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## OTC Market

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## **The OTC Markets**

By Tiffany Walsh

Every private company should consider the advantages and disadvantages of going public when promoting the growth of their operations and earnings. Because of the benefits a public company can offer, a company should consider taking their company to this next stage of growth and the various avenues to do so. The most known and prestigious stock exchanges, such as NASDAQ and NYSE, are catered to larger and more established companies, however, there are trading boards available for smaller companies as well which encompass many of the large stock exchange characteristics.

The over the counter (OTC) market provides an alternative for companies that do not wish to be listed on a U.S. stock exchange or do not meet the relevant listing requirements to do so. The OTC market has a wide range of companies which are assigned a Market Tier based on how the company chooses to do its disclosures and how established the company is;<sup>1</sup> these tiers include OTCQX, OTCQB and OTC Pink. OTC Pink is the bottom tier of the OTC market. It is a speculative trading marketplace that helps broker-dealers receive the best prices for investors.<sup>2</sup> OTCQB is the middle tier of the OTC market and was created in 2010 to help investors identify OTC-traded companies that report to the SEC or a U.S. banking regulator.<sup>3</sup> Prior to OTCQB, the OTC Bulletin Board was designated for this purpose but now only 5% of all OTC priced quotes are published there.<sup>4</sup> The top tier of the OTC market is OTCQX which represents a trillion dollars of market capitalization.<sup>5</sup>

### **Methods to go Public**

There is a variety of ways a company can access the OTC market such as the conventional Initial Public Offering (IPO) process or through a reverse merger, however, the direct filing IPO process for the public listing is the most common and inexpensive method.<sup>6</sup> The process is quite simple: first, the private company must have their last 2 fiscal years of financial statements audited by a Public Company Accounting Oversight Board registered accounting firm (PCAOB).<sup>7</sup> Next, the company files an S-1 registration statement with the Securities Exchange Commission (SEC) to register the shares it wishes to sell in its private offering as free trading.<sup>8</sup> The company will determine the initial price per share and will generally use the funds raised to pay for the audit and the IPO cost. Once the S-1 is reviewed and the company responds to the SEC's comments in

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<sup>1</sup> <http://www.otcm Markets.com/otcqb/learn/otc-market-tiers>.

<sup>2</sup> <http://www.otcm Markets.com/content/doc/ps/OTCQBfactsheet.pdf>.

<sup>3</sup> *Id.*

<sup>4</sup> *Id.*

<sup>5</sup> *Id.*

<sup>6</sup> <http://nrisharejunction.com/OTCBBListing.aspx> [hereinafter OTCBB Listing].

<sup>7</sup> *Id.*

<sup>8</sup> *Id.* See generally William Woods, CNSX managing director, Raising Capital and Going Public the CNSX way (July 6, 2011) (The securities are not offered under an offering prospectus so the company cannot sell to the general public like a traditional IPO can; the company's offerings are limited to friends, family and accredited investors).

a Form S-1/A, the S-1 registration statement becomes effective.<sup>9</sup> Lastly, the company will need a market maker to file a Form 211 for approval by FINRA to obtain the stock symbol and public price quotation of the company's shares.<sup>10</sup> The whole process takes roughly 6 months from completion of the financial audit. The main difference between the direct filing IPO process and a conventional IPO is that an underwriter must be involved during a conventional IPO.<sup>11</sup> Because there is no underwriter raising money for the company during the direct filing IPO process, the company is unable to issue new shares.<sup>12</sup>

There are quite a few advantages to a direct filing IPO, such as the minimal cost. It can be roughly \$90,000 U.S.<sup>13</sup> for the entire process which typically includes 2 years of audited financials and legal costs,<sup>14</sup> whereas a reverse merger can cost around \$575,000 for the shell alone to access the OTCQB (this does not include financials or legal costs).<sup>15</sup> Also, there are no unforeseen legal issues with a direct filing IPO because the founders are within the process right from the beginning, where as if the company completes a reverse merger, it may be taking over a dirty shell; that is to say, a company with prior or pending legal issues.

There are some disadvantages to a direct filing IPO. In particular, if there is no underwriter involved, the company cannot offer to more than 35 non-accredited investors and can only solicit the people the company has a pre-existing relationship with.<sup>16</sup> This means no advertising and no offers, however, the company can get around this by becoming approved for a public offering with an underwriter.<sup>17</sup> Although, this conventional IPO method is difficult if the company is not already extremely established with large revenues.

In contrast, a reverse merger could provide a significantly quicker means of going public as it only takes a few weeks to complete the transaction and additionally the company wouldn't need to worry about meeting the minimum shareholder requirement

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<sup>9</sup> OTCBB Listing.

