
“Today Hedge Funds Are The Driving Force In Our OTC Market.”

Using 75-years of tradition, market maker Hill Thompson adapts to today's empowered customers with their flavor-of-the-month trading technology to keep adding small-cap value. In the OTC, market makers with in-depth understanding can still make a big difference—liquidity. Sometimes doing nothing can be brilliant.

BY ROBERT J. FLAHERTY

It seemed like yesterday when I sat down in Jersey City, NJ with Hill, Thompson, Magid & Co.'s now retired CEO Tony Broy and his hand-picked successor Nicholas D. Ponzio, Jr. But the cover shot hanging on their Wall reads 1999. Now, I was sitting opposite Nick and his own choice to keep Hill's trading technology up to date and relevant. Nick "Tuna" DeMaria. Tuna is Managing Director of Trading Operations and, for a trading specialist that is a big deal. So is the fact that while hundreds of famous-name Nasdaq and OTC market makers bit the dust since 9/11, Hill is happily celebrating its 75th Anniversary.

Merrill Lynch paid around \$1 billion for Herzog Heine Geduld and then liquidated it. Schwab deep sixed most of its Mayer and Schweitzer. Troster Singer, Nash Weiss and hundreds of other competing market makers disappeared. Suddenly, their models no longer fit in with that of their acquirers because the SEC placed the old timers at a competitive disadvantage with the new ECNs, which SEC electronic trading rules created. The combination spelled their doom. And in trading most large-cap NYSE and Nasdaq stocks, electronic trading eliminated much of the need for intervention by the traditional market maker, while



Hill, Thompson, Magid & Co. President and CEO Nicholas Ponzio, Jr., & Nick "Tuna" DeMaria - Managing Director of Trading Operations.

price decimalization devastated the former fat profitable spreads between bid and ask prices.

But Hill, while acquired itself in 1999, has never been integrated into the U.S. brokerage business of its parent, the Royal Bank of Canada (NYSE:RY-41.60). A highly-successful independent business, Hill provides market-making and trading services to over 600 institutions and other broker dealers. It makes markets and takes proprietary positions in about 9,000 securities. Over 1,000, more than double a few years ago, are in 25 foreign countries.

Besides all of the 3,200 OTC BB stocks, Hill also covers thousands of Pink Sheet stocks. The latter includes "safety net" liquidity markets for delistings from exchanges and bankruptcies. Many confused frightened investors are forced to trade there as a last resort.

Hill specializes in infrequently traded small and micro-cap solid stocks as well as unique trading and execution focus in the following sectors: distressed company stocks, small-cap regional banks, American Depository Receipts, alternative investments and as an accommodation to customers for their order flow of

about 1,000 Nasdaq stocks.

Hill leverages its in-depth understanding of the OTC marketplace to add liquidity for thinly-traded securities, including the so called Grey Market, where stock prices do not appear electronically on a machine, and unknown buyers and sellers still must be found. Hill finds quite a few and does the job.

So far in 2006, with its unremitting series of potential stock market disasters from the record price of oil, soaring commodities, the crisis in Iraq and the Israel-Lebanon conflict, judged historically, Hill's trading volume is holding up well.

One reason for Hill's longevity is that it has never tried to be the Number One OTC market maker in terms of trading volume or the number of OTC stocks in which it makes markets. It likes to be around second or third and do its job quietly.

"We don't publish research," says Ponzio. "We don't have retail customers. We just serve other market makers and institutions. We do try and stay up on

point here in our best execution presentation."

Today, speed is the most important criteria for determining best execution in the very liquid stocks. But if Hill took every OTC order and immediately put it into the market to execute as quickly as possible, it would often destroy its customers' efforts for best execution. By focusing on price improvement, enhanced liquidity, enhanced order fills, Hill claims to be able to get 95% of most orders done within the national best bid or offer at the time of order receipt.

All customers are bombarded by vendors with new trading programs. Some want those programs, which work very well in the liquid markets, also used and adapted to illiquid OTC stocks. In fact, many of these technologies boast empowering the investor so you are on an even footing with market makers. Clearly, many investors now have information which was formerly only available to the market maker.

"It affects our business because there

maker providing a different service. All these services are being evaluated and there will be shake outs ahead.

"We've adapted our market to the so-called technology trading flavor-of-the-month," says DeMaria. "We will handle your order flow. Tell us how you want it handled and we'll adapt and improve. However, we won't change our game plan or strategy because of a fad. People don't realize in our market how long it takes to stare at the wall and to understand that the best course is to do nothing."

"Right," Ponzio agrees laughing. "Clearly, when it comes to thinly traded stocks or inactive ones or stocks that were delisted from an exchange, market makers add value."

Here trading still remains an art. In some cases an exotic trading system can transfer well. In others when used in the OTC market it can actually detract from value. "We employ our traders to add value," Ponzio repeats. "Sometimes that's telling a customer that 'I know you

If Nick Ponzio had one wish, it would be for everyone to embrace the OTC market.

corporate actions, structural changes and we advise clients on how they may effect the way a stock will trade."

While old names are gone, new powerful firms now have replaced them to make a bigger trading impact on OTC stocks, led by Bear Stearns, Goldman Sachs, Pershing and Smith Barney. Still, there are nuances making markets in OTC stocks that can't be learned over night. So Hill claims the competitive edge of having traded OTC securities and staying within regulatory oversight compliance for 75 years.

