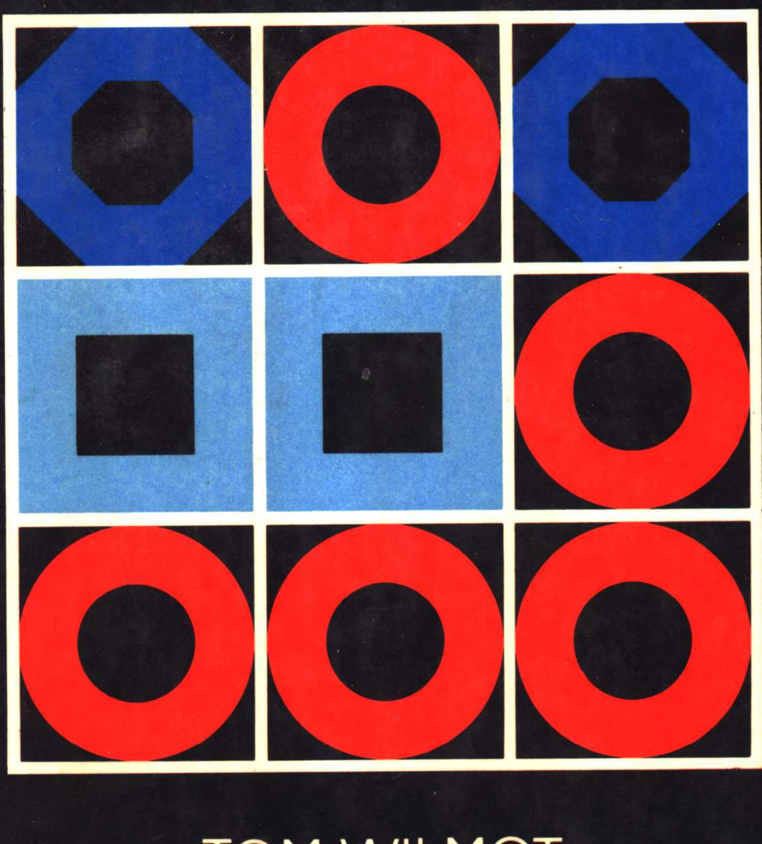
INSIDE THE OVER-THE-COUNTER MARKET



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Foreword

by Roger Baden-Powell
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The over-the-counter (OTC) market is a new and dynamic market which has attracted considerable public interest. Those in favour of the growth of a third-tier stock market consider that its development is clearly benefiting a sector of UK industry where new companies can raise equity finance which might otherwise be unavailable to them from The Stock Exchange, its Unlisted Securities Market (USM) or the banks. Those against the OTC market contend that it is nothing but a gamblers' casino, where angels fear to tread. For those in the market and optimistic of its prospects for growth, however, it is generally accepted that there is only one thing worse than being talked about, and that is not being talked about.

I have known Tom Wilmot for a number of years and have watched Harvard Securities grow to its present size despite considerable opposition from the financial establishment. The resulting publicity has ensured that Harvard Securities is better known to the general public than most firms of stockbrokers and it has generated an awareness of the OTC market in the United Kingdom which no affordable advertising campaign could have achieved.

A new 'market' in any commodity begins to develop when a group of dealers gets together in a loose association to offer a service that the public wants. Market makers on the OTC do not often meet in coffee houses as members of Lloyd's and The Stock Exchange used to, since we now have the benefit of telephones and computers. None the less, OTC market makers have suffered the same sort of criticism that stockbrokers used to in the past. In fact, it was a common form of abuse a century or so ago to refer to someone as a 'mere stockjobber', thus depicting a type of person involved in the sort of transactions to which the recognised establishment would not stoop (at least, not while anybody was watching).

