UNITED STATES VENTURE MARKET

Has the Time Come?

CFA Institute

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Executive Summary

In recent years, there has been increased interest in the idea of establishing a venture exchange or venture market in the United States, one with less strict listing and regulatory rules to serve smaller and startup companies. The idea behind such an exchange is that a lighter regulatory touch would encourage more small companies to use the public markets to raise initial capital and to trade.

Venture exchanges already operate in a number of developed markets, with those in London and Toronto being the most prominent. A venture exchange was also attempted once before in the United States, but it failed to catch on with investors and issuers. The experiences of these markets can help inform what kind of listing and regulatory requirements and market structures might work in a similar system in the United States.

CFA Institute assembled an expert panel to discuss the potential of a venture market in the United States and to determine what such a venture market would need to look like in order for it to thrive.

This report addresses the opportunities and challenges such a venture market would face, as well as what features it would need to offer investors, issuers, broker/dealers, and other parties in order to succeed.

These features include the following:

- Sufficient market liquidity to encourage investors, issuers, and broker/dealers to participate in such a market
- A robust vetting process to weed out bad actors in management, on the board, and in the principal investor ranks of potential venture companies
- Annual audits, with the auditor's report and quarterly updates on performance and financial condition
- Use of generally accepted accounting principles (GAAP) in the preparation of financial statements
- Liability of company principals for fraudulent representations made in offering documents, financial statements, or company announcements delivered through these channels
- A high standard of transparency and governance, deviating from best practice standards only for legitimate reasons unique to small companies

United States Venture Market: Has the Time Come?

In recent years, there has been increased interest in the idea of channeling capital to small and medium-sized businesses in the hope of generating economic growth and fostering a new era of innovation and competition. The Jumpstart Our Business Startups Act of 2012 (JOBS Act) was the first step in that direction; it exempts small, publicly listed companies from the entire panoply of rules imposed by the Sarbanes–Oxley Act of 2002 after the bursting of the tech/telecom bubble in the early 2000s. Congress has proposed and passed a number of other bills intended to reduce the regulatory burden on small companies when they seek capital.

Coincident with the JOBS Act—and no doubt a benefit of its reducing regulatory burdens—the number of small and midsized companies selling common shares to public investors as part of an IPO doubled between 2012 (the year of the bill's enactment) and 2014. From a low of 64 in 2011, small-company IPOs nearly tripled by the end of 2014, to 178, raising $10.4 billion—a substantial increase over the $3.6 billion raised in 2011. IPO activity declined across the board in 2015, with small companies raising $5.7 billion from 110 offerings. Both the extended low-interest environment and general improvements in the broader economy were no doubt significant contributors to the increase in IPO activity. Nevertheless, it must be noted that the increase began soon after the JOBS Act was passed, reducing burdens on small companies seeking public capital.

The creation of a *venture exchange*—a venture market system of publicly traded companies—in the United States has been suggested as a way to serve smaller and startup companies. Under such a system, "venture" companies would have access to an organized trading market but would not have to meet the more comprehensive governance and regulatory requirements mandated for larger publicly traded companies with extensive operations and subsidiaries. Venture companies would still have to publicly file quarterly financial reports for investors. But under the JOBS Act's exemptions, venture companies would not have to adhere to certain other requirements, such as the Rule 404A internal controls audit required by Sarbanes–Oxley.

With a "lighter-touch" regulatory regime and reduced reporting requirements, however, venture companies could create more investment risk for investors. As already noted, venture companies are exempt from certain governance requirements, such as the audit of internal controls relating to financial reporting. Many investors are unaware that emerging growth companies (EGCs) operate under a different regulatory structure than the other public companies they invest in; thus, they may not know that EGCs could pose an increased risk of fraud in their financial statements and quarterly releases owing to the lack of a third-party audit of financial reporting systems.

Ultimately, a venture market would need to balance a number of competing interests. Issuers are likely to favor a lighter regulatory burden to reduce the costs of entering the public equity market. Investors want to be able to invest in such companies in the public market, but they still want reliable information about them and a regulatory regime that ensures their interests are adequately protected. The views of potential venture market operators will align closely with those of the companies they seek to list when it comes to the reporting and governance structures, but they too will have their own interests regarding trading rules and competitive aspects of the marketplace. The interests of broker/dealers will also need to be considered. Broker/dealers will wish to make retail investors aware of these venture companies and ensure that they can invest in them without creating unnecessary risks for the intermediaries that provide access. This report aims to outline what challenges lie ahead for policymakers as they consider how to introduce a venture market or venture market system in the United States.

At this point, it is unclear whether a venture market would be a physical "venture exchange" with a dedicated exchange venue or an alternative trading system that could be open to different market structures. Therefore, we use the term *venture market* throughout this report unless specifically referring to a national securities exchange (a venture exchange) or other trading system.

A venture market would offer a listing and trading venue for EGCs that might not be ready for the costs and regulatory burdens that come with being listed on a larger traditional exchange. Under a lighter regulatory touch, more EGCs might once again see the public markets as a venue for raising capital, which has become more costly and intrusive following the governance reforms mandated by Sarbanes–Oxley.

In an effort to achieve an acceptable balancing of these interests, both houses of Congress held hearings in 2015 to consider legislation that might foster a venture market. Such a market would list EGCs and provide investors in EGCs' securities with a liquid and transparent marketplace in which to buy and sell those securities.[1]

Several concerns were raised during the hearings. One concern was that such a system could create a two-tiered marketplace in which large- and mid-cap companies would receive the bulk of investor interest, with only high-net-worth individuals and institutions as the primary investors in small and private companies. Another concern was that a venture market could lead to "adverse selection," whereby only lower-quality companies would be listed. Implicit in this argument is that companies with better prospects would either bypass the venture market or quickly graduate to a more prestigious listing.

A venture market system might be able to address these concerns. By creating such a market, Congress could ensure that affiliated companies have relatively high governance and transparency standards—which could result in listing high-quality companies that are simply small or at an early stage of development—and thus increase investor confidence. The "graduation" of some EGCs from the venture market system to exchanges for more established companies could also enhance the reputation, and investor perceptions, of a venture market as an effective incubator for future successes. For example, from 2013 to 2015, more than 200 companies "graduated" from the over-the-counter (OTC) equities markets operated by OTC Markets Group to a national securities exchange listing.

Venture exchanges/venture markets are not new. They already exist in a number of markets, with the most prominent being in London (the AIM market) and Toronto (the TSX Venture Exchange, or TSXV). Moreover, for some time after its creation, the NASDAQ Stock Market effectively operated as a venture exchange for emerging and innovative companies that today are among the best-known and most successful companies in the world. Currently in the United States, OTC Markets Group's OTCQX and OTCQB markets function as de facto public venture markets for more than 1,300 companies, which we discuss in greater detail later in the report.

