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PENNY STOCK MANIPULATION AND THE SMALL INVESTOR

The views expressed herein are those of Chairman Ruder and do not necessarily reflect those of the Commission, other Commissioners, or the staff.

Penny Stock Manipulation and the Small Investor

Introduction

The occasion of the Rocky Mountain State-Federal-Provincial Securities Conference in Denver gives me a chance to announce that the Securities and Exchange Commission is mobilizing its efforts to protect small investors from "penny stock" fraud and manipulation. Since Denver has long been the home for thousands of low priced penny stocks, it seems particularly appropriate to discuss with you today the increasing problem of fraud and market manipulation in the over-the-counter penny stock market. As you are all aware, penny stock fraud has long been a matter of concern in the Rocky Mountain region. Now, with the growth of computers, telefax machines, and wide-area telephone systems, manipulators of penny stocks are operating nationwide. In the words of Forbes Magazine, penny stock manipulations may even have become "America's hottest export." 1/

In increasing the Commission's commitment to combat penny stock fraud, we will be reviewing the actions of all participants in these schemes, including promoters, broker-dealers, broker-dealer sales personnel, attorneys, accountants, transfer agents, public relations firms and even those investors who participate in the initial phases of penny stock manipulations. Our remedies will include injunctions, bars

1/ See Henry, America's Hottest Export-Funny Money Stocks, Forbes, September 23, 1985 at 38.

from the securities industry, other disciplinary sanctions, and, where appropriate, recommendations for criminal proceedings.

The Penny Stock Market

Let me begin by describing the penny stock market.

Penny stocks are low-priced securities traded over-the-counter. They are usually traded outside of the National Association of Securities Dealers' Automated Quotation System (NASDAQ) and are usually quoted in the National Quotation Bureau's "pink sheets". For the most part, these stocks are thinly-traded and subject to domination and control by a single market-maker. As a result, they are an attractive vehicle for manipulative, artificial schemes designed to affect (almost always to raise) the price or volume of these securities.

While penny stocks are generally low in price and may even be sold at less than one cent per share, the penny stock label used to describe this market is a misnomer. The fact is that many issues begin as penny stocks, but end with innocent public investors holding worthless stocks which they have purchased for many thousands of dollars. Nor are these stocks viewed as pennies by perpetrators of frauds, since there are large amounts of money to be made through dishonest activities in the penny stock market. According to a survey done by the Commission's Denver Regional Office, during the period 1982 to 1984, secondary market trading of just 500 Denver area penny stock offerings aggregated over 15 billion dollars.

Profits to the brokerage firms involved in the penny stock market can be enormous. For example, over approximately a one month period, two penny stock brokers monitored by one of the Commission's offices traded shares of two companies with a combined net worth of about one million dollars. During this month, the brokers' profits in transactions involving these companies amounted to \$3.5 million, more than three times the net worth of the two companies. In another case, a branch office of a penny stock firm made more than a one million dollar profit in a single day through its activities in the penny stock market.

The penny stock market is also exceedingly lucrative for the registered representatives who sell to the public. Registered "reps" can reportedly make \$5,000 a month after 6 months and \$10,000 to \$20,000 per month after a year's sales experience. A top broker in the penny stock market can earn from \$20,000 to \$50,000 per month. 2/

Of course penny stock market abuse hurts innocent investors. Examinations of penny stock brokers' books and records have revealed large markups and large commissions. For example, one customer recently paid \$25,000 for a stock without knowing that the broker's commission was \$12,500, exactly half of the amount paid. In other cases, customers who believe they have made large paper profits find that their brokerage firms

2/ See Confessions of a Penny Stock Broker, Sylvia Porter's Personal Finance, September 1988 at 65.

will vigorously resist their attempts to liquidate their stock positions for cash.

A Typical Manipulation

While the techniques used to perpetrate frauds in the penny stock market are varied, there are some common features.

