



U.S. Securities and Exchange Commission

Microcap Stock: A Guide for Investors

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Introduction

Information is the investor's best tool when it comes to investing wisely. But accurate information about "microcap stocks" — low-priced stocks issued by the smallest of companies — may be difficult to find. Many microcap companies do not file financial reports with the SEC, so it's hard for investors to get the facts about the company's management, products, services, and finances. When reliable information is scarce, fraudsters can easily spread false information about microcap companies, making profits while creating losses for unsuspecting investors.

In the battle against microcap fraud, the SEC has toughened its rules and taken actions against wrongdoers, but we can't stop every microcap fraud. We need your help in winning the battle. Before you consider investing in a microcap company, arm yourself first with information. This alert tells you about microcap stocks, how to find information, what "red flags" to consider, and where to turn if you run into trouble.

What Is a Microcap Stock?

The term "microcap stock" applies to companies with low or "micro" capitalizations, meaning the total value of the company's stock. Microcap companies typically have limited assets. For example, in cases where the SEC suspended trading in microcap stocks, the average company had only \$6 million in net tangible assets — and nearly half had less than \$1.25 million. Microcap stocks tend to be low priced and trade in low volumes.

Where Do Microcap Stocks Trade?

Many microcap stocks trade in the "over-the-counter" (OTC) market and are quoted on OTC systems, such as the OTC Bulletin Board (OTCBB) or the "Pink Sheets."

- **OTC Bulletin Board** The OTCBB is an electronic quotation system that displays real-time quotes, last-sale prices, and volume information for many OTC securities that are not listed on the Nasdaq Stock Market or a national securities exchange. Brokers who subscribe to the system can use the OTCBB to look up prices or enter quotes for OTC securities.

Although the NASD oversees the OTCBB, the OTCBB is *not* part of the Nasdaq Stock Market. Fraudsters often claim that an OTCBB company is a Nasdaq company to mislead investors into thinking that the company is bigger than it is.

- **The "Pink Sheets"** The Pink Sheets — named for the color of paper on which they've historically been printed — are listings of price quotes for companies that trade in the over-the-counter market (OTC market). "[Market makers](#)" — the brokers who commit to buying and selling the securities of OTC issuers—can use the pink sheets to publish [bid](#) and [ask](#) prices. A company named Pink Sheets LLC, formerly known as the National Quotation Bureau, publishes the pink sheets in both hard copy and electronic format. Pink Sheets LLC is not registered with the SEC as a stock exchange, nor does the SEC regulate its activities.

How Are Microcap Stocks Different From Other Stocks?

Lack of Public Information The biggest difference between a microcap stock and other stocks is the amount of reliable, publicly available information about the company. Larger public companies file reports with the SEC that any investor can get for free from the SEC's website. Professional stock analysts regularly research and write about larger public companies, and it's easy to find their stock prices in the newspaper. In contrast, information about microcap companies can be extremely difficult to find, making them more vulnerable to investment fraud schemes.

No Minimum Listing Standards Companies that trade their stocks on major exchanges and in the Nasdaq Stock Market must meet minimum listing standards. For example, they must have minimum amounts of net assets and minimum numbers of shareholders. In contrast, companies on the OTCBB or the Pink Sheets do not have to meet any minimum standards.

Risk While all investments involve risk, microcap stocks are among the most risky. Many microcap companies tend to be new and have no proven track record. Some of these companies have no assets or operations. Others have products and services that are still in development or have yet to be tested in the market. Another risk that pertains to microcap stocks involves the low volumes of trades. Because microcap stocks trade in low volumes, any size of trade can have a large percentage impact on the price of the stock.

Which Companies File Reports With the SEC?

In general, the federal securities laws require all but the smallest of public companies to file reports with the SEC. A company can become "public" in one of two ways — by issuing securities in an offering or transaction that's registered with the SEC or by registering the company and its outstanding securities with the SEC. Both types of registration trigger ongoing reporting obligations, meaning the company must file periodic reports that disclose important information to investors about its business, financial condition, and

management.