In this report, we explore the experiences of issuers, investors, broker/dealers, and regulators in these markets to highlight the opportunities and challenges that a venture

[1]The House Financial Services Committee reported that the Main Street Growth Act (HR 4638) was approved on a 32–25 vote on 3 March 2016, with all Democrats opposing. Ranking member Congresswoman Maxine Waters offered an amendment (the "Waters Amendment") to direct the SEC to evaluate (1) past efforts to create venture exchanges; (2) the effectiveness of venture markets, including those operated by alternative trading systems; and (3) whether additional relief for venture exchanges or other improvements to venture markets are warranted. The amendment failed on a 25–32 vote.

market in the United States would present. To better investigate these issues directly in the United States, CFA Institute assembled a group of experts on the issues unique to venture systems; their names and affiliations are listed at the end of this report. We thank them for their help on this project and will continue to seek their counsel as we explore these issues further.

Is a Venture Market Needed/ Desirable in the United States?

Those advocating for a venture market in the United States believe that such a system would give more small companies access to capital through an organized market. A venture market is also seen as potentially providing investors with an opportunity to invest in these companies in a way that they would not otherwise have.

Some small companies already have a place to raise equity capital: Rule 506.[2] Rule 506 offers a safe harbor for any "private" company wishing to raise capital without registering with the SEC under Regulation D.[3] Using Rule 506, some small companies can attract capital from accredited, more sophisticated investors. Because the shares sold under this type of capital raising are not registered, however, most small companies do not have a way to raise capital from ordinary (nonaccredited) investors and have their shares immediately traded in a regular and transparent way. A venture market could provide investors with liquidity and a marketplace where their shares are valued by market participants on the basis of public information.

A venture market could have other benefits for investors, intermediaries, and exchanges.

Investor Awareness

A venture market system would have the potential to consolidate companies benefiting from JOBS Act exemptions into a limited number of listing venues. By virtue of seeking to acquire the securities of such companies, investors will be able to recognize that these companies pose unique risks to investors because they do not provide the

[2]See www.sec.gov/answers/rule506.htm.

[3]See www.sec.gov/answers/regd.htm. Under the Securities Act of 1933, any offer to sell securities must either be registered with the SEC or meet an exemption. Regulation D (Reg D; 17 CFR §§ 230.501 et seq.) contains three rules that provide exemptions from the registration requirements, allowing some companies to offer and sell their securities without having to register the securities with the SEC. For more information about these exemptions, refer to SEC publications on Rules 504, 505, and 506 of Reg D. Companies that rely on a Reg D exemption need not register their offering of securities with the SEC, but they must electronically file what is known as Form D with the SEC after they first sell their securities. Form D is a brief notice that includes the names and addresses of the company's promoters, executive officers, and directors, as well as some details about the offering, but contains little other information about the company.

same kind of disclosure or comply with the same governance requirements as do other companies in the national market system.

Consolidation of Trading Activity

A venture market could consolidate trading activity for public EGCs into one listing exchange, or a limited number of venues, to showcase the depth of liquidity and trading interest in these companies. Currently, that trading interest is spread across more than two dozen trading venues and the OTC market. Some argue, however, that such a consolidation of trading activity in one market is unnecessary so long as market participants can "see" liquidity in aggregate.

Such a system also has potential pitfalls. Consolidation of trading into one venue means less competition in the marketplace and can lead to high trading and listing fees.

Enhance EGC Visibility

A venture market could enhance the visibility of small-company securities. At present, these firms compete with larger, better-capitalized, more established, and more liquid securities in a broad, diverse, and dispersed marketplace. One or more marketplaces created exclusively for small companies could give them more visibility. Moreover, EGCs would benefit from the "graduation" of some of their peer venture companies, increasing investor interest in potential future successes showcased within the system.

Innovation in Trading Venue Rules

Although regulation-based listing standards are an imperative, a venture market could also be given greater flexibility in trading rules to address the unique issues concerning low-volume, low-capitalization stocks. Among the changes a venture system might consider are the following:

- As proposed in the pending Main Street Growth Act,[4] securities exchanges within the system could require trading for such companies to occur on registered venture exchanges or on their listing exchanges, thus avoiding dark-market trading,

[4]See http://financialservices.house.gov/uploadedfiles/bills-114hr-pih-msga-g000548.pdf.

which could impair liquidity and price discovery. All entities operating one or more exchanges in the system should comply with prohibitions against trading on information gleaned from these markets for their own books.

- Similarly, a venture market could choose to create a dealer-driven market structure, which was identified as a key characteristic of a successful venture market by Professors Reena Aggarwal and James Angel, CFA.[5]

- Venture exchanges or venture markets could be authorized to place appropriate restrictions on high-frequency traders' rapid placement and withdrawal of orders. Although high-frequency trading can provide an immediate boost in liquidity for EGCs, such activity can also undermine the willingness of other market participants to trade where their orders will face a significant time disadvantage. If regulators would permit innovation within a venture exchange system, individual exchanges could seek an appropriate balance for high-frequency trading.

Those who are wary of venture markets cite the challenges investors face in getting information on some small companies and the heightened risk of investing in such companies. These firms often lack physical, financial, and human capital; rely more on a limited number of key employees and key customers for their success; and cannot provide, or do not have, some of the data that investors take for granted when investing in larger, more established companies.

Trading activity and liquidity for such companies are typically much lower than for larger companies. As noted earlier, few companies listed outside the big national exchanges have meaningful analyst coverage, further limiting the information investors can obtain on these companies.

Another challenge is that something much like a venture exchange market already exists in the United States: the markets operated by OTC Markets Group.

[5]Reena Aggarwal and James J. Angel, "The Rise and Fall of the Amex Emerging Company Marketplace," *Journal of Financial Economics*, vol. 52, no. 2 (May 1999): 257–289. This paper identified some factors that could be used to build a more successful venture market—factors that have since been adopted by other venture markets.

Current Role of OTC Markets Group

OTC Markets Group Inc. (OTC Markets) provides markets for OTC securities in the United States. OTC Markets is not an exchange but, rather, a market that operates via an alternative trading system (ATS), which is an important distinction that we explore in more detail later in this report.

OTC Markets' trading system, OTC Link ATS, is subject to fair access rules under SEC Regulation ATS.[6] It is also an "SCI entity" subject to the systems compliance and integrity requirements of SEC Regulation SCI,[7] which applies to the national securities exchanges.

Investors can often buy and sell OTC securities much as they trade securities listed on the New York Stock Exchange (NYSE) or NASDAQ. In fact, they likely do not see any difference in the mechanics of trading.