Phase one begins with the creation of a shell corporation by a promoter, although in some instances an already existing shell will be used. Usually the "shell" company will have no operating history, few employees, few assets, and not uncommonly, no legitimate prospects. The shell is used as the vehicle for the manipulation. If a new shell is formed, the stated business purpose will usually be to look for mergers, acquisitions, or business opportunities. However, no merger partner will be identified and no disclosure will be made as to the proposed nature of the company's business.

Initial distributions are often made to buyers or mere holders who do not care what the prospectus says. In one recent case considered by the Commission, more than 100 persons in the state of Colorado were given securities in a sham shell company distribution scheme. 3/ The "Colorado 103," as we called them, were told that they could make money at no risk by accepting stock to be given to them without payment and thereafter selling it. They were told that the promoter merely wanted to use names of Colorado investors because Colorado laws

3/ Complaint of the Securities and Exchange Commission, SEC v. Colonial International Import, Ltd., et al., No. C-88-510-JLQ (E.D. Wa. filed September 28, 1988).

made it easy for companies to go public. These individuals became an integral part of a fraudulent penny stock market manipulation scheme.

The point is that at the beginning of the manipulation the promoters will have sold small amounts of stock, or given away stock, or acquired an inactive company which nevertheless has shareholders. At this juncture, the promoters will themselves own, or secretly control through nominees, large quantities of stock or warrants to purchase stock. They will then be poised to make substantial profits when the price of the stock rises.

At the completion of the first phase, the promoters will control a "shell company" which has few assets but also has a sufficient number of shareholders so that a market can be said to exist. In the next phase, the shell frequently is merged with a private company, which is described as having great prospects because it has a purported product with great potential, making the combined company's stock an attractive buy in the secondary market. Currently fashionable products involve AIDS cures, uranium, or gold, always a trusty standby.

In some cases, these shell offerings are organized and orchestrated by promoters who are habitual securities law violators. These promoters appear to be assisted in creating the shell packages by professionals who may be knowing and regular participants in the fraudulent schemes. These professionals include attorneys, accountants, public relations firms, and transfer agents, who frequently are involved again

and again in providing legal opinions, certifying financial statements, providing publicity, and serving as transferors for stock certificates. These individuals are all critical players in the steps necessary to bring the securities to market.

The next phase in the manipulation is to obtain access to the market by making arrangements with a broker-dealer who will act as market maker. Promoters may give stock or pay cash to a firm in exchange for its services as a market maker. To create the appearance of a legitimate market, the broker-dealer sometimes arranges for other firms to list themselves as additional market makers. These secondary market makers will often agree to provide this service in exchange for a similar favor in the future or for a small payment. In some cases, these arrangements are simplified because the primary broker-dealer has an ongoing relationship with the promoter.

Once the shell package has been established, the stage is set for the manipulation of the price and volume of the penny stock in the secondary market. The broker-dealer purchases the penny stock in large incremental blocks for sale to the public at pre-determined prices. The broker-dealer then uses an extensive telephone system coupled with high pressure and misleading sales practices to sell stock to an unsuspecting public. Salesmen routinely make hundreds of "cold" telephone calls per day. Although some of the sales personnel are experienced in high pressure sales techniques, many are naive and enthusiastic young people. These sales people are given

exaggerated, glowing reports on the stocks they have been told to sell. Using scripts provided by their broker-dealer employers, their sales techniques feature a steady stream of spectacular -- and false -- promises of alluring investment opportunities.

The idea behind the sales program is that the penny stocks will be sold to the public at ever increasing prices, so that the promoters will profit by selling at grossly inflated values and the broker-dealers will profit by huge markups and commissions. One version of the sales manipulation scheme is a technique called the "1 - 2 - 4 - Flip". In this scheme, securities are sold to the public at an initial offering price of one cent per share. Subsequently, the issue is traded in the aftermarket at two cents and resold to other customers of the broker. The issue is resold again to another group of customers at four cents. Having completed this cycle, and after the price is manipulated above four cents, the broker convinces the last group of customers to liquidate their purchases at a fictitious paper profit and then to use the proceeds to purchase another new securities issue. When the original issue reaches a price above four cents, it is then sold (flipped) as a block to another market-maker or promoter who, in turn, will use the securities for a new manipulation scheme. Of course, the four cent purchasers are losers. If they try to sell for cash instead of reinvesting in another offering, they are told the market will not absorb their

securities. If they try to sell the new securities, they are put off by promises of still greater profits. It is, of course, inevitable that there will also be a "last buyer" who will suffer financial loss when the manipulation collapses.

