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THE NATURE & POTENTIAL OF AN OVER-THE-COUNTER SHARE MARKET IN AUSTRALIA

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1. INTRODUCTION

In many advanced commercial countries there exist "Over-the-Counter" public share markets ["OTCs"] where equity may readily be bought & sold in small to medium enterprises ["SMEs"]. Although these OTC-listed SMEs are constituted as public companies, their capitalization & history of profitability is far less than that required for listing on the established national Stock Exchanges.

OTCs allow listees to commence & expand business using equity finance, which is (or could be) often readily available for investment by its own employees, their superannuation funds and civic-minded locals as well as professional investors & financial institutions. The availability of OTCs has been a great boon to SMEs and, ultimately, to national economies.

Unfortunately, Australia lacks any OTC share market, largely due to the mistaken belief that its small size would not support one, and because political & bureaucratic organization is lagging behind technology & entrepreneurial desire. An application to establish an OTC share market, lodged in 1987, remains unprocessed eight years later at the time of writing. This condemns our vibrant & vital SMEs to remain chained to stultifying & expensive debt financing, and at a disadvantage to competitors in Asia, Europe & the USA.

Australian legislation[1] envisages the establishment of public share markets. With many examples of successful OTCs worldwide, there need be no impediment to definition of appropriate listing rules & operating regimes. It is urgent that Australia benefit from this promising & productive form of financial institution & facilitative intermediary.

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[1] *Corporations Law* (Cth. 1990) ss. 769, 770A, 771

2. THE SMALL TO MEDIUM ENTERPRISE ["SME"] SECTOR

(a) The SME Sector Generally

A commercial enterprise is an SME when it falls short of being able to list on the Australian Stock Exchange ["ASX"][2]. Most SMEs have a capitalization of $2.00 to $1.5m., employ 3-15 people and in may cases have little nett profit after paying a living salary to directors. Few qualify for an ASX listing. SMEs typically begin as shelf companies with $2.00 capitalization, Mum & Dad as shareholder/directors and operating capital raised by bank loans secured against the family home.

There are some 850,000 SMEs in Australia[3], and they are vital to our economy, providing 60% of the non-government workforce and around 40% of the private sector output[4]. In regional Australia there is rarely any form of economic unit other than the SME. As smallness, efficiency & flexibility ousts giant organizations in the manufacturing arena[5], SMEs are becoming the way of the future. In SMEs there is inspiration & commitment in abundance, and tremendous creative & productive potential. It is at this level that family cohesion, small group dynamics, personal motivation, direct management, independence, ambition, dedication, discipline, flexibility, creativity, lateral thinking, lean efficiency and sheer grit is most intense. The utility of SMEs, both to the individual & national economy and in terms of regional development generally, has been recognised by a series of Federal enquiries[6]and major national statements[7]

> The small firm is in fact an essential medium through which dynamic change in the form of new entrants to business, new industries and new challenges to established market leaders can permeate the economy. In the absence of an active and vital small firm sector, the economy would ossify and decay.[8]

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[2] See below p.
[3] Although only some 10% aspire to capital growth.
[4] National Investment Council, DIST *Financing Growth* Commonwealth of Australia, August 199, p.9.
[5] See AMC/McKinsey & Co Emerging Exporters - Australia's High Value-Added Manufacturing Exporters, 1993.
[6] E.G. Federal Government Taskforce on Regional Development [Kelty Report, December 1993]
[7] E.G. "Working Nation, Policies and Programs", presented by the Prime Minister, the Honourable P.J. Keating, MP, House of Representatives 4 May 1994, AGPS Canberra; esp. Chap. 7.
[8] Report of the Committee of Enquiry on Small Firms (Bolton) Cmnd. 4811 (HMSO: London 1971) para 13.

(b) Intellectual Property SMEs ["IP-SMEs"]

Australia (perhaps because of its youth, space, freedom & quality education) abounds with brilliant inventors, engineers, chemists & technicians, and its population (both personal & corporate) is ever-keen to access cutting-edge inventions. At grassroots level of individual creativity & inspiration, Australia is already the "Clever Country", with a rate of scientific discovery & patenting which is one of the highest in the developed world[9]. Wealth creators will continue to graduate from this sector and should be recognized, endorsed & nurtured so that their inventions & skills are fashioned into cutting-edge products which capture substantial markets & create income for Australia, rather than be lost.

Sadly, Australia falls down when it comes to implementing and successfully commercializing the insights of this academic & inventive achievement: the CSIRO is not results-driven and theoretical insights are often not implemented by industry. The IP-SME sector usually faces a long lead-time between conception & creation of a viable new technology, the protection of same by patenting, the manufacture & testing of prototypes, mass-production & marketing, and hence profitability. Typically, start-up enterprises in this sector cannot afford thorough due diligence testing so as to convince investors to support manufacture & marketing, and such “angel” investors as are available have no reputable due diligence service-providers to whom they can turn.

Frequently, creative & industrious innovators (especially when in the private sector) apply their savings and borrow what they can (mortgaging the family home etc.) in order to perfect & protect their invention or industrial process, and then vend it into an SME having intellectual property rights in the form of patents pending or granted ["IP-SMEs"].

Sometimes IP-SMEs languish awhile without cashflow, unable to meet the high cost of international patent protection[10], until their expensive patents wither and die, or fall into the public domain, or are snaffled by overseas competitors. Sometimes they sell out to predatory high-risk venture capitalists (often offshore) and good minds & income are lost to Australia. Sometimes they battle on, labouring to meet payments on directors' mortgages, using leased equipment, continuously frustrated as regards hiring & training of quality personnel, upgrading to improve productivity and affording necessary marketing research. Sometimes, by sheer grit, they establish 1-3 year trading histories and mezzanine-level status, thus "qualifying" for merchant-bank funding or underwriting (at considerable sacrifice of equity share by those who have borne the bulk of the real work & worry) and ultimately achieve a public float. It is common for IP-SMEs and their human drivers, exhausted by the cost of patenting & start-up tooling, frustrated with trying to master the arcane mysteries of mass-manufacturing & marketing, with energies dissipated in abortive quests for finance, to collapse or compromise their true potential.

(c) Financing Problems of SMEs

Historically, SMEs have confronted continuous frustration in attempts to obtain seed or developmental finance with which to "pull themselves up by the bootstraps" into productive viability. More than 56% of companies turning over less than $10m have been refused finance at the time they wanted to expand[11]. With direct equity investment unlikely, proprietors of SMEs lacking adequate retained earnings to support growth have nowhere to turn for funds except to debt financiers, especially the banks. However, these demand a high rate of interest and "bricks & mortar" collateral security (e.g. a mortgage over real estate or perhaps a charge over the company as a going concern). As a result, Australian small business has amongst the highest debt to equity ratios in the world[12]. Maintenance of debt finance damages viability since the long lead-time faced by start-up SMEs makes it very difficult to meet interest payments. However, some banks are now offering loans (at 15% interest) on the basis of cashflow figures, without security over hard assets.

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9 See speech to ANZAAS by Senator Peter Cook, Minister for Industry, Science & Technology, 25 September 1995.

10 Which generally has to be commenced within 12 months of the filing date and costs of search, drawings, application an initial $1000, then $8000 for international PCT status in convention countries (not counting examiners), with annual maintenance fees of some $300-1000 per convention country.

11 *Financial Review* 7 April 1994 p.13.

Compounding this situation for IP-SMEs, there are at present no authoritative procedure for assessing & promoting technological innovation. Reliable, independent due diligence reports on promising products are vital to define which ones most deserve government support, and which ones are relatively secure investments. Lacking the support of technical & market intelligence, neither the inventor nor the average potential investor has the competence to assess the market potential of a new product, to ascertain the solidity of its patent or its patentability, or to research the viability & cost of production. As a result, technologically illiterate investors are forced to operate in an information vacuum, resulting in many needlessly- failed investments. This further exacerbates the culture of investor reluctance.

There are two major impediments to financing Australian SMEs: distraction of investment funds and lack of an exit mechanism:--

(i) Distraction of Investment Monies

Finance will be distracted from productive investment into speculation so long as vested interests are permitted, thanks to public apathy & ignorance, to warp the Australian political & economic system into allowing community-generated increases in land value (especially triggered by the rezoning process) to be pocketed by private land-holders as unearned profit. This is not only highly inflationary, but is a tragedy for national productivity & employment, since funds are diverted which would otherwise have nowhere to go but into productive enterprise. The resulting economic, social & environmental distortion (which is of course amplified worldwide) is massive, endangering the global financial system (by gearing prudential standards & collateral securities to boom & bust bubbles) and indeed (due to the avoidance of meaningful environmental accountability) threatens human survival.

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[12] See Financial Review 2 November 1993, page 26.

Private control over sites is essential for privacy & security, and hence for investment & productivity. Sites (which were not made by humanity and are an essential factor in production) are thus in demand and command a price which reflects their value, whether due to location or to natural endowment. It is impossible for an economy to balance (and perpetuation of the boom-bust cycle will continue) unless the financial advantage bestowed upon siteholders is collected as public revenue. This can be done by "Site Revenue"[13], i.e. collecting the rental-value (on an "unimproved" basis) of sites privately occupied, whilst not disturbing ownership of them and their improvements. Indeed, there is no other logical source of public revenue, since all taxes upon effort or transactions serves to suppress or distort them.

If the site revenue is not collected, value inheres to the site above the value of improvements to it. So long as individuals can pocket community-created increases in site value, investment will be distracted away from productive enterprise, unemployment will exist, the currency will be inflated (since such profits do not reflect true extra goods & services in circulation) and interest rates will be high (or even exist at all).

(ii) Absence of an Exit Mechanism

[13] The Site Revenue proposal (sometimes called the "Single Tax") was first propounded in detail by Henry George in *Progress and Poverty* (1879); *Social Problems* (1884); *The Condition of Labour* and *Protection or Free Trade* (1886) and *A Perplexed Philosopher* (1892).

George's basic analysis has remained intact intellectually for the last century and has been endorsed, from time to time, by various major thinkers: "It is quite true that land monopoly is not the only monopoly that exists, but it is by far the greatest of monopolies -- it is a perpetual monopoly, and it is the mother of all other forms of monopoly." (Winston S. Churchill The Peoples' Rights Jonathon Cape Ed., London, 1970 at p.117). "The unearned increment in land is reaped by the land monopolist in exact proportion, no, not to the service done but to the disservice done." (Speech by Churchill at Edinburgh, 17 July 1909 as reported in his *Liberalism and the Social Problem*. "The earth, being the birthright of all mankind, its rental is the property of the people. Thus the site rent is the debt owed to the community by every landed proprietor, the duty of the State being to collect that debt as its revenue, to utilize it for the purposes of the community and not to tax." Tom Paine, Commonsense.