"We have adjusted to the marketplace," begins Ponzio. "If you are not relevant, if you are not adding any value, you're not here anymore. That goes for ECNs, crossing networks or market makers. You have to prove to your customer how you are adding value. That's a key

is more transparency," concedes DeMaria. "Customers are educated to the point where some may be over educated. I don't believe there is anything market makers are keeping back today from their customers. It has cut into margins along with decimalization of prices. Customers have more control over their order flow now and the customer always believes that they are right."

The last few years in the trading market have been about new products and services all claiming to get best execution. What people can add value to their execution? How do you cope with the SEC's rule NMS forcing speedy quotations? Now systems call for trading at the market opening, intra-day automated crosses, end of the day market close orders, volume weighted averages, really exotic platforms and you have a market

want to buy over the course of the day, but my gut tells me to buy it now because your stock is going to close higher.' That's a worthwhile incite in a marketplace where there is not much information flow."

"Remember, there are still times when you need a market maker on a stock," says Ponzio. "That's when you want an order handled a certain way; you want liquidity. That's important! In our end of the market stocks are different; they trade differently. There is less liquidity. You have a critical mass of community banks, inactive stocks, illiquid ones. Here the market maker is more important than ever."

"Our customers want us to do the things we do that an electronic network can't," says DeMaria. "Provide liquidity where it doesn't naturally exist. Give buy-

“We provide liquidity where it doesn’t naturally exist. Give buyers or sellers a little background on a stock, a little color. Let our customers know if a stock isn’t trading and if we have to cultivate a buyer.”

–Nick “Tuna” DeMaria

ers or sellers a little background on a stock, a little color. Let them know if a stock hasn’t traded and we have to cultivate a buyer.”

What investors are buying OTC stocks? A lot more foreigners and now some U.S. OTC stocks are even being traded in Canada and Germany.

Why? Ponzio believes the much vilified Sarbanes -Oxley Act, which obviously needs modifications so small caps can afford to do annual accounting and stay profitable, gives the U.S. market more credibility. People come here because they have faith and trust in our market. The fact that the Pink Sheets have moved on to a more electronic media and have more disclosure and relevant information also is attracting new buyers. “Regulators have done a good job of rooting out many of the frauds in every market and it’s an ongoing effort,” says Ponzio. “All this is adding to investor confidence.

Most mutual funds have grown so enormous that many can’t buy stocks with less than \$1 billion in market cap. Tiny capitalizations don’t have sufficient liquidity to safely trade in and out so big funds can’t be significant OTC players.

The vacuum has more than been filled. “Today hedge funds are the driving force in our OTC market,” says Ponzio.

“Venture firms and hedge funds, which are not regulated as heavily as mutual funds, have sophisticated investors who understand the importance of start-ups and small firms. The big thing about the OTC market serves as an incubator for Nasdaq. Anyone who understands capital formation understands these are the small issues that create new jobs. Hedge funds appreciate emerging growth stocks and understand capitalism doesn’t work unless you have new ones like we have on the OTC to form capital and create new value.”

While Hill’s foreign stock business is booming, Ponzio believes reforms will improve it even more. Emerging countries and our domestic brokers are making it easier to trade foreign stocks which increase their volume although it hurts the growth of traditional ADRs. “More and more, you can readily trade the foreign stocks so you don’t need their ADRs,” points out DeMaria.

“A key catch phrase today is emerging markets and people want to go there,” adds Ponzio. “One reason many hold back, is stock prices are only reprinted at the end of the day in some markets. If those markets release more prints and more volume is reported, even more investors will be attracted and volume



will continue to be higher.”

Without this OTC emerging growth incubator and also this Pink Sheet safety net to trade delisted stocks and bankruptcies, the entire U.S. economy would be hurt. But oddly the OTC is a bit of an orphan. Because Nasdaq wanted to go after more large-caps and also trading of NYSE securities, Nasdaq spun off the OTC. Today it is owned and regulated by the NASD. The Pink Sheets is not an exchange, but a quotation service.

Long term, Ponzio feels optimistic, noting that, “People in the right places

are acknowledging SOX needs adjustment. Listing on London Stock Exchange’s micro-cap AIM is exploding and AIM is getting small caps that in the U.S. couldn’t sustain the U.S. regulation costs.

“We need new entrepreneurs who at some point decide between making their next monthly home mortgage payment and using their credit card to help his or her small company get to the next level. America needs those people. That’s the American Dream. We don’t want to lose that in our effort to over regulate.” OTC stocks without a lot of information from emerging growth stocks to distressed securities are some of the riskiest stocks anywhere. But there are investors who are willing to do the work, try a little harder to get information and continuously reap big rewards for decades in this inefficient market.

If Ponzio could have one wish for improving this OTC market, what would it be?

“People need to embrace this market place, not run from it,” he summarizes. “The improvement at the Pink Sheets is the right approach. Let us see how we can make the market better– increase investor confidence; add more electronics and more reliable information.”

“We want more information,” agrees DeMaria. “Full transparency. Everyone on a level playing field, small investors, large investors and the market makers.”

This often missing support from Nasdaq and regulators is vital to obtain for an obvious reason. You have to maintain a marketplace that attracts participants to create liquidity and to provide the ability to flourish with the right governance in place.