Certain patterns emerge in this process. These include: a thinly-traded market; control by one or only a few brokers who often have contacts with the promoter of the issuer; matched purchases and sales of the penny stocks effected to increase their prices; false or misleading press releases; high pressure "boiler-room" sales practices made by professionals and by young, inexperienced sales personnel; grossly inflated spreads and markups by the broker-dealers involved; and the dumping of the securities at inflated prices by the promoters or brokers who then move on to the next manipulation.

A dominated and controlled market results in enormous power to the broker-dealer in setting spreads and mark-ups. Because one main broker dominates and controls the market in a penny stock manipulation, it can establish a wide spread between its bid and ask prices without fear of competing prices from other brokers. For example, a broker-dealer firm may buy 20,000 shares at the bid price of 10 cents per share (\$2,000) from one customer, and sell to another customer at the ask price of 20 cents per share (\$4,000). The firm often gives 50 percent of the spread (\$1,000) to its registered representative. A similar \$4,000 trade at a typical wire house in a listed security would result in only a \$42 gross agency

commission with 30 percent or \$12.60 to the registered representative. In addition to excessive spreads, we have found that some penny stock brokers charge mark-ups well in excess of 100 percent over their contemporaneous costs -- and may even charge up to as high as 300 percent.

Boiler-Room Sales Operations

Recently a member of the Commission's staff, who regularly examines broker-dealers, recounted to me his observations of a firm engaged in a penny stock manipulation. What he told me was truly shocking.

Let me set the stage. The set-up is a large single office containing:

- numerous telephones and desks;
- an elevated platform where the sales managers and traders have desks, telephones, and maintain daily records of inventories and sales; and
- a blackboard containing names of securities, prices at which they are to be sold, and the commissions to be paid to the sales representatives.

The penny stock of the day being sold to customers has an inflated balance sheet and overly optimistic income projections. The company's products have been the subject of numerous news releases.

The cast of characters begins with middle-aged salesmen who have made a career of working for penny stock brokers. Also on the stage are younger sales personnel. These are young

men and women between 20 and 30 years old who have little background in the securities industry. Their most important assets are good telephone voices and a "gift of gab." Many have dropped out of college. They make \$5,000 to \$20,000 or more a month, own high priced cars, take expensive vacations, and live in luxurious surroundings. They are required to attend motivational meetings every morning, to work 12 hours a day, and to make 300 telephone calls a day. They are not permitted to leave their desks for lunch. They start the day with the attitude: "Let's go get 'em."

The persons they will call during the day are from all walks of life: young, old, doctors, lawyers, plumbers, businessmen, persons, retired people. Although telephone directories are good sources for names, lists of prospects are frequently purchased from various sources. Advertisements by brokers offering free information also result in numerous leads.

Our young salesperson is given certain guidelines:

1. Use first names: Mr. Jones -- may I call you John?
Please call me Marv.
2. Be aggressive:
 - (a) My firm is the fastest growing stock broker and investment banking firm in the country.
 - (b) John! Listen my clients double their money every six months. Some have even tripled their investments.

(c) If I could guarantee that you could double your money in three weeks what would you say?

3. Be specific:

(a) Look John this is a special situation. We have bought a large block of stock cheap which we are offering to our customers at 10 cents. The market is at the moment 12 cents, so for every \$10,000 you invest you are immediately up \$2,000.

(b) We expect the stock to go to 30 cents in the next six weeks. This means that you will make \$20,000 on your \$10,000 investment.

4. Close the sale: How many shares shall I reserve for your account? Shall we make it \$10,000 worth so that you can have that \$2,000 profit today and \$20,000 in a few weeks? Great!