For a modern analysis, see Fred Harrison *The Power in the Land* Shepheard-Walwyn, London (1983) and Steven B. Cord Henry George: Dreamer or Realist? Uni. of Pennsylvania Press, 1965.

It is the lack of an exit mechanism for investors in SMEs which this essay primarily addresses. Investors have traditionally been reluctant to invest as shareholders in SMEs due to the absence of a ready market on which to liquidate their holding when desired. From the point of view of a minority shareholder, an equity investment is fraught with danger unless the shares are tradable on an independent market to which reports must be made, which provides buyers and which sets a fair price. Without this, the minority shareholder may be "locked in", unable to attract buyers and at the mercy of whatever majority shareholders may be willing (if at all) to pay for their shares.

> Unlisted small and medium size businesses face great difficulty in raising equity capital. Investors are extremely cautious about becoming minority equity holders in unlisted companies.
>
> A Major reason for this is the absence of a market in which to buy and sell such equity. Investors fear they will be locked in if they take a minority stake in a private company because they will be unable to find a buyer if they wish to sell out. Superannuation funds generally avoid such investments because there is no market to set a price.
>
> The creation of a new market for unlisted securities would open up new sources of finance for small and medium sized companies. There are difficulties in creating such a market with adequate safeguards to protect investors, but the Government should pursue the concept.[14]

However, it cannot be assumed that the mere establishment of an OTC market will automatically, within a desirable timespan, enable those listings and that investment & liquidity which is needed. Proactive government endorsement is desirable[15].

(d) National Ramifications of the SME Financing Problem

Australia has traditionally been able to rely, for its continued affluence, on its mineral & agricultural resources to underpin a trade surplus and, until recent years, has not depended upon the ability of its citizens to develop & produce world-competitive manufactured products. Thus, a culture of investment in risk-carrying innovation has never developed in Australia, which consequently lacks a sufficiently diversified value-added manufacturing base. This lack exacerbates & entrenches unemployment and exposes our economy to fluctuations in commodity prices & increased reliance on imported products, draining our earnings.

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14 Federal Government Taskforce on Regional Development [Kelty Report, December 1993]

15 See below p.

Both this deficit in the balance of our import/export payments and our widespread unemployment could be reversed by removing the artificial barriers to equity financing of Australian SMEs, thereby enabling them to flourish free of debt. The Australian technology sector, especially, is capable of sustained, world-wide competitiveness and is particularly promising since patents can be exploited for an exclusive period of 20 years (6 for petty patents), thereby enhancing the potential returns. In this area (unlike in heavy industry), our small population and distance from world markets need be no obstacle to exporting advanced technological products. Australia must urgently identify & assist promising technological ventures and foster equity investment in them.

The ultimate reward for such action will be a country in the forefront of developing, commercialising & exploiting both routine & cutting-edge technology world-wide. Such assistance will engender a culture of technological literacy and ensure that future generations avoid a technological wilderness. Australia cannot afford, in the face of world competition and free trade, to leave SMEs -- its economic powerhouse, especially regionally -- crippled & languishing without access to equity finance. Failure to foster equity investment into Australian SMEs will doom Australia to a devaluation of its best inventors & patents and to remain a significant importer (rather than exporter) of all but humdrum manufactures. Given the industry & ambitions of developing nations, no country, of whatever size, can expect to remain an affluent member of the technologically-developed world, whilst being so inert & apathetic. The raising of capital by SMEs via an OTC share market would reduce demand for debt finance and assist in reducing interest rates.

The crying need of SMEs for equity capital, rather than debt funding, has been (and is) consistently recognized, both by government and the market, throughout Australia. The situation identified by the Espie committee a decade ago is the same glaring situation examined in depth by the December 1993 Federal Government Taskforce on Regional Development chaired by Mr. Bill Kelty. One of the Kelty Report recommendations (#10) was that "the Government should consider ways of establishing a market for equity capital in small and medium sized private companies". The most direct and least bureaucratic way of achieving that is by formation of a healthy OTC market.

Politicians have recognized the need to harness regional motivation in order to "grow strong economies and create employment", to "look beyond their region and find niches in mainstream markets in Australia and abroad" and to "provide strategic assistance of a kind that will enable the people of the regions to help themselves by investing in their own communities"[16].However, political remedies have only involved "tinkering at the edges", e.g. assisting formulation of small business plans, export-enhancement schemes and reducing the concessional tax rate from 25% to 15% for Pooled Development Fund ["PDF"][17]income derived from investments in SMEs. Worthy as these circumferential, bureaucratic & intermeddling "big government" schemes may appear to be, they are no substitute for liberating SMEs from artificial financing constraints and enabling direct investment into, and competition between, them. This latter course will allow SMEs to flourish of their own accord whilst conserving public expenditure.

3. TRADITIONAL FINANCING OF THE SME SECTOR

(a) Equity Investment

Equity investment is contributed in return for a share of ownership. It is not repayable, demands no provision of securities (other than issued shares), bears no interest and augments credit-worthiness for both the investor and the company. Of course, to a major shareholder or proprietor, equity investment has its downside too, since it dilutes control, is expensive to attract and cannot (usually) be repaid at will. The existence of an exit mechanism[18](preferably a public securities market) is essential to give confidence to equity inventors.

16 "Working Nation" pp. 174, 175.

17 See below p.

18 See above p.

Trading of securities on secondary markets is regulated to ensure that they are properly approved, to prevent manipulation of information and to ensure takeovers are efficient & competitive. It is an offence to conduct an unauthorized securities market[19], and approval will not be given unless a satisfactory business proposal (relating to membership and conditions of trading) & listing rules is proposed[20] Thus, as a matter of practical commercial reality, attracting equity investment necessitates flotation & listing as a public company, for only then can offers of securities be made to the public, and only then can investors access the one market which exists (the ASX) and confidently expect ability to liquidate their holdings. This heavy-duty & expensive process is mostly beyond the means of SMEs and, indeed, inappropriate given the start-up nature of their enterprises. Even if it be affordable & appropriate it may not be possible if the track-history & turnover required for public listing is lacking.

A stock *exchange* is a place where appropriate securities are quoted and traded by licensed operators in a fair & efficient market. A stock or share *market* performs the same task but may lack a physical trading floor and be screen-based. There is only one approved Stock Exchange or public Share Market in Australia: the ASX.

On 30 June 1987 the ASX was established as a single, co-ordinated national stock exchange, replacing the original state exchanges, which were independent although they were all members of the Australian Associated Stock Exchanges, a company limited by guarantee to secure uniform regulations. The ASX is a company limited by guarantee and incorporated in the ACT, with qualifying firms & individuals (holding dealers' licenses) as its members and its operation governed by its Articles of Association. The Board is elected at a general meeting: it levies members to meet operational costs, delegates local operating powers to its wholly-owned subsidiaries (the previous state exchanges), can admit or discipline members, imposes audit & surveillance standards and can set listing requirements. Some 1200 companies are presently listed. The National Guarantee Fund consists of the pooled State guarantee funds, and protects the public in the event that a dealer becomes insolvent.

19 *Corporations Law* s.767

The business & listing rules of a stock exchange are more than a private concern enforceable by members (who should, however, have recourse thereto in the first instance): compliance therewith, by its members & listees, is enforceable by the courts at the suit of the ASC, the ASX or an aggrieved person[21]. The Court has power to give directions securing compliance[22]or to issue mandatory injunctions[23]. The ASX must notify the ASC of disciplinary action against a member[24]and must cease trading particular securities when notified by the ASC that, for reasons stated, it has formed the opinion that this is necessary to protect those trading in the shares or the public.

(b) Constraints on Equity Investment

(i) Prospectus Requirements

Only public companies may raise money by issuing shares, debentures or other prescribed interests to the public[25], and they do so in substantial volumes.[26] In each instance a prospectus is required, either where the security is issued ["primary prospectus"] or where securities are issued with the intention of their then being traded ["secondary prospectus"]. The prospectus must disclose sufficient information to enable a potential investor to make an informed assessment regarding the assets & liabilities, financial position, profits & losses and prospects of the corporation and the rights attaching to the securities[27]. Written consent of any expert quoted must accompany expert statements.

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20 *Corporations Law* ss.769, 770.

21 *Corporations Law* s.777

22 *FAI Insurances & Anor v Pioneer Concrete Services Ltd & Ors (No 2)* (1985-1986) 10 ACLR 801

23 *Hillhouse & Ors v Gold Copper Explorations NL & Ors (No 3)* (1988-1989) 14 ACLR 423

24 *Corporations Law* s.776

25 *Corporations Law* s.116

26 $16081m in 1986-87 (before the stock market crash) to $6596m in the financial year to 30 June 1991 and $16953m to the end of the financial year to 30 June 1995.

27 *Corporations Law* s.1022

Every prospectus must be registered[28]and applications for securities must be physically attached to same[29]. The ASC can reject a prospectus if it appears to be inadequate or misleading, but does not take responsibility for its accuracy. Investors have a right of action, both in tort and under s.1005, against the company and its directors in respect of false & misleading representations in a prospectus, but various statutory defences are available[30]. A company which issues a prospectus must apply for listing on the ASX within three working days from its issue[31].

An issue of shares in exempted[32] from the prospectus requirements if the investors to whom the offer is made come within the s.66(3) "excluded offer" categories. This applied where the minimum subscription is $500,000.00, if the shares are bonus shares issued to existing shareholders without consideration, if the recipients of the issue are exempt recipients (such as underwriters & fund managers), or if they are not "members of the public" in that only limited individuals (less than 20, as regards a single type of security, in any 12 month period) have been approached. These extreme exemptions (large scale, on the one hand, or constricted, on the other) constraining location of investors dispossess the vast "middle ground" of most SMEs.

Given the complexity of issues to be addressed in a prospectus, the number of expert opinions which should be included and the heavy potential personal liability for any error, the cost of a prospectus for floating a public company is rarely less than $300,000.00 and frequently is over $1m. This heavy-duty and expensive process is often not only way beyond the means of individuals & SMEs, but is inappropriate given the start-up nature of their business, or even impossible since the track-history & turnover required for public listing is absent. The prospectus requirements of the Corporations Law are coming under increasingly heavy criticism.

