

## **Commentary: End of an Era for OTC Bulletin Board?**

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Last Monday, FINRA announced that it intended to sell the OTCBB website and trade names associated with the OTC Bulletin Board and exit the interdealer quotation business. In my view, this announcement was long overdue. The OTCBB has never lived up to the hopes of its founders.

In the early 1990s, amid an earlier financial crisis involving the Savings and Loan industry, the small business community urged Congress to cause the Securities and Exchange Commission to take better care of the capital raising efforts of small businesses. The OTC Bulletin Board was one of the initiatives produced by the SEC's reinvigorated concern for the needs of small businesses.

An earlier initiative to accommodate entrepreneurial zeal resulted in the establishment of NASDAQ in the early 1970s. At that time, OTC equity market pricing for securities was limited to the "pink sheets," a daily paper produced by the National Quotation Bureau. The SEC tried to convince NQB to produce this information electronically to improve market quality in the OTC markets, but NQB was in the newsprint business and thought that would cannibalize their existing business. Since no one else in the private sector expressed any interest in producing an electronic marketplace, the SEC, with some help from Congress, convinced the NASD, FINRA's predecessor, to take on the project.

NASDAQ's success exceeded all expectations. But, as it evolved, NASDAQ increasingly came to resemble a listed market. The smaller issuer, who could not satisfy NASDAQ's listing standards, was squeezed out of NASDAQ as a consequence. Once again, the NQB, now owned by Commerce Clearing House, a large book publisher, declined to produce an electronic quote medium, and the NASD was charged to fill the void. The OTCBB was created to provide an electronic quotation system for the OTC equity securities issued by smaller non-NASDAQ listed issuers.

In some ways, NASDAQ ruined the NASD. The NASD was, first and foremost, a regulator of OTC broker-dealers, rather than a commercial enterprise. With all due regard for my libertarian friends, there is a difference between a regulator and a commercial enterprise. The regulator's primary concern is to protect the public, and in the case of a market regulator, the investing public. A commercial enterprise

seeks to increase profits. Without adopting the tactics of organized crime, protecting the public is not a profit-seeking business, which is why we pay taxes.

NASDAQ was instituted to improve market quality, a worthy regulatory goal. When NASDAQ also proved to be a commercial success, the NASD began to view the world from the perspective of business, which ran afoul of its regulatory goals.

Unlike NASDAQ, the OTCBB was not a commercial success. Infected with the thinking of a businessman, the NASD came to view the OTCBB as a resource drain, and like any business enterprise, sought to limit the damage by restricting development expenditures. In the meantime, the Pink Sheets, under new ownership, transformed its print business into an electronic quote vendor and competed with OTCBB for the OTC marketplace. As the Pink Sheets continued to modernize, the OTCBB's business declined, deepening the NASD's losses.

Worse yet, fraudsters discovered that the public thought that because the NASD operated OTCBB, it was a well-regulated market. The fact is that the OTCBB is a broker-quoted marketplace, rather than a listed market. The NASD regulated the brokers that used the OTCBB, but the same regulation also applied to all brokers operating in the OTC market. The NASD made no effort to make sure the issues traded in the OTCBB were legitimate.

As a result, the OTCBB's ownership by a regulator conveyed a false impression of the legitimacy of the issues that traded there, a deception fraudsters were all too happy to exploit. A startling expose by a Canadian journalist a few years ago revealed that fully one-quarter of the stocks traded on the OTCBB were issued by fraudulent shells with no business operations at all. In contrast, Pink Sheets has consistently warned investors about the risks of investing in OTC stocks and the securities quoted in the Pink Sheets. Recognizing that fraud is bad for business, Pink Sheets has exposed fraudulent issuers by segmenting its markets. Suspect issues are marked with a skull and crossbones, a technique that discourages fraudsters. As a result, although Pink OTC Markets lacks any regulatory authority, it has not been necessary to mark more than two-tenths of a percent of the dollar volume of securities traded through the Pink Sheets with a skull and crossbones.

Eventually, NASDAQ was split away from the regulatory side of the NASD, which became FINRA. In the ensuing shuffle, the OTCBB became the property of FINRA. The systems for running it remained at NASDAQ and are leased to FINRA.

FINRA's latest announcement reflects the realization that FINRA is a regulator, rather than engaged in the commercial business of running markets. It also represents the latest in a long march away from the market reforms of the 1930s.

The New York Stock Exchange originally was entirely a commercial enterprise. The Securities Exchange Act of 1934 transformed it into a “self-regulatory organization,” responsible for regulating the conduct of its broker-dealer members. Like NASDAQ, the commercial goals of the New York Stock Exchange were in constant conflict with its regulatory goals. In both cases, this confusion of roles resulted in scandal and huge regulatory fines. Eventually, the commercial enterprise was split off from the regulatory function. The NYSE and NASDAQ have self-regulatory responsibility to regulate the operation of their markets, but the regulation of the broker-dealers who use their facilities is left to FINRA.

Ultimately, I believe we will go full circle, evolving away from the notion that commercial exchanges should have a self-regulatory component. The SEC will regulate securities markets, FINRA the broker-dealers that use them. Small businesses, and the investing public, will be better served in the process.

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