In any financial dealings between professionals and members of the public, or, in fact, between members of the public themselves, there is always the danger of a conflict of interest, dishonesty or fraud. Such deals may sometimes be reported in the newspapers, especially if they are large and have some other 'human interest' attraction, but, in general, they are a part of business life which most of us have learned to be wary of, accepting the maxim *caveat emptor*. Once a pattern of dealing begins to develop in a market, however, and once the market begins to assume a distinct identity, any sharp dealings or misrepresentations gain a much higher profile and tend to damage the business of all members of that market by undermining the confidence of the public. We have all seen newspaper headlines to the effect that the 'City is rocked by scandal in Leeds' when, very often, the story has nothing at all to do with the City but the word has been used, because of its encapsulating association with money, as a convenient phrase to stimulate interest in the subsequent article.

Once the identity of a market has been established, therefore, there is a strong necessity to have some form of regulation to safeguard the public interest and also the reputation of those professionals dealing in that market. This can be done either by statute or by means of self-regulation. The United Kingdom is extremely fortunate to have a strong tradition of self-regulation of financial markets. Self-regulation works because it is in the commercial interests of those involved in any trade association to see that it does and because it can be carried out by regulators who understand the problems of the market, since they are in it themselves and can therefore act quickly and effectively to protect the public. The old saying 'If we do not hang together, we will hang separately' tends to bury a lot of commercial rivalry if the sins of one can be visited on another by the publicity surrounding an identifiable market-place. A number of steps are now being taken to regulate the OTC market more effectively and, with this objective in mind, Harvard Securities is playing its part, along with other market makers, to establish a self-regulatory system to match the requirements of the growing market-place.

The OTC market in the United Kingdom is still very young compared to its counterpart in the United States and this book should achieve a greater understanding of the market among members of the public who are bored with building societies and unit trusts and who are prepared to risk a greater involvement in new and growing companies, where both substantial profits and substantial losses can be made.

Author's preface

Although the OTC market in the United Kingdom is a relatively new phenomenon and is still very much in its infancy, it is considered to be the fastest growing equity market in the world. During the last two and a half years it has grown from 26 companies to some 180 and is at the moment capitalised at around £1,000 million, providing great opportunities for new businesses as well as creating new employment. In fact, of the £100 million raised in 1983/84 for BES qualifying companies, Government statistics indicate that in excess of 60% came via direct equity investment in small companies which largely qualified for an OTC quotation. The deregulation of The Stock Exchange and the breakup in 1987/88 of BES funds almost guarantees that the explosive growth of the OTC market will continue unabated. The whole concept of a multi-location, telephone-based market with no central trading floor remains a difficult one with which to contend for the UK investor. However, the growth of the OTC in the United States is a clear indication of the potential interest in the UK market. It is normal with innovative advances of this type for general recognition to be slow, and a crucial element in expanding the market is the education of both professional and private investors in the methods of the OTC. I hope that this book will begin to fill the previous void that existed concerning information on this market. I have tried to cover the market's origins, workings and future as clearly as possible, highlighting the potential of OTC stocks as well as the risks involved when dealing with them. I hope it will prove useful to both professional and private investors and also encourage more and greater involvement in the OTC market, which, after all, is a seed-bed of innovation, wealth and employment.

May 1985 T. G. Wilmot

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1 Why has the over-the-counter market developed?

Before dealing with the rationale for the development of the over-the-counter (OTC) market, a brief description of The Stock Market may help professionals and non-professionals alike to understand the vacuum that the OTC market fills.

The Stock Exchange is a fine private club dating back to the 1700s when old coffee houses around London's Royal Exchange were frequented by gentlemen who bought and sold shares in companies on a basis of mutual trust. A share is a part of a company. If a company has a capital of £100, then it is possible to have 100 £1 shares or 200 50 pence shares, etc. If an individual owns 51 £1 shares then he has control of the company. The shares can be bought and sold and ownership of companies can change hands without the acquiescence of the directors if they do not have control of 51% or more. It soon became apparent that to raise capital outside of the personal and business acquaintances of the gentlemen in the coffee houses around the Royal Exchange a formal market-place should be brought into being and in

1773 The Stock Exchange was born. As the name suggests, it is a place where stocks and shares may be exchanged, purchased or encashed.

With a centralised market, stocks and shares could be actively promoted as investments which could be quickly bought and sold, thus leading to a very liquid and vigorous market.

