PENNY STOCKS

A guide for beginning investors

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This booklet is designed to provide you, the beginning investor, with general information about penny stocks and the markets in which they are traded. Because there is so much fraud involving penny stocks, this booklet serves mostly to warn potential investors against becoming involved with penny stocks. However, you should be aware that many small, deserving, completely legitimate companies issue stock that trades for pennies a share in the over-the-counter market. The trick is to be able to spot the potential fraud. We hope this booklet will help you do just that.

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What are penny stocks?

There is no set, accepted definition of **penny stock**. Some people define it as stock priced under one dollar, some under five dollars. Some people include only those securities traded in the "pink sheets", some include the entire OTC market. The Securities Division considers a stock to be a "penny stock" if it trades at or under $5.00 per share and trades in either the "pink sheets" or on NASDAQ. In addition, a true penny stock will have less than $4 million in net tangible assets and will not have a significant operating history. (In other words, if a company has real assets, such as equipment and inventory, and is engaged in some real business, such as manufacturing, then the Division does not consider the stock to be penny stock even though the shares are low-priced.)

The "OTC" market

Penny stocks are not traded on a stock exchange but are traded in the over-the-counter (OTC) market. Part of the OTC market is the NASDAQ National Market (**NNM**) of the **NASDAQ** National (Association of Securities Dealers Automated Quotation) System, which does not include any penny stocks.

There are also non-NNM NASDAQ securities, including some penny stocks. The NASDAQ system has listing standards that change from time to time and, depending on the standards, there may be more or fewer penny stocks on NASDAQ. If you purchase a low-priced security that is listed on NASDAQ, it will meet certain minimum standards. In addition, many NASDAQ prices are quoted regularly in newspapers, allowing you to follow the price of your security instead of forcing you to rely on your broker for all price information.

The third major component of the OTC market is the National Quotation Bureau's (NQB) service, commonly referred to as the "pink sheets". The NQB's securities lists and price information, printed on pads of long, narrow sheets of pink paper, have, for all practical purposes, no meaningful listing standards, and price information is sometimes difficult, if not impossible, for the small investor to obtain. Broker-dealers obtain their price information by calling the trading desks of three "market makers". Obviously, small investors do not have access to those traders and must rely on their stockbroker for accurate price information.

Principal/ Agency

In most securities transactions, your broker-dealer acts as your **agent**, arranging a transaction directly between you and a third party. In compensation for arranging that trade, you pay your broker-dealer a commission. In some instances, the broker-dealer has the security you seek to purchase in inventory, or wants the security you wish to sell. The broker-dealer may trade with you on its own behalf, as a **principal** in the transaction. When the broker-dealer acts as a principal, and not as an agent, the trade confirmation should say that on its face. The broker-dealer is not paid a commission in principal trades, but makes its money on the spread, and by buying and selling at advantageous times, the same as any other investor. A sizeable portion of penny stock trades are principal transactions, and an investor should be alert to the potential conflicts of such transactions.

Bid/Ask

Penny stocks do not each have a single price at which they are bought and sold, but a number of different prices. The first difference is between the **bid** price and the **ask** price. The bid price is how much someone is willing to pay for the security, or the price at which you could sell your shares. The ask price is how much someone will sell their securities for, or how much you will have to pay. The difference between the prices is the **spread**.

The spread

To most investors, the spread represents a built-in loss at the time of investment. For example, if you purchased a stock that traded at 1/2 cent bid, 1 cent ask, the bid would have to more than double in price for you to *break even* (the "more than double" comes from additional costs such as "ticket" charges and other miscellaneous costs). Many investors buy penny stocks believing that "trading at 12½ cents" means that they can buy and sell at 12½ cents. This simply is not the case, and any salesperson who uses such a phrase is only telling half of the truth. The spreads in penny stocks are most commonly 25-33%, are often 50-100% and sometimes are over 100%.

Another factor to keep in mind when evaluating price information about penny stocks is that there are two "bid" and two "ask" prices, the **inside** and **outside** bid and ask. As a general rule, the price you will be interested in will be the outside bid and ask, or the lower bid and the higher ask, as those are the bid and ask prices to public customers.

Mark-ups

The last pricing factor concerning penny stocks is called the **mark-up**. A broker-dealer who has held the security in its account and subject to the risk of market price fluctuation, may mark the price of the security it sells to you up by a certain percentage, **on top of the spread**. This is to compensate broker-dealers for maintaining inventory sufficient to supply demand for an orderly and liquid market. What it means to the average investor is another cost that creates a built-in loss at the time of investment. In other words, the instant your transaction is effected, your securities are worth less than you paid for them.

Although it is no guarantee of a good price, you are more likely to get a better price in an agency transaction using a broker-dealer that has no interest in the transaction, due to the pricing factors above. In the typical penny stock transaction, the broker-dealer buys from its customers at the bid and sells at the ask, capturing as compensation the spread, plus any mark-up.

Market makers

A **market maker** is a broker-dealer who stands ready to buy or sell 100 shares of the stocks in which it makes a market. When a transaction is proposed, the market maker will give a price at which it would be willing to effect that transaction. The market maker's price applies only to the first 100 shares. While the market maker system has been widely criticized (after all, how much of a commitment is it to buy 100 shares at a penny apiece?) the system does offer investors some level of fairness. The more market makers there are in a given stock, the more likely they are to bid against each other, and the price will more likely move to a true "market" price. The names of the market makers of securities traded in the pink sheets are listed in the pink sheets.

Manipulation Especially when there are few or only one market maker, penny stocks are susceptible to price manipulation. A common and easy manipulation is for a broker-dealer to gather a large holding of a penny stock at a very low price. Through the use of high-pressure sales techniques, the sales force of the broker-dealer hypes the stock and stirs up demand, which seemingly justifies the continual rise in prices given by the broker-dealer (which is probably also the only market maker).