<sup>10</sup> *Id.*

<sup>11</sup> *Id.*

<sup>12</sup> See [http://gopublicpros.com/images/The\\_Direct\\_Filing\\_IPO.pdf](http://gopublicpros.com/images/The_Direct_Filing_IPO.pdf) (A company raises its capital in the private placement to accredited investors, family and friends. It cannot issue new shares until they are registered and an underwriter is involved.).

<sup>13</sup> See generally <http://www.gopublicpros.com/gopublicotcbb.html> ([T]he cost to go public [on the OTCBB] by direct filings is approximately \$70,000(USD) [but this cost can be inflated depending on the size of the company, and which auditing company or law firm is used].).

<sup>14</sup> Drew Bernstein, Bernstein & Pinkchuk, Accounting: Financial Statement Requirements, Reverse Merger Conference, Toronto (June 29, 2010) (transcript available on the Reverse Merger Conference CD Rom 2010) (stating,

Privately held companies that plan to go public by virtue of the form S-1 [after a private placement] only have to disclose two years of audited financial statements (or less if the company has existed for less than two years), whereas larger, fifty-million-dollars-plus companies may need to provide three years or more of audited financials.).

<sup>15</sup> See <http://www.publicshell.com/shells.html> ("Bulletin Board Shells can range in price from \$350,000 to upwards of \$600,000.").

<sup>16</sup> <http://www.goingpublicld.com/benefitsgoingpublic.html> [hereinafter Benefits].

<sup>17</sup> *Id.*

because the shell it is acquiring already has a preexisting shareholder base that meets the requirement. However, the costs of conducting a reverse merger costs anywhere from \$375,000 to more than \$575,000 U.S. (including legal fees and the public shell cost) and the Company could run into future problems if the shell turns out to be dirty.

### **OTCQB Requirements**

The requirements for listing on the OTCQB are minimal. There is no underwriter obligation, and there are no revenue or asset requirements. The only listing requirements are that the Company has a minimum of 35 shareholders and that its financial reports are audited by a PCAOB registered accountant.<sup>18</sup> After the Company is public the OTC requires yearly audits by a PCAOB registered accountant, quarterly reports filed with the SEC and ongoing compliance with the Sarbanes Oxley Act.<sup>19</sup>

### **OTCQB Advantages vs. Disadvantages**

OTCQB is the middle tier of the OTC market. Private companies have many incentives to go public on the OTCQB, such as greater company valuation to its investors, and enhanced credibility and prestige in the business world. As soon as a company goes public it gives “its founders greater visibility, credibility, clout, and prestige with customers, employees, the press, and the entire financial community.”<sup>20</sup> Thus, investors are more confident in the company and view the company as a less risky investment. Moreover, the enhanced public visibility increases the credibility of the company for employees as well. The company can hire more sophisticated and competent employees by offering stock options as incentives which will also increase employee motivation.

It is also cheaper for an OTCQB company to raise and get greater access to capital. It can raise capital by issuing stock or bonds and may also convert debt to equity.<sup>21</sup> Moreover, an OTCQB company has better access to capital because most investment bankers and funds will not invest in private companies because they’re less liquid and they have no disclosure requirements so it’s like investing blindfolded. In contrast, an OTCQB company is more transparent and the information is easily accessible to an investor “because the company must submit audited financials and be current in its periodic and current filings”.<sup>22</sup> Consequently, investors are more confident in an OTCQB company than a private company.

One of the major disadvantages of going public on the OTCQB is DTC Eligibility (Depository Trust & Clearing Corporation). A DTC-eligibility application must be filed with a clearing firm affiliated with DTC before the shares of an OTCQB company can be

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<sup>18</sup> See OTCBB Listing.

<sup>19</sup> *Id.*

<sup>20</sup> See Benefits.

<sup>21</sup> *Id.*

<sup>22</sup> See OTCBB Listing.

bought and sold electronically through brokers or online.<sup>23</sup> The problem is, most OTCQB companies have limited revenues and without approximately \$100,000 per year in company revenues, it is extremely difficult to acquire DTC eligibility.<sup>24</sup> Another disadvantage to be aware of, yet not exclusive to OTCQB listings, is the Sarbanes-Oxley Act, which requires full disclosure on just about everything which increases the ongoing costs.<sup>25</sup>

### OTCQX U.S. Requirements

To access the OTCQX U.S. marketplace the company must not be subject to any bankruptcy or reorganization proceedings, it must have ongoing operations and in good standing, at least 50 shareholders whom each own at least 100 shares of the Company's common stock, and the minimum bid price must be at least \$.10 (for preceding 90 business days).<sup>26</sup> The Company must be included in the Standard & Poor's Corporation Records or Mergent Manuals (formerly known as Moody's), which satisfies the Blue Sky<sup>27</sup> requirements for secondary transactions in many states, together with a list of any other states in which the security is Blue Sky compliant and eligible to be sold by brokers in those states.<sup>28</sup> Lastly, upon completion of the application process to OTC Markets Group Inc, the Company is required to have a Designated Advisory for Disclosure (DAD)<sup>29</sup> Letter of Introduction confirming that the issuer has made adequate current

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<sup>23</sup> See generally Benefits.