What I have just described happens every day in the world of boiler-room penny stock manipulations. Over the past year, we have received indications that penny stock manipulations are increasing nationwide. Not only have the number of Commission enforcement actions and investigations concerning penny stock fraud and manipulation increased, but these activities are spreading geographically. They are no longer centered in Denver and its "sister" city of Salt Lake, where, unhappily, these problems have existed for many years. They are expanding

to other areas, including Miami, Seattle, Atlanta, Chicago, and Los Angeles.

The activities I have just described cannot be tolerated. They are aimed at investors who cannot afford to lose. And for the most part they are illegal. While the sale of "penny stock" by itself is not necessarily fraudulent, activities that often occur in connection with sales of penny stock may violate both the civil and criminal provisions of the federal securities laws. Specifically, the federal securities laws are violated by:

- making material misrepresentations regarding a company whose stock is being sold;
- failing to disclose that a market is dominated;
- representing that the price of a stock will double or triple in value;
- soliciting unsophisticated investors to buy unsuitable speculative securities;
- making recommendations about a stock without having a reasonable factual basis;
- concealing excessive markups of securities; and
- participating in a scheme to defraud.

In seeking to stem these practices, the Commission will not hesitate to bring proceedings against broker-dealers, registered representatives, attorneys, accountants, public relations firms, transfer agents, and others when their

activities as participants in the penny stock market violate the law.

Solutions

In the coming months, the Securities and Exchange Commission will be giving special attention to penny stock manipulations. We will be taking the steps within our power to combat penny stock fraud, and we will be urging other law enforcement authorities to do the same. We have already begun an active program, particularly in Denver and Miami.

-- In the last seven months, the Commission has halted trading in over 125 penny stocks listed in the pink sheets. These actions have alerted investors and brokers to questionable offerings. We will continue to halt trading when questionable stocks are being traded and we will monitor the activities of broker-dealers who enter the market after a suspension expires.

-- The Commission is actively examining the penny stock area and is bringing injunctive actions and administrative proceedings to attack fraud and market manipulation in the over-the-counter market. Thus far in 1988, the Commission has initiated more than 25 enforcement actions involving fraud or abuse in this market. 4/

4/ Since 1986, the Denver Regional Office has initiated more than thirty cases involving penny stock abuses.

-- In addition, this year new pink sheet price and volume reporting procedures are being initiated by the National Association of Securities Dealers, Inc. (NASD). These procedures will assist the Commission in monitoring and policing abuses in this segment of the market.

Despite substantive efforts already underway, it is clear that more needs to be done. I am asking members of the securities bar and the accounting profession, members of the public, the Justice Department, the NASD, state securities administrators, and the securities industry to join with the staff of the Securities and Exchange Commission in a vigorous effort to combat abuse in the penny stock market.

A task force on penny stock manipulation has been established within the Commission. Under the leadership of our Associate Director of Enforcement, Joseph Goldstein, and with significant input from our Regional Offices, the task force will identify regulatory solutions to the problems posed by penny stock manipulations.

From another perspective, we hope to educate investors regarding the dangers of penny stock fraud. We will urge all investors to investigate before investing in penny stocks. Investors should ask about commissions and mark-ups. They should ask for prospectuses. They should be wary of issuers that have no assets and no business plans. They should know that there is no easy profit to be made in the securities

markets and that promises of "free stock" or guaranteed profits are red flags warning them of unlawful conduct.

Over the last year, since last October's market break, there has been a well-publicized effort to examine trading mechanisms in the stock and futures markets in order to promote investor confidence. I believe the time has come to focus our attention on a segment of the market that has received less publicity and attention -- the over-the-counter market for low-priced securities quoted in the pink sheets. Investors who are abused in penny stock market frauds may lose confidence in the securities market. Money lost as a result of penny stock market abuse is money not invested in legitimate small businesses. Fraud and manipulation in this market needs to be stopped. I look forward to joining with you in this effort.