This information is a treasure trove for investors: it tells you whether a company is making money or losing money and why. You'll find this information in the company's quarterly reports on Form 10-Q, annual reports (with audited financial statements) on Form 10-K, and periodic reports of significant events on Form 8-K.

A company *must* file reports with the SEC if:

- it has 500 or more investors *and* \$10 million or more in assets; or
- it lists its securities on the following stock markets:
 - American Stock Exchange
 - Boston Stock Exchange
 - Chicago Stock Exchange
 - Cincinnati Stock Exchange
 - International Securities Exchange
 - Nasdaq Stock Market
 - New York Stock Exchange
 - Pacific Exchange
 - Philadelphia Stock Exchange; or
- its securities are quoted on the OTCBB.

If you'd like to learn more about the SEC's registration and reporting requirements, read [Q&A: Small Business and the SEC](#).

All OTCBB companies must file updated financial reports with the SEC or with their banking or insurance regulators. Any company that does not file timely reports with the SEC or their banking or insurance regulators is removed from the OTCBB.

Tip: When an OTCBB company fails to file its reports on time, the NASD will add a fifth letter "E" to its four-letter stock symbol. The company then has 30 days to file with the SEC or 60 days to file with its banking or insurance regulator. If it's still delinquent after the grace period, the company will be removed from the OTCBB. You'll find a list of securities that have been removed from the OTCBB at www.otcbb.com.

With few exceptions, companies that file reports with the SEC must do so

electronically using the SEC's EDGAR system. EDGAR stands for electronic data gathering and retrieval. The EDGAR database is available on the SEC's website at www.sec.gov. You'll find many corporate filings in the EDGAR database, including annual and quarterly reports and registration statements. Any investor can access and download this information for free from the SEC's website. [Click here](#) if you want to view detailed instructions on how to use EDGAR.

Caution: By law, the reports that companies file with the SEC must be truthful and complete, presenting the facts investors find important in making decisions to buy, hold, or sell a security. But the SEC cannot guarantee the accuracy of the reports companies file. Some dishonest companies break the law and file false reports. Every year, the SEC brings enforcement actions against companies who've "cooked their books" or failed to provide important information to investors. Read SEC filings — and all other information — with a questioning and critical mind.

Which Companies Don't Have to File Reports With the SEC?

Smaller companies — those with less than \$10 million in assets — generally do not have to file reports with the SEC. But some smaller companies, including microcap companies, may choose voluntarily to register their securities with the SEC. As described above, companies that register with the SEC must also file quarterly, annual, and other reports.

A Word About Offering Requirements

Any company that wants to offer or sell securities to the public must either register with the SEC or meet an exemption. Here are two of the most common exemptions that many microcap companies use:

- **"Reg A" Offerings** Companies raising less than \$5 million in a 12-month period may be exempt from registering their securities under a rule known as Regulation A. Instead of filing a registration statement through EDGAR, these companies need only file a printed copy of an "offering circular" with the SEC containing financial statements and other information.
- **"Reg D" Offerings** Some smaller companies offer and sell securities without registering the transaction under an exemption known as Regulation D. Reg D exempts from registration companies that seek to raise less than \$1 million dollars in a twelve-month period. It also exempts companies seeking to raise up to \$5 million, as long as the companies sell only to 35 or fewer individuals or any number of "accredited investors" who must meet high net worth or income standards. In addition, Reg D exempts some larger private offerings of securities. While companies claiming an exemption under Reg D don't have to register or file reports with the SEC, they must still file what's known as a "Form D" within a few days after they first sell their securities. Form D is a brief notice that includes the names and

addresses of owners and stock promoters, but little other information about the company. You may be able to find out more about Reg D companies by contacting your state securities regulator. You will find the contact information for your state securities regulator at www.nasaa.org.