The price continues to rise until there are no more investors who will buy, and then the bottom falls out and the price plummets. Sometimes the broker-dealer will buy back the securities at the fallen prices to recapture the stockpile for a future revival of the stock; more often investors are simply left holding the worthless stock.

Initial public offerings The price and market discussion above relate to penny stocks already trading in the market. Stocks are introduced into the market through an **initial public offering** (IPO). In most cases, an IPO would need to be registered with the Securities Division, which applies a set of guidelines to the offering to determine whether the offering is "fair, just and equitable". Although the "merit" system of applying those guidelines is not foolproof, fraudulent offerings are rejected and not granted registration. For this reason, Missourians are not usually victims of penny stock scams in an IPO, but lose their money in the secondary market. In the secondary market, there are broad exemptions in the law that allow many penny stocks to trade in Missouri without meeting the merit standards.

Legitimate penny stocks

Despite all of the problems with penny stocks and the millions of dollars of loss involved with them, there are legitimate companies whose securities trade in the pink sheets at very low prices. Struggling young companies just starting out are perfect examples. Investment in such a company, held through the company's formative years, can pay off well. Such an astute investment requires three things: the ability to choose the right company, the capital to invest and **hold** the investment, and luck.

In order to choose the right company, you must know something about the business in which the company engages. You must be able to evaluate the feasibility of the company's business plan and the company's ability to compete in its field of endeavor. You must be able to evaluate the ability of the company's management to run the company. Finally, you must be able to evaluate the capitalization and cash flow of the company.

If you find the right company, you must be able to hold the investment for years to allow the company to mature and for the stock to appreciate in value. **Investment in "growth" companies is long-term investment.** Furthermore, you must have sufficient capital to be able to withstand total loss of your investment. **Investment in emerging companies is always a high-risk investment.**

Finally, there is simply an element of luck in any stock investment. Luck plays an even greater role in a market in which manipulation is so prevalent. Some legitimate companies have had their stocks manipulated to such an extent that they were were forced out of business. Even without manipulation, the success or failure of a fledgling business is simply unpredictable.

Sources of information

Your broker can be a tremendous help in evaluating an investment. However, in the penny stock area, there are many unscrupulous brokers whose only goal is to sell. Be sure that the advice you receive is balanced and addresses your investment needs. When in doubt, avoid a penny stock investment, especially if your broker "specializes" in penny stocks.

The **prospectus** is the most comprehensive source information about an IPO. It sets out where your investment money will be used, describes the capitalization, history and management of the company and describes the cash flow system of the company. If you need help interpreting the information you find in the prospectus, the Division has another pamphlet in this series entitled "How to Read a Prospectus".

Trade confirmations contain a wealth of information. The confirmation will show basic information, such as number of shares, but will also indicate whether the transaction was agency or principal, was solicited or unsolicited (it will say "unsolicited" if you called your broker to place the order without your broker having tried in any way to get you to place the order) and, in the case of most pink sheet and non-NASDAQ National Market trades, provide the bid and ask at the time of execution of the transaction.

Manuals such as *Moody's* and *Standard and Poor's* have current financial information about companies, and most penny stocks are listed in the manuals.

Periodic reports filed with the U.S. Securities and Exchange Commission have updated information about companies that register with the SEC. The most common report is a "10-K".

Warning signs Watch for the following warning signs to alert you to a possible penny stock fraud:

High-pressure sales techniques. Investment in a legitimate emerging company is long-term. A good little company is not going to skyrocket in a couple of weeks. Building a sound company takes years; you have a few days or weeks to decide whether the investment is right for you.

Blind pools and blank checks. Do not invest in any security without being told *exactly* how your money will be spent. Be sure you know which properties the company plans to buy with the offering proceeds and how much money is to be spent on management and promoters.

Mismarked trade confirmations or new account cards. Be very wary if your trade confirmation is marked "unsolicited" if your broker did, in fact, solicit the trade. While it may be a simple mistake, unscrupulous penny stock brokers often mark the confirmation as unsolicited to avoid the registration laws and the "fair, just and equitable" standard. Watch for misstatements about your net worth, income and account objectives as well. Investing in penny stocks is speculative business and involves a high degree of risk. Often, brokers will enhance the new account card to make it seem that you are suitable for a penny stock investment when you are not.

Unauthorized transactions. Be alert to placement in your account of securities you did not agree to purchase. In some instances, a broker may try to pressure you into purchasing the stock, claiming that since you have the stock, you must pay for it. In some cases, the broker is temporarily "parking" the securities in your account, perhaps to meet the minimum distribution of an IPO, or for any number of reasons. In some cases, an unauthorized trade is simply a mistake, but in any case, complain **immediately, both verbally and in writing** to your broker, your broker's manager and to the Securities Division.

Investigate before you invest

Millions of dollars are lost in the penny market each year by Missourians. Those few who make money in the market are largely investors in legitimate, fledgling companies. Before you invest in any penny stock, read about the company. Do not allow yourself to be pressured into a transaction that is not right for you. Check out the broker-dealer, the salesperson and the stock itself with the Division. The Securities Division registers broker-dealers and their salespeople and has information about their complaint histories and other information about their experience in the securities business.

The staff of the Division is available between 8:00 a.m. and 5:00 p.m. to answer questions and to check registrations at the following numbers:

Registration of broker-dealers and their salespeople:
(573) 751-2061

Registration of securities:
(573) 751-4136

Questions and complaints:
(573) 751-4704

Toll-free hotline:
(800) 721-7996

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