way quotation is being made.
In some cases, a stock's volume for the previous week is provided if it is available. Actual consummation of a transaction is effected through the negotiations of the buying and selling broker-dealers. After a transaction is completed the broker-dealers inform their clients, the company in whose stock the transaction took place and the NASD. Investors do not have available, however, the relevant price and volume data generally considered desirable to follow a stock, nor are there any procedures being developed to make such data available.

The Nature of the Market

Some 20 years ago the SEC's Special Study recognized the sporadic nature of the "pink-sheet" market. It observed that, "of the approximately 14,000 domestic over-the-counter stocks for which broker-dealers advertised markets in 1961-1962, only about 8,100 were quoted on January 15, 1962." During 1980, the National Quotation Bureau estimated that about 16,000 stocks were quoted in the sheets, although some of these might have appeared for only a few days during the year. On November 15, 1980, there were approximately 10,480 stocks quoted. In its directory, The OTC Market, Standard and Poor's estimates the total size of the OTC market as containing approximately 28,000 companies. If accurate, this would mean that there maybe some 10,000 OTC stocks which do not even have a listing in the "pink-sheets."

The types of companies whose shares are traded solely in the "pink-sheets" vary widely. As might be expected in such a casually organized environment, this universe includes companies which are
essentially private but have a small number of shares in the hands of the public and the stocks of "shell" companies (corporate entities with no real operations or earnings or assets). Also included are the stocks of certain foreign companies.

At the same time, this universe contains many firms with good records of earnings and growth. These stocks, in part because of lack of exposure, may be ignored by the public. One manager of an equity fund specializing in small companies told us, "I could name five or six solid computer software companies off the top of my head with histories of 25% annual growth rates and excellent potential and stocks which are priced well below book value and languish in obscurity. These are some of the best investments around and everyone overlooks them."

It is appropriate to ask why this situation exists, especially at a time when many securities market theoreticians embrace the concept of an efficient market, where it is contended prices reflect the information available above a company's stock at any given moment. We explore this area in Chapter 7 where the results of the interviews are analyzed. In part, the explanation lies in the belief of company management and the market-makers in their stocks that they can exploit the inefficiencies of "pink-sheet"trading to their own advantage.

A company seeking to repurchase its own shares can often do so at a cheaper price if an illiquid market depresses its stock price. An elderly executive who controls a company and is seeking to minimize the taxes on his estate can do so by taking actions that help make the market in his stock illiquid.
Market-makers who wish to maximize their return on capital often see the wide spreads quoted in "pink-sheet" as a fertile opportunity for profit. The lack of activity which usually accompanies illiquid securities may result in a lack of competition among market makers. A reason for many "pink-sheet" companies remaining in that market is that according to one vice-president of a major national brokerage house, is that their dealers find it more profitable than the NASDAQ market and therefore discourage those companies from seeking to have their stocks traded in NASDAQ.

The SEC's Jurisdiction Over the "Pink-Sheet" Market

The original securities Exchange Act of 1934 gave the SEC broad authority and powers to regulate all the nation's markets for corporate securities, but the Act made only passing reference to the OTC market. The Maloney Act of 1938 set the basis for the creation of the NASD. The upheavals which rocked the securities industry in the 1960's resulted in major changes throughout the nation's stock markets. The NASD introduced the NASDAQ system in 1971 for the most active OTC securities. The SEC does not directly regulate the secondary markets of either NASDAQ or "pink-sheet" traded companies but instead, has chosen to delegate responsibility to the NASD, whose activities it oversees.

Of the approximately 16,000 companies whose shares were reported in the "pink-sheets" in 1980, only about 6,000 were required to submit quarterly reports and 10-K's to the SEC under Section 12 g (2) of the Exchange Act. The remaining 10,000 companies do not meet the requirements set forth in that section.
The various anti-fraud provisions of the securities acts extend to the trading markets of "pink-sheet" companies as do SEC Rules 10b-5 and 10b-5 governing insider trading. Rule 15c2-11 requires dealers to be in possession of disclosure information such as the annual reports and 10-K's of companies in whose stocks they make a market. The SEC occasionally decides directly to involve itself in the OTC market and has expressed its concern about rule violations in the "penny stock" market in Denver.

The Congress gave the SEC a mandate to develop an NMS and the SEC desires to link the NASDAQ system with the stock exchanges through the ITS (Intermarket Trading System). And yet, despite all the energy which both the government and the securities industry have devoted to enhance the trading markets, none of the actions which is being carried out will have any direct impact upon the markets of those OTC companies whose stocks do not participate in NASDAQ, in other words, the bulk of all publicly-traded companies in the nation.

Investor Protection and Market Surveillance

While the gap in efficiency between the trading methods in NASDAQ and "pink-sheet" stocks is wide, the gap in self-regulatory surveillance is just as wide. Officials at the NASD have good reason to take pride in their surveillance of the securities in the NASDAQ system. They contend that the present technology of the NASDAQ system makes it possible to monitor trading in its securities even more closely than those of exchange-traded securities.

The NASD has described the procedures involved in market surveillance in a pamphlet entitled, Investor Protection In The Over-The-Counter Securities Market. It says, "The Market Surveillance Section of the NASD's Department of Enforcement
makes daily reviews of computer produced reports on all securities quoted in NASDAQ. Members of the surveillance team monitor trading patterns and note unusual activity, quotations and fluctuations. These trained analysts investigate extraordinary movements in price, volume, and spread (unusual variances between bid and asked prices). As part of their investigations, NASDAQ company press releases, earning reports, financial filings and price-volume trends are reviewed. Normally, there are legitimate and reasonable explanations for aberrations, but the surveillance indicators trigger inquiries which may lead to the discovery of manipulation or illegal insider trading."

The efforts of the NASD have been concentrated on NASDAQ. Surveillance of the "pink-sheet" market has been largely overlooked. Perhaps the NASD had to focus its regulatory attention and tools on the more actively traded securities such as those in NASDAQ. The net result, however, is that the securities of most of the nation's public corporations are largely outside the scope of regulatory surveillance. Investors, therefore, approach these stocks gingerly, not simply because of the limited disclosure, but also because of the limited amount of regulatory supervision and surveillance. This attitude, in turn, impairs liquidity and makes it more difficult for these small companies to obtain public financing.

At the present time, the new NASDAQ machine, built by the Harris Corporation, is being installed in trading rooms around the country. This machine, with its increased capacity, greatly strengthens the potential of NASDAQ. Several dealers we interviewed suggested that the resulting increased capacity could be utilized by including in the NASDAQ system "pink-sheet" stocks with two or more market-makers willing to make a two-sided market in them. NASD officials have
been apprehensive to relax the requirements for inclusion in NASDAQ on the grounds that it might damage both the image and credibility of the market. To avert such an outcome the dealers further suggested that a symbol be attached to these stocks indicating that though they participated in the facilities, they were not full-fledged members of the system, in much the same manner that stocks with unlisted trading privileges, traded on an exchange, are not listed on the exchange. Such an expansion of NASDAQ would, of course, facilitate the surveillance of the added securities.
Chapter 6: The Interview Approach and the Sample

The basic source of information in the study was the interview. Two types were conducted. The first was held with executives of small publicly-held companies. This provided the data base used in the analysis. The second was with dealers of stocks and investment bankers which provided insights into important issues, as discussed in the analysis, but did not lend itself to statistical summation.

The company interviews, conducted over a seven-month period, from March through September, 1980, covered 70 companies in Connecticut, New York and New Jersey. The project's budget did not permit a national survey. Sixty-five of these interviews are included in the statistical analysis. The remaining five were deemed inappropriate because the responses were not meaningful or the companies had either gone private or were in the process of doing so.

This chapter discusses the rationale underlying the interviews, the nature of the questions, the methodology employed in selecting the sample and the character of the sample. The results of the interviews are summarized in Appendix B.
The Rationale of the Interviews

The purpose of the interviews was to obtain information which would be useful in analyzing the secondary markets of the stocks of small companies and the interrelationship between these markets and the companies' ability to meet their financial requirements. The broad scope of these issues necessitated a detailed series of questions which, in turn, required some financial knowledge on the part of the respondents. Lack of this knowledge resulted in several interviews that were not meaningful and so were excluded from the sample, as mentioned above.

The interviews sought three types of information. One was factual and concerned the companies and the trading markets for their stocks. Another was attitudinal - specifically, the opinions of the company executives and securities dealers about the present and future structure of the trading market in the companies' stocks. The third type of information sought dealt with actual company experience in going public and raising capital.

The Nature of the Questions

Each interview comprised approximately 65 questions. (The exact number depended upon the respondent's answers to particular questions.) Ordinarily, the questions concerned
with factual information required brief answers, while those which probed the company's attitudes and experiences, required lengthier answers. It was hoped that each interview could be completed in about an hour, but the average was between one and a half and two hours. Most of the respondents allowed time for the full interview but in a few cases curtailment was necessary and certain questions had to be dropped.

The questions were divided into five parts. The first was concerned with the general background of the company, such as how it was founded, its major operating activities and the amount of total assets and sales.

Part 2 covered both factual data and management attitudes towards the trading market in the company's stock, as well as the influence of these markets on the company's ability to raise money from the public.

Part 3 focused on the NMS. It began with a detailed explanation of the NMS and the process by which it seemed likely that companies would be chosen for eligibility in the system. This introduction was followed by a series of questions about management attitudes to these criteria, the effect that both inclusion in and exclusion from the NMS would have on the market for the companies' stocks, the willingness of market-makers to continue to make a market in the companies'
stocks, and the companies' ability to raise capital from the public in light of the NMS.

Part 4 was relatively brief. It was concerned with questions relating to the decision to go public, the selection of underwriters and management's evaluation of their performance. Only the first question ("Why did the company decide to go public?") proved susceptible to statistical summary; the others however provided interesting comments.

Part 5 probed the companies' experiences with alternatives to public equity financing such as internal financing and bank loans. The respondents were also queried about more specialized routes such as private placements, government loans and commercial paper, although too few companies used these sources to make a statistical summary meaningful.

The results presented in Appendix B are analyzed in Chapter 7. Without this analysis summary data could be misleading. For example, a number of managements did not think that exclusion from the NMS would have an adverse impact on the market for their company's stock but the reason for this attitude, as stated by several respondents, was that "the market can't get any worse than it is now."
The Methodology Employed in Selecting the Sample

The sample was selected from directories that contained a large number of small companies. The National Stock Summary, published every six months by the National Quotation Bureau, lists the bulk of publicly-held companies in the U.S. and identifies them by their trading market and location. This directory was used as a starting point. After initial identification, the companies were cross-referenced with the corporate directories of Standard and Poor's and Dun & Bradstreet's. These sources supplied information about the companies' size and their industry which was necessary to select a sample that was balanced and appropriate for our objectives.

From the outset, it was recognized that the sample would be limited in its regional character because of budgetary constraints. To compensate for this limitation, it was considered important to obtain a broad diversification of industries.

A final and obvious requirement for inclusion in our sample was the willingness of the potential participants to be interviewed. Most were quite receptive. Approximately one out of every two managements that were approached agreed to be interviewed.

The Character of the Sample

The sample was selected randomly within the framework of obtaining a suitable diversification of size and industry.
An initial problem was the definition and identification of a small business. There is no shortage of definitions. For instance, the SBA considers $5.5 million in net sales to be the maximum upper limit while the Harvard Business School Project on Small Business employed $25 million as a limit. At the far end of the spectrum, the 1980 White House Conference on Small Business allowed any company with annual sales of under $100 million a year to participate. In view of the wide range of definitions and for the purposes of our study, it did not seem necessary to apply precise standards of size.*

An inherent limitation was the requirement that all the companies be public. The securities markets, except in moments of speculative fever, are generally unreceptive to very small companies. As a result, all the companies in our sample are established economic entities. Still, they are small relative to other public companies.

* For purposes of the Regulatory Flexibility Act, the SEC has adopted final definitions of the terms "small business" and "small organization" as these terms will be used in with future Commission rule making proceedings under the Federal Securities law. These include: Securities Act of 1933 -- any issuer other than an investment company, whose total assets on the last day of its most recent fiscal year were $3,000,000 or less, and who is engaged in small business financing; Securities Act of 1934 -- an issuer or person, other than an investment company that, on the last day of its most recent fiscal year had total assets of $3,000,000 or less; Investment Company Act of 1940 -- an investment company with net assets of $50 million or less at the end of its most recent fiscal year. The SEC is also adopting small business definitions in connection with entities regulated by the Commission under the Investment Advisers Act of 1940, the Public Company Act of 1935, and the Trust Indenture Act of 1939.
Below, the 65 companies in our sample are presented by category according to the amount of total revenues.

<table>
<thead>
<tr>
<th>Total Revenues ($ millions)*</th>
<th>Number of Companies in the Category</th>
<th>% of Sample</th>
</tr>
</thead>
<tbody>
<tr>
<td>0-1</td>
<td>2</td>
<td>3.1</td>
</tr>
<tr>
<td>over 1-5</td>
<td>15</td>
<td>23.1</td>
</tr>
<tr>
<td>&quot; 5-10</td>
<td>18</td>
<td>27.7</td>
</tr>
<tr>
<td>&quot; 10-20</td>
<td>14</td>
<td>21.5</td>
</tr>
<tr>
<td>&quot; 20-30</td>
<td>8</td>
<td>12.3</td>
</tr>
<tr>
<td>&quot; 30-40</td>
<td>3</td>
<td>4.6</td>
</tr>
<tr>
<td>&quot; 40-50</td>
<td>4</td>
<td>6.2</td>
</tr>
<tr>
<td>&quot; 90-100</td>
<td>1</td>
<td>1.5</td>
</tr>
</tbody>
</table>

* Fiscal year 1979.

As these statistics illustrate, the bulk of our sample, or 75.4%, is composed of companies with total revenues of $20 million or less in 1979. Only two companies had sales of $1 million or less, suggesting the relatively small number of public companies of that size. The largest company we interviewed (and the only retailing company in the sample) had 1979 revenues of about $90 million. The companies in the sample are not dissimilar in size to those in the SEC's March 1981 report concerning Form S-18, although the larger companies in our sample are bigger than those which used Form S-18. Almost 51% of the companies in our sample had sales between about
$1 million and $10 million, while 83% of the operating issuers which used Form S-18 were within that same range.

When assets, rather than sales, are used as the measuring standard, the distribution range of the companies in our sample is narrower, as seen below.

<table>
<thead>
<tr>
<th>Total Assets ($millions)</th>
<th>Number of Companies in the Category</th>
<th>% of Sample</th>
</tr>
</thead>
<tbody>
<tr>
<td>0-1</td>
<td>2</td>
<td>3.1</td>
</tr>
<tr>
<td>over 1-5</td>
<td>25</td>
<td>38.5</td>
</tr>
<tr>
<td>&quot; 5-10</td>
<td>16</td>
<td>24.6</td>
</tr>
<tr>
<td>&quot; 10-20</td>
<td>16</td>
<td>24.6</td>
</tr>
<tr>
<td>&quot; 20-30</td>
<td>5</td>
<td>7.7</td>
</tr>
<tr>
<td>&quot; 80-90</td>
<td>1</td>
<td>1.5</td>
</tr>
</tbody>
</table>

#Fiscal year 1979

Fifty-seven out of the 65 companies, or 87.7%, had total assets between about $1 million and $20 million. With the exception of one company, an owner and operator of cable television systems, all the companies in the sample had total assets under $30 million. Of these, only two had assets of $1 million or less in 1979.

The Age of the Companies

Management was also asked the age of their companies and how they were started. The age distribution is listed below.

<table>
<thead>
<tr>
<th>Age</th>
<th>Number of Companies</th>
</tr>
</thead>
<tbody>
<tr>
<td>0-10</td>
<td>2</td>
</tr>
<tr>
<td>over 10-20</td>
<td>22</td>
</tr>
<tr>
<td>&quot; 20-30</td>
<td>13</td>
</tr>
<tr>
<td>&quot; 30-40</td>
<td>14</td>
</tr>
<tr>
<td>&quot; 40-50</td>
<td>6</td>
</tr>
<tr>
<td>&quot; 50-60</td>
<td>4</td>
</tr>
<tr>
<td>&quot; 60-70</td>
<td>1</td>
</tr>
<tr>
<td>&quot; 70-80</td>
<td>1</td>
</tr>
<tr>
<td>&quot; 100</td>
<td>2</td>
</tr>
</tbody>
</table>
Interestingly, the two companies that were over 100 years old were both engaged in the publishing industry. Most of the companies, however, were relatively young; about two-thirds were started within the past 20 years. Moreover, many were still managed by their founders.