The key distinction, however, is the extent of each market's standards for entry, which provide a measure of due diligence for their companies. This distinction gives brokers comfort about the quality of the companies and the companies' securities made available to their clients. OTC Markets enforces listing-like standards for companies on its OTCQX and OTCQB markets. (See Appendix A for a thorough description of OTC Markets' trading markets.)

Some companies that trade on OTC Markets graduate to the NYSE and NASDAQ, as noted earlier. Other companies "fall" to OTC Markets from a national securities exchange, whether by choice or necessity. According to OTC Markets, 60 companies graduated from its markets to the NYSE or NASDAQ in 2015, and about 100 companies joined an OTC market directly from a listing exchange.

Although OTC Markets provides a trading venue for many companies, in some cases, the trading is infrequent and comes with wide bid–ask spreads, similar to the bottom third of companies listed on NASDAQ. One CEO of an OTC Markets–traded company told us that one of the main advantages of trading on an OTC market over listing on a larger exchange is the cost savings, which he estimated to be about $300,000 to $400,000 a year. He emphasized that such savings are crucial to a small company that can plow the

[6]SEC Regulation of Alternative Trading Systems (www.sec.gov/rules/final/34-40760.txt).
[7]SEC Regulation of Systems Compliance and Integrity (www.sec.gov/rules/final/2014/34-73639.pdf).

money saved back into the company. He acknowledged that the savings did come at the cost of lower liquidity than would be expected in a larger market, but he believed the trade-off was worth it to help the company grow.

A key question to consider is whether the type of trading venue (i.e., national securities exchange or SEC-registered ATS) makes any difference in how these securities are traded or whether rules generally applied to venture securities regardless of trading venue can help increase liquidity.

OTC Investor Protections

It is important to understand that there is a level of oversight, regulation, and transparency in the OTC markets.

In particular, the Financial Industry Regulatory Authority (FINRA) and the SEC regulate OTC Link ATS (OTC Link), the trading platform operated by OTC Markets' wholly owned subsidiary OTC Link LLC. OTC Link is a member of FINRA and, as noted previously, is an SEC-registered ATS. Unlike the NYSE and NASDAQ, neither OTC Markets nor OTC Link is a stock exchange or a self-regulatory organization (SRO).

An important feature of the OTC markets (and one adopted by venture markets in the United Kingdom and to some extent in Canada) is the concept of a sponsor for companies that list their shares on OTC markets.

Sponsors in the OTCQX market may be qualified securities attorneys, FINRA member investment banks, or, in the case of bank and bank holding company securities, FINRA member broker/dealers with sufficient experience in bank stocks. These sponsors are responsible for providing advice and guidance on the company's compliance with the OTCQX rules, including corporate governance standards, and on US federal and state securities laws. Sponsoring an OTCQX company carries a degree of reputational risk as well. OTC Markets makes publicly available the names of all OTCQX sponsors.[8]

Sponsors in the TSXV in Canada[9] and the AIM market in London are responsible for vetting the corporate governance structures and viability of the companies they choose to

[8]OTCQX Advisors and Principal American Liaisons: www.otcmarkets.com/research/otcqx-advisor-list.
[9]A minority of new listings on the TSXV have sponsors, although not all. All companies in the AIM market must have sponsors.

sponsor. A sponsor's reputation will eventually be tarnished if a disproportionately large number of the sponsor's companies encounter problems.

OTC Markets satisfies some of the criteria of a venture market; it is a market where many small and emerging growth companies are traded. OTC Markets is not an SRO, as national securities exchanges are, though it does set standards that companies must follow or risk losing their OTCQX or OTCQB qualification. OTC Markets is not an exchange; it is an alternative trading system.

An Exchange vs. an ATS

Companies on the OTCQX and OTCQB markets are quoted on an alternative trading system (OTC Link ATS). This type of system relies on a negotiated dealer market where both buyers and sellers know who their counterparties are and where each party can see the depth of the trading book. Many other ATSs operate as dark pools that trade exchange-listed securities and rely on matching engines, like an exchange.

In contrast, a stock exchange in the United States functions as an SRO. Although SROs set regulations for those who list and those who trade on their markets, they themselves must also adhere to full sets of regulations that do not currently apply to ATSs.

These differences are important when considering how to establish a venture system for US markets, issuers, and investors. The goal of a venture system would be to offer investors a high standard of transparency and governance at a price that is acceptable to venture companies. Both an exchange and an ATS can achieve this goal, but the mechanisms are simply different.

Congress could establish a baseline of venture market standards equally applicable to markets operated by an ATS or by a national securities exchange. One possible approach would be to require ATSs operating as venture markets to either function as an SRO or create a separate SRO to regulate trading activity. Policymakers and regulators need to be informed about the merits of each trading venue, but they should set company-based standards applicable across trading venues.

US markets have operated under a congressional mandate that promotes competition among trading venues even if the markets served are fundamentally different in nature. Whereas large companies listed on the NYSE and NASDAQ have significant public float for their shares (together with a pool of large institutional investors that track and invest in them), a venture exchange would operate in a very different atmosphere.

The diminutive size of EGCs would naturally limit the number of shares outstanding. Moreover, insiders—typically management—tend to own a large percentage of the shares of EGCs, further reducing the float of the companies' shares in the public market. The limited float reduces the willingness and ability of institutional investors to invest, thus leaving this market largely to retail investors and brokers.

There are other concerns to consider when deciding between a venture exchange and a venture market. If a venture exchange is created, that market might have a legislation- and regulation-mandated monopoly or oligopoly status, which by its very nature limits competition and runs the risk of higher fees being charged to listed companies and investors.

Giving a venture exchange a monopoly over the trading of companies' shares has potential benefits. All shares would be centrally located in one trading venue—versus more than 30 venues for national market stocks—thus largely eliminating dark trading in those shares and possibly enhancing their price development. Moreover, restricting all trading to the market where the securities are listed could increase investor awareness of the availability of shares to buy or sell (see the earlier discussion of the advantages).

At the same time, a monopolistic venture exchange could lead to an increase in trading costs for investors. Without competition, exchanges would have greater leeway to raise listing, trading, connectivity, and market data fees. To a degree, these extra costs are understandable; they ensure that exchange operators will be willing and able to secure returns commensurate with the risks they must take to launch their exchanges.

Those who argue for an ATS model say that the costs would be much lower than for an exchange model, owing to less need for the creation and upkeep of a traditional exchange infrastructure. Furthermore, they say that concerns about oversight could be addressed in either legislation or regulation. Nevertheless, regulators and policymakers need to be aware of pricing policies at exchanges and should perhaps regulate fee structures—rather than the fee levels themselves—or be ready to open the market to increased competition.