<sup>24</sup> *Id.* (stating,

Since mid 2010, companies cannot get DTC eligibility without approximately \$100,000 per year in revenues. This is a guideline, and not a steadfast rule . . . DTC eligibility used to be almost automatic after a company cleared its registration statement and its 15c2-11. One of the company shareholders would deposit their shares with their broker, who would apply for the DTC-eligibility through a clearing firm affiliated with the DTC [to buy/sell stock electronically]. . . . In Jan 2009, FINRA issued a notice to its broker-dealer members reminding them of their responsibility to insure federal securities laws and FINRA rules are complied with when they are participating in the sales of unregistered securities. Since these brokerage firms were charged with investigating the stock issuances of issuers to make certain there were no unregistered distributions, smaller companies were immediately hit the hardest, because they have the shortest operating histories and are more likely to trigger red flags with FINRA. . . . [Now] many shareholders of these non-eligible companies cannot deposit or trade their shares . . . In a nutshell, a company needs to be a 'real' and not a 'shell' in order to become DTC eligible.).

<sup>25</sup> *Id.*

<sup>26</sup> <http://www.otcqx.com/qx/otcqx/listing> [hereinafter OTCQX Listing].

<sup>27</sup> See <http://www.seclaw.com/bluesky.htm> (stating,

Each state in the United States has blue sky laws that require registration of all securities offerings and sales. Each state's blue sky law is administered by its appropriate regulatory agency to reduce securities fraud.).

<sup>28</sup> OTCQX Listing.

<sup>29</sup> <http://www.bowne.com/securitiesconnect/details.asp?storyID=1480> (stating,

As part of the application process for OTCQX, a company must engage a professional, independent advisor to guide it through the listing process. The goal of the requirement, the authors indicate, is to underpin the market's confidence in the quality of the OTCQX issuer's disclosures. The Designated Advisor for Disclosure ("DAD"), who must be an investment banker or a securities attorney, assists the company in complying with the disclosure requirements, federal and state securities laws, and the OTCQX rules. The DAD must verify that the issuer meets the requirements of OTCQX and understands the disclosure requirements. Investment bank DADs must have at least \$5 million in net capital, a majority of the bank's board must have at least

information publicly available and meets the tier inclusion requirements.<sup>30</sup> Once the Company is public it is required to provide ongoing quarterly and audited annual financial reports posted on OTCQX.com (SEC Registered issuers can use EDGAR).<sup>31</sup>

### **OTCQX U.S. International Requirements**

To access the OTCQX U.S. International the company must be listed on the Toronto Stock Exchange (TSX) or TSX Venture Exchange (TSX-V) for at least the last 40 days and be an SEC reporting company or be eligible to rely on the Rule 12g3-2(b) exemption as a foreign private issuer.<sup>32</sup> This exemption means that the company's foreign home market is its primary trading market with more than 50% of the company's shares held by non-U.S. residents and disclosures published in English on the company website (or another website, like SEDAR).<sup>33</sup> The company must also appoint a Principal American Liaison (PAL) to guide through the process and certify compliance annually, and have proprietary priced quotations published by a U.S. market maker in OTC Link.<sup>34</sup> Lastly, the Company must be included in the Standard & Poor's Corporation Records or Mergent Manuals<sup>35</sup> and must maintain its Foreign Private Issuer status, which includes continuing to list its securities on the TSX or TSX-V as its primary trading market.<sup>36</sup>

### **OTCQX Advantages vs. Disadvantages**

OTCQX U.S. and International are the top tiers of the OTC market designed to meet the needs of small to medium-sized U.S. public companies which undergo a thorough qualitative review and have higher financial standards<sup>37</sup>. "OTCQX separates out the credible companies from the large number of economically distressed and questionable companies that trade OTC".<sup>38</sup> Private companies that are listed on the OTCQX market experience similar, yet heightened, advantages as a public company listed on the OTCQB, such as enhanced credibility, prestige and ability to raise capital. Investors are drawn to the increased "transparency, disclosure and quality control which

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two years' experience in the securities business, and it must have raised at least \$50 million as an underwriter for securities listed on NASDAQ. Attorney DADs—which can be used only by seasoned issuers whose shares have been publicly traded for at least two years—need significant experience advising on federal securities-law disclosure obligations, and they cannot be paid in company stock.).

<sup>30</sup> OTCQX Listing.

<sup>31</sup> *Id.* (only the annual financial reports are audited).