> "The prospectus requirements undoubtedly inhibit capital formation in Australia, especially among emerging businesses" ... "The prospectus requirements are full of anomalies and

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28 *Corporations Law* s.1018

29 *Corporations Law* s.1020

30 *Corporations Law* ss.1008, 1009

31 *Corporations Law* s.1031

32 Under *Corporations Law* s.1017A

> consumer/investor protection that has been taken to the nth degree" ... "We have not stopped the general public from driving cars because they run a risk of hitting pedestrians but we have effectively stopped emerging businesses from seeking informal finance because of our concern over the risk to potential naive investors."[33]

Circumvention of the frustrating prospectus requirements leads to a rash of hopeful, and probably futile, advertisements in the business pages of newspapers seeking "joint venture partners", or sheer blatant share-hawking[34]. Such efforts are time-consuming, hit-and-miss, with no guarantee of contacting the best (or even a fair) deal and the most likely respondents are the sharks & vultures of venture capitalism.

(ii) Listing Rules

The Board of the ASX, whilst ultimately responsible, has delegated to its National Listing Committee the admission of companies to the Official List. A company will be considered for listing on the ASX if[35] it issues a prospectus and has a conforming Memorandum of Association and Articles of Association whereunder all its ordinary shares are of the same nominal value and "restricted securities" must be held in escrow for a year after issue before being traded.

Restricted securities are those issued by a company in consideration for acquisition of an interest in a mining tenement, patent, invention, industrial chemical or biological process etc, which has not been profitably exploited for at least two years and has no readily ascertainable value. Also subject to the escrow restraint are shares issued to underwriters for consideration other than cash.

[33] National Investment Council, DIST *Financing Growth* Commonwealth of Australia, August 1995, Quotes from interviews; pp. 33-35

[34] In contravention of *Corporations Law* ss.1078, 1081

[35] Under Listing Rule 1A

The shares of a listed company will only be quoted where[36] the issue price is at least 20 cents, at least 500 shareholders have a parcel worth at least $2000, and where the company is a going concern in the same predominant business activity & with unqualified audited accounts for at least 3 full financial years, with an aggregated profit over that period of at least $1m, an operating profit for the previous 12 months (as certified by an accountant) of at least $400,000.00, and net tangible assets of not less that $2m.

The sum of $10,000 is payable[37] upon application for quotation of stock worth at par up to $3m. Beyond that, the fee increases on a sliding scale. Fees are payable if additional securities are to be quoted. A recurring annual fee of $5000 is payable where the stock quoted is up to $3m. Total capital raising costs (underwriting, prospectus & listing) for companies joining the ASX range from about 5-9% of the sum raised[38].

Once listed, an entity must make periodic reports to the ASX and comply with its rules regarding allotment of securities, despatch of certificates, new issues, calls, options, voting rights, directors, capital reconstruction, forfeited shares, takeovers, changes in either the control or the scope of its activities, vendor securities, and company buy-back schemes.

(c) The "Second Board" Experiment

During the mid-1980's, commencing with the Perth SX in January 1984, listing became permitted in all state exchanges upon a "Second Board" of companies having much smaller membership (usually 200+ shareholders) and far less capital (usually about $200,000) than Main Board companies. There

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[36] Listing Rule 3(b)

[37] Listing Rules s.4

[38] National Investment Council, DIST *Financing Growth* Commonwealth of Australia, August 199, p.37.

was no requirement for net tangible assets or a history of operating profit (so long as there were firm proposals for the investment and/or expenditure of at least 50% of the funds raised by prospectus), nor any power in the Stock Exchanges to order an independent audit of the value of an asset to be bought by the company. Second-Board listees were allowed to issue a class of share providing a bulwark against takeover by a "first board" company. Unfortunately, institutions tended to be reluctant to invest in amounts less than $500,000 or to hold more than 5% equity lest on-sale distort the market: a reluctance which effectively necessitated a minimum capitalization of $10m.

The Second Board was hard-hit by the 1987 share market crash. At 30 June 1988, 412 companies were listed on Australian Second Boards but by 30 June 1991 this had fallen to 224 [see ASX Annual Reports] and major liquidity problems were being experienced in their share trading, leading to listees liquidating, delisting or graduating to the Main Board, with which the remnants were merged from 1 January 1992.

(d) Venture Capital

Isolated from professional & institutional investment due to high due diligence & flotation costs and the lack of an exit mechanism, and with Exempt Markets[39] inappropriate, SMEs are left with virtually nowhere to turn (once directors' collateral to secure debt finance is fully committed) but to the "angelic vultures" of Venture Capital. Inventors and technology entrepreneurs are left, in a desperate search for funding, like peddlers to haul their creations around a cynical circle of venture capital fund managers & merchant bankers, who are often simply incompetent to assess the market potential of a new technology, ascertain the solidity of its patent or patentability, research the viability & cost of production and thus feel confident to fund flotation, or even to recommend thorough due diligence testing. As a result, a lot of promising inventions "slip through the cracks" into oblivion, or are lost to overseas interests.

Certain merchant banks[40] will invest early at a discount, in highly-promising but under-capitalized SMEs. However, in practice target SMEs must "qualify" by having established a substantial degree of credibility, perhaps in the form of international patenting, profitable trading patterns or proven management. Venture capitalists have no interest in assisting capital-starved, struggling SMEs or start-ups, because they perceive it as not worthwhile even to expend due diligence costs upon (let alone to underwrite the flotation of) technologies with little or no proven viability. As a result, many promising ventures fall by the wayside, or are lost to foreign predators.

Often the investment made by Venture Capitalists comes at a steep cost in dilution of the equity of those inventors, founders & believers who have wrestled & risked to bring the enterprise thus far down the road to viability. This costs tends to involve the issue of preference shares with prior interest entitlements, substantial blocks of shares at a discount and warrants or options permitting uptake of further tranches at fixed prices should the enterprise flourish. Despite the modern changes to the *Income Tax Assessment Act*, Venture Capitalists do not particularly seek franked dividends but rather (taxable) capital gains. The average gains sought are 45% for pre-startups, 32% for startups and 21% for established businesses[41]. When (if) their SME "takes off", especially if it publicly lists or is taken over, capital gains on share prices can be large.

(e) Government Schemes

A continually-changing flux of government schemes provides some relief to SMEs, especially those in the technology sector. However, these schemes are invariably peripheral to the central problems, and are bureaucratic, with high delivery costs. Whilst they may ameliorate repressive pressures, they tend to swell public sector deficits.

(i) "Nut and Bolt" Decentralization

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[39] See below p.

[40] Such as Hambros or Macquarie Investment Trust

[41] Mason C.M. and Harrison, R. 'The informal venture capital market in the UK', in Hughes, A. and Storey D.J. (eds) *Finance and the Small Firm*, Routledge, London, 1994.

During the 1970s the "nut & bolt" dismantling & relocation of industry to provincial centres was subsidized in the name of regional growth, but, as often as not, these industries were derelict when they relocated and promptly collapsed once the subsidies were removed. This was a tremendous waste of effort and far less effective that nourishing the natural growth of start-up industries already located in those centres.

(ii) The MIC Scheme

In 1983, upon the recommendation of the Espie Committee, the Federal Government launched a Management Investment Company ["MIC"] Program directed specifically at catalyzing finance for high-technology SMEs, especially during the start-up & early growth stages. To hold MIC status, a company had to use innovative technology, be competitive internationally, have potential for rapid growth & employment, be export-orientated, and upon this basis achieve licensing by a statutory Board. Investors in MICs could claim a 100% taxation deduction in the year of investment. The MIC scheme was severely dented by collapse of investor confidence after the October 1987 share market crash, and was stymied by uncompetitiveness when licensees "captured" the licensing Board.

(ii) The R&D Taxation Provisions

Expenditure upon Research and Development ["R&D"] work, so essential for advancing the frontiers of technology, is encouraged [42] by the granting of 150% deductibility of the monies expended. To qualify as R&D, the work must consist of systematic, investigative or experimental activities that are carried on in Australia, involve innovation or technical risk, and be carried on for the purpose of acquiring new knowledge, or for creating new or improved materials, products, devices, processes or services. "New" has been construed as meaning knowledge that, at the time the activity commences, either does not exist or, if it does, is inaccessible to the claimant on acceptable financial terms. Neither market research nor "reverse engineering" can qualify as R&D work.

...20...

42 Under s.73B of the *Income Tax Assessment Act* 1936-91

Any Australian company (not individuals or partnerships) is eligible, and can claim the full 150% deduction if it contracts the R&D work out to an unrelated[43] organization, but if the proposed expenditure exceeds $50,000.00 it is unnecessary for that organization to be an Approved Institute or Registered Research Agency.

The Industrial Research & Development Board ["IRDB"] has ultimate authority in deciding whether or not a project is/was truly R&D. Projects must be registered with the IRDB before claiming the deduction. In applying its tests, the IRDB will be interested in the aim of the work, where it was/is to be performed, what problem is being faced, what activities are proposed, and why the activity is novel. The IRDB will rarely provide an advance ruling, however it does provide guidelines. The IRDB has developed three main tests:--

(a) The end objective of the project was either to acquire new scientific or technical knowledge or to create new or improved materials, products, devices, processes or services;

(b) There was at least one clearly identified technical or scientific problem which had to be resolved in attaining the stated objective and its resolution was approached in a planned, systematic, investigative or experimental manner;

(c) If aimed at the introduction of new products, devices, processes or services; the claimed projects were directed to the development of "new" technology or techniques (phenomena, structures or relationships) or to the application of available technology or techniques in a "new" way.

Whilst of some encouragement to R&D work, investors purchasing shares in an R&D company cannot claim their expenditure as a 150% deduction. That expenditure would merely be a purchase of income-producing assets, the expense of maintaining which (book-keeping etc.) would be deductible under s.51, and losses or gains on resale deductible or assessable (as the case may be). The R&D provisions thus give no direct assistance to investors, although it may encourage investment into new technologies in the hope that, assisted by the R&D provisions, they will develop profitable enterprises and eventually pay good dividends.