Unless they otherwise file reports with the SEC, companies that are exempt from registration under Reg A, Reg D, or another offering exemption do not have to file reports with the SEC. For more information about the registration requirements and offering exemptions, read [Q&A: Small Business and the SEC](#).

What's So Important About Public Information?

Many of the microcap companies that don't file reports with the SEC are legitimate businesses with real products or services. But the lack of reliable, readily available information about some microcap companies can open the door to fraud. It's easier for fraudsters to manipulate a stock when there's little or no information available about the company.

Microcap fraud depends on spreading false information. Here's how some fraudsters carry out their scams:

- **E-mail Spam** Fraudsters distribute junk e-mail or "spam" over the Internet to spread false information quickly and cheaply about a microcap company to thousands of potential investors. Spam allows the unscrupulous to target many more potential investors than cold calling or mass mailing.
- **Internet Fraud** Fraudsters often use aliases on Internet bulletin boards and chat rooms to hide their identities and post messages urging investors to buy stock in microcap companies based on supposedly "inside" information about impending developments at the companies. For more information about Internet fraud and on-line investing, read [Internet Fraud](#) and [What You Need to Know About Trading in Fast Moving Markets](#).
- **Paid Promoters** Some microcap companies pay stock promoters to recommend or "tout" the microcap stock in supposedly independent and unbiased investment newsletters, research reports, or radio and television shows. Paid promoters are generally behind the unsolicited "junk" faxes you may receive, touting a microcap company. The federal securities laws require the newsletters to disclose who paid them, the amount, and the type of payment. But many fraudsters fail to do so and mislead investors into believing they are receiving independent advice.
- **"Boiler Rooms" and Cold Calling** Dishonest brokers set up "boiler rooms" where a small army of high-pressure salespeople use banks of telephones to make cold calls to as many potential investors as

possible. These strangers hound investors to buy "house stocks" — stocks that the firm buys or sells as a market maker or has in its inventory. To learn more about cold calling, read [Cold Calling Alert](#).

- **Questionable Press Releases** Fraudsters often issue press releases that contain exaggerations or lies about the microcap company's sales, acquisitions, revenue projections, or new products or services. These fraudulent press releases are then disseminated through legitimate financial news portals on the Internet.

Microcap fraud schemes can take a variety of forms. Here's a description of the most common schemes:

The Classic "Pump and Dump" Scheme It's common to see messages posted on the Internet that urge readers to buy a stock quickly or to sell before the price goes down, or a telemarketer will call using the same sort of pitch. Often the promoters will claim to have "inside" information about an impending development or to use an "infallible" combination of economic and stock market data to pick stocks. In reality, they may be company insiders or paid promoters who stand to gain by selling their shares after the stock price is pumped up by the buying frenzy they create. Once these fraudsters sell their shares and stop hyping the stock, the price typically falls, and investors lose their money.

The Latest Variation of the "Pump and Dump" Scheme

Some people are finding that they have received a "misdialed" call from a stranger, leaving a "hot" investment tip for a friend. The message is designed to sound as if the speaker didn't realize that he or she was leaving the hot tip on the wrong answering machine. If you get a message like this, it's not a wrong number at all. Instead, it is from someone who is being paid to leave these messages on a whole lot of answering machines. Check out ["Wrong Numbers" and Stock Tips on Your Answering Machine](#) for more information and to hear one of these scams.

The Off-Shore Scam Under a rule known as "Regulation S," companies do not have to register stock they sell outside the United States to foreign or "off-shore" investors. In the typical off-shore scam, an unscrupulous microcap company sells unregistered Reg S stock at a deep discount to fraudsters posing as foreign investors. These fraudsters then sell the stock to U.S. investors at inflated prices, pocketing huge profits that they share with the microcap company insiders. The flood of unregistered stock into the U.S. eventually causes the price to plummet, leaving unsuspecting U.S. investors with enormous losses.

How Do I Get Information About Microcap Companies?