Primarily investors in stocks and shares were the landed rich and industrially wealthy, who were encouraged to protect their wealth by investing in the shares of companies. This investment enabled companies to develop quickly using risk capital, without having to pay interest to banks and money-lenders. The welcome injection of capital into business stimulated and encouraged the dramatic industrial growth seen during the nineteenth century in the United Kingdom.

Private investment

Over the last 50 years, however, the market-place has changed. The emergence of institutional investment has had a far-reaching effect on The Stock Exchange. (Institutional investors, i.e. pension funds, charities, investment trusts, unit trusts, etc., are organisations that put themselves out as managers of investments on behalf of others.) Funds controlled by institutions are immense and growing at an accelerating pace. The institutional dominance of the UK stock market which has developed over the last 30 years can be seen in Table 1.

Table 1 UK holdings of quoted shares

	1957	1963	1969	1975	1981
Individuals	66%	54%	47%	38%	28%
Institutions	18%	24%	32%	43%	57%
Others	17%	21%	21%	19%	15%

Source: The Stock Exchange.

Stockbrokers in the United Kingdom identified institutions as excellent clients; they understand the market and communicate on a professional basis. Processing buying and selling orders is most rewarding to the successful and persistent broker and it is no wonder that a large number of them moved away from their private client business and invested in corporate research, using specialist salesmen to deal with the large institutions.

This move left the private client in a vacuum, however – he was used to dealing in shares on a personal basis, but, as the emphasis shifted to the institutional client, nobody seemed really interested in his business unless he had £25,000 to £1 million to place in a discretionary managed account. (A discretionary account is where a client gives control of his money to a third party who is entitled to buy and sell on behalf of the client without referring to him before or after trading, although the third party will usually provide dealing statements at the end of every six months. Non-discretionary, on the other hand, means that a client has to give his written or verbal consent before a transaction can be completed on his behalf.) The only alternative left to the private investor was to invest with the unit trusts or investment trusts, etc. – and these were, ironically, the very institutions whose entry into the market-place had forced large numbers of private clients into the financial wilderness.

This has resulted in a marked fall over the last 30 years in the proportion of equities held by private individuals, as can be seen from Table 1. Today, only around 2 million people in the United Kingdom, or 5% of the adult population, directly own shares. This compares with 42 million, or 25% of the adult population, in the United States. The fact that this increased institutional investment is normally in blue-chip companies also means that little is being done to foster growth in the small-to-medium-sized company sector.

Stock Exchange listing

The past two decades have also witnessed a significant and continuing reduction in the extent to which UK companies have been coming to the securities markets in search of equity finance. Certainly, the fiscal bias in favour of loan finance has to a certain extent discouraged companies from utilising equity as a source of long-term finance, but the escalating fees for companies seeking a quotation have been another major factor.

In the late 1960s and early 1970s an average of some 50 companies per annum achieved listed status, but between 1974 and 1979 new admissions were running at less than half this rate. Although there has been a slight reversal of this trend as the memories of 1974 recede (when falling share prices and general disillusionment with the stock markets made the idea of a market flotation virtually unthinkable), the costs associated with a full listing are still prohibitive for many companies.

There are other reasons, too, for the steady decline in applications for admission to The Stock Exchange. First, the general economic climate has been unhelpful to small and medium-sized companies, especially if an owner sought to dispose of part of his company as a way of capitalising on previous effort. Low real profitability has the effect of greatly reducing the extent to which businesses can expect to finance themselves from internally generated funds and means that prices for securities are kept at a low level, thus discouraging any offer for sale of shares. In the mean time rates of inflation have greatly increased the working capital requirement of many companies even though the real volume of output may have remained unchanged, with the result that profits are used to finance the day-to-day running of a company instead of being reinvested.