[43] Within the s.26AAB definition

(iii) Pooled Development Funds

The PDF scheme[44]replaced the MIC program in June 1992. Basically, a PDF fund is structured as a virgin company with one class of shares. It must be approved by the PDF Registration Board (set up under the Act) after presentation of capital-raising & investment plans. The PDF raises capital by public subscription for shares, usually pursuant to a prospectus, and provides a way to channel long-term patient equity capital into SMEs.

PDFs may invest (as new equity) in ordinary shares of any eligible Australian company (retailing & real estate development, and companies with $50m.+ (used to be $30m.+) capitalization are excluded), with up to 30% (used to be 20%) of its capital in any one business, and it must have invested 65% within five years. The PDF must take up at least 10% of each investee (although this can be organized jointly with other PDFs) but cannot take up more than 5% in a start-up business. The Board's permission is required for investment in non-ordinary shares, e.g. preference shares giving preference on return of capital (but not merely dividend or voting preferences). The investment must be used for establishing or expanding a business or its market, not for enabling its debt retirement.

Income (dividends etc.) from investment in eligible SME enterprise is only taxed at 15%; other income (e.g. from interest or "blue chip" investments) is taxed at 25% (previously 30%). Capital Gains are tax exempt. Dividends funded out of such taxed income come with franking credits under the tax imputation system and are tax exempt at the hands of shareholders.

[44] Under the *Pooled Developments Ac*t (Cth; 1992)

Hitherto, there has been little interest in PDFs by the big funds (banks, superannuation), since the tax advantages do not clearly outweigh the risks, but they are becoming more aware of the positive community “spin-off” which investment of workers’ savings locally can bring, and the potential profitability of investing "development capital". If OTC tradeability were added to the enhanced taxation advantages then the PDF vehicle would be much more likely to engender that investment into regional industry which the Government so clearly desires[45].

(iv) Export & Discretionary Grants Schemes

To a certain extent, promising high technology industries (whether listed or unlisted) can obtain vital seed or start-up capital on a dollar-for-dollar basis (although this can be arranged conditionally) under the Federal Government's Discretionary Grants Scheme. Development funding may then be obtained via the Export Market Development Grants Scheme or the International Trade Enhancement Scheme etc.

However, a convincing business plan must be prepared, extensive bureaucratic complications are inevitable, and lengthy delays awaiting an annual allocation or being selected are to be expected. Such delays can be fatal given the rapidly-changing technological climate, wherein efficient exploitation of a fleeting "window of opportunity" is essential to establish market share and a toehold for keeping abreast of developmental trends before competitors & new methods supervene. The grants process tends to require the CEO, so important to the survival of a start-up enterprise, to "take his eye of the ball" to such an extent, and to become so absorbed in an application for a grant, that his enterprise's main game is itself endangered. The existing Grants process can be very debilitating for an SME and is widely perceived to be so cumbersome & even treacherous as not to be worth the effort.

45 See e.g. Federal Government Taskforce on Regional Development [Kelty Report, December 1993] and "Working Nation, Policies and Programs" Presented by the Prime Minister, the Honourable P.J. Keating, MP, House of

(f) Conclusion: the Fatal Funding Gap

Thus, the brilliant potential of Australian SMEs is frustrated due to the absence of an appropriate equity market. Neither Exempt Markets nor the ASX are suitable, the former because they are too narrow, the latter because the pertinent prospectus & listing requirements render it inaccessible. Historically, the range of ameliorative schemes devised by governments have been narrow in scope, bureaucratic and of limited effectiveness.

The vast bulk of Australian SMEs, particularly IP-SMEs, remain trapped & stagnant in a vast middle ground from which investment is diverted by artificial speculative attractions, and into which investment is virtually prohibited due to the absence of a market to provide an exit mechanism.

4. THE NATURE OF AN OTC SHARE MARKET

(a) Characteristics of a Share Market

(i) General

A securities market gives listed stocks prestige and enables their valuation & use as collateral. It allows buyers & sellers to locate counterparties and provides information & quotations so as to facilitate transfer of securities at the best price. A securities market should obtain, collate & share information, ensure that the market is conducted in a fair & orderly manner, keep a record of transactions, maintain a fidelity fund, monitor compliance with its rules & prosecute breaches, ensure clearance & settlement procedures work effectively, and investigate complaints. Public confidence in the market is essential: this requires that guard be made against failure of its intermediaries or trading mechanism, distortion or non-disclosure of relevant information, failure of the settlement mechanism or fraudulent & manipulative practices.

(ii) Listing

Representatives 4 May 1994 AGPS Canberra: esp. Chap. 7.

Typically, the listing rules of a securities market will require full public disclosure of material activities and of all transactions in the market. Other parameters tend to require a single class of shares, an annual independent audit, public accounts (which must be clearly not tax-driven) and even business plans, board meetings at least quarterly, new issues to be offered proportionally to existing owners so as to avoid equity dilution, disposal of significant assets to require a special resolution of members, retention in escrow for 12 months of "restricted" securities issued for unproven intellectual property, approval by AGM of remuneration for & loans to directors & senior management, and their removal in the event of undeclared conflict of interest, insolvency, bankruptcy or long-term illness.

(iii) Dealers & Drivers

Dealers may operate in either a "single" or a "dual" capacity, and markets may be either "quote-driven" or "order-driven", or both.

Traditionally, it was believed that a broker, acting as agent for an investor, would face an impossible conflict of interest if, in the capacity of principal, s/he bought from or sold to that investor. This led to the "single capacity" system, which was predicated upon the distinction between brokers (who bought or sold securities at best market prices strictly as agents for clients) and jobbers. Jobbers kept inventories of selected securities (often those for which they acted as underwriters) and maintained "market-making" bid/ask ["two-way"] quotes on them, being always bound to execute a trade in at least one "unit" (which may be, say, 100 or 1000 shares). Jobbers sold only to brokers, with whom they dealt off-floor, on their own account, and enjoyed stock-borrowing privileges & stamp-duty exemption. In a "dual capacity" system, dealers are able to act either as principals or as agents. This avoids the artificial mechanisms (use of dummies etc.) employed in the traditional "single capacity" system to evade the enforced distinction between brokers & jobbers., leading to the demise of the latter[46].

Traditionally, under the "single capacity" system, the market was "quote-driven": i.e., it was the continuous quotes in specific securities, as supplied by market-making dealers, which attracted buy

& sell orders through brokers. Under modern practice on quote-driven markets (such as the London Stock Exchange), each security must have at least two brokers bound to "market-make" in that security by providing continuous "two way" buy/sell quotes in its stock. A multiplicity of market-makers increases operational capacity, ousts monopoly, spreads risk and assists an *even* market, whilst intense competition between them assures investors of easy & anonymous liquidity at the best price available.

Market-making means that dealers must commit their own capital to maintain the inventory and make risky unilateral deals with buyers and sellers, their exposure being limited, however, only to "normal size" parcels of particular stocks. The spread between buy & sell in a quote should be adequate to make profit, and the extent of a spread will reflect transaction costs, both fixed (rent, equipment, staff, communications etc.) and unique (e.g. risks, especially from informational asymmetry, in maintaining inventory stocks of specific securities for buffering purposes). The greater the volume of sale, the less spread is likely between buy & sell quotes and the greater will be the stability. In practice, the spread between buy & sell quotes on illiquid stocks will be so great as to deter all but the most desperate or determined investor. Dealings in large volumes and competition between market-makers can minimize spread; volatility or illiquidity increases it.

The quote-driven system has the advantage that is assures immediate liquidity, at least as regards one unit . However, unless constrained to report transactions to the central market, a dealer holding out two-way price can sell direct to other dealers or investors, and thus could create an unofficial "kerbside" market operating outside the official market, thereby distorting pricing mechanisms. The quote-driven system also distorts the price mechanism (for instance, when news of a series of large piecemeal transactions leaks midway, or when a dealer receives a big sell order, s/he changes her/his price mechanism defensively even although no value judgment has necessarily been made by the seller), and does nothing to provide liquidity for smaller company shares.

[46] See generally Paul Stonham *Global Stock Market Reforms* Gower, 1987.

In a modern screen-based system, where every transaction is recorded sequentially, every transaction has to be reported and the whole market-pricing mechanism is transparent, the chances of a broker dealing as principal and defrauding a client are reduced to approximately zero. The "dual capacity" broker system therefore enjoys every advantage, and this can be further augmented by having the market driven by ***both*** quotes ***and*** orders. If only brokers or substantial institutions can place the orders, irresponsible & untraceable quotes or executions are filtered out, and (for the latter) direct-trades without the intervention of intermediaries is enabled.

In an "order-driven" system, buy & sell orders (as regards stock, volume & price) are posted centrally, where they can be accessed by the broker, who is obliged to comply with the "best execution" rule (i.e. , as agent for his client, sell at the highest or buy at the lowest price available), and trades are executed when matches are made. Minimum "unit parcels" of each stock should be required for trading, so as to avoid rapid turnover & fragmentation. Exchanges of shares may also be possible. The broker must direct all order flow & report all transactions to the central market. There is a regulatory need to ensure that any in-house matching of orders (rather than remitting them centrally) meets the best-execution rule. The role of the jobber as middleman is thus cut out and costs are reduced. There is no guarantee of liquidity (as the "spread" between the buy & sell orders may be unbridgeable), however there is no chance of "kerbside" markets.

Problems arise with order-driven systems because initial bid/ask offers, especially where made to "test the waters" after a period without trades, may be merely optimistic guesses and not reflect a true market price at all. If a seller's offerings are ignored, or a reserve price is not met for a substantial period of some months, the operator should be able to withdraw the offer and require proof the price is realistic before restoring it.

In order to test the market and forge a true price, especially where trading in a security has been sporadic, it may be desirable that if a seller's asking price is met or surpassed then competitors be given time to lodge higher bids. Conversely, if a seller's asking price is not met, the seller should be able to elect to accept the highest bid. Alternatively, it is possible for the software to allow a seller to opt for an "auction" wherein the asking price is progressively lowered by a minimum increment until a matching bid is forthcoming. The first matching bid succeeds immediately.

(b) Impact of Modern Technology on Securities Markets[47]

The replacement of printed with electronic information has revolutionized the securities industry, but as a matter of routine precaution all those accessing the electronic system should be strictly authorized and screened via passwords, etc., to guard against the entry of unauthorized data or manipulation by hackers. Indeed, order-driven electronic markets provide such immediacy, cheapness & anonymity that they could, potentially, replace existing floor- & quote-based central share markets & dealers altogether, and sidestep existing regulatory structures, or even any enforceable regulatory structures whatsoever.