<sup>32</sup> See <http://www.lexology.com/library/detail.aspx?g=d5380fcf-72a6-4fe8-87c6-f3ec0422a274> [hereinafter Lexology]. See generally BRAD WIGGINS, *Should your Canadian company seek a dual listing in the United States on the OTCQX?*, SECURITIESLAWUSA, Mar. 31, 2011 [hereinafter Brad Wiggins].

<sup>33</sup> See Brad Wiggins.

<sup>34</sup> <http://www.otcqx.com/qx/int/listing> [hereinafter OTCQX Int. Listing].

<sup>35</sup> *Id.*

<sup>36</sup> See Lexology.

<sup>37</sup> <http://www.otcmarkets.com/otcqx/home>.

<sup>38</sup> <http://www.otcqx.com/qx/int/overview>.

OTCQX provides”<sup>39</sup> through its fully electronic trading platform (similar to the NYSE and NASDAQ) where investors can view real-time quotes online<sup>40</sup>. To understand the superiority the OTCQX encompasses consider the following example: in 2009, 78 OTCQX securities traded a dollar volume of 10.2 billion, where as 3390 securities quoted on FINRA’s BB (which is similar to the OTCQX) traded a dollar volume of 16.5 billion<sup>41</sup> - OTCQX traded over 26 times more dollar volume per security.

OTCQX International is an excellent choice for foreign companies because it provides access to U.S. markets without the need to list on a U.S. exchange, without being an SEC reporting company and without complying with Sarbanes Oxley<sup>42</sup>. After cross listing from TSX or TSX-V to OTCQX International it increases company’s trading volume and expands its shareholder base.<sup>43</sup> Further, if the company uses the Rule 12g3-2(b) exemption the foreign company can rest easy because there is no minimum share price requirement.<sup>44</sup>

OTCQX is also a great market for larger companies that want to save money while improving their business. “Pink OTC Markets reports that small companies typically save \$500,000 to \$750,000 annually by moving their listing from a national exchange and deregistering under the Exchange Act”.<sup>45</sup> A substantial amount of management’s time is associated with having to comply with large exchange rules and as a result the management spends less time on the business, thus a higher opportunity cost. Further, the annual fee for NASDAQ is around \$27,500 - \$100,000 (based on the company’s Total Shares Outstanding),<sup>46</sup> the annual fee for NYSE is \$35,000 - \$500,000,<sup>47</sup> while the annual fee for OTCQX is only \$15,000.<sup>48</sup> By trading on the OTCQX instead of a national exchange, even just temporarily, a company can save an enormous amount of time and money so management can focus its attention on company operations and expansion.

In summary, the minimal listing requirements for the OTCQB is a highlighting factor for companies that wish to enter the public market, however, if the company is more established then it should consider the OTCQX to enhance the company’s prestige and credibility. Nevertheless, whether the company decides to ease its way into the public markets via the OTCQB or decides to advance to the superior quality OTCQX

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<sup>39</sup> <http://www.otcmarkets.com/otcqx/learn/otcqx> [hereinafter OTCQX Learn].

<sup>40</sup> See Lexology (Electronic trading platform available through the OTCQX website: [www.otcqx.com](http://www.otcqx.com)).

<sup>41</sup> See OTCQX Learn.

<sup>42</sup> See Brad Wiggins.

<sup>43</sup> *Id.*

<sup>44</sup> *Id.*

<sup>45</sup> See <http://www.allbusiness.com/company-activities-management/company-structures-ownership/13750952-1.html>; see also <http://www.golfshaftsasia.com/2010/01/aldila-inc-to-move-its-stock-listing-to.html>.

<sup>46</sup> [http://www.nasdaq.com/about/nasdaq\\_listing\\_req\\_fees.pdf](http://www.nasdaq.com/about/nasdaq_listing_req_fees.pdf).

<sup>47</sup> [http://www.qa.nyse.com/Frameset.html?nyseref=http%3A//www.google.ca/search%3Fhl%3Den%26biw%3D1259%26bih%3D633%26q%3DNYSE+Annual+Listing+fee%26oq%3DNYSE+Annual+Listing+fee%26aq%3Df%26aqi%3Dgb1%26aql%3D1%26gs\\_sm%3De%26gs\\_upl%3D832719224101937217161010101412721110710.1.415&displayPage=/listed/1022221392800.html](http://www.qa.nyse.com/Frameset.html?nyseref=http%3A//www.google.ca/search%3Fhl%3Den%26biw%3D1259%26bih%3D633%26q%3DNYSE+Annual+Listing+fee%26oq%3DNYSE+Annual+Listing+fee%26aq%3Df%26aqi%3Dgb1%26aql%3D1%26gs_sm%3De%26gs_upl%3D832719224101937217161010101412721110710.1.415&displayPage=/listed/1022221392800.html).

<sup>48</sup> <http://www.otcqx.com/qx/int/requirements>.

listing, the OTC markets cater to those companies that want the benefits of a stock exchange, yet want to avoid the difficulties and expense of getting there.