The entrepreneurs who started some of the companies in our sample were able to obtain seed capital from professional venture capital sources. More typically, the bulk of those in the sample were forced to rely largely on their own personal savings and those of relatives and friends. Some companies had more unorthodox beginnings. One custom optics manufacturer in the sample was originally the only profitable division of a corporation which went bankrupt and became the property of the parent's bankers. Incidentally, this company never "went public" through a primary offering but instead "became public" through a secondary distribution.

Industry Distribution

The development of a table which classified the individual companies in the sample by industry was difficult for several reasons. Many companies were engaged in different operations which spanned several industries, such as electronic components and industrial controls or computer services and engineering. Also, many companies had products which bridged several industries, such as electronic optical instruments.
and optical character recognition equipment. Another qualifying consideration was the role of the company in the industry. On occasion, for example, a respondent would be one of three or four companies in an entire industry or it would be the only company in its industry that was not a division or subsidiary of a major conglomerate.

Nevertheless, it was possible to develop a table representing part of the sample on an industry by industry basis. For this purpose, some latitude was employed in designation and a single multi-industry company, such as a producer of electronic optical instruments, was classified in two separate industries (in this case, both the electronic and the optics industries). This technique was employed in only two other cases. The outcome was inclusion of 11 industries in which 42 of the 65 companies were classified. The following table presents these results.

<table>
<thead>
<tr>
<th>Industry</th>
<th>Number of Companies</th>
</tr>
</thead>
<tbody>
<tr>
<td>Aircraft Equipment</td>
<td>4</td>
</tr>
<tr>
<td>Computer Services</td>
<td>6</td>
</tr>
<tr>
<td>Electronics</td>
<td>6</td>
</tr>
<tr>
<td>Engineering and Environmental Consulting</td>
<td>3</td>
</tr>
<tr>
<td>Garment</td>
<td>4</td>
</tr>
<tr>
<td>Medical-related (includes producers of drugs &amp; medical equipment)</td>
<td>5</td>
</tr>
<tr>
<td>Optics</td>
<td>3</td>
</tr>
<tr>
<td>Photography-related</td>
<td>4</td>
</tr>
<tr>
<td>Printing</td>
<td>3</td>
</tr>
<tr>
<td>Publishing</td>
<td>5</td>
</tr>
<tr>
<td>Rubber and plastics</td>
<td>2</td>
</tr>
</tbody>
</table>
The 23 companies which were not included in the above table were the only ones in the sample in their particular industry. These industries include investment advisory services, phonograph cutting, ceramic and decal, manufacturing specialty steel manufacturing, automatic speech recognition equipment and a custom telephone manufacturer, to name some. While this table helps describe the sample, it should be remembered that each company in the same industry may have products which are very different and do not compete directly with the others in the sample from the same industry.

As may be observed, a number of different industries are represented, but reflecting the generally small size of the companies, they either provide services or are engaged in light industry. Companies of this type tend to have much lower asset/sales ratios than those in heavy industry. This differentiation, to a large extent, probably explains the narrower asset rather than sales distribution of the companies in our sample.
Chapter 7: An Analysis of the Interviews

In this chapter, the results of the interviews which are summarized in tabular form in Appendix B are analyzed.

Both Congress and the SEC have evinced considerable interest in the development of a National Market System which, as presently envisioned, affects secondary market transactions in the stocks of a relatively small number of companies. Simultaneously, both Congress and the various regulatory agencies have demonstrated a significant concern for the problems of small business. As discussed in Chapter 3, the SEC has shared in this concern as revealed largely in its activities in easing the registration requirements of small companies seeking to raise capital in the primary market.

Basic Question: Why the Lack of Interest in the Secondary Markets of Small Companies

It is understandable that the concern with the secondary markets should initially focus on the stocks of a small group of large companies. The development of the NMS has been a complex and arduous undertaking which has required experimentation with innovative facilities. This situation has necessitated limitations on the number of companies that are able to participate in NMS facilities during the early stages of their implementation.

It is odd, however, that it has taken so long for this concern about the secondary markets to extend to the stocks of small companies. Indeed, the latest SEC plan to include OTC securities in the NMS, which was adopted in 1981, as mentioned previously, permits only about 1,500 of the 28,000 or stocks traded over-the-counter to participate in the NMS. No action has been taken to address the
problems of the secondary markets of those companies which will be excluded from this system. Presumably, if improved secondary markets are helpful to big companies and those who invest in them, improved secondary markets would also be helpful to small companies and their shareholders. Whatever gains could be achieved in the markets of the companies which will be excluded from the NMS would be particularly beneficial to them in view of the antiquated methods by which most of these securities are presently traded.

The activities of the regulatory agencies are influenced, in part, by Congressional sentiment. These sentiments are, to some extent, a result of public concerns and pressures. The question might be asked, therefore, in view of the widespread interest in the welfare of small business, why have the companies, their stockholders or their traders not applied any pressures to strengthen the markets where their securities are traded. Pressures stem from the attitudes towards and understanding of existing issues. Accordingly, in analyzing the results of the interviews, we have given special attention to the attitudes displayed by both the management of small companies and the market-makers in these companies' stocks.

A Partial Explanation: Management Attitudes Towards the Market-Making Function

By its determination of strategic policies and administration of operating procedures, management plays a major role in creating the basic financial value of a company's stock. Public perception and interpretation of these values, in turn, create market value, or the price of a company's stock. In general, changes in a stock's price can often be attributed to two factors: 1) a change in the public's estimate of a particular company's prospects, or 2) a change in the public's estimate of the prospects for the
overall economy. To a large extent, the ability of investors to translate their changed perceptions into the actual purchase or sale of stock depends upon the quality of market-making in the stock.

When the public perception of a company's financial value changes favorably, buying pressure is created and the market value of the stock rises until it finds a new equilibrium price. Conversely, when the public perception changes unfavorably, the resulting selling pressure lowers the market value of the stock. This continual buying and selling revolves about the market-maker who, therefore, is in a position to stabilize and influence the market movements by his own investment activities. Thus, while financial value is the basic determinant of market value, the market-maker contributes to this determination.

Since they both play a role in the establishment of market value, the relationship between the management of a company and the market-makers in its stock is important. Management has no authority to choose the market-maker. In all instances, the initial impetus comes from the market-maker, who decides that he wants to serve this function in a particular stock. Three of the 65 companies in our sample, about 5%, are traded on the American Stock Exchange, which establishes the qualifications for and eventually approves or disapproves the applications of the firms that desire to become the market-makers (specialists) in its stocks. Forty-seven, or about 72%, are traded over-the-counter through the NASDAQ system, where the NASD permits freedom of entry for market-makers who meet its qualifications. Fifteen, or about 23% of the companies, are traded over-the-counter through the "pink-sheets," where serving as a market-maker is limited only
by the minimal qualifications established by the NASD and the SEC.

In view of the fact that management has little control over selecting the market-maker, who provides liquidity and thus influences the market value of a stock, one would think that management would be particularly interested in the quality of its market-makers' performance. Yet, of the 61 companies in our sample that responded to question 2p, which probed the attitude of management towards its market-makers, 25, or 41% (the largest percentage), expressed indifference. Some respondents actually confessed to apathy.*

*The final report of the joint SEC/SBA project on initial public offerings (IPO) of common stock, released in August, 1981, shows that 65% of 85 IPO issuers responding to a survey rated their markets "excellent" or "good". This outcome is different from that indicated in our study, where, as stated in the text above, 41% of the managements in our survey expressed indifference concerning the performance of their market-makers and only 30% were "very satisfied" or "somewhat satisfied." This difference could be accounted for by various factors such as the period covered and the composition of the sample. Indicative of the importance of composition, as discussed later in the text, 67% of the respondents in our sample with a public float over 600,000 shares expressed satisfaction with the performance of their market-makers. This figure is well above the 30% of our total sample expressing this attitude and in line with the SEC/SBA results. To take into account the effect of the period covered and help assure the accuracy of the response, our tabulations were recorded by the interviewer as a result of a personal interrogation. This direct relationship permitted the reference to "apathy" mentioned in the text. The SEC/SBA tabulations were based on responses to distributed questionnaires. Both the SEC/SBA mailed questionnaires and our personally handled questionnaires provided for five quality ratings. The SEC/SBA questionnaire did not contain an "indifferent" category which was the one most frequently elected by our respondents. In lieu of this category, the SEC/SBA questionnaire contained one labelled "adequate."
Many of the executives expressed little knowledge of their trading market, explaining that they were not selling their own stock and only became involved in the market when a dealer would inquire about their interest in buying shares for the company's treasury account. In some cases, they indicated a belief that it would be improper or unethical to try to improve the market-making activity. They felt that if they managed the company well, the market for their stock would eventually take care of itself, and more accurately reflect their estimate of the company's real value.

Several respondents said that their only personal contact with dealers had been during the market crash of 1974-1975 when the dealers became unwilling to make markets in their stocks. The respondents had received complaints from stockholders who were unable to sell their shares because the dealers refused to make markets. In these cases, the executives had tried, usually without success, to persuade the dealers to make markets so that their shareholders could effect transactions.

In general, however, there was a striking failure on the part of the managements of companies and their market-makers to communicate with each other. Company executives often complained that their market-makers knew nothing about their company ("we're just a number, a spread, to them"). Dealers acknowledged that there was some truth to this description but added that communication was a "two-way street" and pointed out that management rarely took steps to inform them about their companies' operations and prospects. Several market-makers noted that the executives of a few companies, whose stocks they handled, met with
them several times a year and one dealer commented, "We can't guarantee these companies a higher stock price but I think we can supply them with a more liquid orderly market so that, at least, they have a better idea of where they really stand."

The companies' attitudes towards their market-makers did not appear to depend on the companies' financial results. Had such a relationship existed, it could have been assumed that the companies were blaming their own problems on their market-makers, but this was not the case. Of the six companies in the sample which reported net losses in fiscal year 1979, four said they were satisfied with their market-makers' performance. The managements of these companies were somewhat surprised that their market had not completely collapsed as it had in 1974-75 when the news of their losses became public information. They were gratified that their market-makers and the rest of the investment community maintained a long-term perspective and overlooked their companies' immediate situation. On the other hand, the financial performance of the companies that expressed dissatisfaction was reasonably successful. Of the seven companies that said they were very dissatisfied with their market-makers' performance, four earned an after-tax return of over 10% on their assets.

The foregoing analysis suggests that neither the management of small firms nor the market-makers of their securities are likely to take the initiative in developing a better secondary market for their securities. As elaborated later in this chapter, the managements of these companies tend to be immersed in day to
day operational problems. They are likely to have relatively little interest in secondary market liquidity and to be more concerned about their ownership and control position in the company than the status of the investor in the stock. The market-maker, in turn, who has a natural affinity for the status quo and an instinctive aversion to change, is likely to avoid stocks in which he does not see immediate profit opportunities.

The Influence of Company Characteristics

Because of this apparent barrier between management and market-maker in the stocks of small companies, it seemed necessary to investigate more closely how attitudes of these two groups are affected by the characteristics of the particular companies and their trading markets. Of particular importance are: 1) liquidity, gauged by the public float (the number and percentage of outstanding shares in the hands of the public), or the number of market-makers in a company's stock; and 2) market-price action gauged by the total market value of a company's outstanding common stock in relation to its book value.

Through percentage relationships, we observed how the attitude of the companies' managements was affected by these characteristics in such areas as market-making, the National Market System, and the company's ability to meet its own financial requirements. In evaluating these relationships, we have relied upon the percentage of responses under differing conditions without employing any refined statistical tests. Our primary intent for the purposes of this study, was to ascertain an overall picture of the secondary markets of small companies; in many cases, the percentage differences were quite sharp.
In general, our method of analysis was first to hypothesize a relationship and then investigate to what extent it was validated by the facts. For example, one might expect that the higher the market value of a company's stock in relation to its book value, the more satisfied company management would be with the performance of its market-makers. To test this hypothesis, we observed this relationship through a procedure explained later in this chapter. By these and other similar means, it was possible to obtain a better understanding of the results in Appendix B and to draw various conclusions from them. Throughout this analysis, it should be remembered that not every company in the sample responded to every question in the interview, so that the number of responses being analyzed may fall short of 65.

The Liquidity of the Stocks of Small Companies As a Characteristic

Although there are several definitions of liquidity, a common one is the spread between the bid and asked prices of a stock. The spread in turn, is affected by activity. The more active a stock, the narrower its spread is likely to be, because market-makers, knowing that they can liquidate their holdings with relative ease, are willing to accept reduced profit margins in the form of narrower spreads. Conversely, inactive stocks often carry wider spreads because of the possibility that a market-maker may become "locked-in" to his inventory for an extended period of time.

The Significance of Public Float

Liquidity is obviously an important characteristic. It affects both a stock's value and the company's ability to raise capital by selling securities to the public. Whatever definition is used,
the number of shares in the hands of the public is a key determinant of a stock's liquidity. When there are a large number of such res, there are apt to be relatively more shareholders who can meet in buy and sell transactions. As a result, the opportunity for active trading and smaller price changes from trade to trade is enhanced.

Accordingly, all other things being equal, the greater a company's public float the more likely it is that the company will have a liquid trading market. Conversely, a small float could lead to liquidity problems. In our sample, 41 out of 65 companies, or 63.1% had less than one million shares outstanding. The same number of respondents had public floats of less than 600,000 shares. Thus, both the size of the issue and the proportion of shares in public hands are relatively modest, suggesting the stocks probably would not attract the attention of large institutional investors.

However, the amount is sufficiently large to constitute a trading base which is liquid enough for small institutions and for the typical individual investor. Indicative of this fact, 250,000 shares of public float is the minimum number required for inclusion in the NMS, as specified in Chapter 4.

Because of their small public floats, the managements of the companies in our sample may be able to have a special influence on the liquidity of their stocks. As an illustration, the purchase of its own shares for its treasury account by a large company is unlikely to have a significant impact on the liquidity of the shares held by the public. On the other hand, when a small company undertakes a similar course of action, the liquidity of its shares can be drastically impaired. Yet, many of the respondents in our
sample said that they had reduced the percentage of public ownership in their companies by repurchasing shares in the open market because of the bargain prices that prevailed after the OTC market collapse of 1974-75.

Management policy with respect to its common stock is often a key indicator of the financial direction which the company intends to follow. A company that wishes to raise capital from the public may choose to split its shares in order to attract public attention, enhance liquidity and create investor interest. Conversely, a company which seeks to go private will sometimes reverse-split its stock and thus reduce the number of shares outstanding in order to make them less liquid, thereby encouraging stockholders to sell their shares back to the company. The stock of one such company, Simpson Timber, traded at about $45,000 a share in October, 1980, following several reverse-splits.

The Effect of Public Float on Management Attitudes

Many of the companies in the sample were still being run by their founders or the founders' families, and these insiders often chose to retain a significant degree of control over the ownership structure. Despite their relatively modest public floats, all but two of the 65 companies in our sample had turned to the public for financing at some time and the public held a substantial interest in most of them. Thus, in 39, or 60% of the companies, the public held 40% or more of the shares outstanding.

Since the classic study by Berle and Means of corporate organizational structure almost 50 years ago, students of finance have been interested in the influences of management, control and ownership on the policies of corporations. In large corporations,
management and ownership are often separated and each tends to serve as a check on the other. This check, and the wider ownership distribution that usually exists in large corporations combine to protect and enhance the trading markets of these companies' shares. This protection is attenuated in the case of small corporations, particularly when their shares are traded outside of NASDAQ. In these companies, management, control and much of ownership often reside in the same group, despite the fact that there is a substantial public interest in them. Consequently, management tends to have both less interest in the trading markets of their stocks and greater ability and latitude to affect these markets.