Second, it has been frequently suggested that the conditions imposed by The Stock Exchange for access to the listed market represent a real disincentive to listing. For an initial sale of securities by way of a full quote, The Stock Exchange expects a company to be able to show at least a five-year trading record and has certain requirements as to the contents of a company's prospectus as well as onerous disclosure requirements. Indeed, although the Stock Exchange minimum size for a listing is a market capitalisation of £0.7 million, in practice the minimum size before an issue of shares becomes economic is around £5 million (equivalent to pre-tax profits of approximately £1 million). The consequent professional fees and advertising costs add to the expense of a flotation, which, including commissions, may easily amount to between 5% and 10% of the proceeds. Of the costs incurred there is a very high element of fixed costs, resulting in the net amount raised being wholly unrelated to the size of the issue. This problem has been particularly acute for companies raising only relatively small amounts of capital where in fact the issue costs have become totally disproportionate. It is a fact that this rapid increase in costs has deterred companies from coming to the listed market. Obviously, inflation accounts for some of the increase, but the large upgrading in disclosure requirements and the consequent increase in accountancy and legal fees have caused the bulk of the escalation. What is more, potential investors have come to expect weighty and informative prospectuses. On top of this a prospectus is quite rightly seen as a marketing document as a whole, being a complete reflection of the company's activities. As such, there are considerable PR, presentation and printing costs.

The reduction, in September 1977, by The Stock Exchange of the required, minimum amount of a new company's equity which has to be made available to the investing public, from 35% to 25%, was met with mixed feelings. Certainly, from the point of view of the aspiring company, a reduction in the amount of equity which has to be released on to the market was very welcome. However, this limited marketability was not at all well received by the long-term investing institutions. The influence of the major institutions on the market-place could well be a significant factor in the decline in applications for full listing. Undoubtedly, institutional funds dominate the equity markets and due to their obligations (e.g. payment of insurance claims or pensions) they are inherently risk averse. Therefore, pressure may well have been placed upon the Quotations Department of The Stock Exchange to retain the strict requirements of companies seeking a listing. Thus, small, high-risk companies have essentially been squeezed out of the equity market-place.

The Unlisted Securities Market (USM)

The Wilson Committee Review of the functioning of financial institutions in 1980 recognised the need 'to improve the market mechanisms for dealing in unlisted securities . . . in order to improve the marketability of equity stakes in small companies'. At this time, dealing in unlisted securities by members of The Stock Exchange was only allowed under Rule 163 of the Stock Exchange Rule Book, which was later revised and reclassified as Rule 535. Rule 163(2) allowed trading in small, unquoted UK companies and was originally intended to enable relatively infrequent transactions to take place in the shares of small, public companies. Rule 163(3) applied specifically to mineral exploration companies. Each company was, and still is, briefly scrutinised by The Stock Exchange and each deal in the shares required specific Stock Exchange approval. Although the jobber takes a turn (the profit resulting from the difference between the buying price and the selling price of a share) and the broker charges commission, each trade in Rule 163(2) shares is effectively a matched bargain with the jobber putting through the transaction for a small turn. The Stock Exchange will refuse permission to deal in shares where it considers that the Rule 163 facility is being abused. For example, Intervision was delisted in March 1982 by The Stock Exchange Council as it was being traded far too often under this rule.

Following publicity gained as a result of the Wilson Committee in 1978 the number of deals under Rule 163(2) grew rapidly, with a number of companies issuing securities specifically with a view to trading under this rule. This, combined with the recommendations made in the interim report of the Wilson Committee, prompted The Stock Exchange to issue a discussion document in December 1979 on the development of a market in unlisted securities. The general response to the idea was good, the proposals being praised for their innovative approach in encouraging new issues. After a number of amendments this document actually formed the basis for the Unlisted Securities Market, which was launched on 10 November 1980. For the first time in its history The Stock Exchange offered a three-tier market in company securities – the first tier being a full listing, the second tier being the USM and the third tier consisting of dealings still made possible by the new Rule 535(2).

One of the early driving forces behind the USM was Licensed Dealers Tringhall. Dennis Poll of Tringhall identified a market need and set about floating companies on the USM. However, his method of ensuring that Tringhall's issues were successful ultimately engineered its downfall. Any shareholder in Tringhall shares was given priority of allotment of any new USM issue floated by Tringhall. With its earlier issues being very successful it did not matter that most of the investors at the issue price were speculators purely and simply interested in short-term gain (i.e. stags); the novelty of the USM ensured a reasonable after-market which allowed them to take their profit. However, as the USM became recognised and more and