If you're working with a broker or an investment adviser, you can ask your investment professional if the company files reports with the SEC and to get you written information about the company and its business, finances, and

management. Be sure to carefully read the prospectus and the company's latest financial reports. Remember that unsolicited e-mails, message board postings and company news releases should never be used as the sole basis for your investment decisions. You can also get information on your own from these sources:

- **From the company** Ask the company if it is registered with the SEC and files reports with us. If the company is small and unknown to most people, you should also call your state securities regulator to get information about the company, its management, and the brokers or promoters who've encouraged you to invest in the company.
- **From the SEC** A great many companies must file their reports with the SEC. Using the [EDGAR](#) database, you can find out whether a company files with us and get any reports in which you're interested. For companies that do not file on EDGAR, check with the SEC's [Public Reference Room](#) to see whether the company has filed an offering circular under Reg A.
- **From your state securities regulator** We strongly urge you to contact your state securities regulator to find out whether they have information about a company and the people behind it. Look in the government section of your phone book or visit the website of the [North American Securities Administrators Association](#) to get the name and phone number. Even though the company does not have to register its securities with the SEC, it may have to register them with your state. Your regulator will tell you whether the company has been legally cleared to sell securities in your state. Too many investors could easily have avoided heavy and painful financial losses if they only called their state securities regulator *before* they bought stock.
- **From other government regulators** Many companies, such as banks, do not have to file reports with the SEC. But banks must file updated financial information with their banking regulators. Visit the Federal Reserve System's National Information Center of Banking Information site at www.ffiec.gov/nicpubweb/nicweb/nichome.aspx, the Office of the Comptroller of the Currency at www.occ.treas.gov, or the Federal Deposit Insurance Corporation at www.fdic.gov.
- **From reference books and commercial databases** Visit your local public library or the nearest law or business school library. You'll find many reference materials containing information about companies. You can also access commercial databases for more information about the company's history, management, products or services, revenues, and credit ratings. The SEC cannot recommend or endorse any particular research firm, its personnel, or its products. But there are a number of commercial resources you may consult, including: Bloomberg, Dun & Bradstreet, Hoover's Profiles, Lexis-Nexis, and Standard & Poor's Corporate Profiles. Ask your librarian about additional resources.

- **The Secretary of State Where the Company Is Incorporated**
Contact the secretary of state where the company is incorporated to find out whether the company is a corporation in good standing. You may also be able to obtain copies of the company's incorporation papers and any annual reports it files with the state. Please visit the National Association of Secretaries of State website at www.nass.org for contact information regarding a particular Secretary of State.

Caution If you've been asked to invest in a company but you can't find any record that the company has registered its securities with the SEC or your state, or that it's exempt from registration, call or write your state's securities regulator or the SEC immediately with all the details. You may have come face to face with a scam.

What if I Want to Invest in Microcap Stocks?

To invest wisely and avoid investment scams, research each investment opportunity thoroughly and ask questions. These simple steps can make the difference between profits and losses:

1. Find out whether the company has registered its securities with the SEC or your state's securities regulators.
2. Make sure you understand the company's business and its products or services.
3. Read carefully the most recent reports the company has filed with its regulators and pay attention to the company's financial statements, particularly if they are not audited or not certified by an accountant. If the company does not file reports with the SEC, be sure to ask your broker for what's called the "Rule 15c2-11 file" on the company. That file will contain important information about the company.
4. Check out the people running the company with your state securities regulator, and find out if they've ever made money for investors before. Also ask whether the people running the company have had run-ins with the regulators or other investors.
5. Make sure the broker and his or her firm are registered with the SEC and licensed to do business in your state. And ask your [state securities regulator](#) whether the broker and the firm have ever been disciplined or have complaints against them.

We've spelled out the questions you'll need to ask in the following publications: [Internet Fraud](#) and [Ask Questions](#). When you ask these questions, write down the answers you received and what you decided to do. If something goes wrong, your notes can help to establish what was said. Let your broker or investment adviser know you're taking notes. They'll know

you're a serious investor and may tell you more — or give up trying to scam you. We've developed a [Form for Taking Notes](#) to help you. You'll find these and other useful publications on the [Investor Information](#) section of the SEC's website or from our toll-free publications line at (800) SEC-0330.