The relatively lackadaisical attitude of management towards its market-makers' performance suggests a similar attitude towards the secondary market, in general. As mentioned earlier, a plurality (41%) expressed an indifferent attitude to the market-makers in their companies' stocks. However, when the size of the public float is taken into account a different picture emerges. This differentiation may be observed in two ways.

In one way, the attitude towards the performance was used as a benchmark characteristic. Eighteen of the 61 companies responding to question 2p (concerned with the attitude towards the performance of market-makers), or 29.5%, expressed dissatisfaction with their performance. Fourteen of these 18, or 77.8%, had a public float of 600,000 shares or less. Conversely, the same number of companies, 18, expressed satisfaction with market-maker performance, and of this category of the sample, 12, or 66.7%, had a public float of over 600,000 shares.
Earlier in this chapter, we observed that the companies' financial condition did not appear to play a significant role in the attitudes of their managements to their market-makers' performance. Apparently, the size of the public float was a more important factor in both the attitude of management and the interest of the market-makers in these securities. It is possible that the presence of more market-makers contributed to a better, more liquid market in these companies' stocks and therefore to a more satisfactory attitude on the part of management. This notion will be discussed in more detail later in the chapter.

The Implications of Public Float for Small Companies

Many of the respondents gave priority to other objectives such as earnings per share and the prevention of a hostile takeover. To achieve these objectives, the companies might reduce the floating supply of their shares thereby adversely affecting liquidity. Some companies, for example, had repurchased their own shares in recent years because, in the words of one respondent, "it was the best investment we could make." Similarly, when their stock, as was often the case, sold at a substantial discount from book value, which in turn, was less than the replacement cost of their assets, executives might seek to buy back their companies' shares.

Some of these respondents acknowledged that a repurchase policy was detrimental to the interests of stockholders who wished to sell their shares in the near future because the reduction in the size of the public float made the stock less liquid. However, they thought their primary responsibility was to those shareholders who, like themselves, were interested in the company as a long-term
investment. They claimed that their repurchasing plans would benefit these individuals by making it less probable that they would be forced to tender their stock to an acquirer at a price that did not reflect the fair value of their investment.

Not all of the companies who pursued this repurchase policy attributed it to the altruistic motives mentioned above. A few, who did not wish to be named, said they were considering taking their companies private and their ability to repurchase a part of the public float at relatively low prices would reduce the eventual cost of going private should they choose to do so. Thus, it was in their interest to see that an inefficient trading market was maintained in their stock so that they could continue to exploit it at the expense of their public stockholders.

Though the companies in the sample were all publicly held, many were run in a manner similar to a personal fiefdom. This apparent anomaly caused a continual conflict of attitudes and objectives which affected the financing of these companies and their relationship with market-makers and investors. The explanation of one vice president of finance, who had been the assistant dean of a major American business school, of his reluctance to do a primary offering at a time when he considered his company's stock to be overvalued, provided some insight into this anomaly. He said, "One can build all sorts of models about how the cost of capital must equal the use of capital, but when one gets out in the business world, you realize that the key objective is power and control, and the insiders at our company will refuse to dilute their 35% interest at all."
The objectives of greater insider control and a more liquid secondary market are not necessarily inconsistent. One company president discovered a simple method to boost earnings per share, prevent the likelihood of a takeover and develop a more liquid secondary market at the same time. First, his company repurchased about 5% of the total outstanding shares and then declared a three-for-two stock dividend. In two simple steps, he was able simultaneously to increase both the insider control of the ownership structure and the size of the public float which made the company less susceptible to a hostile takeover and enhanced the liquidity of the stock.

The size of the public float, both in the actual number of shares outstanding and in the percentage held by the public, was a source of contention between the small business community and the securities industry. The investment bankers and traders we interviewed thought the desire on the part of small company executives to maintain their present ownership structure was a major impediment to the development of improved secondary markets. In their opinion, many small companies lacked the public float to give the investment community something "to sink its teeth into" and were unwilling to take the necessary steps to rectify this situation.

As the data in this section shows, the market for small public companies is one where there is simultaneously a significant degree of insider control and a substantial public ownership. This situation creates difficulties for both insiders and public stockholders. The public often suffers from the inability of company management to reconcile conflicting objectives. It also suffers from the inability of the companies and their market-makers to communicate. At the same time, management is constantly compelled to take the implications of being public into consideration. One
president told us, "Being a public company makes us much more conservative in our planning, and unfortunately, this often benefits no one. There are projects we would definitely have undertaken in recent years if we had been a private company which we felt were too risky to expose our stockholders to. As things turned out for our industry, these projects would have been tremendously successful." Many respondents said they thought that their companies incurred all the costs of being public without being able to reap any of the benefits.

A number of the respondents were aware of the financial predicament they faced as small public companies but could not see any way to extricate themselves. They were told by investment bankers and market-makers that an important reason for the illiquidity of their stock and its undervaluation was the small float. The solution indicated was to increase the size of the float. Yet, this step could also diminish management control. Indeed, some managements preferred to keep their stock out of public attention to secure their own control and enhance their flexibility of action. This "chicken and egg" dilemma helps explain the apathetic attitude of the managements of many small companies toward their market-makers. Such an attitude, combined with a lack of understanding of the significance of the secondary markets, sheds light on why the management of small companies has not taken any action to improve these markets.

Market Action as a Characteristic

While, overall, the executives in our sample tended to be indifferent to the role of market-making, they showed more interest in the actual market action of their stocks, and this factor did affect their attitude towards their market-makers. Most of the executives of OTC-NASDAQ companies said they followed their stock
on a daily basis in the newspapers. Since OTC "pink-sheet" companies are not listed in the newspapers, many executives of these companies said they would call their brokers, or occasionally their market-makers, to obtain up-to-date price data.

Executives of both NASDAQ and "pink-sheet" companies were concerned about the price action of their stock for similar reasons. For one thing, the value of their holdings in their companies' stock was, many respondents stated, the largest single asset they owned, so their personal financial future was closely tied to that of the company. Then, again, the executives were interested in the changes that occurred in the composition of the stockholders. This interest focused primarily on individuals who were buying the company's stock rather than those who were selling it because of management's apprehension that someone might try either to acquire the company or become a substantial minority shareholder. They were also interested, to a lesser degree, in the sale of large blocks of stock (1,000 shares or more) because of the effect on their stocks' price and the fact that a sale meant someone else had been a large purchaser. A third reason, cited by only a minority of executives, was that market action helps determine the financing options available to a company. They indicated that both the price and the liquidity of their stock had an effect not only on their ability to raise money from the public but also to negotiate private placements.

It was necessary to obtain a measure of price action in order to evaluate its influence. For this purpose, we used, as a measure, the relationship between the market value of a company's total outstanding common stock and its' book value. The fact that a stock sells at a price above its book
value does not necessarily mean that its market performance has been good. Conversely, the fact that a stock sells at a price below its book value does not automatically imply that market performance has been poor. Much depends upon the elements that enter into the computation of book value and the character of the company's operations. (For example, five years ago the Chrysler Corporation had a book value of approximately $50.00 a share; today, it probably has no equity at all). Nevertheless, book value is a quantifiable figure that does represent underlying financial value, and therefore, it is a measure that for our purpose can be used as a discriminating guide.

The Effect of Market-Price Action

Data which permitted the calculation of both market value and book value were available for 51 companies in our sample. Of these companies, (32%) had market values which were below book value. Within this category of companies selling below book value, 10 (20% of the total) had market values which were less than 50% of their book values and two (4%) were priced below 25% of their book values. At the other end of the spectrum, 19 companies (37%) had market values greater than their book values. Within this category, nine (18% of the total number of companies) were priced between one and two times their book value, four (8%) sold between two and four times book value; and five were priced four to eight times their book value. One glamorous company sold at over 11 times book value.

There was a strong relationship between the companies' attitude towards their market-makers and the action of their stock as gauged by the market-price/book-value ratio. While this relationship does not necessarily mean that the stock is performing
well, it provides a reasonable indication that such was the case. Sixteen of the 51 companies included in this analysis expressed satisfaction with their market-makers' performance. Nine of these 16 companies (56%) had a stock with a market value which was greater than its book value and seven of these nine had a market value which was at least twice its book value. Twenty-one of the 51 companies expressed indifference towards their market-makers and 16 of these 21 (76%) had a market value which was below book value. Fourteen of the 51 companies expressed dissatisfaction with their market-makers and nine of these 14 companies (64%) had stock prices which were below their book value.

The Implications of Market Action

It would be a mistake to conclude from this analysis that company executives hold their market-makers responsible for the price of their stock. By and large, they realized that a market-maker's function is to match buy and sell orders as efficiently as possible and let the order flow determine the price. Yet their attitude towards their market-maker was, in part, a reflection of their attitude towards their market and it was much easier for a company whose stock was priced above its net worth to be satisfied with its market than it was for a company whose stock was priced below its net worth. These issues can be more fully understood if they are examined from the perspectives of the market-makers.

Many market-makers we interviewed thought activity was a function of investors' perception of value and that the more valuable a company was considered to be, the more likely it was that the company's stock would have an active market and thus attract the interest of the trading community. One dealer told us, "There's no way to underestimate the power of glamour. Dealers are followers, not leaders, and the stocks which create interest,
In recent years, the government has manifested considerable concern with preserving the economic position of small business. Legislation, such as the "Small Business Impact Bill" and the "Small Business Innovation Act of 1979," has been introduced in Congress; the White House Conference on Small Business has drafted a report noting that tax policies, procurement practices and export incentives favor big businesses at the expense of small ones; and the Securities and Exchange Commission (SEC) has acted to provide assistance. After holding hearings on the effects of its rules and regulations on the ability of small businesses to raise capital, the Commission issued various modifications, such as the relaxation of Rule 144 resale restrictions and the adoption of a simplified registration form for issuers, Form S-13. The Commission also lifted the maximum ceiling on the amount of money which can be raised under a Regulation A offering from $500,000 to $1.5 million. Moreover, in association with the Small Business Administration (SBA), the Commission has been studying the interrelationship between regional broker-dealers in the securities field and small business in general. Against this background is the fact that the National Market System (NMS) that is emerging, as a result of major governmental and SEC efforts expended over the past two decades, is applicable to a relatively small group of elite companies. In general, companies that will be eligible for the NMS must be of sufficient size and stature to meet the listing standards of the country's two major stock exchanges.

This notion of a so-called "National Market System" that is limited
Appendix A

The Development of a National Market System
with Special Reference to the Securities of
Small Companies and the Over-the-Counter Markets

Sidney Robbins               Evan Simonoff
It is of interest that the Toronto Stock Exchange has indicated that it plans to establish a separate section for smaller, relatively new natural resources and industrial companies. This proposed step stems from a program to encourage capital financing by speculative, small new companies. In explaining this proposal, the exchange stated, "Many commentators suggested the exchange consider establishing a separate junior section so that the exchange might retain its senior character, listing established companies."
The second conclusion is that even after the SEC initiates a program to restructure the non-NASDAQ sector of the OTC market a long time will be required for implementation because of the primitive state and size of this sector.

Accordingly, it is urgent to start now. For this purpose, it seems reasonable that the SEC as the top regulator in the area, should form a committee composed of representatives from the government, small business, and the securities industry. The purpose of the committee would be to study how best to tackle the problem, devise a program that defines the scope of possible solutions, and obtain the participants. The need and technology are present. The committee would be assigned the responsibility of triggering action. Actual implementation would be given to private industry. The design of an operating structure for the huge non-NASDAQ sector of the OTC market could generate considerable trading activity. The resulting profit potential is likely to attract competitive interest on the part of private industry once the undertaking is initiated. The NASD, as the self-regulating agency for the OTC market might have monitoring responsibility to guide actual implementation by private industry. Much as in the case of NASDAQ and the NMS, as implementing experience is gained, the actual elements of the new system to provide an effective secondary market for the stocks of small firms could be modified as deemed necessary.
The First Step

The immediate question is how to get a program started. For reasons cited in our study, the impetus for such a move is not likely to come from the small companies, themselves, or from the dealers in their securities. None of the approaches discussed above, by itself, seems sufficient. Some combined effort seems to be required.

The development of two major ongoing programs affords a useful learning experience. Efforts to automate the over-the-counter market were started by the SEC when, in the early 1960's, its Special Study invited private industry to submit proposals towards that end. Some ten years later, under the continuing guidance of the NASD, automation of the active portion of the OTC market finally emerged in the form of NASDAQ. The idea for the NMS also emanated from the SEC in 1971 as an outcome of its Institutional Investor Study. The elements of that system are still being put into place some ten years later.

This experience suggests two conclusions. The first is that the SEC can be an effective initiating agency, but is not likely to undertake the technical job of implementation. The Commission, for example, has not reacted well to the recommendation made by the Comptroller General in a report to Congress that the SEC be required "...to develop and submit a national market system plan to Congress by a specified date." Rather its attitude seems to be expressed in a statement by a former Director of Market Regulation "...(T)he SEC should use its authority to encourage private groups to sponsor and implement the facilities they perceive as necessary for improved and efficient markets and leave the job of defining the right market structure to the private sector."
If the National Quotation Bureau fails to act, another information-disseminating corporation might enter the scene either because it recognizes a profit potential in the area or obtains some government inducement.

The cover story in the June 29, 1981 issue of *Business Week*, "Window on the World: The Home Information Revolution," detailed how and why corporations are already investing $100 million in developing videotex systems, or home information retrieval systems. The article remarks, "This 'electronic cottage' technology will fundamentally change the way people shop, bank, work, and communicate, since it will permit them to do all these things without leaving their living rooms. They will be able to call up on their video screens the news on any selected topic, as well as a wide variety of continuously updated information on such subjects as airline schedules, and stock and commodity prices." As this industry develops, the chances of the "pink-sheets" surviving in their present form becomes increasingly unlikely. Rather, it is probable that microelectronics will find its way into this area.

Reliance on market forces to influence private industry to take action, however, undoubtedly would take a long time to develop. No firm as yet has manifest any real interest in tackling the formidable problem of rehabilitating the non-NASDAQ sector of the OTC market. Accordingly, if progress along these lines is to take place within the reasonably near-term future some catalytic influence is desirable.
The SEC has not yet evinced any real interest in such an undertaking.

**Action by the NASD**

Another logical candidate is the NASD. Its 1979 study recognized the importance of good secondary markets to help in the financing of small business. As the overseer of the OTC market, the NASD might be expected to react to the shortcomings of the "pink-sheet" market and take remedial measures. Such a step seems particularly appropriate in view of the added capacity that the Harris machine brings to the NASDAQ system. On the other hand, the NASD has been reoccupied with NASDAQ. The agency seems more interested in persuading the OTC companies with active stocks to remain with their present market rather than to recruit new companies whose stocks do not command a strong trading interest at present. Primarily, it is the status of the big companies whose stocks are actively traded that gives credibility and prestige to the NASDAQ system.

**Private Industry Initiative**

For years the National Quotation Bureau, a private-sector corporation has been responsible for the dissemination of information of the great bulk of OTC companies. It would be a logical candidate to assume a leadership role in modernizing the non-NASDAQ sector with which it has been long associated. The incentive for such action might come from pressures arising from the upgrading of NASDAQ facilities thereby widening still further the gulf between this market and the present "pink-sheet" market.
This idea is at least suggested in the SEC's first policy statement on the subject, issued in February 1972. As mentioned previously, this report indicates that concern is only "with such a system for listed securities" but it also made reference to the importance of evolving "a tandem central market for unlisted securities." A similar inference appeared in the second policy statement issued about a year later. Stress continued on listed companies which may be expected to be relatively big. Thus, "the system would contemplate trading only in securities listed on at least one registered national securities exchange..." Then came the hint of providing a central-market system for over-the-counter securities, "...although many of its (central market) features may subsequently be found appropriate for trading unlisted securities."

