**PENNY STOCKS**

# What Are Penny Stocks?

Although definitions for penny stocks can vary, they are generally stocks offered by small companies at relatively low prices, usually under $5 per share.[[1]](#footnote-1) Additionally, many penny stocks have low liquidity, meaning it can be difficult to sell them once they have been purchased.[[2]](#footnote-2) Another common trait of penny stocks is that they are quoted “over-the-counter,” which means that they do not have to meet the more stringent requirements of the national stock exchanges.[[3]](#footnote-3) Many penny stocks are microcap stocks (See resources section).

The combination of these factors creates a high risk investment that is vulnerable to fraud and manipulation.

## Over the Counter

Any security that is not traded on a formal exchange is considered an over the counter (OTC) security or stock.[[4]](#footnote-4) Such stocks are traded directly between brokers, rather than through an exchange, and the price of the stock can be negotiable. Most OTC stocks are quoted by the OTC Bulletin Board (OTCBB) and/or the OTCMarkets Group (formerly the Pink Sheets).

The OTCBB requires that companies be registered with, and follow guidelines set by the Securities and Exchange Commission (SEC) in order to be listed.[[5]](#footnote-5)

OTCMarkets, on the other hand, does not require SEC registration, but does have different tiers representing the amount of information available to the public about a company.[[6]](#footnote-6) The higher tiers require following SEC guidelines, while the lower tiers such as OTC Pink do not have that requirement, and are riskier to trade.

Although stocks quoted on the OTCBB or the higher tiers of OTCMarkets are more trustworthy than those on OTC Pink or lower, it is important to do your own research before buying any OTC stock. Be aware that OTC stocks are generally risky investments due to the small size of the companies involved, the volatility of pricing, and the looser requirements.

# Penny Stock Scams

Penny Stocks are vulnerable to exploitation by scammers because they are traded without the strict requirements of the major stock exchanges. Additionally, a lack of public information is common with penny stocks, making it difficult to find out whether a stock is a good investment.

## Pump and Dump

One common scam that is associated with penny stocks is the “pump and dump.”[[7]](#footnote-7) With the pump and dump scam, a group of unscrupulous investors will by large amounts of penny stocks in a short period. They will then promote the stock using various means, to attract additional investors. The influx of investment drives the price of the stock up significantly. Once the price of the stock is high enough, the scammers then sell all their shares at a large profit. When they do this, however, the price of the stocks plummet so that later investors lose money.

Watch out for unsolicited contact urging you to buy penny stocks. These may be via email, telephone, mail, online forums, or other means. These can be used by fraudsters in order to falsely promote a company that is not really worth the current stock price.

Stay away from any businesses that claim that penny stocks are a sure way to make money, or that you will get rich trading penny stocks. Penny stocks are especially risky, so this kind of promotion is most likely driven by dishonest intent.

## Short and Distort

Another scam that penny stocks may be vulnerable to is the “short and distort” scam. In a short and distort scheme, the scammers make a short sale of penny stocks, getting paid for the stocks at their current price.[[8]](#footnote-8) Then, the scammers spread false or negative information about the stock in order to get other investors to sell, driving down the price. Once the price is down, the scammers buy back the stock they sold in the short sale, but at a lower price, meaning they make a profit. By spreading negative or false information in order to lower the price, the scammers have committed fraud.

A short sale occurs when a seller sells a number of stocks that they do not own, with the stipulation that they will later buy the same number of stocks. This can be done by a seller borrowing the stocks from a brokerage firm, selling them, but then later buying the same number of stocks and returning them to the firm.[[9]](#footnote-9) Short sales are legal, but using a short sale in conjunction with falsely spreading negative information is fraud.

## False Promises

While promotion of a company, either by other investors or by the company itself, is perfectly legal, it is fraud to make knowingly false statements about a company. In order to get you to invest your money into penny stocks, companies, investors, or even brokerages might entice you with promises of phenomenal returns, or assure you that the company’s product will make them the next Microsoft. Do not rely on any such promises, because there is no way to predict where a company will be in the next few years. If you are being pressured to buy with these kinds of promises, it is a sign that someone is desperate to get your money, or to drive the price of the stock up, and will go to any means to do it.

# Tips

## Understand the Risk

Many investment advisors say the best way to handle penny stocks is to avoid them altogether. The risk involved in penny stock trading is higher than in trading stocks on the major exchanges. It is not unreasonable to expect to lose your entire investment in penny stocks. This being said, not every penny stock trade is a scam, and some people have had success trading in penny stocks.

## Research Before Investing

Although there is more risk in trading penny stocks, you may still be interested in investing in them. If you do, be sure that you thoroughly research a stock before investing.

1. Start by checking the SEC’s Electronic Data Gathering, Analysis, and Retrieval system (EDGAR), at <http://www.sec.gov/edgar.shtml>. Many small companies are not required to register with the SEC, but do so in order to help publicize their stock. Just because a company is listed on EDGAR does not mean it is a good or trustworthy investment. Likewise, not every company that is not listed on EDGAR is a bad investment.
2. Contact the company that the stock is being issued for and request financial records and other information for investors. Ask for a prospectus. If a company is unable or unwilling to come up with any of this information, they are most likely either dishonest, or too unorganized to be a good investment.
3. Do research on the specific brokerage or seller offering to sell the penny stock. Consider contacting your state’s Attorney General’s office to find out if complaints have been filed against the seller.

## Be Cautious

If you feel like a deal is too good to be true, it most likely is. Do not invest money into penny stocks that you cannot afford to lose, because they are a risky investment. When investing, diversify by putting your money into various kinds of investments. If you are being pressured into buying penny stocks, walk away. High pressure tactics are most often employed by dishonest sellers.

# Resources

**Please consult the following resources for more information regarding penny stocks:**

* EDGAR – Use to find out if a particular company is registered with the SEC.

<http://www.sec.gov/edgar.shtml>

* Microcap Stock: A Guide for Investors, SEC, 2011

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

* Penny Stock Rules – The SEC’s summary of penny stocks with links to detailed rules.

<http://www.sec.gov/answers/penny.htm>

1. *Penny Stock Rules.* SEC. 2013. <http://www.sec.gov/answers/penny.htm> [↑](#footnote-ref-1)
2. *Id.* [↑](#footnote-ref-2)
3. *Penny Stock Definition.* Investopedia. 2013.<http://www.investopedia.com/terms/p/pennystock.asp#axzz1qZSI1umR> [↑](#footnote-ref-3)
4. *Over-the-Counter Definition.* Investopedia. 2013. <http://www.investopedia.com/terms/o/otc.asp> [↑](#footnote-ref-4)
5. *What is the OTC Stock Market,* Penny Stock Rumble. 2011. <http://www.pennystockrumble.com/penny-stocks/?p=1741> [↑](#footnote-ref-5)
6. *OTC Markets 101.* Securities Lawyer 101. 2013. <http://www.securitieslawyer101.com/otc-markets-go-public/> [↑](#footnote-ref-6)
7. Reeves, Jeff. *Beware of Penny Stock Scam Artists: Penny stocks and microcaps are a playground for crooks.* InvestorPlace. 2012. <http://investorplace.com/2012/07/beware-of-penny-stock-scam-artists/> [↑](#footnote-ref-7)
8. *Short and Distort Definition.* Investopedia. 2013.<http://www.investopedia.com/terms/s/shortanddistort.asp> [↑](#footnote-ref-8)
9. *Short Selling Definition.* Investopedia. 2013. <http://www.investopedia.com/university/shortselling/shortselling1.asp> [↑](#footnote-ref-9)