Those who favor a venture exchange argue for limiting the number of venture exchanges or trading venues where, as noted earlier, all the shares of an EGC are traded in order to have a liquid and efficient market. A large number of exchanges trading an EGC's securities could disperse the limited liquidity of those shares too much to attract market makers, issuers, investors, and analysts to follow the company. Those who argue for an ATS model claim that so long as these markets are linked, the platform does not matter and that a multiplicity of platforms makes sense to drive competition.

Would Investors Participate?

One of the main reasons given by venture exchange advocates to explain their support is that such an entity would give early-stage and startup companies access to investor capital. But would investors have enough ongoing interest in venture companies to provide the liquidity needed to make a venture exchange or venture market viable?

The answer is complicated.

Institutional Investors

Large institutional investors do invest in smaller companies but may be cautious about investing significantly in venture market companies because of liquidity concerns. Institutional investors with long-term investment horizons may be more inclined to invest in venture market EGCs in the hope that they will graduate to larger stock exchanges and eventually produce a handsome profit. In most cases, however, the size of such institutions in terms of assets under management will dwarf the public float of the EGCs listed in the venture markets. Because of this size disparity, institutional investors may try to avoid a situation in which they "become the market" for small-company securities—that is, their purchases are so large relative to outstanding float and normal trading volume that they move the market significantly. Given these concerns, institutions would be unlikely to have more than small investments in many of these companies. Nor is it likely that they would actively trade these stocks because the large blocks of shares that institutions hold would move the market.

We have found that other venture markets have varying degrees of participation by institutional investors. They do participate, but owing to their size, in a smaller way than individual investors. One institutional investor in the United Kingdom stated that the institution does not invest in venture companies because they are too small to have an impact on the institution's performance. A representative of a Canadian pension fund told us that the fund does invest in venture companies but in a very small way because of the limited size of the market. One US institutional investor we talked with said that the institution generally invests in the whole market and would not be shy about investing in venture companies so long as a relatively high baseline of investor protections was in place and the markets were fairly liquid.

Such a high baseline for listing standards, transparency, and corporate governance will likely be needed to make many institutional investors comfortable about investing in venture exchange companies for the long term.

Liquidity is also a concern. Institutional investors would probably be longer-term holders of venture companies, but they would not want to be adversely affected by illiquid markets and would want to be able to sell their shares as needed. The SEC's proposed liquidity risk rules[10] would likely make institutional investors even more wary of investing in less liquid securities.

Individual Investors

Individual investors would likely constitute the majority of investors in venture market companies. We briefly discuss different groups of individual investors here, but it is important to note that the vast majority of these investors lack the sophistication and resources of professional investors. It is therefore paramount that any venture system have baseline vetting, transparency, and governance standards to protect the interests of investors. A venture exchange or venture market system in the United States would give retail investors access to companies with potentially higher rewards but also higher investment risks. Investor protections in the form of listing standards, transparency, and governance are key to attracting a retail investor base that will feel safe investing in a venture market.

Self-Directed Individual Investors

This population of individual investors may be the most likely to invest in venture companies. They are individual investors who manage their own portfolios and are more likely to be relatively well educated about the risks and rewards inherent in securities investing. They are also more likely to understand that venture companies carry higher risks, together with the higher rewards that investors seek from such small companies. These investors typically diversify with a basket of many securities in order to limit some of the risk in their portfolios.

[10]See www.sec.gov/news/pressrelease/2015-201.html. These rules would require firms to set aside funds to ensure that liquidity is available to meet redemptions and other short-term needs. Most investment funds responded in opposition to the proposed rules. CFA Institute also responded negatively to the SEC's proposal; its letter is available at www.cfainstitute.org/Comment%20Letters/20160112.pdf.

Self-directed individual investors would probably welcome a venture market so long as the transparency and governance of the companies in the exchange were at a sufficiently high standard to offer adequate investor protections.

In the group we convened to discuss these issues, the panelist representing individual investors said that small and venture companies are the type of securities in which individual investors are best positioned to have an investing advantage. The reason is that these companies are relatively unknown and unfollowed, with no analyst coverage, and individual investors will often not have to compete with institutional investors and high-frequency traders (HFTs).

For market-savvy, diversified investors, venture companies have a place in a well-diversified portfolio. Individual investors understand that it would be helpful if institutional investor money flowed into these venture companies to provide some stabilization and credibility to venture offerings. Individual investors also believe that it is important to have a robust vetting process for listing companies on such a market, coupled with relatively strong transparency and governance standards, so that a venture market does not suffer from a stigma that would keep investors away.

Self-directed individual investors are the savviest of the retail investor population but also the smallest. For example, the membership of the American Association of Individual Investors in the United States numbered 150,000 as of this writing[11] and has remained relatively stable over the years.

Individual Investors Who Use a Broker or Financial Adviser

Many individual investors still use brokers or investment advisers to help them invest in securities. Please see our discussion on broker/dealers to better understand whether such investors would be involved in a venture market.

[11]See www.aaii.com/membership/about-aaii.

Other Individual Investors

This individual investor population is of most concern to regulators and policymakers. Such investors tend to only "dabble" in the markets. And unlike the self-directed individual investors, they are often insufficiently educated about markets and particular companies to make fully informed decisions. Such investors are the most likely to be adversely affected by investing relatively large amounts in only one or two venture companies that they do not adequately understand.

Knowledge about a venture market, therefore, is key. People who invest in securities listed on such a market need to understand what is different about investing in venture market companies. This can be a daunting task but not a monumental one. Venture markets already exist across the globe, with individual investors providing most of the trading liquidity in those markets.

OTC Markets addresses this issue in its OTC Pink open marketplace by clearly labeling certain of its securities with symbols[12]—for example, a yield sign next to securities with limited information, a stop sign next to companies with no information, and a skull and crossbones next to companies with a public interest concern about the company, the trading of its stock, or a person in control at the company.[13]

High-Frequency Traders

Although estimates vary and hard data are difficult to find, most estimates suggest that HFTs account for as much as 50% of all order traffic in the national market system in the United States. It is unclear to what extent HFTs would participate in the trading of venture market securities. The goal of a venture market system would be to aid and add transparency to the trading system. As with other potential participants, HFTs' participation would depend on liquidity.

Venture markets may appeal to HFTs if they think the reward is great enough for taking on the increased risk of investing in small companies. But liquidity in venture market companies would need to be high enough that traders could back out of trades as needed without moving the market unnecessarily.

[12]See www.otcmarkets.com/learn/otc-market-tiers.
[13]In the early 2000s, a similar structure was attempted in Canada but was abandoned because of the number of errors it generated.

