



# THE INFORMED INVESTOR

No. 5

## MICRO-CAP FRAUD

Micro-cap fraud is similar to the penny stock fraud that was prevalent in the 1980's. Micro-cap stocks are shares in companies that are not well-established, have a small amount of shares in public hands (also known as "thinly traded" shares) and often trade at less than \$5.00 per share. Investors are particularly at risk to micro-cap fraud given that in recent years many have come to expect investment returns exceeding 25%. Micro-cap stocks often trade on the OTC Bulletin Board, the Pink Sheets, or the Pink Sheets Electronic Quotation Service, and are often too small to be traded on the stock exchanges or Nasdaq. Because they are not subject to the listing standards and reporting requirements of an exchange or Nasdaq, public information is often limited.

The North American Securities Administrators Association estimates that investors lose over \$6 billion a year to investment fraud, including micro-cap fraud schemes. Efforts against micro-cap fraud, by state, industry and federal regulators, have had an impact but the problem remains serious and investors need to be on guard. The following are some examples of the ways in which stock promoters or unscrupulous securities brokers illegally profit in the micro-cap area:

↑ Brokers may purchase stock from company promoters for pennies per share and resell them to unsuspecting investors for several dollars per share. The profit to the broker is

known as the "mark-up" or "spread." These are also known as "chop stocks" because the difference between what the broker purchased the stock for and what the investor paid is excessive.

↑ Internet Fraud - unscrupulous promoters or brokers hype a stock through the use of company Web sites, bulletin boards, chat rooms or on-line investment newsletters. They create false press releases or indicate that a company has had a revolutionary product approved by a state or federal governmental agency. After the price sky rockets, the promoter or broker sells to an unsuspecting investor and pockets the large profit. The stock price eventually collapses after the hype ceases. Often, investors end up holding shares that are worthless. This is known as "pump and dump."

↑ Micro-cap stocks are often sold by promoters or brokers that have either been expelled from the securities industry or have extensive disciplinary histories. Some promoters or brokers have also been linked to organized crime.

### How to Protect Yourself Against Micro-Cap Fraud

↑ **Beware** of high pressure, unsolicited telephone calls. The fraudulent micro-cap broker often works in a "boiler room," a bank



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of telephones manned by high-pressure salespersons, working off of scripted sales pitches who tout stocks with outrageous promises. Never allow yourself to be pressured into making an investment. Don't make an investment that you don't understand and be wary of promises of inside information or "get-rich-quick schemes." The best advice is to hang up the phone! Buy and use an answering machine to screen cold-calling salespersons.

↑ **Be wary** of Internet chat rooms, bulletin boards or unsolicited E-mail messages. The person providing the information may be an unscrupulous stock promoter or broker, or an insider who wants to dump their shares.

↑ **Question** micro-cap sales pitches featuring the names of reputable "clearing" broker-dealers. These firms often have no more than a contractual relationship with micro-cap brokers.

↑ **Check out** the broker. Ask the broker for their CRD number. Call your state or provincial securities office, the National Association of Securities Dealers, Inc. hotline at (800) 289-9999 or the North American Securities Administrators Association at 1-202-737-0900 to learn if the broker has a disciplinary record.

↑ **Ask** to see a prospectus if it is a recent public offering, or other up-to-date information before you invest. Read these documents carefully. Greater caution should be taken if a prospectus is not available. A prospectus must be filed with the Securities and Exchange Commission and/or with a state or provincial securities administrator. Anything that a salesperson says that contradicts disclosures in a prospectus or other offering materials should be a red flag that there is a prob-

lem. The following are some risk disclosures within the offering information of a micro-cap stock:

**Risk Factors** – Read these disclosures very carefully. These contain many of the risks that could adversely affect your investment.

**Management** – This information discloses the experience and background of management. Check to make sure, for example, that someone whose sole experience is as the manager of a fast-food franchise is not at the helm of a biomedical research company.

**Company Financial Health** – If they are not already deeply in debt, many micro-cap stock companies have little or no capital to work with. They could be using investors' money simply to keep the doors open. Read the financial statements and accountant's report provided, and if you don't understand them, find someone who does and can explain it to you.

**Dilution** – Promoters often obtain huge numbers of shares free. When the public's money is invested, it is immediately watered down by the absence of cash investment by the promoters. The disclosures provided should have charts or information showing how much investors' dollars have been "diluted" by the "cheap stock" in the hands of promoters. Very high dilution should be a cause for concern.

**Use of Proceeds** – This information tells how the money will be used, whether for product development or some other purpose. If it will be used for suspect, unproductive purposes, such as loans to officers and directors, back taxes or unmet payroll, exercise caution. Use of

proceeds is the key to the legitimacy of the operation.

**Product** – Here the information will reveal if the “electronic asparagus cutter” has been tested and proven. Often these disclosures will contain double-talk indicating that the product is “about to be tested,” “may be tested,” or that money is being raised that will allow testing. If this is the case, particular care should be taken before an investment should be made. Read this information carefully to learn the stage of development – if any – of the “new invention.”

**Transactions with Management/ Conflicts of Interest** – Watch out for interest-free loans to principals and transactions where the officers, directors and promoters sell property to the company at inflated prices. This could indicate that the company is giving its money to the promoters in less than arm’s-length transactions and that there won’t be much left to develop the property or product.

**Litigation and Investigations** – This information will disclose lawsuits filed against the corporation and promoters and, often, government investigations. Investors may be able to obtain information on civil and criminal securities fraud actions, including the names of defendants and companies, by calling the securities administrator in their jurisdiction.

**Financial Statements** – Review the company’s financial statements to determine its current financial status. The accountant may have concerns about the company’s continued ability to operate.

↑ ***Finally, find out*** if the securities are registered with the state or provincial securities agency or the federal Securities and Exchange Commission. Even if they are, investors should not rely on governmental registration of the offering as an indication of government approval of the soundness of the company or the advisability of the investment. All that is required to register a security in many jurisdictions is full disclosure of relevant facts. It is up to the individual to judge from the disclosures contained in the prospectus or other up-to-date offering materials and other reliable sources whether or not to invest in the stock. Don’t take the word of a salesperson! Check out the investment yourself.

The oldest international organization devoted to investor protection, the North American Securities Administrators Association (NASAA) was organized in 1919. It is a voluntary association with a membership consisting of the 66 state, provincial, and territorial securities administrators in the 50 states, the District of Columbia, Puerto Rico, Canada and Mexico. In the U.S., NASAA is the national voice of the 50 state securities agencies responsible for the promotion of efficient capital formation and investor protection.

If you have questions concerning a micro-cap security or salesperson or promoter selling a micro-cap security, call or write the securities agency in your state, province or territory immediately. For a phone number or address contact NASAA at 1-202-737-0900. Contact information is also available on NASAA’s Web site at [www.nasaa.org](http://www.nasaa.org).