The new electronic systems, if allowed to multiply at will, could cause market fragmentation, thereby dividing & spreading gross trading pressure and threatening the depth of liquidity which is needed to transfer large blocks of shares. In such an event, to some extent, the danger of fragmentation could be minimized or overcome by central databanks synthesising corporate & statistical information from a range of diverse markets and making it comprehensively available. Software already exists performing this function and is operated by information vendors such as Reuters and available on Instinet. By linking trade data selected from a variety of markets, those trading could obtain an overview and arbitrage would take up slack between price spreads and ensure relative cohesion.

[47] See D.C. Langevoort "Information Technology and the Structure of Securities Regulation" (1985) Harvard LR 747 and C. Sullivan "A Discussion of the Impact of Information Technology upon the Securities Industry in Australia" (1987) 5 C&SLJ 33.

Electronic data transfer enables the instantaneous provision worldwide of corporate disclosure e.g. dealings with related companies, directorships & shareholdings held by directors & senior management, annual reports, audited accounts, current balance sheets, business plans, prospectuses or even all minutes of directors' meetings (except for "commercial in confidence" items). Independent opinions, reports & analyses and official releases can all be made instantly available, as can up-to-the-minute market data. Vast historical data bases, kept by the ASC and the ASX, may also be searched. Software can sort data to provide a range of analyses & graphs, regarding (for instance) price movements, yield, price/earnings ratios and debt/equity ratios. Software can provide & matching bid/ask quotes or offers, report off-market transactions and even apply algorithms (which should be known to users & participants) so as to execute trades. All of this saves costs and increases market efficiency.

Buy bids & sell offers, for the desired number of shares, are posted & listed in price & time priority: all data may be placed or accessed remotely by a personal computer. Extensive pre- & post-trade transparency is maintained by all deals being on-screen. Price formation takes place instantly & visibly and slippage (between a requested & actual entry or exit price) is impossible. Members can enter, monitor & control their orders in a security's central limit order book, which shows the cumulative bids & offers in price & time priority. Users can build or offload portfolios anonymously, without having to show complete trading intentions: a distinct advantage to an institution seeking to obtain or unload a large stake without revealing its hand.

It is possible to install a high degree of security surveillance using an electronic system, since it retains, very cheaply & permanently, a comprehensive audit trail. Daily transactions can be checked against known patterns of dealers or investors. Real-time inter-day volumes & block-size [10,000+ shares] trades can be isolated and insider trading (by directors, employees or their known relatives & trusts) detected, as can entry of false data & failure to comply with reporting rules. Electronic surveillance can compare trade with quote prices and price/volume histories of specific stocks with comparable ones, causing all subsequent aberrant dealings to be swiftly & accurately flagged, thereby alerting the market's professional analysts as to any "parameter break". The analyst then investigates what prompted the unusual activity: it may have been innocent (due to material corporate or market news), but if it has been due to illegitimate behaviour (such as insider trading, breach of disclosure regulations, or continuous artificial buy/sell by an individual of his own shares ["churning"] or by a group ["pools"].

(c) General Characteristics of an OTC Share Market

The name used for these markets varies internationally, being sometimes called "second Board" or "third board", "parallel markets", "unlisted securities markets" and "over-the-counter markets". Traditionally, companies listed on OTC markets were obligated (under their Articles of Association and the Listing Rules) to act as agents for their shareholders: they would report buy & sell orders, hold vendors' scrip and trade same "over the counter" for payment, as advised by dealers, holding payment monies in trust for the vendor. All transaction costs & stamp duties should be met by the seller, with funds to be abstracted from proceeds & remitted by the company or clearing-house.

An OTC market may be operated by a duly-authorized public company, controlled (subject to the regulatory laws) by its shareholders (as distinct from its listees or approved brokers), or else be a non-profit association owned by the licensed dealers who constitute its members. Both would operate in a strict "caveat emptor" environment, disclaiming any knowledge of listees and making no guarantee or representation regarding the wisdom of a proposed investment.

As a rule, an OTC market will allow any conforming company to list cheaply & easily. Whilst a prospectus and public company status will be necessary for SMEs listing on an OTC exchange, the cost of both the prospectus and the listing are expected to be far below those of traditional listing at the ASX, since no history of trading profitability need be established and since the comparative “low level” of the enterprise engenders far fewer complications. The usual rules regarding listees’ disclosure of relevant information would apply, complete with the obligation to call trading halts to permit its assessment, so as to give investors confidence and avoid the potential of abuse by directors entering manipulative inter-company dealings.

The listees' financial data, and sell & buy offers for shares, then become publicly available, traditionally over the telephone but nowadays over linked computer screens. Dealers in an OTC market should have dual capacity, and the market should be both quote- and order-driven., with trades executing electronically. All transaction costs & stamp duties should be met by the seller, with funds to be abstracted from proceeds & remitted by the clearing-house.

Access to an OTC market by licensed dealers (acting as agents for investors), financial institutions and fund managers is to be expected, but approval of private investors trading on their own behalf is a possibility. It would also be possible to have the listed companies themselves, compulsorily acting as their shareholders' agents pursuant to the Articles of Association, lodging buy & sell offers electronically and collecting funds, in return for scrip, when advised by the market as to the identity of the successful buyer. Thus, theoretically, it would be possible to have a market which is not in the least dependent upon dealers or intermediaries of any kind, but where professional investors trade directly. However, such a market would have to screen out spurious bids and guarantee settling & clearing of transactions electronically executed, and it would lack that dimension of service which expert brokers acting as agents can provide to sub-professional investors. Despite these theoretical possibilities, the requirements in ss.769 & 770 relating to expulsion, suspension or disciplining of members for misconduct, and the need for a fidelity fund, make it likely that the ASC will only approve a market limited to licensed securities dealers.

(d) NASDAQ in the USA[48]

(i) General

The NASDAQ OTC market in the USA is by far the most important, experienced & advanced in the world. Its structure, operation & regulation merit detailed study since any Australian OTC is likely to be modelled closely upon it.

[48] See generally: *The NASDAQ Handbook: The Stock Market of Tomorrow - Today* Probus Publishing, Chicago 1987. Also see Paul Stonham *Global Stock Market Reforms*, Gower 1987.

NASDAQ was initiated by investment banks & stockbrokers as a telephone market (without a trading floor) in the USA during the 1920s, so as to enable trading in SME stocks. Investors could never be sure they had got the best price. It remained a sleepy paper-based market, a nursery for graduation to the New York Stock Exchange ["NYSE"], relying on telephones and circulation of "pink sheets" supplying the previous day's quotes, until the computer revolution began and operation, regulation & surveillance of the market was revolutionized in 1971.

(ii) Structure

The modern NASDAQ market is operated by the National Association of Securities Dealers Inc. ["NASD"], a non-profit association which conducts examinations, processes applications for membership, and has over 7000 firms & brokers as members. These are organized in 13 districts federated nationally. Members elect district and national boards to manage daily operations and recommend changes to membership & listing rules, which are then submitted to meetings, then to the United States Securities & Exchange Commission ["SEC"], for approval. NASD maintains a fidelity fund, can discipline its members, and provides an arbitration service for their disputes with customers. So as to provide early warning of financial or operational problems, members must file with NASD monthly reports as to their volume & break-down of trades, cash & capital & inventory position, customer exposure and profit & loss. NASD is dedicated to promoting & standardizing ethical practices in the securities business, and interfaces with government as a peak lobby group.

(iii) Operations

The new NASDAQ market is innovative & technologically sophisticated. It is dispersed & screen-based, without a physical trading floor and fully automated. It is "information itself", independent of space & time, operating continuously (24 hours per day). NASDAQ has grown strongly over the past 20 years and is now (on dollar value traded) the third largest securities market in the world (after the New York & Tokyo Stock Exchanges). NASDAQ also lists foreign securities (more than twice the number of both exchanges). Now 90% of US companies with traded securities are listed on OTCs[49].

[49] T.W. Taylor *The Financing of Industry and Commerce*, Heinemann, 1985.

Some 4500 geographically-diverse companies are listed on NASDAQ, covering a broad spectrum (industrial, transportation, finance, utility, retail etc.). Listees must have assets of at least $2m, at least 100,000 public shares, at least 300 shareholders, and one class of share, each with one vote. New enterprises prepare a prospectus, which must be approved by the SEC, and shares will be publicly offered, although often many are kept by underwriters (who tend to be "market-making" brokers interested in that security) for gradual release. The SEC requires ongoing disclosure of information about the company (including quarterly & annual financial reports) and its shareholders. As a condition of listing, trading of a particular stock is suspended whilst material news is about to be released. Quotation is resumed once the disclosure is made. Companies can be delisted if they fall short of requirements, but there is an appeal mechanism.

(iv) Trading

The computerized system displays the "double-sided" bid/ask spread quoted each of its registered brokers willing to act as "market-makers" as regards each specific security. Not all brokers quote for each listed security, only those in which they "market-make". Whilst some NASDAQ companies have as low as 2 (the requisite minimum) and others 40 or more "market-makers", usually each has 8-20. Non "market-maker" brokers in specific stocks can supply to other brokers "indicative prices" in them. Brokers may act in a “dual capacity”, either as principals or agents, and bid/ask spreads can be entered or deals executed electronically.

NASDAQ continuously displays data regarding each market-maker's current bid/ask spread in descending order, best overall ("inside") bid/ask quotes & volumes available thereat, volumes & prices of last sales, yield, price/earnings ratio etc. Various corporate records, balance sheets & accounts, and news items about specific securities can all be accessed electronically. The "Equity Audit Trail" database provides second-by-second quotation, transaction & clearing information for all NASDAQ securities indexed on a firm-by-firm basis. The displayed data is transparent to impact by such variable factors as profitability & risk, and is instantly vended to registered brokers and to interested subscribers both in the USA and abroad.

Some 60% of trading on NASDAQ is done by individuals, the remainder being institutional, both domestic & foreign. An investor may place orders direct with the "market-maker", who must execute the deal (for at least a single "unit" of 100 shares) at his best bid/ask quote; no commission being payable. Alternatively, the investor can contact his local broker, who may not be a market-maker in the desired stock. That broker, acting as the investor's agent, consults his terminal for the market-maker with the best price and executes the order electronically or by telephone, commission then being payable separately. Both principal and agency trades are completed in a few minutes.