A 2015 study[14] on high-frequency trading in Canada's TSXV, published by the British Columbia Securities Commission (BCSC) and the Alberta Securities Commission (ASC), tested two hypotheses: (1) High-frequency trading increases the volatility of the share prices of TSXV-listed issuers targeted by HFTs compared with securities that are infrequently targeted by HFTs, and (2) HFTs more frequently sell short, or try to sell short, on a post-news downtick than do other market participants. The study found no evidence to support the first hypothesis and was generally inconclusive regarding the second hypothesis. The Public Venture Market Working Group—comprising the TSXV, the Investment Industry Regulatory Organization of Canada, the ASC, and the BCSC—conducted the study.

[14]See www.canadiansecuritieslaw.com/2015/10/articles/securities-distribution-tradin/high-frequency-trading-in-canadian-capital-markets.

Would Broker/Dealers Participate?

Another challenge to the success of a venture market system is getting market makers to participate. Market makers are broker/dealers who accept the risk of buying, holding, and selling shares of a security to facilitate trading. Market makers want to make sure there is enough liquidity in the stocks they own to ensure an efficient and orderly market. Some of these firms will shy away from a market with insufficient liquidity.

For a venture market to work, a critical mass of investors must have enough trust to be willing to put money at risk in the securities traded in that marketplace. In this respect, the main concern is whether a venture market can both serve investors' interests and be structured in such a way that broker/dealers want to participate.

If broker/dealers do not want to invest their clients' money in the companies in such a system, it is unlikely that such an endeavor could succeed. Broker/dealers will also be needed to provide liquidity for trading in these venture companies by making markets for the securities. Many broker/dealers will be unlikely to take this action if venture companies are too thinly traded, or if margins are too tight to make such an endeavor profitable.

Like all other potential participants in a venture system, the main reasons broker/dealers would choose to participate in a venture system are liquidity and the potential for adequate risk-adjusted returns. If liquidity levels in these companies are high enough for broker/dealers to operate profitably, they will participate. Broker/dealers can also earn revenues from the bid–ask spread and principal trading. So, if brokers are part of the market, that should help liquidity in that market.

Also like other potential participants, broker/dealers would want baseline regulatory, transparency, and governance requirements that would assure them that the securities they recommend are suitable for their clients.

Broker/dealers would also want assurance that they would not be breaching regulatory standards by selling venture companies to their clients. For example, if limitations were placed on who can invest in venture companies (e.g., would they be allowed in IRAs?), such limitations might limit the willingness of broker/dealers to offer these securities to their clients.

If a sponsor system is adopted—as in the United Kingdom, the OTCQX market in the United States, and to some extent in Canada—broker/dealers might be responsible for the original due diligence on companies before bringing them to the IPO market. Therefore, they would need to adopt a robust process for ensuring that the companies they sponsor are viable and ready to be listed in the venture exchange system.

There are also legal concerns for broker/dealers who recommend or sponsor venture companies. Broker/dealers need to operate in an environment in which they can sponsor venture companies for listing and not face burdensome legal challenges if a company fails through no fault of the broker/dealer. Broker/dealers would want similar protections concerning venture companies they recommend that subsequently fail.

Thus, there must be a sufficiently high baseline of transparency and corporate governance standards to persuade broker/dealers to own and trade the shares of venture companies—and to recommend those companies to their clients.

Would Companies Participate?

One of the appeals of a venture market system is that smaller and startup companies could access the public capital markets at costs below those of traditional financial markets and then have a venue in which the company shares could freely trade. And they would hope to do so under a lighter regulatory burden than is currently imposed on companies in larger exchanges.

Some of these small and startup companies might wish to eventually graduate to larger exchanges. But at the early or startup stage, lighter regulatory and governance rules might make sense—so long as investors were well aware that investing in venture companies is different from investing in the more established "blue-chip" companies listed on the NYSE or NASDAQ. Therefore, listing standards, transparency standards, and governance standards need to make sense for the companies listed on a venture market while providing investors with the protections they need.

We talked with small-business owners whose companies might be candidates for being listed on a venture market—and one company was already listed on the Canadian venture exchange—to discuss the potential of such a system in the United States. One small-business owner said he would welcome the ability to access capital more quickly than if he were to pursue a listing on the NYSE or NASDAQ. Owners were also intrigued by the prospect of a lighter regulatory burden and the lower listing fees that a venture exchange could provide.

One company CEO thought a venture market was an intriguing way to bring together investors who want an opportunity to participate in early-stage companies and issuers who want to raise capital but are not ready for the onerous regulatory requirements and costs imposed on traditional public companies. The CEO believed that such a market could help his company—and similar companies—gain exposure to the capital markets, which would allow the companies to grow over time, with the ultimate goal of graduating to a higher market, such as the NYSE or NASDAQ.

Another small-company CEO stated that such a venture system could allow the company to access the public markets sooner in the company's life cycle, allowing it to ramp up its growth sooner and to spend some time growing if the regulatory and reporting burden was not too onerous.

Who Would Regulate Such a Market?

Among the group of experts we convened in the United States, there was a clear consensus that participation by investors, broker/dealers, and issuers would be more forthcoming if a venture entity had a stamp of authenticity or approval from a US regulatory body.

An important question to contemplate, therefore, is what the regulatory framework should be for venture market–listed companies. Much of the regulation would likely mirror that of companies listed on such large US exchanges as the NYSE and NASDAQ but no doubt with some differences.

For example, a venture market could be an SRO overseen by the SEC or an ATS regulated by the SEC. Congress could establish, or instruct the SEC to establish, venture company standards applicable to all venture markets. The OTC Markets Group's OTCQX rules offer one possible set of standards, but there should be substantial flexibility to experiment with other standards to encourage issuers, investors, and broker/dealers to participate.

For a venture system to survive, it would need a robust minimum regulatory and transparency structure that investors could trust. Under this structure, companies would receive an annual audit by an independent auditor and produce and publicly release quarterly financial reports prepared in accordance with GAAP. Significant corporate events occurring between financial reports would need to be reported using standard delivery mechanisms, and company principals must be liable for fraudulent reports.

Experiences in Other Jurisdictions and Past Venture Exchanges

In investigating the value of a venture market system, it has been instructive to look at other venture markets already in operation. Currently, the two most prominent venture markets are the TSXV in Toronto and the AIM market in London. We briefly examine each market to learn what best practices should be adopted if a similar system were to be established in the United States. We first examine an earlier attempt at a venture market in the United States—and the lessons we can learn from it.