Moving from the early statements to the current status, we could interpret the provision of a two-tier basis for NMS qualification as giving some recognition to the undesirability of confining the system to the securities of big companies. The relaxation of the standards from those contained in the original Rule 11 Aa2-1 as proposed in July 1979, to those provided in the Rule that was adopted in February 1981, also suggests an intent to broaden the scope of the NMS.

Still, the principal criterion in the Rule was national investor interest as reflected in the restrictive average monthly volume requirement. So long as the NMS qualifications include an activity standard, most OTC stocks will be excluded. The problem is that in many cases the absence of activity probably reflects the lack of a suitable trading structure. What is required, therefore, is to direct attention to improving this structure for the non-NASDAQ sector of the OTC market.
This combination of interest in the securities field and small business could set the stage for congressional action to create an adequate trading structure for the stocks of small companies. Some encouragement of this possibility lies in the fact that Congress is not unaware of this area. As far back as 1973, the report of the Subcommittee on Securities of the Senate Committee on Banking, Housing and Urban Affairs made reference to the "pink-sheet" market. In the 1972 House hearings on the NMS, the then vice-chairman of the Board of Governors of the NASD, raised the question (which was never answered) of "...how broad is the scope of this national market. There are some 3,000 stocks in NASDAQ. There are probably 19,000 in the so-called pink-sheets...are these all to be a part of this central market?"

The importance of liquidity in the secondary markets has risen in subsequent congressional hearings. Congress has considered a bill to encourage market-making in the stocks of small companies. These are, however, only occasional rays of light in what is now a generally dark area. The overwhelming importance of fiscal issues and an administration that favors deregulation do not augur well for the possibility of congressional legislation to provide for a more adequate secondary market for the securities of small firms.

SEC Directive

The SEC is responsible for creation of the concept of the NMS. As one views developments in this area, an argument can be made for the proposition that the Commission from the onset intended to concentrate its attention initially on the securities of big companies but eventually intended to extend the national system's network to embrace the shares of smaller companies as well.
these companies' stocks over the past 50 years.

Many companies have survived despite the inadequate markets for their stocks, while others have grown into big enterprises whose stocks may now be traded in the NMS. It could be argued, therefore, that a "do nothing" program would merely leave untouched a reasonably satisfactory status quo, while allowing the concentration of efforts on the stocks of the bigger companies that represent the more important part of the nation's industrial structure.

Such a program, however, would also result in a maintenance of the trading markets in the stocks of many worthwhile small companies continuing to languish. There is no doubt that the inefficient trading mechanism of the non-NASDAQ market has contributed to the illiquidity of these stocks. This factor plus obscurity and stigmatization have impeded their capital-raising ability and hindered long-term growth. Perpetuation of this condition runs counter to a national policy that both recognizes the importance of and seeks to help in the development of small business.

A Congressional Requirement

When public policy issues have loomed in the forefront, Congress has taken action in the securities field. Congress, of course, is responsible for the industry's current regulatory structure. It mandated the creation of the NMS. It played a leading role in preserving the "third market" representing over-the-counter trading in listed securities. Congress has also manifest a concern for small business and has adopted important measures in such areas as taxation and pension-fund investment, to ease the financing problems of small firms.
makers from supplying liquidity and investors from purchasing the
stocks of the companies which are traded in it. The extremely
positive attitude displayed by the corporate executives in our
sample towards entering the NMS if they had the choice represented
not so much interest to become part of the NMS, in particular, but
rather a general desire to obtain improved trading market for their
stocks. Most executives thought the chief beneficiaries of the
NMS would and should be the investing public. Because transacting
would become more visible, fairness and orderliness would be en-
hanced and liquidity improved. Since most of the executives (72%)
in the sample had stocks which participated in NASDAQ, they had been
able to experience the benefits of improved liquidity and compare
the present automated transaction mechanisms with the antiquated
methods of "pink-sheet" trading. The NMS was perceived as a further
volution of NASDAQ and, as a result, was popular with the respon-
dents who appreciated the improvements offered by NASDAQ.

The Alternative Routes

In our judgment, it is imperative that a program be launched
now to modernize the non-NASDAQ sector of the OTC market. Such
a program requires independent study but several approaches are
briefly indicated below as guides to future action.

Do Nothing

The SEC's relaxation of the original standards to permit the
inclusion of additional OTC stocks into the NMS is constructive.
The extension, however, still covers only a small fraction of
all OTC stocks. With respect to the large overlooked segment,
therefore, it is a "do nothing" program which merely continues
the absence of progress that has characterized the market for
Despite repeated delays, progress, encouraged by SEC pressure, has been maintained for the integration of OTC stocks that meet stipulated eligibility standards into the NMS.

The Rest of the OTC Market

The progress made in the OTC-NASDAQ and NMS secondary markets, embracing only a handful of the country's publicly traded stocks, is in stark contrast to the lack of movement in the rest of the OTC market, where most of the stocks of small companies are traded. The vast size and diffuse character of this latter sector makes its modernization an intimidating, but not an unrealizable, task. Indeed, the sluggish attitude in this area is reminiscent of the hesitation that marked the efforts, in the early 1960's, to introduce automation into the OTC market. The concentration of government, industry, and investor attention on stocks which are traded in either one of the exchanges or the OTC-NASDAQ market in turn has resulted in little public pressure to improve this segment of the market which is obscure in the public perception. And the complications in developing the NMS have encouraged both the SEC and the self-regulatory authorities to confine the number of companies eligible for participation in these facilities to a relatively small group.

The reasons for taking action to improve the non-NASDAQ OTC markets, however, are compelling. The technological backwardness and inefficiency of this market ultimately impair the allocation of the nation's financial resources. Moreover, its primitive condition and the related illiquidity of many of its stocks are factors which might cause modernization to have particularly positive results. The fact that this market exists only on the telephone and has no centralized interface where all buy and sell orders can meet each other leads inevitably to fragmentation which discourages market-
Chapter 8: Possible Courses of Action

At the present time, important steps are being taken to improve the secondary markets of the country's actively traded stocks. The most prominent of these measures involve the development of the NMS, described in Appendix A which, after a decade of initiatives and experiments, is falling into place. The NMS undoubtedly represents the most efficient securities market in the world for those stocks which participate in its facilities. The NMS will allow exchanges and OTC market-makers to compete with each other in the trading of qualified stocks. Capital will become more mobile as barriers between markets are broken down. More efficient pricing in the secondary markets will lead to the more efficient allocation of the nation's capital resources.

Integration Progress

The NASD is upgrading its NASDAQ system by developing such features as automatic execution and order display capability as well as an order routing switch linked with the Securities Industry Automation Corporation (SIAC) message switch. The enhanced NASDAQ operation, called the Computer Assisted Execution System (CAES), is being started on a pilot basis and will be extended to cover additional stocks. It will eliminate time-consuming telephone conversations on modest-sized retail orders.

CAES provides the basis for incorporating OTC stocks into the NMS. As experience is gained in a linkage between the stock exchanges, joined in the ITS and the OTC market, new rules will be formulated to take care of problems that may develop, such as securities firms internalizing transactions rather than exposing them to the public market.
The Consensus

An overwhelming reaction came when the companies were asked in question 3. Thirty what they would do if they were given the choice of entering the NMS. Fifty-two of the 65 executives (80%) said they would enter the NMS. An additional 8 (12%) explained an uncertain response by stating they would place the issue before the companies' boards of directors for consideration. Only five (8%) respondents gave a negative answer.

The principal reasons advanced for desiring entry were the greater exposure and increased stock liquidity that would result. Also mentioned was enhanced prestige. The five executives who said they would not enter the NMS were more concerned about the additional regulations and expenses that might be incurred as a result of inclusion than they were encouraged by the possible market benefits.
the stagnation of their markets was as much attributable to particular characteristics of their companies, such as small floats and capitalizations, as it was to the antiquated methods by which "pink-sheet" stocks are traded.

When the perspective is shifted and inquiry is made into the implications of exclusion from the NMS on the market-makers and market, the majority of companies, regardless of whether or not they were eligible for the NMS, thought that the effect would not be as significant as that of inclusion. Overall, 34 of the 63 responding companies (54%) believed that exclusion of their stock from the NMS would have no effect on their market-makers. In general, their feeling was that their market-makers were not much interested in their stocks anyway but did enough business to continue to trade in them. Forty-one of the 62 responding managements, also thought that exclusion from the NMS would have relatively little influence on the quality of the market for their stocks. In many cases, however, the reason was that their market "couldn't get any worse than it is now".

On the other hand, some dealers thought that the markets of the OTC stock excluded from the NMS might be improved by the pressure on the securities industry from the increasing competition in the market for OTC stocks included in the NMS. One brokerage house executive in charge of trading said, "The decision of the NASD to go to inside quotes is an example of this." He added, "It is natural that competition will flow outwards from the center to the periphery and, in the case of the OTC market, the center is where the most active stocks are."
inclusion would have no effect on their market; only four (6%) thought it would have a negative impact; and seven (11%) were uncertain.

When these responses are analyzed by market designation, some differences appear. Of the OTC-NASDAQ companies whose stock was ineligible for the NMS, 85% said that inclusion would improve their market. These companies had experienced the transition from the "pink-sheets" to NASDAQ and thought it was, in the words of one respondent, "a miracle compared to what we had before." To many of these respondents, the concept of the NMS appeared to have evolved naturally from the NASDAQ system and, having experienced the benefits of NASDAQ, they instinctively wanted to be able to participate in further advances in market structure.

In general, the companies whose stocks were eligible for the NMS were reasonably satisfied with their present markets which were active and liquid. Nevertheless, seven of the 15 companies (47%) in this category thought that their markets would be further improved by affiliation with the system. Two of these 15 respondents (13%) thought inclusion would have no effect on their markets; four (27%) were uncertain what the effect would be; and two (13%) thought it would have a negative impact because of the probable loss of some market-makers.

Eight of the 15 "pink-sheet" companies (53%) thought inclusion in the NMS would improve the market for their stocks. Four (27%) said it would have no effect and the other three (20%) were uncertain about the outcome. Those seeing gains from inclusion tended to feel that "anything has got to be an improvement over our present market." On the other hand, the sentiment among those who saw no effect or were uncertain about the results of inclusion was that
When ability to meet the original eligibility standards is used as a differentiating factor, there is relatively little variation among the respondents. Within a range of 42%-53%, the preponderance of respondents in all categories thought that affiliation with the NMS would make their market-makers more willing to trade their stocks. This consistency was less visible among those who believed their market-makers would be less willing to trade their stocks. Thus, of the companies whose stocks were eligible for the NMS on the basis of the proposed standards, a relatively large minority of 25% claimed their market-makers would become less interested in their stocks as a result of inclusion. They felt that their market was already quite competitive because, in most cases, there were already several market-makers in their stocks and if the structure of the market became more competitive it might cause the least competitive of them to look for more profitable places to commit their capital. In contrast, none of the executives whose stocks were traded through the "pink-sheets" thought inclusion in the NMS would have a negative impact on their market-makers, because any resulting increased activity would be welcomed by the small number of market-makers involved but would not be sufficient to attract much increased competition.

Forty-five of the 65 companies (69%) in the sample, responding to question 3o, said inclusion would improve the market for their stock. This response compares with 50% in question 3n who thought inclusion in the NMS would increase market-maker interest. This difference reflects, in part, a segment of the sample who thought that inclusion in the NMS might cause some market-makers to drop out but those that remained would make better markets under the pressure of competition. Nine of the 65 companies (14%) thought
Overall, 31 or half the respondents thought that inclusion in the NMS would provide a positive incentive to the market-makers in their stocks and would improve the quality of the markets. The reasons advanced were that the greater resulting liquidity, exposure and prestige of their stock would make investors more eager to buy it and this benefit would more than offset the effects of increased competition on their market-makers. Seventeen executives (27%) believed that the inclusion of their stock in the NMS would have no influence on their market-makers. The eight respondents (13%) who thought inclusion would affect their market-makers negatively based this opinion on the assumption that increased competition would lead to a fall-off in market sponsorship. Some dealers corroborated this last opinion. They cited the action of the NASD in 1980 to display the OTC market's inside price quotations (the highest bid and the lowest asked prices) on the NASDAQ machine and said that this action had caused them to drop out of the markets of some of the most active stocks and look for fertile, less competitive areas for profit in the more inactive stocks. In a somewhat similar vein, one executive vice-president of an OTC trading firm said a stock's exclusion from the NMS would be "a positive factor" in his decision to make a market "because I will have competition but I know I'll get my share of the market whereas in the NMS the
The main reason advanced for this opinion was that underwriters would experience less difficulty in distributing stock to the public because of the prestige associated with the NMS and because the modernized electronic facilities of the system would facilitate handling any sharp rise in volume that might follow an increase in the public float. Twelve respondents did not believe that inclusion would have an effect on their ability to raise money from the public because other factors, such as the reputation of the underwriter, the company's record and the state of the primary market at the time of the proposed offering were more important. Four respondents expressed no opinion.

From a different perspective, the respondents were also asked what effect exclusion from the NMS would have on their ability to sell stock in the primary market. Thirty-six of the 61 responding companies (59%) thought that in this case it would be more difficult to raise money from the public, while 20 (33%) believed it would have no impact. Five expressed no opinion. Most of the 36 respondents stating that exclusion would impair their ability to raise capital contended that their new offering would be stigmatized because of exclusion and its liquidity would be hampered. The 20 respondents who thought exclusion would have no effect on their capital-raising ability claimed the key determinants of an offering's success were the timing, the underwriter and the company's past history.

The Effect of the NMS on the Market-Makers and the Market

In question 3n managements were asked what they thought the effect would be on their market-makers' willingness to make a market in their companies' stocks if they were included in the NMS, while question 3o inquired as to whether or not inclusion would improve the market, itself. The results are summarized in the table below.
the AMEX, to determine whether or not a company was qualified to be included in the NMS. Only 20 of the 64 respondents (31%) agreed with these requirements. Thirty-five (55%) disagreed. Almost all of these executives thought that the listing requirements of the major exchanges were too restrictive and that they excluded too many small companies. One cynical respondent said that the SEC developed these criteria because it lacked the imagination to develop any criteria of its own.

The Effect of the NMS on the Primary Market for Small Companies

The respondents clearly thought that affiliation with the NMS would have a constructive effect on their ability to raise capital from the public. Forty-five (65%) of the companies answering the question indicated that the market for their stock would be improved if it qualified for inclusion in the NMS. And 48 (75%) of the 64 responding managements, in turn, felt that in these circumstances, it would become easier to sell stock in the primary market. Of these, 48, somewhat less than one half, stated that it would be much easier to raise capital.

This favorable reaction was not affected by the eligibility of the company's stock for the NMS. Ten of the 14 responding companies (71%) whose stocks met AMEX listing standards and therefore were eligible for the NMS said inclusion would make it easier to sell stock to the public in the primary market. Twenty-seven of the 35 OTC-NASDAQ companies (77%) whose stocks were ineligible for the NMS on the basis of the original standards stated inclusion would make it easier to raise capital in the public market. And 11 of the 15 OTC-"pink-sheet" companies (73%) believed that inclusion would enhance their capital-raising abilities.
encroachment upon the private sector. Following this question, the respondents were given the opportunity to ask questions (they usually did) about the NMS and how its various facilities were intended to function.

The Standards for Inclusion in the NMS

Question 3h explained the procedures by which securities would be selected for inclusion in the NMS at the time that the interviews were conducted. Specifically, the respondents were asked whether or not they agreed with the principle of the SEC and members of the securities industry determining which securities are qualified for inclusion in the NMS. Twenty-four of the 65 executives (37%) indicated acquiescence, while 34 (52%) disagreed. The remaining seven expressed no opinion. Those who agreed thought that the SEC and representatives of the securities industry were the best qualified to determine these procedures. In general, those who disagreed believed that the business community should have more and the SEC less voice.

Some of the respondents questioned the desirability of any selection process and suggested that the NMS should be open to any OTC company that wants to be included and is willing to comply with the system's regulations and pay the costs. Several of these individuals added that a system might be established to assess fees on small public companies which want to be included in the NMS but whose stocks were not profitable enough for the securities industry to trade. These companies could then decide whether or not the costs of inclusion were offset by the benefits of a more liquid secondary market.