Also, watch out for these "red flags":

- **SEC Trading Suspensions** The SEC has the power to suspend trading in any stock for up to 10 days when it believes that information about the company is inaccurate or unreliable. Think twice before investing in a company that's been the subject of an SEC trading suspension. You'll find information about [trading suspensions](#) on the SEC's website.
- **High Pressure Sales Tactics** Beware of brokers who pressure you to buy before you have a chance to think about and investigate the "opportunity." Dishonest brokers may try to tell you about a "once-in-a-lifetime" opportunity or one that's based on "inside" or "confidential" information. Don't fall for brokers who promise spectacular profits or "guaranteed" returns. These are the hallmarks of fraud. If the deal sounds too good to be true, then it probably is.
- **Assets Are Large But Revenues Are Small** Microcap companies sometimes assign high values on their financial statements to assets that have nothing to do with their business. Find out whether there's a valid explanation for low revenues, especially when the company claims to have large assets.
- **Odd Items in the Footnotes to the Financial Statements** Many microcap fraud schemes involve unusual transactions among individuals connected to the company. These can be unusual loans or the exchange of questionable assets for company stock that may be discussed in the footnotes.
- **Unusual Auditing Issues** Be wary when a company's auditors have refused to certify the company's financial statements or if they've stated that the company may not have enough money to continue operating. Also question any change of accountants.
- **Insiders Own Large Amounts of the Stock** In many microcap fraud cases — especially "pump and dump" schemes — the company's officers and promoters own significant amounts of the stock. When one person or group controls most of the stock, they can more easily manipulate the stock's price at your expense. You can ask your broker or the company whether one person or group controls most of the company's stock, but if the company is the subject of a scam, you may not get an honest answer.

Additional Red Flags Don't deal with brokers who refuse to provide you with written information about the investments they're promoting. Never tell

a cold caller your social security number or numbers for your banking and securities accounts. And be extra wary if someone you don't know and trust recommends foreign investments. For more tips on avoiding danger, be sure to read [Cold Calling](#) and [The Fleecing of Foreign Investors](#).

What If I Run Into Trouble?

Act promptly! By law, you only have a limited time to take legal action. Follow these steps to solve your problem:

1. Talk to your broker and explain the problem. What happened? Who said what, and when? Were communications clear? What did the broker tell you? Did you take notes about what your broker said at the time? If so, what do your notes say?

Note: If you believe your broker engaged in unauthorized transactions or other serious frauds, be sure to put your complaint in writing right away and send it to the firm. Your written complaint may be the only way to prove that you complained to the firm about unauthorized transactions. For more information about unauthorized transactions, please read our "Fast Answer" on [that topic](#).

2. If your broker can't resolve your problem, then talk to the broker's branch manager.
3. If the problem is still not resolved, put your complaint in writing and send it to the compliance department at the firm's main office. Explain your problem clearly, and tell the firm how you want it resolved. Ask the compliance office to respond to you in writing within 30 days.
4. If you're still not satisfied, then send a letter to your state securities regulator and attach copies of any letters you've sent already to the firm. Or send your complaint to the SEC using our [online complaint form](#).

We will forward your complaint to the firm's compliance department and ask that they look into the problem and respond to you in writing.

Please note that sometimes a complaint can be successfully resolved. But in many cases, the firm denies wrongdoing, and it comes down to one person's word against another's. In that case, we cannot do anything more to help resolve the complaint. We cannot act as a judge or an arbitrator to establish wrongdoing and force the firm to satisfy your claim. And we cannot act as your lawyer.

<http://www.sec.gov/investor/pubs/microcapstock.htm>

We have provided this information as a service to investors. It is neither a legal interpretation nor a statement of SEC policy. If you have questions concerning the meaning or application of a particular law or rule, please consult with an attorney who specializes in securities law.

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