United States: Amex Emerging Company Marketplace

A venture market has been tried before in the United States—and failed. The Amex Emerging Company Marketplace was launched by the Amex in 1992. The brief history of this market is well told in the 1999 paper "The Rise and Fall of the Amex Emerging Company Marketplace" by Reena Aggarwal and James Angel. It summarizes the beginning and ultimate failure of this venture market and offers important lessons about what makes a successful venture market.

The market started off well as bid–ask spreads fell for listed companies and the launch of the exchange boosted interest and trading volumes. In time, however, according to Aggarwal and Angel, several factors contributed to its failure:

> The organizational structure of the Amex as a membership organization meant that most Amex stakeholders had little to gain from the success of the ECM [Emerging Company Marketplace]. Firms affiliated with NASDAQ market makers held almost one-fourth of the Amex board seats, and these firms could have had a vested interest in seeing the venture fail.
>
> The ECM also suffered from the same adverse selection problem that has affected other junior markets. The successful firms graduated to the main Amex as soon as they could, leaving the unsuccessful firms on the ECM.

> Scandals affecting three of the original stocks damaged the ECM's reputation for monitoring the quality of its listings, one of its initial selling points.
>
> Because the ECM was owned by the Amex, there was no incentive for the ECM to try to prevent its listings from moving onto the Amex, which exacerbated the adverse selection problem. (p. 283)

Advocates for a new venture market in the United States should learn from the mistakes of the Amex ECM by

- adopting robust vetting processes to ensure that companies will not fail because of poor business plans or unscrupulous management, boards, or investors;
- ensuring that those who operate in the market have a vested interest in its success (issuers, investors, broker/dealers);
- encouraging successful companies to stay in the market, partly by recruiting a diverse set of venture companies with different business cycles; and
- making sure that the new venture market is not duplicative of markets already in existence, such as those of the OTC Markets Group.

Canada: TSX Venture

The Canadian Venture Exchange was created in 1999 through a merger of the Vancouver Stock Exchange and the Alberta Stock Exchange. From the beginning, the Canadian Venture Exchange focused on small and emerging companies that were too small to be listed on the Toronto Stock Exchange (TSX). In 2001, the TSX Group purchased the Canadian Venture Exchange and renamed it the TSX Venture Exchange (TSXV).[15]

In its short history, the TSXV has been dominated by resource companies that have generally followed the boom–bust cycles in the resource sectors. According to the TSXV, 60% of the companies in the TSXV are mining companies and 10% are oil and gas companies. The companies that make up the TSXV are mostly Canadian (93% are based in

[15]As of 2014, the total market capitalization of the nearly 2,000 TSXV companies was less than $30 billion. In comparison, the Main Street Growth Act would list EGCs with market capitalizations of up to $2 billion each.

Canada), with only 7% of TSXV-listed companies coming from other markets (57% of the foreign firms are from the United States).[16]

Large institutional investors do invest in TSXV companies, although their allocations to this market are quite small. The main investors in TSXV companies are individual investors and small institutions.

TSXV is responsible for much of the transparency and governance requirements imposed on the companies listed there. Potential TSXV companies must go through a thorough screening process that includes the screening of company officers and directors. Thorough background checks are also required for any 10% shareowners as part of the vetting process required before a company can be listed.

Issuers see TSXV as trying to create an appropriate market for issuers lacking the resources to access public markets while maintaining a high level of integrity in the marketplace. That is why the entry requirements and vetting process for companies wishing to list on the TSXV are rather onerous. The exchange recognizes that it cannot remove the business risk from investing in venture exchange companies, but it aims to eliminate any regulatory risk as much as possible.

The TSXV tends to be “hands on” with its companies if necessary, and managing the TSXV can be labor intensive. For example, issuers cannot enter into agreements to issue securities without exchange approval. The extent of review depends on the materiality of the transaction and whether related parties are involved. Issuers regularly return to the market to raise capital, so this approval of equity raising is a labor-intensive process but one that is seen as vital to protecting the integrity of the market.

Most of the transparency requirements are similar to those imposed on larger TSX companies, with annual audits and quarterly financial statements required. However, TSX companies must file quarterly financial statements within 45 days of the quarter-end versus 60 days for TSXV companies. Similarly, TSX listings must file audited annual financials within 90 days of year-end compared with 120 days for TSXV companies. TSXV companies also have lighter burdens for reporting internal controls and compliance simply because they are smaller companies without the complexity of larger, more integrated, diversified companies, allowing for a smaller number of internal controls staff and systems.

[16] See www.tsx.com/listings/current-market-statistics (as of 29 February 2016); see also www.tsx.com/resource/en/1290.

TSXV companies also have lower board and board committee independence requirements than their larger TSX brethren. A company must have at least three board members and at least two must be independent, so a TSXV company may have a slightly larger board with a minority of independent directors. The audit committees of TSXV companies are required to be majority independent, but other board committees are not.

Finally, TSXV companies may be required to have a broker/dealer sponsor in order to enter the public markets, although not all new listings require sponsorship.[17] There is a general requirement that all new listings have a sponsor, but there are multiple exemptions and TSXV can waive the sponsorship requirement as appropriate. The result is that only a minority of new listings have sponsors. Furthermore, TSXV is considering reducing the instances where sponsorship is required. After years of experience and much consultation with market participants,[18] TSXV believes the value provided by a sponsor has diminished, and it is not always the case that the cost to the issuer is justified by the value that a sponsor can bring to the market.

The Experience in Canada

We also talked with the CEO of a small TSXV-listed company to get the perspective of a company operating in that venture exchange environment. This entrepreneur said that the process for getting approved for listing on the TSXV was very involved and burdensome at times. In retrospect, the rigor was worth the effort in his opinion, because the thorough investigation of the company and its officers, directors, and investors offered new investors a level of due diligence that would have been absent with a lower bar for listing approval.

In this CEO's view, TSXV tries to create a good experience for companies and to stay out of their way once they are listed. As noted earlier, the regulatory burden for being listed on TSXV is lower than that for being listed on the larger TSX. But financial reporting requirements for TSXV companies are similar to those for TSX companies, as are governance standards. However, because boards are often rather small, full boards often function as a governance committee for venture companies.

[17]TSXV Sponsorship Policies (www.tsx.com/resource/en/422).
[18]Revitalizing TSXV (www.tsx.com/revitalizing-tsxv?lang=en).