In question 3k, the executives were asked if they agreed with employing criteria, such as the listing requirements of the NYSE and
were successful in obtaining financing from both the primary market and other sources. A significant observation came from an executive who had done a successful offering. He commented, "After we did the primary two years ago, our stock became more liquid, our stock price rose and suddenly a broad range of financial packages became available to us.

The NMS and Small Public Companies

Based on the criteria set forth in the original proposal, only 15 of the 65 companies (23%) in our sample were eligible for inclusion in the NMS. These minimum criteria under Proposed Rule 11Aa2-1 were the requirements for a listing on the AMEX. After the SEC adopted somewhat less restrictive standards for inclusion in the NMS in February, 1981, we estimated that an additional four of the companies in our sample met the tier two criteria bringing the total to 19 (29%). These criteria are described in Chapter 4. Since the original criteria of the Proposed Rule were used in the interviews, they are employed for the analysis in this chapter.

Before the respondents could be asked questions about the NMS, it was necessary to explain the system to them. Of the 65 companies in the sample, the executives of only 38 (59%) had ever heard of the NMS, primarily by skimming articles in the newspapers. Because of the limited knowledge of the executives in our sample, the description of the NMS in question 3b was read to them. Forty-seven of the 65 companies (72%) had positive reactions to this description, of which 27 (42%) had very positive reactions. Most of these respondents thought the primary beneficiary of the NMS would and should be the public. The six executives who had negative reactions felt the NMS was another example of big government's
hundred thousand. What bothers me most is that everyone, particularly our stockholders, holds us responsible for the market in our stock and yet we have no control over it." Under the circumstances, it is not surprising that some companies, which see no possibility of obtaining public financing in the future and yet which comply with all the regulations required of a public company, said they regretted their original decision to go public and had considered taking the company private.

Various companies in the sample confirmed the observations made by executives in the securities industry, who stressed the importance of liquidity and pointed out that the larger public float and stronger balance sheet which are created as a result of a new public offering would help produce this liquidity. One company, when it was in dire need for an infusion of capital, was able to make a convertible debenture offering to several insurance companies and other institutions through a private placement. The company's president told us, "The fact that we had an orderly, liquid trading market in place made this private placement possible because the buyers of the convertible debenture were aware that an avenue existed through which they could unload. Though they haven't chosen to do so, they would have never made the investment in the first place if they thought they might become locked in. If our company had not been able to do this deal, we might have had to declare bankruptcy. Today, our future looks very promising."

While the companies' responses indicated some awareness of the interdependence between the primary and secondary markets, their general lack of sophistication with regard to the whole spectrum of alternative financial instruments was apparent. This general lack of sophistication was highlighted by the creativity of the few who
in the interviews even though the executives held significant stakes in their own companies. The result of this perception was the development of a defensive financial strategy.

Several executives said that brokerage houses had acquired over 5% of their companies' shares. In one case, where a brokerage firm acquired nearly 15% of his company's stock, the executive commented, "Our stock is selling today at $4 a share and if a larger company were to make a tender offer at $7 a share, these traders would sell us out in a minute without even calling us. We are worried very much about this possibility. The people in the securities industry are interested in quick profits, not long-term investments, and they wouldn't hesitate for a second if given the opportunity to make a fast buck." Twelve months after this company was interviewed, its stock sold for $12 a share. In many instances, managements' perception of their companies' susceptibility to a takeover may have been greater than the reality. Nevertheless, the perception was there and its mere existence often influenced the strategic behavior of the companies.

The Firms That Recognized The Importance Of The Secondary Market

A number of firms recognized the importance of the secondary market in effecting a primary offering. In some cases, they wanted to raise funds through the sale of stock but felt the secondary market in their stock would not support such an offering.

These firms thought that their stock was too inactive and illiquid for an offering to be feasible and its price too low for one to be desirable. One executive said, "Our trading market makes a new offering impossible. How can a company whose stock normally sells a couple of hundred shares a day go out and sell a couple of
The Firms That Did Not Consider The Primary Market

A number of executives did not consider the primary market a realistic alternative for several reasons. Some said their company did not need any significant external financing and so they had not looked into the possibility of a primary offering. Several thought the key determinant of an offering's success was the quality of the underwriter and felt they could not attract a sufficiently prestigious underwriter. Still others indicated that the bulk of their financing came from banks which base their credit decisions on a company's balance sheet and income statement rather than the stock market.

The Firms That Preferred To Avoid The Primary Market

In various instances, firms simply preferred to avoid the public markets to the extent possible. Some were hesitant to consider an offering in the primary market because it would dilute the ownership of present stockholders and because they were afraid it would further depress the price per share. As one executive said, "Our stock price hit $60 a share in the 1960's and we still have stockholders who paid close to that price. Today, our stock sells at about $12 a share and if it went up to $20 we would definitely consider an offering desirable, but I know that many of our long-time stockholders who paid much more than $20 for their stock would be upset about the dilutive effect."

Another factor which dissuaded some of the companies in our sample from raising capital in the primary market was that a new offering would increase the public float and thus the likelihood of a takeover by a larger corporation. The perception of their companies' susceptibility to a hostile takeover became apparent
To the extent that the stocks of small publicly-held companies are traded in inefficient markets, a handicap is placed on investors who cannot readily buy and sell these stocks; on the companies, who are limited in their financing opportunities; and on the national economy which does not receive the benefit of an effective allocation of its financial resources.

The Relationship of the Secondary Markets to the Primary Markets

The distribution of the securities of small companies in the primary market usually follows the typical fixed-price offering pattern used in the offerings of the securities of big companies. Technical differences exist, such as the compensation of underwriters, but the underlying principles are essentially the same.

As mentioned previously, the distributions of small-company securities historically have displayed much greater volatility than those of big companies. To some extent this difference is caused by the greater speculative characteristics of the securities of small companies. The difference, however, also reflects the more inefficient, less liquid character of the market where the securities of many of these small companies are traded. Investors are reluctant to buy the stocks of companies which may later be difficult to sell, and underwriters, during dull markets, are reluctant to handle such offerings. The financial problems of small companies are also exacerbated by their inability to tap the public debt markets for loans.

A question asked of the managements was the effect of the secondary market on their companies' ability to raise money in the primary market. The reactions varied: some did not give consideration to the primary market; some preferred to avoid public financing; still others, recognized the significance of the primary market.
in the future and this development should help to improve the market for the stocks of these companies. At the same time, the difficulty of covering a market which is so vast and diffuse is intrinsic. And, though an increase in the number of individuals researching small companies will help the markets of the companies which are analyzed, it cannot compensate for the archaic structure of the secondary markets in "pink-sheet" securities, where transacting is hindered by the cumbersome, time-worn methods described in Chapter 5.

There are some exceptions to the tendency for market-makers to be attracted to active stocks that we have described. For example, the executive vice-president of one securities firm, when asked what factors influence his decision to make a market in a particular stock, said, "Our approach is different. We look for the neglected stocks no one else wants. Our criteria are a low multiple (price/earnings ratio), a deep discount to book value and a debt/equity ratio of less than one to one. We are one of the few firms that does this. We look for illiquid markets. It's our niche, we have expertise in it and customers who are willing to pay for it. We don't do our business on an eighth of a point doing volume. We prefer to buy at 2 and sell at 4, old-style positioning." This philosophy of market-making at least in part, was the exception rather than the rule. The dealers' final comment, however, is reflective of the ease with which a market-maker can stop supplying liquidity to a company's shares when it no longer serves his interest and, as a result, make it that much more difficult for investors to effect transactions. He added, "Sometimes, when we think a stock has reached its true value or has become overvalued, we may drop out of the market and close out our inventory."
ributed during January 1972 and June 1979 had research coverage at the end of June 1980 and 15 broker-dealers accounted for half of the research reports. Thus, the conditions requisite for efficiency, by and large, are not present in the "pink-sheet" market where there is a predominance of small companies, and they may be absent, at least to a significant degree, from the market of some of the less active NASDAQ stocks.

Certain strategic steps taken by various firms in the securities industry indicate that Wall Street is aware of the inefficiencies in the markets of small public companies and thinks that some of them can be exploited for profit. In the last several years, there has been a growing interest on the part of brokerage firms in undertaking research to identify small companies with growth prospects. This is an area which the securities industry has traditionally ignored in the past.

An article, "Hot Stock Pickers," in the April 6, 1981 issue of Barron's, described the boom in several research departments of analysts who are termed "special-situations generalists." The article quoted the Research Director of Shearson/American Express, Elliot Fried, who described the work of these analysts as "just coverage of obscure securities that are not covered by other people." In the same article, the Research Director at Bache, Halsey, Stuart & Shields, said he had hired an analyst solely for the purpose of following "non-Big stocks, inefficiently priced stocks, overlooked stocks."

These developments indicate a recognition on the part of the securities industry that their neglect of small companies has created interesting opportunities for their clients to earn capital gains. The fact that brokerage houses are taking these corrective measures means that information will be more closely analyzed and disseminated
their market-makers posted on the company's situation he could supply these companies with a "more liquid orderly market" and though this did not guarantee a higher stock price, "at least they have a better idea of where they stand."

Few corporate executives in our sample were as conscious of the importance of liquidity as the one mentioned above who switched his company's stock from the OTC market to the AMEX. Few of the respondents had been able to compare the auction and negotiated markets, but most had experienced "pink-sheet" trading in the days prior to 1971 and NASDAQ's advent. Among these executives there was a consensus that their present NASDAQ market was a tremendous success when compared with their former "pink-sheet" market. And, though they differed in their assessments on how much improvement was still left to be made in the NASDAQ system, most of these executives thought that NASDAQ had given investors "a market they can see" and considered the "pink-sheets" to be, in the words of one "high-tech" company president, "an archaic, antiquated and ridiculous method given today's technological capabilities."

The Evidence of Inefficiency

The bulk of the stocks of small companies are traded through the "pink-sheets." As has been described, the structure of this market is inadequate, trading is relatively inactive, and in many instances it is questionable if there is sufficient information on which to base rational decisions, an indispensable requirement for market efficiency. Indicative of this problem for the stocks of small companies, the SEC/SBA study notes, in its Phase II report, the high correlation between the number of research reports on new public companies and the size of the revenues of the issuers covered. Moreover, it points out that only 17% of the IPO's dist-
The ability of investors to execute transactions influences the efficient pricing of the companies' stock. Market-makers, when deciding how much capital they should commit to a given stock weigh the risks and potential rewards of each security they trade, and then decide on the allocation. To a significant degree, this decision determines the ability of investors to trade sizable blocks of a stock. If the secondary market is sufficiently liquid to absorb at least modest blocks without affecting the price substantially, the stock may become eligible for investment by institutions, thereby contributing to its efficient pricing. Like other investors, including traders, institutions are more likely to buy a stock if they know they will have little trouble selling it.

The experience of one company whose stock had become listed on the AMEX five months before our interview illustrates that efficient pricing helps to clarify the options available to management. The company's president told us, "Shortly after we were listed, a major stockholder sold a block of 75,000 shares to the specialist and the price didn't budge. This never could have happened in the OTC market, where an order to buy or sell 10,000 shares would have moved the price significantly and an order for 20,000 shares or more could not have been executed. It took the specialist six weeks to unload his inventory in our stock and he was able to drive the price up a little. Shortly thereafter the price declined with the rest of the market (in February and March, 1980). Now there is more activity in the stock because people know it is marketable. While the price is still too low for us to do the equity offering we want to do, at least we know where we are." This observation corresponded closely with that of the OTC trader, quoted earlier in this chapter, who said that when companies kept
makers, and the average monthly share volume of nine of these 21 (43%) was 20,000 shares or less. Seven of the 46 companies had eight or more market-makers and all of these had an average monthly share volume of more than 20,000 shares. These relationships are summarized below.

<table>
<thead>
<tr>
<th>No. of Market-Makers</th>
<th>Number of Companies</th>
<th>Companies With Average Monthly Volume of 20,000 Shares or Less</th>
</tr>
</thead>
<tbody>
<tr>
<td>4 or less</td>
<td>18</td>
<td>16 89%</td>
</tr>
<tr>
<td>5 to 7</td>
<td>21</td>
<td>9 43</td>
</tr>
<tr>
<td>8 or more</td>
<td>7</td>
<td>0 0</td>
</tr>
</tbody>
</table>

The tendency for market-makers to be attracted to active stocks rather than intervene in the market of inactive stocks minimizes the significance of their market-making role. The failure to recognize this gap in the market-making function is illustrated in the comment of one market-maker. He said, "I rarely take the lead and create activity by buying or selling a stock myself. Usually, I only start buying or selling a stock because someone else, most often the customer of a retail brokerage house, wants to buy or sell that stock. My function, if I'm on the buy side, is to decide whether I should take 1,000 or 5,000 or 20,000 shares and that depends upon two factors which pertain to my assessment of the risks involved: 1) how easily I think I can get rid of those shares, and, 2) whether I think the price of the stock is going to rise or fall in the near future". In pointing to his assessment of the ability to "get rid of those shares," the market-maker above was minimizing his own role in the creation of liquidity because he executes rather than initiates transactions. The outcome of his decision whether to buy 1,000 or 20,000 shares of a given security clearly influences both the activity and liquidity of small companies' stocks. The degree of liquidity a dealer is willing to supply places limitations on the size of the transactions which can take place.
The Market-Making Function

Market-makers consider their primary purpose to be the execution of orders and regard the decisions which determine the order flow as being the responsibility of institutional money managers, individual investors, security analysts and stock brokers. They judge themselves on their ability to earn a profit while maintaining smooth, continuous markets. Even in the large integrated securities firms where the trading department may be asked to make a market in a particular stock to satisfy the objectives of another department in the firm, such as corporate finance or research, the executives claim that their primary goal is to make markets in stocks where they can earn money. The market-makers we interviewed generally said that the most profitable stocks to trade are the active ones.

The hypothesis that activity influences the level of market-maker interest in a stock was supported by evidence obtained from the interviews and the 1980 NASDAQ Securities Fact Book. From the Fact Book, we derived the average monthly volume for 1980 in 46 of the 47 NASDAQ companies in our sample and compared this statistic with the number of market-makers in each of these securities (the company from which we were unable to obtain data was delisted from NASDAQ after we interviewed it).

The results of this analysis demonstrated that, indeed, activity was a key variable which helped determine the level of market-maker interest. The stocks of 18 of the 46 companies had four or fewer market-makers. The average monthly share volume of 16 of these 18 companies (89%) was 20,000 shares or less. The stocks of 21 of the 46 companies had between five and seven market-
label and even if such a company were able to develop an exciting new product and show signs of dynamic future growth it might take the investment community a surprisingly long period of time to become aware of this condition. Company managers tended to confirm that often a substantial time lag intervened before the investment community became aware of their company's new developments. In effect, the market-makers tend to follow the stocks of companies in which there is active investor interest rather those of companies which do not have an investor following, even though their shares appear underpriced.

**The Inefficiency of the Secondary Markets of Small Companies**

It is widely held that the U. S. securities markets are efficient. The Efficient Market Hypothesis holds that stock prices are usually in equilibrium because they have taken into account all the available information which affects the companies' outlooks. Such markets are considered fair because all investors, with the exception of insiders, have equal access to the same information. In these markets, where prices reflect appropriate underlying values, capital flows to the companies with the most promising futures. As a result, a nation's financial resources are efficiently allocated which helps it to experience smooth and healthy economic growth.

Implicit in the existence of efficient markets is the presence of a large number of buyers and sellers who have sufficient information to permit rational decisions that can be effected in markets capable of handling them. Occupying an important role in such markets is the market-maker who provides the focal point for the interchange of the transactions.
and thus activity and liquidity, are the ones which have a significant
share of the market in a growing industry. As their stock price
rises, this appreciation creates interest in the company and so the
stock becomes more active." By comparing the number of market-makers
in a company's stock with its market value/book value ratio, it was
possible to observe the validity of this hypothesis.