(v) Utility of NASDAQ

NASDAQ provides companies & shareholders with high & transparent market visibility for their stock and the ability to execute trades & access liquidity almost instantly, with minimal "slippage" between the buy/sell quote when the order is placed and that when it is executed. "OTC liquidity tends to dominate Amex liquidity for stocks of the same size"[50]; and there is a marked decline in liquidity (by some 25%) for securities moving from the NASDAQ market to either of the organized exchanges.[51]

As a result of all this, plus low entry costs, facility in capital-raising and minimal paperwork, NASDAQ has become the preferred market for about half its companies, which are qualified to list with a stock exchange.

(vi) Regulation

The NASDAQ operation relies very much on "self-regulation" by local peer-group pressure. However, it has tight official regulation so as to preserve corporate credibility & investor confidence in fair & orderly markets: more than half its staff is devoted to this task. Examiners ensure licenses are current and review for abuses of advertising guidelines, market manipulation or customer fraud. NASDAQ annually conducts on-site audits of brokers' records & supervisory procedures. As usual in a securities market, so as to allow investors to digest & judge, trading halts must be arranged when important corporate information is to be released.

50 *Liquidity, Exchange Listing and Common Stock Performance*, Texan A&M University, 1983 study.

51 David A. Dubofsky & John C. Groth "Exchange Listing and Stock Liquidity" in Winter 1984 *Journal of Financial Research*.

The NASDAQ automated surveillance system electronically monitors trading, employing all the mechanisms listed above[52] Rogue firms or brokers receive disciplinary hearings at district level, reviewable by the national board, and can be expelled, suspended or fined; profits can be ordered disgorged and defaulting companies delisted. Appeal lies to the SEC and ultimately the US Court of Appeals.

(e) OTCs in the UK

(i) General

Despite the existence of OTCs in the USA for half a century, none was introduced to Great Britain until 1972 due to the availability of what was (in those times) seen to be comprehensive trading on the London Stock Exchange ["LSE"], and due to investor reluctance to invest in unlisted securities due to lack of information, difficulties in monitoring and the danger of illiquidity.

(ii) The OTC Market[53]

The UK OTC, which is really a network of some scores of independent licensed brokers, addresses these concerns and makes markets in unlisted SME securities (which often have strong upside potential) by offering dealers' buy & sell prices in the securities of some hundreds of SMEs (which are screened, and must meet undertakings, before being allowed to list). Although a comparatively small market, which is ignored by big investors, it is important to the companies and shareholders with traded securities.

(iii) The London Stock Exchange ["LSE"]

The London Stock Exchange ["LSE"] still maintains its traditional unique quote-driven trading system, wherein brokers who "match-make" in a stock must quote to both buyers & sellers their firm's "two-way" prices. Whilst the LSE system does have the advantage of always offering immediacy in dealing, it is under threat from European automated trading systems. Tradepoint halves

[52] *Supra*, p.???

[53] See generally: Tom Wilmot Inside the Over-the-Counter Market in the UK, Quorum Books, London, 1985.

the LSE's transaction fees, and from a market transparency point of view, Tradepoint is superior to LSE since no delay can occur in reporting transactions and there are no inter-dealer transfers at undisclosed prices. The threats from the new electronic exchanges make the LSE look increasingly like an antiquated dinosaur from 1762, a tradition doomed to die, and have forced it to plan an automatic order-driven system, commencing in 1997. All of its traditional informational, dealing and settlement roles can be separated out and performed better & cheaper by others using electronic systems. "The growth of the new technology and the growing institutionalization of the market means that the [LSE's] users could operate their own mini-marketplaces from their desktops"[54]. In a distortion of market transparency, the LSE's quote-driven SEAQ system does not display best-available prices, since brokers rarely display their best price and institutions can haggle.

(iv) The Unlisted Securities Market ["USM"]

During the 1970's, probably due to onerous listing conditions, listing on the LSE fell sharply and, in the face of shareholder demand, Rule 163(2) was adopted allowing brokers to make deals in shares of unlisted companies provided the annual balance sheet & accounts were disclosed and the broker obtained permission on each occasion (i.e. there was no continuous market). However, demand for this facility was so strong that in 1980 a formal USM was established and companies with regularly-traded securities were expected to join.

Listing requirements (as regards the percentage of shares held publicly, length of trading history, etc.) are considerably less onerous than for the Main Board. There is comparative volatility in prices, due to the untested nature of products and the small amounts traded, but generally the USM has raised prestige, fostered growth by merger or acquisition, provided liquidity and thus indirectly encouraged investment. The USM caters for less-risky ventures than the OTC, and acts as an antechamber to a Main Board listing, with some 12.5% making this transition after the first 6 years.

54 Financial Times, 18 October 1993

(v) Tradepoint

Tradepoint, commenced operations based in London in August 1995 within the existing regulatory framework supervised by the Securities and Investments Board. It is a Recognized Investment Exchange[55], and is required to maintain surveillance of its operation aimed to detect market manipulation and to ensure that its formal requirements for listing are met. Tradepoint is a public company which was set up by ex-LSE electronic systems gurus, at a cost of £8m (subscribed in Vancouver) and has some 30 employees. Members may be financial institutions, fund managers or licensed traders (usually acting for clients) and pay a flat £1000 p.a. membership fee. Members have no control over the operation.

Tradepoint provides a low cost, efficient, fully-automated, screen-based and neutral market (both quote & order driven) enabling the leading 400 UK equities (initially), to be anonymously traded by members. Thus, at present Tradepoint does not service the SME end of the spectrum at all, however its trading software is very advanced, allowing deals to be made not only via the traditional "quote-driven" mechanism but also via electronic posting & automatic matching of separate bid/ask offers.

Tradepoint plans to become a major global forum by expanding listings to foreign shares, ADRs and bonds (but not derivatives). It is estimated that Tradepoint will only need 1.5% of the market to break even. A transaction fee of 0.05% is charged to buyers on 100 LSE-listed stocks and 0.1% for the other 300 less-liquid stocks: less than half the LSE transaction fee. Sellers & advertisers pay nothing, so as to encourage maximization of listing & liquidity.

Trades in liquid securities execute instantly once bids & offers match, excluding participation by middle-man "match-making" brokers: institutions thus find each other & deal directly & simply (without the need for brokers). Less liquid and "small capitalization" securities are "auctioned" at a set time daily, at a single "call to market" price which is electronically calculated to maximize turnover. An independent, licensed central clearing house effects settlements, holding payments in trust and handing over transfers & scrip. Parties remain anonymous: which is very helpful when large

[55] As of 7 June 1995, under the Financial Services Act 1986

institutions wish to take or liquidate positions by gradual trickle. The clearing house acts as counterparty, guaranteeing execution of the electronic trades, and applies comprehensive risk management procedures to financially assure settlement.

(vi) AIM in the UK

In response to the Tradepoint, Instinet and looming EASDAQ threats, on 19 June 1995 the LSE launched the Alternative Investment Market ["AIM"], which permits the listing of smaller companies, whether foreign or domestic, thereby bringing them advantages in widening public profile, accessing equity finance and enhancing liquidity for existing shareholders. A prospectus, containing all information investors would reasonably require for an informed assessment and disclosing details of directors & substantial shareholders (10%+), must be issued[56] No tests are imposed regarding capitalization levels, trading history or shareholding diversity.

All that is required for admission to AIM is that the company be public, publish annual accounts and nominate an adviser[57] who is experienced in bringing companies to public markets, who performs extensive due diligence obligations and is responsible to the LSE). The company must also nominate a broker, who is a member of LSE and maintains an electronic information register as regards shares on issue, percentage in public hands, turnover, profit after tax and dividends. The nominated broker must undertake match-making if no other brokers do.

Companies listed on AIM must adopt a code constraining directors & employees dealing in its shares at sensitive times. Unless there is a two-year history of profitable activity, directors & employees may not dispose of their shares for a year after listing on AIM. Listed companies are subject to extensive disclosure requirements[58] concerning changes of directors, major shareholdings, transactions with related parties, dividends and price-sensitive acquisitions & disposals. In default, AIM can censure or suspend trading. This information may be transmitted to the LSE electronically, where it is verified and then relayed unedited via the official Regulatory News Service.

56 Pursuant to the *Public Offer of Securities Regulations 1995*.

57 Licensed pursuant to the *Financial Services Act 1986*

58 Pursuant to the *Traded Securities (Disclosure) Regulations 1994*.

AIM is supported by the LSE trading, monitoring & settlement services, and stamped transfers are remitted the next day to company registrars for registration. Although the traditional LSE quote-driven trading system applies, it is planning (with difficulty, given the threat to its broking members) to install software enabling electronic matching of direct buy & sell orders. The LSE's Surveillance department monitors AIM against suspected fraud, insider dealing and manipulation.

(f) OTCs in Japan[59]

The securities of SME corporations, once approved by the Securities Dealers Association of Japan, are eligible for listing on the OTC market. 99% of Japanese enterprises are SME (with capitalization below Y100m), but often those seeking listing are adventurous or individualistic, by Japanese standards. In 1983 the Japanese OTC market reformed on the NASDAQ model so as to reduce obstacles to participation. Registration standards were relaxed, no minimum dividend or trading period was required, but some history and an upward trend of profitability is required (unlike with NASDAQ). Dealers (who operate as market-makers on a buy/sell quote system) were required to be registered: this improved the market noticeably. There is an expectation that a dealer will underwrite new issues, and thereafter maintain quotes (which may vary between dealers) on its stock. OTC stocks may be included in trust portfolios or used as collateral. The market has grown steadily, improving employee morale (encouraging participation schemes), enabling formation of prices, liquidity to shareholders and recovery of capital by founders. There is no physical trading floor and orders for OTC stock are placed with the dealers, with payment being made at that time. Trading can be thin or volatile. The Japanese OTC market is nowhere near as big as NASDAQ.

(g) OTCs in Germany

OTCs listing & trading in smaller company shares exist in various European countries, such as the *Deuxieme Marche* in France, the *Parallel-market* in Amsterdam, Share Market III in Denmark and the *Ungeregelter Freiverkehr* in Germany. There are plans to launch a pan-European EASDAQ. Reuters, which is traditionally a news-gathering service, has now usurped the traditional information-gathering role of the European bourses and vends cross-market data on Instinet. Indeed, it has augmented this role by entering the trading field with Instinet, which has now become an order-driven automated trading system in European equities.