United Kingdom: AIM Market

The AIM market was launched in 1995, near the start of the tech/internet boom, as the Alternative Investment Market to help smaller companies in the United Kingdom access the capital markets under lower regulatory standards. The lighter regulatory burden of an AIM listing has persuaded many international companies to choose the AIM market for their listing; these companies enjoy the prestige and access to capital that a London Stock Exchange (LSE) listing provides without the regulatory burden imposed on the larger LSE companies. Nevertheless, the majority of AIM listings come from UK- or Ireland-based companies seeking to take advantage of the lower-cost capital raising available in their own backyards. According to recent information from AIM, about 80% of AIM companies come from the United Kingdom or Ireland and about 20% are from elsewhere.[19] The AIM market is more diversified across sectors than the TSXV in Canada, which is highly concentrated in mining and the oil and gas markets. In the AIM market, no industry currently represents more than 18% of the listed companies.[20]

Although the regulatory standards for the AIM market are relatively low, there is still oversight of AIM companies.[21] Regulation operates on a "comply-or-explain" model, with AIM companies having to explain why they do not comply with any regulation they choose not to follow. Also, AIM companies are generally required to follow only the corporate governance standards of their home jurisdictions—which may be quite lax, depending on the market. Many AIM-listed companies follow the Quoted Companies Alliance (QCA) corporate governance code, which suggests, but does not require, at least two independent non-executive directors and also suggests that companies establish committees of non-executives charged with audit, remuneration, and nomination duties.

As far as financial reporting, AIM standards are not as stringent as those of TSXV, with AIM companies required to provide only semi-annual and annual reports. The annual reports must be presented within six months of the end of the financial year and may use International Accounting Standards if the company is domiciled in the European Economic Area. Companies based outside that area may file their financials according to International Accounting Standards, US GAAP, Canadian GAAP, Australian International Financial Standards, or Japanese GAAP.[22] Prospective AIM companies must provide three years of audited financial information as part of the IPO process.

[19]"A Guide to AIM" (2015): www.londonstockexchange.com/companies-and-advisors/aim/publications/documents/a-guide-to-aim.pdf.
[20]"A Guide to AIM."
[21]"AIM Rules for Companies" (February 2010): www.lseg.com/sites/default/files/content/documents/aim-rules-for-companies.pdf.
[22]"AIM Rules for Companies" (pp. 8–9).

In the AIM market, a sponsor is charged with ensuring that companies wishing to list there are vetted before coming to market. An AIM company's underwriter, or nominated adviser ("nomad"), is responsible for initial and continuing oversight of the companies the nomad sponsors. The AIM market relies heavily on nomads[23] to ensure that companies are suitable for investment.

The matter of sponsorship is a key difference between the TSXV venture system in Canada and the AIM market. The TSXV system appears to have a more stringent due diligence procedure on the front end of the company-vetting process and is even moving away from requiring sponsorship of companies. The AIM market has chosen a different model, with nomads responsible for most of the vetting of companies and continued oversight. This approach can lead to uneven standards of oversight in the AIM market because each nomad provides a different level of oversight to the companies the nomad sponsors.

There is also a concern about an inherent conflict of interest in the nomad system. Commission rates have fallen as a proportion of broker income in the small-cap market, so brokers who sponsor AIM companies have become more dependent on the corporate fees they get from the companies they sponsor. This arrangement can pose a conflict of interest because investors are reliant on brokers' oversight of the companies they sponsor. Brokers may be reluctant to be too vigilant with companies that may seek another nomad if they become displeased with the service they are getting from their current adviser.

Published in 2012, the paper "IPO Survival in a Reputational Market"[24] highlights the importance of a good nomad to the success of AIM companies and seems to argue for higher standards. The authors analyzed the IPO survival rate in the AIM market and found that the reputation of the nomad sponsoring a company was more important than firm age, size, or public float. They concluded that regulators could increase survival times by tightening listing rules, in particular, by requiring that issuers retain reputable nomads to certify and control listing quality.

[23]"AIM Rules for Nominated Advisers" (May 2014): www.londonstockexchange.com/companies-and-advisors/aim/publications/aim-rules-for-nominated-advisers.pdf.
[24]Susanne Espenlaub, Arif Khurshed, and Abdulkadir Mohamed, "IPO Survival in a Reputational Market" (April 2012): www.cass.city.ac.uk/__data/assets/pdf_file/0007/86479/5-AIM-IPOs.pdf.

Challenges to Creating a Venture Market

For a venture market to work in the United States, some key questions must be addressed. Investors, issuers, and broker/dealers all need incentives to participate, including certain regulatory protections for investors, reduced regulatory burdens for issuers, appropriate listing standards for broker/dealers, and some degree of regulatory barriers for exchange operators. Following is a simple summary of some of the issues to be addressed for each constituency.

Investors

- Trading market liquidity to enable investors to easily buy and sell shares
- Threshold level of regulatory protections to earn investor trust
- Clear understanding of standards (transparency, governance)
- Financial reporting standards that adhere to GAAP
- Annual audits of financial statements
- Periodic financial statements, preferably quarterly
- Standards that are enforced
- Rules to encourage investment research
- Trading fees that are not prohibitive of investor trading

Issuers

- Sufficient investor interest to fully fund IPOs
- Heightened exposure to investors as a consequence of being listed on regulated markets

- Aggregation of trading activity in company securities in one or more transparent trading markets
- Active trading market for shares to give shareowners a market in which to buy and sell their holdings
- Tailored regulatory burdens to avoid unnecessary compliance costs directed toward larger, more complex companies (e.g., compliance and control structures inappropriate for small companies)
- Trading protections that inhibit the ability of certain investors to accumulate large stakes with which to launch takeovers without shareowner approval

Broker/Dealers

- Sufficient market liquidity to make market making in these companies' shares profitable
- Listing standards sufficient to indicate due diligence and regulatory approval of listed companies, enabling firms to recommend investments in those companies
- Legal safe harbors that encourage broker/dealers to help EGCs go public without bearing significant legal liability for companies that fail through no fault of the sponsoring broker/dealer
- Rules that enable firms to produce research with prominent and appropriate disclosures concerning conflicts of interest
- Trading fees that are conducive to market making and trade execution for clients

Markets

- Sufficient market liquidity to encourage investors, issuers, and broker/dealers to participate in such a market
- Listing standards sufficient to earn investor trust without being too onerous for issuers
- Self-regulatory flexibility to experiment with trading rules in order to prevent practices that might undermine investor confidence and trading interest

Conclusion

Investor trust is key to successful capital markets. Without individuals who are willing to invest available funds in securities issued by companies, municipalities, mutual funds, and other types of issuers, there would be no capital markets.

Key to investor trust, therefore, is assurance that investors have reliable, relevant, comparable, and sufficient information to make reasoned investment decisions. They do not need riskless investment options, but they do need clarity on the risks they face in different investment environments.