The results help to support the supposition that market-makers
are attracted to stocks to which the market assigns a high premium
and avoid those stocks which the market chooses to discount. Twenty
of the 32 companies in the analysis (63%) with market values below
book values had four or fewer market-makers; ten of the 32 companies
had market values which were less than 50% of book values and of
these 10, nine had four or fewer market-makers. In contrast, 14
of the 19 companies (74%) with market values greater than book value
had five or more market-makers, a significant contrast to the under-
valued segment of the sample.

This analysis can be viewed from another vantage point.
Twenty-six of the 51 companies had five or more market-makers and
14 of these 26 (54%) had market values greater than their book values.
On the other hand, of the 25 companies in this analysis which had
four or fewer market-makers, 20 (80%) had market values below book
values.

Dealers and investment bankers interviewed in the study
attributed these relationships to the fact that stocks selling at
a premium are likely to represent relatively glamorous companies
which attract investor interest. Conversely, in the competition
for the investment dollar, the stocks of small companies selling
at a discount from book value tend to be overlooked. It was
pointed out that the stocks of these companies are given a "dull"
to no more than a few thousand big companies has permeated the thinking on the system from the very outset. Thus, in an important statement issued in January 1972 summarizing developments, the Commission stated, "The second major National Market System principle supported by the Congress was that the types of securities qualified to be included in the National Market System ('qualified securities') should depend primarily on their characteristics (e.g., trading volume, price and number of shareholders) rather than where they happen to be traded (i.e., on an exchange or over-the-counter)." Implicit in this statement is a National Market System for big companies. This exclusionary aspect raises the question -- if such a system is desirable for big companies is it not also desirable for small companies? A related question is -- would a fully operative NMS for the securities of big companies have any effect on the securities of the excluded small companies? These questions will be explored through interviews. It is desirable, however, to have them in mind when reviewing the events leading to the idea of an NMS and the concerns raised by such a system.

Background of the National Market System

In the decade or so prior to 1975, various elements interacted to focus Congressional and SEC attention on the securities industry; the result was to create an impetus which led to the development of the NMS. Rise of the Institutional Investor

The rise of the institutional investor was an important catalyst leading to change in the securities industry. The fact that institutions deal in the securities of big companies was a major reason for the subsequent attention directed toward the securities of these companies.
During the decade of the 1960's, the role of institutions in the securities markets came to the forefront. Their increasing participation was widespread, as indicated by the following changes in the common and preferred stock holdings of various institutions between 1960 and 1971: private non-insured pension funds grew from $15.5 billion to $24.8 billion, a change of 52%; state and local retirement funds climbed from $0.4 billion to $11.3 billion, a change of 272%; and open-end investment companies rose from $15.4 billion to $52.5 billion, a change of 371%.

Life insurance companies and mutual savings banks showed large but less dramatic gains. During this period, institutional trading grew rapidly, accounting for 33.3% of public share volume on the New York Stock Exchange (NYSE) in 1961 and 59.7% in 1971. The institutions, of course, deal in much bigger share blocks than individuals. As a result, transactions of 10,000 shares or more represented 17.8% of share volume on the NYSE in 1971 compared with 3.1% in 1965.

**Commission Rates**

During this period, the various stock exchanges imposed fixed minimum commissions on transactions. Thus, the charge on a 10,000 share order was 100 times that on a 100-share order, although it did not require 100 times the effort to execute the big order. The significance of this differential remained in the background as long as orders were generally of modest size. The institutions changed the picture, however. Their typical order was large and they were sufficiently sophisticated to recognize that there was considerable "fat" in the commission dollar.

To ease this condition, the institutions resorted to a variety of tactics. For example, they demanded services from the securities firms
or member firms that desired to trade listed stocks in the over-the-counter market.

The execution of orders in the third market was not recorded in the stock exchange tapes. Moreover, these orders could not participate in the exchange auction process, even the underlying bid and asked quotations were superior to those in the exchanges. Thus, the classic auction market principle of price priority was violated and this "fragmentation" of the markets contributed significantly to the impetus for the development of an "S.E.S." 4

The Farer-Work Crisis

In the latter part of the 1960's an explosion in securities trading volume took place. At that time, a stock transaction typically required many steps involving the movement of the stock certificate and other pieces of paper. This combination of heavy expansion of trading and an awkward securities-handling process resulted in many firms losing track of the ownership of securities. As a result, the firms were not able to effect deliveries of certificates as required. As "fails to deliver" piled up, the offsetting movements of funds to pay for purchases dwindled because the buyers did not receive the certificates. As a result, the securities industry was virtually brought to its knees in what the SEC described as the "most prolonged and severe crisis in the securities industry in forty years." 5

Eventually, Congress intervened. In 1970, it passed the Securities Investor Protection Act, which created a mechanism for providing investors with some safeguards against loss in the event of failures of securities firms. In parallel actions, Congress directed the SEC to
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of fixed minimum commissions, therefore, quieted one of the major complaints that was voiced during this period. Accordingly, there was some justification for believing that an easing of the pressure for the NYSE might also take place. But the momentum had already been unleashed and no such languishing of interest occurred.

Commission rates on transactions in the securities of small companies ordinarily occur in the over-the-counter market and are effected on a principal basis, with the reimbursement of the securities firm taking the form of a mark-up. These charges are regulated by the National Association of Securities Dealers (NASD). Since institutions ordinarily are not involved in these transactions, the commission problem is not the same as that on the stock exchanges. On the other hand, the charges imposed are more difficult to police and the protection afforded investors is, therefore, correspondingly less. Nevertheless, the hue and cry about commission rates never wafted over to the principal transactions in the over-the-counter area.

The Third Market

The rigidity of fixed minimum commissions had another effect. The umbrella provided by these wide margins enabled various non-member broker-dealer firms to make over-the-counter markets in listed stocks (the third market). From 1965, when the SEC first began collecting reports on these transactions, until 1972, volume increased steadily, reaching a peak level in that year, when on a share basis these transactions represented 7.3% of NYSE volume. In some individual issues, the percentage was much higher. To reduce the pressure of this competition, the NYSE adopted Rule 394 which established a procedural program
issued his report. Under the heading of "The Public Interest," the report pointed out that "ownership of common stock is shared by 31 million Americans directly" and "...that the market should be designed to serve the small investor equally as well as anyone else." Presumably, this sweeping reference included the investor who bought securities of small over-the-counter companies. But Martin's interest was in the New York Stock Exchange.

His recommendation was for "...a national exchange system...to provide a single, national auction market for each security qualified for listing." He said nothing about a system for the over-the-counter shares of small companies held by the public. Indeed, with few exceptions, this oversight was continued in the innumerable writings, hearings and discussions that subsequently took place.

In essence, Martin proposed that the NYSE should be converted to the national exchange system with two divisions based on the listing requirements of the New York and American Stock Exchanges. There was some logic to this suggestion. The NYSE was already doing some 85% of the volume of trading in its stocks. Extending this proportion to 100% undoubtedly would have been the simplest method of creating a national system for listed stocks. Neither Congress nor the SEC gave any counterpoint to such a step. There probably were two major reasons for this out-of-hand dismissal. One was the reality of existing regional exchanges and the third market: the other was the then negative attitude generally held towards the NYSE because of its historic self-serving and arrogant posture.

The SEC Policy Statements

The SEC followed the recommendation made in the letter of trans-
mittal to the Institutional Investor Study with two important policy statements. The first, issued on February 2, 1972, was entitled Statement of the Securities and Exchange Commission on the Future Structure of the Securities Markets. In this statement, the SEC for the first time provided a definition. It observed that "the term 'central market system' refers to a system of communications by which the various elements of the marketplace, be they exchanges or over-the-counter markets, are tied together. It also includes a set of rules governing the relationships which will prevail among market participants. To mandate the formation of a central market system is not to choose between an auction market and a dealer market. Both have an essential function and both must be put to work together and not separately in the new system."

The important notion underlying this definition is that, at least at this stage, the SEC visualized the NMS as an interconnected arrangement of the various exchanges and the third market. The statement indicates that this principle represented "something of a shift in the historic position of the Commission, which over many years...tended to favor competing but separate markets." The shift is not as striking as might first appear. The definition provides for the preservation of separate markets; the change is that they are linked together rather than operating independently. Moreover, it is specifically intended that the markets continue to compete. The statement later notes that, "The central market system we look towards should be designed not only to strengthen competition but to make its operation direct and comprehensible and its results fully public." Presumably, this would be done by making "...visible to the investing public, the competition which now takes place among the separate exchange markets and between all of them and the third market."
The statement also takes passing note of the over-the-counter market but then brushes it aside. "While the Commission believes it is important that a tandem central market system also evolve for unlisted securities, and recognizes that significant strides are being made in this direction through NASDAQ, this report will concern itself only with such a system for listed securities." The reference to a "tandem central market system...for unlisted securities" suggests that the SEC at that time expected eventually to move in that direction. It has not done so. The problems of designing a NMS for listed stocks may have proved greater than had been anticipated; the idea for a tandem central market over-the-counter system may have been forgotten; or perhaps the Commission still expects to provide for a central market system for unlisted securities at a later date. Whatever the reason, at this point, the idea is in limbo.

Following the issuance of this statement, the Commission appointed three advisory committees which formulated recommendations; two congressional subcommittees that had been studying the securities industry also completed their final reports and began to introduce legislation to implement their recommendations. Having received the benefit of this additional thinking, the Commission issued its Policy Statement on a Central Market System on April 2, 1973. In this statement, the Commission refined further but did not change its original definition. "At the heart of the central market system described in the Policy Statement would be a comprehensive communications linkage between market centers, consisting of a real-time composite last sale reporting system and a composite quotation system displaying the bids and offers of all qualified market-makers in listed securities." Moving still further ahead, the
statement indicated the kind of rules necessary for a central market system. Specifically mentioned was an auction trading rule that would provide price priority for all public limit orders in the system and a public preference rule that would prevent any broker-dealer in the system from participating as a principal in a transaction unless his purchase price was higher or his sale price lower than any public bid or offer recorded in the system.

This statement discussed to some extent the economics of the securities markets. It pointed the importance of ensuring "...the continuing availability of increasing quantities of investment capital," and noted that, "The ability of our markets to work in this manner depends on their efficiency and their ability to provide liquidity." Thus, the Commission observed that the liquidity of a corporation's stock in the secondary market is important in determining its ability to raise investment capital. Once more, it is indicated that the primary concern is with big companies whose securities are eligible for listing. "The system initially would contemplate trading only in securities listed or at least one registered national securities exchange..." Again, however, there is the veiled reference to a central market system for over-the-counter securities, "...although many of its (central market) features may subsequently be found appropriate for trading unlisted securities."

The SEC also reiterated its concern with the small investor. "The Commission will take all reasonable steps to ensure that the developing central market system will provide a welcome environment for the small investor." The concern, however, seems to lie with the small investor who desires to buy or sell the listed securities of big companies.
rather than the small investor who desires to buy or sell the over-
the-counter securities of small companies.

The Congressional Reports

Subcommittees of both the House and Senate undertook studies of
the securities industry which included sections on the central market
system that essentially endorsed the approach of the SEC.

The Subcommittee on Commerce and Finance of the Committee on
Interstate and Foreign Commerce of the House of Representatives issued
its report in August 1972. In the move towards a central market system,
it recommended three specific steps: (1) the creation of a consolidated
tape and a composite quotation system; (2) the removal of certain
barriers to competition between potential members of a central market
system such as NYSE Rule 394; and (3) the attainment of such uniformity
in the rules and regulations of the various exchanges as appeared
feasible.

Echoing the principle enunciated by the SEC, the report stated,
"In contrast to a single exchange, the system would consist of a multi-
plicity of different exchanges together with the third market, where
market-makers, by being subject to appropriate regulation, would them-
selves be part of the system." At the same time, there was some recog-
nition in the report that future technology might permit the supplanting of
exchange floors by a central communications system. "This is not to
say that exchanges themselves should be declared obsolete. Until the
day when trading may be done exclusively through a nationwide electronic
communications system there will be a need for trading floors." At
least implicitly, this statement foreshadows the Cincinnati system
which is discussed later.
The Subcommittee on Securities of the Senate Committee on Banking, Housing and Urban Affairs issued its report in February 1973. Like its House counterpart, this endorsed the SEC principle of competing, linked markets. "For this reason, the Subcommittee approaches the question of the 'central market system' not from the point of view of returning all trading in NYSE-listed stocks and subjecting all participants in that trading to NYSE rules and procedures, but from the point of view of preserving the competing markets that have developed, breaking down barriers to communication and competition between them, and imposing those rules -- and only those rules -- which are necessary to protect public investors."  

The Senate report gave much attention to the over-the-counter market. The Subcommittee expressed its belief "...that all investors in publicly-held companies are entitled to the best market available, given the characteristics of that particular stock." Its concern, however, was with the stocks of substantial companies capable of meeting the listing requirements of the major exchanges. "The Subcommittee intends, therefore, simultaneously with the implementation of the combined auction-dealer market in presently listed securities, to consider proposals for the establishment of procedures by which exchange trading could be commenced in presently unlisted securities without the necessity of formal action by the company management."  

The Subcommittee's focus on the securities of big over-the-counter companies is of interest because the Subcommittee was aware of the considerably broader scope of the over-the-counter market. In an earlier section of the report, the Subcommittee reviewed the structure of the securities markets. As part of this discussion it noted that an estimated
20,000 "unlisted" securities were traded solely in the over-the-counter market. It then pointed out that prior to 1971, the only formal method of communicating quotations in this market was through the publication of a daily compilation of bid and asked prices of each dealer in each stock at the close of the previous day (the so-called "pink-sheets"). The Subcommittee further noted that, on February 8, 1971, the National Association of Securities Dealers implemented an automated quotations system, NASDAQ, which provided continuously updated price quotations on a real-time basis on cathode ray terminals in subscribers' offices. The Subcommittee report indicated that there were 2,600 NYSE and American Stock Exchange listed issues, about 300 issues traded solely on one or more regional exchanges, 3,470 NASDAQ issues, and some 16,500 issues traded through the "pink-sheets."

There was at the time of the Senate Subcommittee report, as outlined above, and there still are three different securities systems: (1) the exchanges, (2) NASDAQ over-the-counter, and (3) "pink-sheet" over-the-counter. Of these systems, substantial progress is being made in improving trading methods in the first two, while the third -- "pink-sheet" over-the-counter -- is still being handled in much the same way that it has been for the past several decades. The NMS encompasses only the exchange and NASDAQ securities that meet certain designated criteria. Excluded from the NMS are the NASDAQ securities that do not meet the required criteria and the "pink-sheet" issues.

As mentioned previously, the SEC in its report did hint about a "tandem central market system for over-the-counter stocks" but did not pursue the idea. The House report makes little reference to the over-the-counter market and while the Senate report does consider this
sector, its interest is in those over-the-counter issues that would meet the criteria established for qualification in the NMS. In the extensive hearings on the subject, the question of the scope of the NMS was raised. This was done by J. Robert Doyle, president of Doyle, O'Connor & Company of Chicago, Illinois and then vice-chairman of the Board of Governors of the NASD and chairman of the Association's NASDAQ committee. During the course of the House hearings in which Doyle participated, he observed, "One comment I would like to make about our discussion so far is that how broad is the scope of this national market. There are some 3,000 stocks in NASDAQ. There are probably 19,000 in the so-called pink-sheets. Most of these 3,000 are included there. Are these all to be a part of this central market system?" This question is not answered at the House hearings. The Senate Subcommittee refers to Mr. Doyle's comment but only for the purpose of using the data and not for responding to the question.

One can only surmise about the reason for these brief references to an NMS for over-the-counter companies. This much is clear, however. To the extent that the SEC and Congress contemplated such a system for the relatively small, over-the-counter companies, both in NASDAQ and in the "pink-sheets," it was to be developed only after the NMS for actively traded stocks of big companies had been put in place.

The Securities Acts Amendments of 1975

These amendments represent the most far-reaching changes to the Securities Acts since their passage in the early 1930's. The amendments cover many areas including a specific mandate to the SEC "to facilitate the establishment of a national market system for securities." The legislation provides further insights into what Congress had in
rather than prescribing any particular form to the NMS, the
mandate establishes certain objectives and gives the Commission
considerable leeway in developing the system. Nevertheless, the bias
towards the linking principle is indicated. In Section 11A, Congress
states that, "The linking of all markets for qualified securities
through communication and data processing facilities will foster
efficiency, enhance competition, increase the information available
to brokers, dealers, and investors, facilitate the offsetting of
investors' orders, and contribute to best execution."