(h) Proposed Australian OTC

A proposal[60] for approval of an OTC has been before the regulatory authorities since June 1987. Details of the application remain "commercial in confidence" and not publicly known, however one can safely presume that the best of the NASDAQ and Tradepoint models would be adopted. Delays in approval have been encountered, initially with a demand for evidence that there was a need for an organized equity market for small enterprises and subsequently due to debate over criteria for the listing rules, the proposed trading mechanism, the applicant's experience & resources and detailed management & staffing arrangements. Further delay has been caused by the translation of NCSC responsibilities to the ASC and the need to revise (in the light of modern world experience) the old NCSC Policy 151 (regarding approval of securities exchanges). NCSC Policy 151 has recently been replaced with ASC PS100.

A well-supported Australian OTC market will be a vital element in fostering all SMEs (including IP-SMEs), for without diverse listings and a substantial trade in shares the market will lack that diversity and liquidity so essential for investor confidence. Upon its advent, it is imperative that quality SMEs be encouraged & enabled to list, preferably in substantial numbers so as to give depth to the market, and that investors be attracted to participate. Should an Australian OTC market fail, it may be years before another OTC could be developed: this would be a great tragedy for the national economy.

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59 See generally Takeji Yamashita *Japan's Securities Markets: A Practitioner's Guide*, Butterworths, Singapore 1989; Jonathan Isaacs & Takashi Ejiri *Japanese Securities Market* Euromoney Books 1990; Rodney Clark *Venture Capital in Britain, America and Japan* St Martin's Press, New York 1987.

5. AUSTRALIAN LEGISLATION TOUCHING OTC MARKETS

(a) Approval of Stock Markets under the *Corporations Law*

The operation of an unapproved stock market is an offence under s.1311 of the *Corporations Law (Cth. 1990)* ["the *Law*"]. A "stock market" is broadly defined s.9 if the *Law* and covers any market, exchange or other place at which, or a facility by means of which, offers to sell, purchase or exchange securities are regularly made or accepted, or at which information about the prices of, or parties to, securities transactions are provided. Both elements necessary to effect transactions, i.e. firm buy/sell offers and the identity of the parties, are needed for a market (as distinct from a bulletin board which provides insufficient data to facilitate actual trades) to be present. A degree of systematic regularity & recurrence (rather than sporadic low-volume informality) should exist. Clearly the word "facility" encompasses any form of electronic market. The power to approve stock markets resides in ss. 769, 770, 770A and 771 of the *Law.* Four types of stock market are envisaged.

(i) Stock Exchanges

First, there are Stock Exchanges, which include the traditional Stock Exchanges and those approved under s.769 (none at present). These markets cater for retail transactions, in which unsophisticated investors often participate, in a very broad range of securities. It is envisaged that any OTC market would be approved under s.769, whereby any body corporate may apply to the ASC for approval by the Minister as a stock exchange. The Minister is required to have regard to a range of factors [set out in s.769(2)] bearing upon integrity, responsibility and experience. Whilst this section gives the Minister broad discretions, these must be exercised responsibly, after hearing the applicant and giving reasons. Policy Statement 100 governs ASC thinking on the operation of s.769.

(ii) Approved Securities Organisations ["ASO"]

The requirements (under s.770) for approval of an ASO are similar to those for a stock exchange. Again, its members should be licensed intermediaries, but only a distinct & restricted range of

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[60] Initially made, under s.38 of the *Securities Industry Act & Codes*, by Unlisted Securities Market Pty Ltd [an illegal name], now held by Austpac Limited.

securities should be traded. ASOs cater for specialist traders in specific fields, and lack the public & retail nature of a stock exchange.

(iii) Special Stock Markets for Unquoted Prescribed Interests

Third , there are special stock markets for unquoted prescribed interests, established under s.770A (effective from 1 January 1995), which allows a management company of unquoted prescribed interests to apply to the ASC for approval of a stock market on which the interests (whether or not they remain unquoted) may be traded by means of an electronic trading facility. Under s.770A(2) the Minister must be satisfied that the management company's business rules make satisfactory provision for the fair & orderly conduct of the stock market and for an independent & qualified "supervisor" to monitor the market's compliance with those rules, that satisfactory arrangements (eg insurance) are in place to ensure the management company meets its liabilities, that the stock market will not be used except for trading the prescribed interests (whether or not they remain unquoted) by means of the electronic trading facility, and that there is an approved deed (for the purposes of Division 5 Part 7.12) in relation to the interests. A management company under s.770A may trade a number of prescribed interests (s.770B). "Unquoted" in this section means, in relation to prescribed interests, that the interests are not included in any class of securities that are quoted on a stock market of a securities exchange (i.e. one of the historical Stock Exchanges, or a stock exchange approved under s.769). Probably the sort of prescribed interests envisaged would be units in trusts, tenancies-in-common in syndication schemes etc. The necessity for an “approved deed” to be in place renders this section basically inappropriate in an OTC context.

(iv) Exempt Markets

Various specialist "Exempt" share markets exist in Australia, approved under s.771 of the *Corporations Law*. These have the lowest level of regulatory control, and are only appropriate where the distinct & specialist nature of the securities means that there is no retail or public element, no realistic danger of market manipulation or fraud, and no substantial default risk, so investors can assess prices & counterparty risk without protection. Various Ministerial Orders have been made granting exempt status to e.g. specialist futures dealings markets (usually run by large Financial institutions) and to markets in specific securities such as Golden Circle Ltd, or to interests in specific types of interest such as horse bloodstock. Because of the high level of retail

investment in prescribed interest schemes, exempt markets for them are unlikely and only approval under s.770A is available[61].

Approval as an Exempt Market is unlikely to be attractive to, or financially appropriate for, an OTC, since its market is essentially public & retail, and its listed securities will lack the necessary specialist focus. For an SME, flotation on some general public market, accessible nationally & internationally and accommodating a wide & shifting range of investors, is necessary. But in contemplating this route, two major impediments face the SME: the prospectus and the listing requirements.

(b) ASC Policy Statement 100

Before approving a body as a Stock Market, the Minister must be satisfied as regards the specific criteria set out in the pertinent sections of the *Law*, one of which is that the proposed market serve the public interest. ASC Policy Statement 100[62], which sets out the considerations (broadly those regarding the operator, the dealers, information disclosure, the trading system, settlements and regulation[63] to be met before any proposal will be endorsed. PS100 indicates the ASC would be reluctant to approve competing exchanges covering the same securities, lest intermediaries face conflicts of interest, trading & information become fragmented and compliance with the "best execution" rule be prejudiced. Due to disciplining & fidelity fund criteria in the *Law*, only licensed dealers should be allowed to trade directly.

(c) Regulatory Concerns

(i) Overview

Opportunities for fraud, manipulation or inefficiency are inevitably present with any market, and must be identified & regulated by effective controls lest unscrupulous persons take advantage of loopholes, the public be defrauded and both the market & the regulators fall into disrepute. The main public concerns with the operation of any securities market relate to the competence of the operator and the fairness of the operation. Typically, in the first instance, a stock exchange will have members

[61] See ASC Policy Statement 100, #52.
[62] Issued 18 September 1995,
[63] As traversed in 4(a)(i) above.

who own and self-regulate its operation, however a detailed web of control mechanisms must be in place.

It is essential that the operator of a market be adequately capitalized, hold appropriate insurances and employ qualified staff. As regards the operation, it is essential that dealers be qualified, licensed & audited, maintain minimum liquidity levels and hold fidelity insurance. All trades on shares must occur at best price (especially with a view to avoiding abuse by brokers trading as principals), inter-broker credit should be controlled and prudential arrangements be in place before short-selling. No preferences should be shown to one client above another (i.e. orders should be executed strictly on a time of receipt basis), and clients' instructions should not be misused by an intermediary for his own trading purposes ("front-running"). Clearing & settlement of executed trades should be orderly, swift & certain.

The usual rules must apply to the listees, requiring due diligence disclosure, and forbidding insider trading & any form of price manipulation (especially a problem where companies are small, with a narrow spread of shareholders) Typical manipulative devices have historically been pools (round robins between several investors), churns (constant buy-sell by one investor) and runs (supported by false rumours), all of which are designed to artificially increase turnover and drive up prices. The great beauty of a fully automated computerized trading system, especially on the thorough NASDAQ model, is that the main likely areas of abuse are subject to constant scrutiny and comprehensive historical recording which can be analyzed with relative ease using constant background programs (eg pinpointing share sales by directors, employees or their families) or "quick find" electronic searches. Against the marvellous transparency, speed & accuracy of the independent automated trading system, any unusual price movements, failure to trade at best available price, insider trading , churns, pools & runs will be instantly apparent.

(ii) Insider Trading[64]

The mischief of insider trading is starkly demonstrated by the instance of Poseidon NL, which announced in October 1969 to the Adelaide Stock Exchange that its exploratory drill had struck 30 feet of sulphides assaying 3.56% nickel. The price of its 2.04m issued shares rose, over the next four months, from $1.10 to $280.00. 500,000 of these shares had been placed (largely with companies associated with the directors) after the discovery but before the announcement. Also, insiders purchased bulk shares during that period.

Insider Trading is usually viewed with hostility: it is basically dishonest & immoral, a fraud upon both other shareholders (who can't combine easily or afford to litigate, and are often unaware they are victims) and upon the market, rendering impossible any equality of chance between big & small investors: it is fatal to confidence in market integrity. There is a need for stiff penalties, including not only disgorgement and a fine, but even imprisonment, to apply to offenders.

Historically, there has always been a big problem with proof, especially if criminal sanctions were to apply (and to respected businessmen too!). The problem with proof, however, largely resulted from lack of surveillance systems, reactive investigation and underfunded regulators. With an automated, computerized trading system, many of these problems evaporate.

(iii) Contracts Involving Directors' Interests

Any loans, contracts, agreements or arrangements with the company or a subsidiary or associated company in which a direct or indirect financial interest is held by a director of the company, or of any of its subsidiaries, or by any members of that director's family or by any company controlled directly or indirectly by that director or any member of his family or by a company in which that director or any member of his family has a material financial interest. Such contracts may be formal or informal,

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64 See generally: *Australia's Securities Markets and their Regulation* Report of the Senate Select Committee on Securities and Exchange [Rae Report] AGPS 1974, and *Insider Trading Regulation and Law Enforcement in Australia* by Roman Tomasic and Brendan Pentony, 43rd Annual Conference, Sydney Law School August 1988.

express or implied, and include an agreement not enforceable by legal proceedings whether or not it was intended to be so enforceable.