A venture market would provide investors with an important disclosure that is not currently available in the market—namely, it would help investors identify those companies operating under JOBS Act exemptions from the governance and financial reporting requirements of most public companies. The vetting of companies wishing to be listed in such a venture system is thus vitally important. This type of vetting, though more expensive up front, would help mitigate many of the problems arising from fraudulent issuers while serving the interests of all stakeholders—issuers, investors, and intermediaries alike—if the system provides certain minimum safeguards, such as the following:

- A robust vetting process to weed out bad actors in management, on the board, and in the principal investor ranks of potential venture companies
- A sponsor system in which broker/dealers, a similar group, or the exchange itself undertakes the initial due diligence on venture companies
- Annual audits, with the auditor's report included in an annual report to shareowners and investors
- Quarterly updates on performance and financial condition
- Use of GAAP in the preparation of financial statements
- Timely disclosure of all important company news through normal public distribution channels
- Liability of company principals for fraudulent representations made in offering documents, financial statements, or company announcements delivered through these channels

- High standards of transparency and governance, deviating from best practice standards only for legitimate reasons unique to small companies

A venture system should be able to consolidate trading activity for public EGCs if it so chooses or to operate as an ATS in a more broadly dispersed trading market. The goal is to permit market operators to experiment with different business and trading models until one or more are able to find a model that works for the benefit of all constituents. The goal is to enhance visibility for small-company securities listed on venture trading venues. Currently, these firms compete with larger, better-capitalized, more established, and more liquid alternatives. Moreover, they do not benefit from being listed on a particular market or exchange. Also, the consistent graduation of listed venture market companies to a larger, more traditional exchange would enhance investor interest in potential future successes showcased within the venture system.

A venture market can work in the United States if standards are high enough for investors, issuers, and broker/dealers to have sufficient faith in the companies and listing/trading venues to come to the market and participate. The liquidity that investors and broker/dealers will need to bring to such a market is the key to making it successful. For that to happen, investors need to see a market with high transparency and governance standards and broker/dealers need to see a market in which they can run a profitable business. Both of these goals are achievable if policymakers decide to make a venture market in the United States a reality.

Appendix A

OTC Markets Group and Trading Markets

OTC Markets Group organizes securities into the OTCQX®, OTCQB®, and Pink® markets, which are tiered on the basis of such factors as level of disclosure, financial standards, and corporate governance standards.

Below is a brief summary of the differences between these markets:

OTCQX

- Three disclosure standards for US companies:
  - SEC-reporting companies must file all annual, quarterly, and other interim reports required to be filed on EDGAR.
  - Regulation A–reporting companies must file all annual, semi-annual, and other interim reports required to be filed on EDGAR under Regulation A Tier 2 and Form 1-U quarterly disclosure, including all information required in the semiannual report.
  - Non-SEC-reporting companies must comply with annual, quarterly, and current reporting obligations, including annual audited financials in accordance with GAAP, as set forth in the OTCQX US disclosure guidelines.[25]
- Two disclosure standards for international companies:
  - Securities must be listed on a qualifying foreign exchange[26] and be current and fully compliant with SEC Rule 12g3-2(b).
  - The company must be an SEC-reporting company and be current and fully compliant in its SEC-reporting obligations.

[25]The OTCQX U.S. disclosure guidelines are available at www.otcmarkets.com/content/doc/OTCQXGuidelines.pdf.
[26]The list of qualifying foreign exchanges is available at www.otcmarkets.com/services/companies/otcqx-international/qualified-exchange-list.

- Annual audited GAAP financials must be prepared by a Public Company Accounting Oversight Board–registered auditing firm.
- Companies must provide quarterly reporting, including unaudited financial disclosures.
- There must be timely disclosure of interim material news events.
- Companies must be sponsored by a qualified third-party investment bank, a securities attorney, or (for banks) a corporate broker.
- A company cannot be a "penny stock" as defined in Exchange Act Rule 3a51-1.
- Companies cannot be shell companies.
- Companies cannot be in bankruptcy.
- Governance requirements must call for at least two independent directors and an audit committee with a majority of independent directors.
- US financial standards are reviewed in **Exhibit 1**.

Exhibit 1. US Financial Standards

	OTCQX US	OTCQX US Premier
Minimum bid price	Initial: $0.25 Ongoing: $0.10	Initial: $4.00 Ongoing: $1.00
Penny stock rule	Meet *one* of the following three exemptions:	Meet *one* of the following two exemptions:
Net tangible assets	$5 million: < 3 years of operations $2 million: 3+ years of operations	$5 million: < 3 years of operations $2 million: 3+ years of operations
Revenue	$6 million average for last 3 years	$6 million average for last 3 years
Bid	$5 And *one* of the following net tangible assets: $1 million Revenue: $2 million Net income: $500,000 Total assets: $5 million	

(Continued)

Exhibit 1. US Financial Standards (Continued)

OTCQX US	OTCQX US Premier	
Market value standard *or* net income standard	**Market value standard**	**Net income standard**
Initial		
Market value of public float	$15 million	$1 million
Market capitalization	$50 million	$10 million
Net income		$750,000
Ongoing		
Market value of public float	$15 million	$1 million
Market capitalization	$35 million	$5 million
Net income		$500,000
Market capitalization	Initial: $10 million Ongoing: $5 million	
Priced quotes by market makers on OTC Link	Initial: 1 Ongoing: 2 (within 90 days)	Initial: 1 Ongoing: 4 (within 90 days)
Stockholders' equity		Initial: $4 million Ongoing: $1 million
Operating history		3 years
Public float		500,000 shares
Shareholders	50 beneficial shareholders, each owning at least 100 shares	100 beneficial shareholders, each owning at least 100 shares

Notes:

1. All criteria must be met using data as of the most recent fiscal year, except for bid price, which is monitored on a daily basis.
2. Initial bid price and market-capitalization standards should be met for each of the previous 30 consecutive calendar days. Ongoing bid price and market-cap standards should be met for at least one of every 30 consecutive calendar days.
3. Public float is defined as total shares outstanding minus shares held by officers, directors, or beneficial owners of more than 10% of the company.

OTCQB

- Companies are current in their SEC reporting, Reg A reporting, or reporting to their bank regulator or (for international companies) are listed on a qualified international stock exchange and are compliant with Exchange Act Rule 12g3-2(b).
- There is a minimum bid price test of $0.01.
- There is an annual management certification process to verify officers, directors, and controlling shareholders.
- There is greater information availability for investors through the OTC Disclosure & News Service.
- There are no governance requirements.

Pink

- There is electronic trading (through institutional, retail, and online brokers).
- Prices are transparent.
- Classification of companies is based on various levels of disclosure and information availability:
    - Pink Current: Companies submit regular quarterly and annual reports.
    - Pink Limited: Companies have submitted information no older than six months to the OTC Disclosure & News Service.
    - Pink No Information: Companies are unwilling or unable to provide disclosure to the public markets.

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