The SEC is intended to apply to a select category of securities.
"The Commission, by rule, shall designate the securities or classes
of securities qualified for trading in the national market system from
wrong securities other than exempt securities." The SEC is left free
to define the characteristics of the qualified securities. These
characteristics could embrace different classes of stocks.

A crucial issue in the conceptual development of the central
market was the role of the third market. It occupied an important
place in the SEC scheme but had been eliminated in the Martin proposal.
The 1975 amendments fully accepted the competitive position of the third
market. The Commission was empowered to review the rules of all self-
regulatory organizations to ascertain that they do not restrain
competition.

The SEC is provided with the necessary muscle to facilitate the
establishment of an NMS. Toward this end, authority to regulate,
coordinate, and direct operations of all participants in the securities
handling process is centralized in the Commission. In general, it has
rule-making and policy oversight responsibility for all self-regulating agencies, clearing agents, and transfer agents (to the extent that clearing and transfer agents are banks, responsibility is coordinated with the banking authorities).

Implementing the National Market System

The SEC has construed its mandate to facilitate the establishment of an NMS as providing an overseeing and guiding role. It has justified this policy as reflecting the intent of Congress to permit competitive forces to shape the structure of the markets. The Commission's responsibility is, in its own words, the creation of "a fair field of competition." As a result, the Commission has avoided the promulgation of definitive time tables for the implementation of the NMS. Instead, it has relied on promptings and urgings, bulwarked by the enforcement of rules when considered necessary. The result has been a long and arduous process. In late 1978, reviewing the progress that had been made, Chairman Harold Wiliams observed that "...it had become painfully obvious last fall that, in order to discharge our mandate to facilitate movement toward a national market system, the Commission would have to assume more of a leadership role in the definition of the structure and the development of the communications, processing and other technological components that will characterize the system." No dramatic change in the Commission's posture, however, seems to have occurred. It has continued to rely on industry initiatives prompted by its own pronouncements and rules.

There follows a summary of the major steps taken by the industry and the SEC in the move towards a NMS. (The 1975 amendments affirm the ending of fixed commission rates but the whole question of commissions,
1. Shortly before and after passage of the 1975 legislation, the SEC adopted various facilitating rules including: amendments of its short sale rules to extend their application to third-market transactions; a uniform net capital rule, applicable to much of the securities industry; and anti-manipulative rules for all market centers then in place.

2. The first major step towards the NMS was the creation of a consolidated tape. Steps in this direction were taken well before enactment of the 1975 amendments. In November 1972, the SEC adopted rule 17a-15 calling for the establishment of a consolidated tape; in March 1973, the major exchanges and the NASD submitted a consolidated tape plan and soon thereafter formed the Consolidated Tape Association to administer the Plan; in June 1975, the tape was initially put into operation. It now provides the latest sale price and volume information in two streams: one for "NYSE" stocks on all markets including the NYSE, regional exchanges, the third market, and Instinet (the so-called "fourth market" providing an automated means of arranging transactions directly between institutions without a brokerage intermediary); the other for trades in the American and selected sole regional issues.

3. A consolidated quotation system that makes available firm bid and asked prices from all reporting market members in a single data stream followed logically the creation of a consolidated tape. The SEC first proposed a rule in this area in March 1972.
but it was not until January 1978 that it actually adopted, in
final form, rule 11Ac1-1 which requires each self-regulatory
organization to collect and disseminate to vendors quotations
for all reported securities. The system initiated operation on
a selective basis in August 1978 and has expanded since that time.
In February 1978, the SEC adopted rule 11Ac1-2 which is intended
to ensure that vendors display transaction and quotation informa-
tion for the consolidated system as effectively as for individual
securities. In a companion release, the Commission also amended
and redesignated rule 17a-15 as 11A3-1 to provide explicit pro-
cedures for amending approved transaction reporting plans.

Another essentially technological step in the handling of
securities is the method of effecting clearance and settlement
of transactions. From the very onset, the Commission has been
concerned with the development of a national system for this
purpose. In January 1977, it approved registration of the National
Securities Clearing Corporation as a clearing agency and since
then has provided for interfaces between it and other clearing
corporations. As a result, progress has been achieved towards
the ability to settle and clear, through a single agency, transac-
tions in whatever market they may have been executed.

The elements initially put into place in the formulation of the
rule dealt primarily with handling and reporting transactions
after they had been completed. There is a certain logic to this
backward development. These steps are largely of a technological
nature and do not involve the actual flow of orders to a particular
market center, which is the important consideration that determines
the competitive position of the center. Accordingly, we have
thus far discussed the clearing of an order after it has been
consummated and the reporting of the completed order. (Reporting
quotations is out of this sequence since it occurs before con-
summation of the order, but this procedure is not a major issue
in the concept of the system or the flow of orders). Still work-
ing backwards, therefore, we come to a crucial decision -- the
method of actually consummating an order once it has been placed.
This method, in turn, depends upon how the different market
centers will be linked. Two proposals have been submitted, both
of which the SEC is pursuing on an experimental basis.

The NYSE has developed an Intermarket Trading System (ITS)
which it has put into effect and is seeking to improve. The ITS
linkage consists of a central computer facility, a network of
interconnected electronic terminal devices in each of the partici-
cipating market centers, and quotation displays in each. Assume,
for example, that an NYSE market broker has received an order to
sell 100 shares of XYZ stock. He checks the quotation display and
finds that the best current bid for XYZ is on the Pacific Stock
Exchange (PSE). Through the ITS terminal on the NYSE floor, he
enters a firm commitment to sell 100 shares of XYZ. This commits-
ment is immediately shown on the ITS screen and printed at the
specialist's post at the PSE where, if the bid is still available,
the order is executed. The execution is relayed back to New York
and reported on the consolidated system by the PSE. The SEC has
expressed concern about the extent to which trades-through occur
(brokers executing transactions on one linked exchange who ignore
better published quotations from other markets) and the slowness of trading particularly during periods of heavy volume.

Weeden & Co. (now merged into another brokerage firm) sponsored the second proposal representing a system which has been sold to Control Data. This system provides an electronic trading facility (operated by the Cincinnati Stock Exchange) whereby approved dealers of the Cincinnati Exchange and specialists in other exchanges may enter principal and agency orders for automated execution in accordance with strict time and price priority. Thus far, participation by other exchanges and broker-dealers in this system has been very limited. As a result, the SEC has not been in a position to make any meaningful comments about its effectiveness.

The NYSE has been effecting improvements in the ITS, particularly in the areas criticized by the SEC. Over the near-term, trading in this system probably will make considerable headway. The system involves the least change in existing arrangements and to a large degree preserves the status quo as far as market relationships are concerned. Over the long-term, however, the Cincinnati system cannot now be dismissed as the possible basis of the future ITS.

Under the 1975 legislation, the SEC was directed to review the rules of all self-regulatory organizations to make sure they do not restrain competition. Responding to this direction, the SEC, within 90 days after the law's enactment, forwarded a letter to Congress contending that off-board rules of exchanges -- notably the NYSE's rule 394 -- imposed burdens on competition. Subsequently,
in December 1975, the Commission adopted rule 19c-1, which provided that after March 31, 1976, an exchange could not restrict its members from executing off-board transactions, as agent, where a third-market firm or off-board block trader was involved. Reflecting this requirement, the NYSE changed the name of the rule to 390, which, within the framework of SEC requirements, continued to prevent members from doing principal transactions off the floor or from engaging in "in-house" transactions as agent for both buyer and seller.

Insofar as the third market is concerned, SEC rule 19c-1 had little effect on the historic patterns of market selection by exchange members as brokers. Indeed, with the demise of Weeden & Co., the once dominant third-market firm, as an independent organization, the volume of business done in the third market dried up perceptibly. In general, it has been running between one and two percent of total volume and even less on particular days. On June 6, 1980, for example, the third market handled one-half of one percent of total share volume on the NYSE compared with the over seven percent mentioned previously that was done in 1972.

The SEC has continued to be aware of the remaining exchange restrictions which, in preventing member firms from engaging in principal transactions with non-members and in effecting agency crosses within their own firm, have anti-competitive implications. It has been reluctant to require the complete elimination of these restrictions because of its apprehension of the fragmentation of exchange trading that could occur if member firms, granted this
authority, opted to do much of their business away from the exchanges. In effect, such firms could become stock exchanges in their own right. In June 1980, however, the commission "bit the bullet," but only slightly, by approving rule 19c-3. This rule only exempts from these exchange restrictions any stock listed after April 26, 1979, the date the rule was originally proposed, or which was traded on an exchange on that date but fails to remain listed for any period of time thereafter. This step is considered essentially experimental to observe the effect of the elimination of the restrictions on a small group of stocks; it is estimated that rule 19c-3 would apply to less than four percent of the approximately 2,600 stocks currently listed on the New York and American Stock Exchanges.15

**Remaining Issues**

Thus far, certain rules and facilities have either been fully or partially implemented in the NMS: a composite tape, a composite reporting system, a national clearance mechanism, experimental market-linkage arrangements, and a relaxation of restrictions that prevent member firms from trading with non-members in listed stocks. Some significant issues, such as those discussed below, still remain largely unresolved and continuing attention is being given to these areas.

1. The SEC has reiterated on various occasions its belief that a basic principle upon which the NMS must be based is the assurance that all public agency orders, regardless of location, receive the benefits of auction-type trading protection by means of a central limit order file, where public limit orders could be entered and queued for auction trading on the basis of price and time priority, and receive execution over any other order by a broker or dealer at the same or an inferior price. Among
the criticisms of this proposal is that the absolute time priority proposed for public limit orders entered in the central file could have a deleterious effect on the exchange trading process. It has also been suggested that ITS participants should provide limit order protection through that system. The Commission, therefore, has deferred action in this area to observe industry developments.

The NYSE has announced the pilot start-up of an ITS block application limit order information system (ICIS). According to the Exchange, this is an "informational facility which captures and aggregates limit order summaries sent by all ITS markets. It provide a dynamic display of shares both below and above the market. Any size-type limit order, both agency and principal, can be input by any exchange member. Any limitation on orders to be entered is to be determined by each market."16

2. The Commission has expressed a belief in the desirability of a "neutral" (non-discriminatory) order routing facility that would enable broker-dealers to direct orders from their offices to any market center. Such systems are available to particular markets. For example, the NYSE has developed a so-called direct order turn-around system (DOR) which permits the transmission of modest-sized orders directly from the brokerage firm to the specialist. It has been expanding this system and studying the possibility of raising the order size handled by this method. The SEC would like to see a generalized linking of common switching facilities to market centers. The Commission's chairman, however, has indicated that "...it would be unlikely for the Commission to require order-by-order routing decisions by retail firms given the existing
structure of the market."

3. The 1975 legislation provides that the Commission shall designate the securities or classes of securities qualified for trading in the NAS. Toward this end, the SEC proposed rule 11A2-1 in June 1979 which established procedures by which securities would be designated as qualified for such trading. The proposed rule required that any stock which met certain minimum standards of assets, earning power, distribution, market activity and multiple market interest would be automatically designated an "N" security (tier 1). Stocks that met certain less stringent standards (tier 2) remained eligible for designation as NAS pursuant to certain procedures and upon the application of the issuer to two or more market centers. In general, tier 1 standards are the listing requirements of the NYSE and tier 2 standards are the listing requirements of the American Stock Exchange. This proposal generated considerable comment and the Commission has not taken any further steps in this area. The proposal, however, clearly indicated the Commission's belief that NAS should possess characteristics relating to "substantial assets and earnings histories." 

4. As indicated previously, the issues concerning the nature of the intermarket linkage that will occur and the extent of off-board restrictions, if any, are still undecided.

5. Other issues that the SEC has mentioned that appear less pertinent at this stage include: the extent to which institutional trading prohibitions may be appropriate; the role that standardized put and call option should play in an NAS; and the need for change in the self-regulatory organizations to provide centralized
The Prospects

As has been indicated, the stance of the SEC has been to permit the securities industry to develop the elements of the NMS while it plays an overseeing role. At times, however, the Commission has been willing to bare its teeth. Thus, a rule proposed in December 1979, would enable the Commission, on its own initiative, to suggest amendments to NMS plans. In general, however, the Commission has preferred to remain in the background, as a prodder, rather than to provide a specific program of action.

This approach has been criticized by the U.S. Comptroller General who, in a report to Congress, recommended that the SEC "...should define the national market system and its requirements, assign responsibility for designating components, and include an implementation schedule." In response, the former SEC Director of Market Regulation, Lee A. Pickard, had defended the Commission's approach, contending that "...the SEC should use its authority to encourage private groups to sponsor and implement the facilities they perceive as necessary for improved and efficient markets and leave the job of defining the right market structure to the private sector." There is no indication that the Commission will change its basic policy despite the criticism of the Comptroller General. It also seems clear that the Commission's concern, at least at this time, is with developing the NMS for the several thousand big companies whose stocks meet certain relatively exclusive trading standards. At the very outset, the Commission did express an interest, as discussed previously, in "a tandem central market system...for unlisted securities."
This interest seems to have dissipated. Possibly, the difficulties and frustrations of working on an NMS for big companies have blocked any thought that may at one time have been given to a tandem NMS for unlisted securities. Yet, to the extent that efficient secondary markets are important in providing liquidity and facilitating financing in the primary markets for the nation's large companies, they are also important for the vast over-the-counter market where the stocks of relatively small companies are traded.
Footnotes


2. These data are from the U.S. Senate, Committee on Banking, Housing and Urban Affairs, Report of the Subcommittee on Securities, "Securities Industry Study," 93rd Congress, 1st Session, 1973, pp. 64-65.


8. Ibid., p. 122.

9. Senate Subcommittee on Securities, op. cit., p. 94.

10. Ibid., p. 126.

11. Ibid., p. 135.


17. Harold J. Williams, op. cit.


Appendix B: A Presentation of the Results of the Interview

In this appendix, the questions and their responses are presented. The rationale behind the questions is explained in Chapter 6 and the raw data is analyzed in Chapter 7. As noted in Chapter 6, not all of the 65 respondents answered every question. Some of the interviews were limited by time constraints. In others, certain questions were not pertinent to the particular respondent, as in the case of the three companies who were listed on the AMEX. As a result, the number of responses to certain questions may fall short of 65.

2a. How many outstanding shares are there?

<table>
<thead>
<tr>
<th>Number of Shares</th>
<th>Number of Responses</th>
</tr>
</thead>
<tbody>
<tr>
<td>100,000-500,000</td>
<td>11</td>
</tr>
<tr>
<td>500,000-1,000,000</td>
<td>30</td>
</tr>
<tr>
<td>1,000,000-1,500,000</td>
<td>10</td>
</tr>
<tr>
<td>1,500,000-2,000,000</td>
<td>7</td>
</tr>
<tr>
<td>over 2,000,000</td>
<td>7</td>
</tr>
</tbody>
</table>
2b. What is the floating supply of shares (floating supply represents shares outstanding less those held directly or beneficially by insiders such as officers and directors)?

<table>
<thead>
<tr>
<th>Number of Shares</th>
<th>Number of Responses</th>
</tr>
</thead>
<tbody>
<tr>
<td>0-300,000</td>
<td>28</td>
</tr>
<tr>
<td>300,000-600,000</td>
<td>14</td>
</tr>
<tr>
<td>600,000-900,000</td>
<td>10</td>
</tr>
<tr>
<td>900,000-1,200,000</td>
<td>8</td>
</tr>
<tr>
<td>over 1,200,000</td>
<td>5</td>
</tr>
</tbody>
</table>

From these two questions, it was possible to develop a table showing the percentage of total shares outstanding held by the public by dividing the response to question 2b by the response to question 2a.