(iv) "Market Information Principle"

As a general regulatory principle[65] every listed entity should operate to the highest standards of integrity, accountability, due disclosure and responsibility. Holders of securities should be consulted on matters integral to their interests, including ownership of major assets and the right to vote. This principle demands continuous disclosure of a listee's affairs where they are not confidential and may affect the market. The market must be advised by timely disclosure of any information which may affect security values or influence investment decisions, or in which security holders, investors and the market have a legitimate interest, or which is publicly disclosed elsewhere.

A Company has a duty to halt trading if some major announcement is imminent. In the case of the ASX Trading Halts may be initiated by a company (only) where speculation about the company has arisen sufficient to warrant a response by it for the information of the market but the company considers that it is not able to make the information available immediately, or where the company is about to make an announcement but is not able to make it immediately. Bids & Offers may be entered on SEATS but transactions may not be effected. A Trading Halt is quite different to a

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65 Reflecting s.1001A of the *Corporations Law.* This principle is embodied in ASX Listing Rule 3A, which provides:

"A listed company shall immediately notify the exchange of:--

(1) any information concerning the company of which it is or becomes aware and which a reasonable person would expect to have a material effect on the price or value of securities of the company. This requirement does not apply if each of the following conditions is satisfied:

(i) a reasonable person would not expect the information to be disclosed; and
(ii) the information is confidential; and
(iii) one or more of the following conditions apply:
a. it would be a breach of law to disclose the information;
b. the information is, or is part of, an incomplete proposal or negotiation;
c. the information comprises matters of supposition or is insufficiently definite to warrant disclosure;
d. the information is generated for the internal management purposes of the company; or
e. the information is a trade secret.

For the purpose of this Listing Rule the company becomes aware of information where a director or executive officer has, or reasonably ought to have, come into possession of the information in the course of the performance of duties as a director or executive officer.

Suspension, which may be called by the ASX or a company. If a company desires a Trading Halt to extend beyond one day, it should request a Suspension.

6. POTENTIAL OF AN AUSTRALIAN OTC SHARE MARKET

(a) General

With the introduction of Capital Gains Tax ["CGT"] in 1985, the reduction of corporate tax from 50% to 39%, the single (rather than double) taxation of dividends and a tighter monetary policy constraining inflation, the '90s looked set to become a decade of equity-financing, rather than debt financing. Australia had ceased to tax debt once and equity twice, and now taxed both once but collected CGT. This reform meant that companies no longer had quite such a perverted incentive to borrow big, minimize tax liability by "negative gearing" their huge interest payments, use leveraged takeovers to asset-strip inefficient companies or eventually sell out for a non-taxable capital gain. Institutions (especially superannuation funds, which are taxed at a mere 15%) no longer invest for capital gain but rather plan to receive dividends, especially those which (thanks to dividend imputation) also carry "franking credits" in respect of tax pre-paid by the company at 39%, and so can be used to shield income from non-franked sources.

The need for equity financing of SMEs is apparent, and only the establishment of an OTC market will foster such investment. Successful OTCs overseas, especially NASDAQ, provide examples of structures, operating procedures, automated information systems and regulatory control which can easily be grafted onto Australian conditions. Australian legislation has long permitted the establishment of share markets, and now that the updated ASC policy statement 100 has been issued * As of 18 September 1995, hopefully applications for OTC markets, which have been before the regulatory authorities for some 8 years, will soon be approved.

> The issue is not whether there is sufficient capital in Australia for long term investments, but whether its price and allocation between different investments is efficient. The immediate focus is whether too much or too little capital is allocated to SMEs -- particularly growth SMEs. [66]

(b) Equity Investment for the SME Sector

Approval of an OTC market will make possible the exit mechanism so desperately needed if private investment into SMEs is to be fostered. Investment into OTC-listed SMEs will permit diversification of portfolios into high-risk/high reward stocks, and this should be attractive (especially if there are added taxation incentives) for those with accrued savings, high-level income earners, financial institutions wishing to hedge & diversify, managed funds & PDFs, equity trusts and superannuation funds. Provision of an exit mechanism will entice employee shareholding.

Ironically, despite the possibility of fewer (but riskier) business loans, the banks themselves are keen to have a clearing house enabling their direct equity investment in SMEs[67], and believe that they could do so (as banks do in Germany and Japan) without upsetting prudential provisions, provided suitable exit mechanism exists.

In this decade, there is actually a shortage[68] of good enterprises into which institutions can invest with a reasonable expectation of receiving substantial, but franked, dividends. The Australian Stock Exchange is dominated by some 250 "Bluechip" companies (each with an average capitalization of some $200m) which make up the All-Ordinaries Index and represent some 90% of market capitalization. However, the ASX also lists some 1200 companies which are not on the All-Ordinaries Index and have an average capitalization of some $20m.

Listed companies having a comparatively small capitalization of say $20-40m and involved in industrial (cf. property, retail, investment etc.) activity are termed "Greenchip". Frequently these have a youthful vigour and niche market command which renders them attractive investments: a field which is already exploited and is a prime focus for PDF funds. However, in the SME sector there are tens of thousands of

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[66] National Investment Council, DIST *Financing Growth* Commonwealth of Australia, August 1995, p.23.

[67] *Australian Financial Review* 2.11.93 p.26

[68] It is estimated that the annual flow of domestic & foreign savings available in Australia is about 20% of GDP, or $80bn. per annum. National Investment Council, DIST *Financing Growth* Commonwealth of Australia, August 199, p.2.

unlisted "Greenchip" companies, often little more than family enterprises, involved in industrial production on a local or regional scale. Only the existence of an appropriate share market can enable direct investment into these and foster regional investment, productivity & employment.

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Superannuation funds are a huge and rapidly growing (due to double by the year 2000) source of equity capital, which is at present unavailable to SMEs due to absence of pricing & exit mechanisms. At present, only about 1% of superannuation fund monies is available for investment into SMEs, although they provide some 60% of private-sector employment. Due to the highly regulated & structured controls upon superannuation funds, and in order to discharge their fiduciary responsibilities, their trustees tend to rely heavily upon the advice of major asset consultancy firms: an informed change in their understanding of SMEs in an OTC environment is essential. Given investigation & monitoring costs, there would be impediments to superannuation funds investing less that, say $10-15m into an SME, however this inherent inefficiency could be minimized by formation of managed funds specializing in the SME sector. Ultimately, investment into IP-SMEs listed on an OTC share market should be particularly attractive for superannuation funds because of the long term growth & patent exploitation they afford. Staff & regional superannuation funds, by investing a comparatively minor part of their portfolio in local SMEs, would stimulate local employment (often of their own contributors) and regional identity.

(c) Government Role

(i) Government Assistance an Artificial but Necessary Evil

In a natural & proper State, the government is merely an umpire, keeping a "level playing field" and doing what private enterprise itself cannot do: it has no role as a player or manipulator. However, ignoring the many worse places on Earth, the equilibrium of Australian civilization is deeply disturbed due to the inevitable defects of democracy (e.g. mass-manipulation and self-interested short-term voting & representation), and due to capture of the public sector by bureaucrats & pressure groups.

This disturbance has occasioned several major abuses which lie at the core of the mischief this essay addresses, that is, financing SMEs. These abuses are the fostering of private profiteering in community-generated real estate values (which diverts funds from productive enterprise) and the impediments thrown up by the *Corporations Law* & ASX listing rules against equity-investment into the vast middle ground of Australian manufacturing. So long as these abuses are permitted to flourish, positive governmental intervention is desirable to assist an OTC and the IP-SME sector. It should not be forgotten, however, that such intervention is only needed to redress an imbalance, and

both the imbalance and the redress could be avoided were the full rental value (on an unimproved basis) of sites privately occupied to be collected as the sole source of public revenue.

(ii) Benefits of SMEs, IP-SMEs & OTC to Government

Given the pragmatic reality of great potential Australian wealth & employment being lost due to our crippled invention industry, there is a crying need -- especially in the early stages -- for use of public money to pick potential technological winners, fund appropriate due diligence and to finance (with long-term, patient equity capital) start-up industries which are an acceptable risk. Government, concerned to keep intellectual property & manufacturing potential on-shore, could assist in the identification & patenting of viable inventions, the funding of in-depth due diligence, the preparation of low-level prospectuses for OTC listing and even the full flotation of technological SMEs. If Government is to enter this role, it must ensure that the mechanism employed is efficient, responsible and free of avoidable bureaucratic red tape. Wherever possible, tenders should be sought from the private sector.

(iii) Recommended Modes of Assistance

In order to assist the IP-SME sector (in particular), and the viability of an Australian OTC share market during its critical formative years by signalling & providing a supporting matrix, it is proposed that three forms of government endorsement be given to IP-SMEs and investors in them, viz:

1. Financial assistance to make SMEs “investor ready”. This includes helping IP-SMEs meet the cost of having their product/technology independently assessed for commercial viability ["preliminary phase"] and, if endorsed, to float on the OTC ["advanced phase"]. During the first two years of this programme a nationwide pilot scheme should test & refine the assistance procedures, at a national (all-States) cost (which may be recouped as shares bear dividends) of around $2m. per annum.

2. Offering major tax incentives (as with the film industry or PDFs) to investors in IP-SMEs listed on the OTC share market.

3. Establishing a direct Federal Government fund, financed by channelling 1/15th of the tax at present levied upon superannuation funds, which would be invested directly into IP-SMEs listed on the OTC share exchange.

7. CONCLUSION

The potential of Australian SMEs, especially IP-SMEs, is being hampered by the distraction of investment funds from productivity into speculation, and by the lack of a market for securities held by investors in that sector. No suitable OTC markets at present exist in Australia, but very successful examples are flourishing overseas. Indeed, the use of dual-capacity, quote- *and* order-driven electronic markets appears likely to fundamentally change, or even oust, traditional Stock Exchanges and to provide a much better regulatory superveillance than has ever been possible hitherto.

Australian law envisages the approval of different types of share markets, and at last the ASC has stated the modern considerations it will address when evaluating applications. It is urgent, in the interests of the Australian economy, that OTC markets be approved and that (so long as distraction of investment capital from production into speculation is encouraged by failure to collect Site Revenue) the government take active steps to support the listing of SMEs and the immediate success of those markets.

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