<table>
<thead>
<tr>
<th>% of Outstanding Shares Held by the Public</th>
<th>Number of Responses</th>
</tr>
</thead>
<tbody>
<tr>
<td>0-10%</td>
<td>0</td>
</tr>
<tr>
<td>10-20</td>
<td>2</td>
</tr>
<tr>
<td>20-30</td>
<td>9</td>
</tr>
<tr>
<td>30-40</td>
<td>16</td>
</tr>
<tr>
<td>40-50</td>
<td>11</td>
</tr>
<tr>
<td>50-60</td>
<td>8</td>
</tr>
<tr>
<td>60-70</td>
<td>9</td>
</tr>
<tr>
<td>70-80</td>
<td>6</td>
</tr>
<tr>
<td>80-90</td>
<td>3</td>
</tr>
<tr>
<td>90-100</td>
<td>1</td>
</tr>
</tbody>
</table>

2c. How many direct offerings of common stock has the company made to the public in the primary market?

<table>
<thead>
<tr>
<th>Number of Offerings</th>
<th>Number of Responses</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>50</td>
</tr>
<tr>
<td>2</td>
<td>9</td>
</tr>
<tr>
<td>3</td>
<td>5</td>
</tr>
</tbody>
</table>

Note: The one company which did not have a primary offering became public through a secondary distribution.

2d. In what market or markets is the company's stock traded?

<table>
<thead>
<tr>
<th>Market</th>
<th>Number of Companies</th>
</tr>
</thead>
<tbody>
<tr>
<td>C: NASDAQ</td>
<td>47</td>
</tr>
<tr>
<td>C: Pima Sheets</td>
<td>15</td>
</tr>
<tr>
<td>C: Other</td>
<td>3</td>
</tr>
</tbody>
</table>
2e. Is the market for the company's stock active or inactive?

<table>
<thead>
<tr>
<th>Type of Response</th>
<th>Number of Responses</th>
</tr>
</thead>
<tbody>
<tr>
<td>1) Active</td>
<td>4</td>
</tr>
<tr>
<td>2) Fairly-Active</td>
<td>19</td>
</tr>
<tr>
<td>3) Neither Active Nor Inactive</td>
<td>5</td>
</tr>
<tr>
<td>4) Fairly Inactive</td>
<td>18</td>
</tr>
<tr>
<td>5) Inactive</td>
<td>19</td>
</tr>
</tbody>
</table>

2f. Is the price of the company's stock stable or volatile?

<table>
<thead>
<tr>
<th>Type of Response</th>
<th>Number of Responses</th>
</tr>
</thead>
<tbody>
<tr>
<td>1) Volatile</td>
<td>5</td>
</tr>
<tr>
<td>2) Fairly Volatile</td>
<td>12</td>
</tr>
<tr>
<td>3) Very Slightly Volatile</td>
<td>4</td>
</tr>
<tr>
<td>4) Fairly Stable</td>
<td>28</td>
</tr>
<tr>
<td>5) Stable</td>
<td>13</td>
</tr>
<tr>
<td>6) Don't Know</td>
<td>3</td>
</tr>
</tbody>
</table>

2n. How many market-makers are there?

<table>
<thead>
<tr>
<th>Number of Market-Makers</th>
<th>Number of Responses</th>
</tr>
</thead>
<tbody>
<tr>
<td>2</td>
<td>5</td>
</tr>
<tr>
<td>3</td>
<td>12</td>
</tr>
<tr>
<td>4</td>
<td>12</td>
</tr>
<tr>
<td>5</td>
<td>13</td>
</tr>
<tr>
<td>6</td>
<td>4</td>
</tr>
<tr>
<td>7</td>
<td>3</td>
</tr>
<tr>
<td>8</td>
<td>1</td>
</tr>
<tr>
<td>10</td>
<td>1</td>
</tr>
<tr>
<td>11</td>
<td>1</td>
</tr>
<tr>
<td>12 or more</td>
<td>4</td>
</tr>
</tbody>
</table>

2p. Are you satisfied with the performances of these market-makers?

<table>
<thead>
<tr>
<th>Type of Response</th>
<th>Number of Responses</th>
</tr>
</thead>
<tbody>
<tr>
<td>1) Very Satisfied</td>
<td>3</td>
</tr>
<tr>
<td>2) Somewhat Satisfied</td>
<td>15</td>
</tr>
<tr>
<td>3) Indifferent</td>
<td>25</td>
</tr>
<tr>
<td>4) Somewhat Unsatisfied</td>
<td>11</td>
</tr>
<tr>
<td>5) Very Unsatisfied</td>
<td>7</td>
</tr>
</tbody>
</table>

2r. How firm are the broker-dealer quotes of bid-ask spreads in your company's stock?

<table>
<thead>
<tr>
<th>Type of Response</th>
<th>Number of Responses</th>
</tr>
</thead>
<tbody>
<tr>
<td>1) Very Firm</td>
<td>3</td>
</tr>
<tr>
<td>2) Fairly Firm</td>
<td>23</td>
</tr>
<tr>
<td>3) Neither Firm Nor Weak</td>
<td>5</td>
</tr>
<tr>
<td>4) Not Very Firm</td>
<td>4</td>
</tr>
<tr>
<td>5) Not Firm At All</td>
<td>9</td>
</tr>
<tr>
<td>6) Don't Know</td>
<td>17</td>
</tr>
</tbody>
</table>
Those who were able to respond to Question 2r were asked the following question.

When activity in your company's stock increases, does the spread tend to narrow or widen or remain the same?

Type of Response
1) Narrow
2) Remain the Same
3) Widen
4) Don't Know

Number of Responses
7
11
18
8

2u. Is the company's stock eligible to be traded on one of the major exchanges?

Type of Response
1) Yes
2) No

Number of Responses
12
49

Does the Company think that its stock would benefit from exchange-type trading?

Type of Response
1) Yes
2) No
3) Don't Know

Number of Responses
26
26
9

3a. Has the company ever heard of the National Market System?

Response
1) Yes
2) No

Number of Responses
38
27

The Securities Act Amendments of 1975 gave the SEC a Congressional mandate to establish a National Market System. This system would link, through a sophisticated communications network, all the exchanges and relevant market centers with each other. The system would be composed of all major exchange-traded securities and certain OTC-NASDAQ securities. Some National Market System facilities have become operational already, such as the consolidated tape reporting all transactions of securities and the composite quotation system listing all bid and ask prices along with the size of the order. The Intermarket Trading System, developed jointly by several exchanges, is designed to permit orders to buy and sell multiply-traded securities to be routed from one market center to another for the most efficient execution. The SEC intends to develop the National Market System so that eventually nationwide price-protection for all public limit orders will be insured.

Do you have any reaction to this description of the National Market System?
3h. Under a proposed SEC rule, a designating body composed of members of the securities industry and the SEC will decide which OTC-NASDAQ securities will be included in the NMS. The companies themselves will not have veto power over the decision of the designating body, though some will have the right of appeal to an appeals commission. Do you agree with the principle of the SEC and members of the securities industry determining which securities are qualified for NMS trading?

<table>
<thead>
<tr>
<th>Type of Response</th>
<th>Number of Responses</th>
</tr>
</thead>
<tbody>
<tr>
<td>1) Yes</td>
<td>24</td>
</tr>
<tr>
<td>2) No</td>
<td>34</td>
</tr>
<tr>
<td>3) Don't Know</td>
<td>7</td>
</tr>
</tbody>
</table>

3j. In general, the SEC has been thinking of applying standards such as the listing requirements of the NYSE and the AMEX to determine qualifications for inclusion in the NMS. Under this process, OTC stocks eligible for the NYSE would be automatically included in the NMS, while companies eligible for the AMEX would be given the right to choose whether they wanted to be included. On this basis, do you think that your stock will be eligible for inclusion?

<table>
<thead>
<tr>
<th>Type of Response</th>
<th>Number of Responses</th>
</tr>
</thead>
<tbody>
<tr>
<td>1) Yes</td>
<td>15</td>
</tr>
<tr>
<td>2) No</td>
<td>49</td>
</tr>
<tr>
<td>3) Don't Know</td>
<td>1</td>
</tr>
</tbody>
</table>

3k. Do you agree with this method of determining qualification for the NMS?

<table>
<thead>
<tr>
<th>Type of Response</th>
<th>Number of Responses</th>
</tr>
</thead>
<tbody>
<tr>
<td>1) Yes</td>
<td>20</td>
</tr>
<tr>
<td>2) No</td>
<td>35</td>
</tr>
<tr>
<td>3) Don't Know</td>
<td>9</td>
</tr>
</tbody>
</table>

3m. If your company is given the choice of entering the NMS, what would you do?

<table>
<thead>
<tr>
<th>Type of Response</th>
<th>Number of Responses</th>
</tr>
</thead>
<tbody>
<tr>
<td>1) Yes</td>
<td>52</td>
</tr>
<tr>
<td>2) No</td>
<td>5</td>
</tr>
<tr>
<td>3) Don't Know</td>
<td>8</td>
</tr>
</tbody>
</table>
If your company's stock qualifies for inclusion in the NMS, do you think the present market-makers in the stock will become more interested in it?

<table>
<thead>
<tr>
<th>Type of Response</th>
<th>Number of Responses</th>
</tr>
</thead>
<tbody>
<tr>
<td>1) Much more interest</td>
<td>13</td>
</tr>
<tr>
<td>2) Somewhat more interest</td>
<td>12</td>
</tr>
<tr>
<td>3) Slightly more interest</td>
<td>6</td>
</tr>
<tr>
<td>4) No Effect</td>
<td>16</td>
</tr>
<tr>
<td>5) Some negative Effect</td>
<td>8</td>
</tr>
<tr>
<td>6) Don't Know</td>
<td>7</td>
</tr>
</tbody>
</table>

3o. If your stock qualifies for inclusion in the NMS, do you think that the market for the stock will be improved?

<table>
<thead>
<tr>
<th>Type of Response</th>
<th>Number of Responses</th>
</tr>
</thead>
<tbody>
<tr>
<td>1) Significantly improved</td>
<td>20</td>
</tr>
<tr>
<td>2) Somewhat improved</td>
<td>22</td>
</tr>
<tr>
<td>3) Slightly improved</td>
<td>3</td>
</tr>
<tr>
<td>4) No effect</td>
<td>9</td>
</tr>
<tr>
<td>5) Some negative effect</td>
<td>4</td>
</tr>
<tr>
<td>6) Don't know</td>
<td>7</td>
</tr>
</tbody>
</table>

3p. If the market in your company's stock is improved because it qualifies for trading in the NMS do you believe it will become easier to sell stock directly in the primary market?

<table>
<thead>
<tr>
<th>Type of Response</th>
<th>Number of Responses</th>
</tr>
</thead>
<tbody>
<tr>
<td>1) Much easier</td>
<td>21</td>
</tr>
<tr>
<td>2) Somewhat easier</td>
<td>24</td>
</tr>
<tr>
<td>3) Slightly easier</td>
<td>3</td>
</tr>
<tr>
<td>4) No effect</td>
<td>12</td>
</tr>
<tr>
<td>5) Don't know</td>
<td>4</td>
</tr>
</tbody>
</table>

3q. If your company's stock does not qualify for inclusion in the NMS do you think the present market-makers will become less interested in making a market in the stock or do you think it will have no impact on them?

<table>
<thead>
<tr>
<th>Type of Response</th>
<th>Number of Responses</th>
</tr>
</thead>
<tbody>
<tr>
<td>1) Much less interest</td>
<td>5</td>
</tr>
<tr>
<td>2) Somewhat less interest</td>
<td>8</td>
</tr>
<tr>
<td>3) Slightly less interest</td>
<td>4</td>
</tr>
<tr>
<td>4) No effect</td>
<td>34</td>
</tr>
<tr>
<td>5) Somewhat more interest</td>
<td>2</td>
</tr>
<tr>
<td>6) Don't know</td>
<td>10</td>
</tr>
</tbody>
</table>

3r. If your stock does not qualify for inclusion in the NMS, do you think the market will be adversely affected?
Type of Response | Number of Responses
--- | ---
1) Significant adverse effect | 7
2) Some adverse effect | 10
3) Slight adverse effect | 3
4) No impact at all | 41
5) Don't know | 1

3s. If your stock is not included in the NMS, do you believe it will effect your ability to sell stock in the primary market?
Type of Response | Number of Responses
--- | ---
1) Much more difficult | 16
2) Somewhat more difficult | 17
3) Slightly more difficult | 3
4) No effect | 20
5) Don't know | 5

4a. Why did the company decide to issue stock to the public in the way that it did?
Type of Response | Number of Responses
--- | ---
1) Working capital to expand | 37
2) Money for acquisitions | 5
3) Estate reasons | 5
4) Options to attract key personnel | 4
5) To create a public market for principal stockholders | 4
6) To reduce debts | 1
7) Don't know | 6

5c. Do you think that the company has been able to raise all the money it needs from both internal and external sources?
Type of Response | Number of Responses
--- | ---
1) Yes | 38
2) No | 20

5d. Have you been satisfied with the proportional share between internal and external financing?
Type of Response | Number of Responses
--- | ---
1) Yes | 37
2) No | 21

5e. Does the company use internal financing because it wants to, or has to, or neither, or both?
Type of Response | Number of Responses
--- | ---
1) It wants to | 30
2) It has to | 15
3) Neither | 8
4) Both | 3
3f. Has the company achieved the internal financial goals and objectives they intended to?

<table>
<thead>
<tr>
<th>Type of Response</th>
<th>Number of Responses</th>
</tr>
</thead>
<tbody>
<tr>
<td>1) Yes</td>
<td>27</td>
</tr>
<tr>
<td>2) No</td>
<td>28</td>
</tr>
</tbody>
</table>

5g. Has there been any trend towards more or less internal financing?

<table>
<thead>
<tr>
<th>Type of Response</th>
<th>Number of Responses</th>
</tr>
</thead>
<tbody>
<tr>
<td>1) More internal financing</td>
<td>30</td>
</tr>
<tr>
<td>2) Less internal financing</td>
<td>14</td>
</tr>
<tr>
<td>3) About the same amount</td>
<td>12</td>
</tr>
</tbody>
</table>

5h. Compare the availability of short-term vs. long-term bank loans?

<table>
<thead>
<tr>
<th>Type of Response</th>
<th>Number of Responses</th>
</tr>
</thead>
<tbody>
<tr>
<td>1) Short-term is more available</td>
<td>28</td>
</tr>
<tr>
<td>2) Both are equally available</td>
<td>21</td>
</tr>
<tr>
<td>3) Long-term is more available</td>
<td>1</td>
</tr>
<tr>
<td>4) Neither</td>
<td>1</td>
</tr>
<tr>
<td>5) Don't know</td>
<td>4</td>
</tr>
<tr>
<td>6) No loans</td>
<td>8</td>
</tr>
</tbody>
</table>

5i. Compare the desirability of short-term vs. long-term bank loans?

<table>
<thead>
<tr>
<th>Type of Response</th>
<th>Number of Responses</th>
</tr>
</thead>
<tbody>
<tr>
<td>1) Short-term is more desirable</td>
<td>8</td>
</tr>
<tr>
<td>2) Long-term is more desirable</td>
<td>23</td>
</tr>
<tr>
<td>3) It depends</td>
<td>15</td>
</tr>
<tr>
<td>4) Neither</td>
<td>6</td>
</tr>
<tr>
<td>5) Don't know</td>
<td>5</td>
</tr>
</tbody>
</table>

5j. Has the company been satisfied with its banking relationships?

<table>
<thead>
<tr>
<th>Type of Response</th>
<th>Number of Responses</th>
</tr>
</thead>
<tbody>
<tr>
<td>1) Yes</td>
<td>44</td>
</tr>
<tr>
<td>2) No</td>
<td>9</td>
</tr>
</tbody>
</table>

5m. Has there been any trend towards more or less bank financing?

<table>
<thead>
<tr>
<th>Type of Response</th>
<th>Number of Responses</th>
</tr>
</thead>
<tbody>
<tr>
<td>1) More bank financing</td>
<td>25</td>
</tr>
<tr>
<td>2) Less bank financing</td>
<td>18</td>
</tr>
<tr>
<td>3) No change</td>
<td>10</td>
</tr>
</tbody>
</table>