

## Investor Publications

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# 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 publicly-available information is scarce, fraudsters can easily spread false information about microcap companies, making profits while creating losses for unsuspecting investors. Even in the absence of fraud, microcap stocks historically have been more volatile and less liquid than the stock of larger companies.

Before you consider investing in a microcap company, arm yourself first with information. This Guide 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. A typical definition would be companies with a market capitalization of less than \$250 or \$300 million. The smallest public companies, with market capitalization of less than \$50 million, are sometimes referred to as 'nanocap stocks.' This guide will use the term 'microcap stock' to refer to both microcaps and nanocaps.

Microcap companies typically have limited assets and operations. 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, rather than on a national securities exchange such as the New York Stock Exchange or NASDAQ. They are quoted on OTC systems, such as the [OTC Bulletin Board \(OTCBB\)](#) or [OTC Link LLC \(OTC Link\)](#).

- **OTC Bulletin Board** The OTCBB is an electronic inter-dealer quotation system that displays quotes, last-sale prices, and volume information for many OTC equity securities that are not listed on a national securities exchange. Under the OTCBB's eligibility rule, companies that want to have their securities quoted on the OTCBB must seek sponsorship by a market maker firm that is a registered broker-dealer as well as file current financial reports with the SEC or with their banking or insurance regulator. The OTCBB operated by the Financial Industry Regulatory Authority (FINRA). The OTCBB is *not* part of The Nasdaq Stock Market. Fraudsters may claim that an OTCBB company is a Nasdaq company to mislead investors into thinking that the company is bigger than it is.
- **OTC Link LLC** OTC Link is an electronic inter-dealer quotation system that displays quotes, last-sale prices, and volume information in exchange-listed securities, OTC equity securities, foreign equity securities and certain corporate debt securities. In addition to publishing quotes, OTC Link provides, among other things, broker-dealer subscribers the ability to send

and receive trade messages, allowing them to negotiate trades. OTC Link is registered with the SEC as a broker-dealer and as an Alternative Trading System, and is a member of FINRA.

OTC Link organizes securities into three marketplaces based, in part, on the amount and quality of available information:

- OTCQB - includes the securities of companies that are current in their reporting to the SEC or a U.S. bank, thrift or insurance regulator;
- OTCQX - reserved for the securities of companies that are current in their reporting to the SEC or a U.S. bank, thrift or insurance regulator, or, in the case of companies that are not required to report to the SEC, meet and remain current in their reporting obligations to OTC Link under its proprietary Alternative Reporting Standard; meet certain eligibility requirements; have audited financial statements; and partner with a third-party securities attorney or investment bank that reviews disclosure and acts as a professional advisor; and
- OTC Pink - an open marketplace for a broad spectrum of equity securities, with no financial standards or reporting requirements.

### **How Are Microcap Stocks Different From Other Stocks?**

**Lack of Public Information** Often, the biggest difference between a microcap stock and other stocks is the amount of publicly available information about the company. Most large 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 on the Internet or in newspapers and other publications. In contrast, information about microcap companies can be extremely difficult to find, making them more vulnerable to investment fraud schemes and making it less likely that quoted prices in the market will be based on full and complete information about the company.

**No Minimum Listing Standards** Companies that trade their stocks on exchanges 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 OTC Link generally do not have to meet any minimum standards, although companies quoted in OTC Link's OTCQX marketplace are subject to initial and ongoing requirements and companies quoted in the OTCQB marketplace must be SEC reporting companies.

**Risk** While all investments involve risk, microcap stocks are among the most risky. Many microcap companies are new and have no proven track record. Some of these companies have no assets, operations, or revenues. 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 many 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 a class of the company's 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 2,000 or more investors or more than 500 investors that do not qualify as 'accredited investors,' and \$10 million or more in assets; or
- it lists its securities on any 'national securities exchange,'; or
- its securities are quoted on the OTCBB or in the OTCQB marketplace of OTC Link; or it has registered an offering of its securities under the Securities Act of 1933 and has more than 300 holders of record or more than 1,200 holders of record if a bank or bank holding company.

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

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

**Tip:** Tip: When an OTCBB company fails to file its reports on time, filed an incomplete filing or for those companies that file with a banking or insurance regulator, has not provided FINRA a copy of the report, FINRA will add a fifth letter "E" to the OTCBB trading 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 <http://www.otcbb.com/DailyListContent/delisting/OTCBBDelOpenReport.pdf>.

OTC Markets require companies to be current in their SEC or other regulatory disclosure to be quoted in the OTCQB marketplace. Companies must also be current in providing disclosure to be quoted in the OTCQX marketplace, though that requirement can be met by providing information in accordance with OTC Link's proprietary Alternative Reporting Standard rather than through filing with the SEC or a banking or insurance regulator. Companies quoted in the OTC Pink tier are assigned different symbols by OTC Markets, depending on whether they have provided "current" information, "limited" information or "no information." You can find the symbol currently assigned to a stock by OTC Markets and read more about the OTC Market marketplaces at [www.otcmarkets.com](http://www.otcmarkets.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](http://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. View [Researching Public Companies Through EDGAR: A Guide for Investors](#).

**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, or fewer than 2,000 shareholders of record - generally do not have to file reports with the SEC. But some smaller companies, including microcap companies, may choose voluntarily to file reports 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 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 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. Reg D also exempts some larger private offerings of securities that are sold exclusively to accredited investors and other sophisticated investors. In general, offerings under Reg D are not permitted to use the internet, broadcast media or other means of 'general solicitation and general advertising' to attract investors. In legislation enacted in 2012 called the 'JOBS Act,' Congress required the SEC to permit public advertising in Reg D offerings where securities are sold only to accredited investors and the issuer takes reasonable steps to verify that they are accredited. 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 [contact information](http://www.nasaa.org/about-us/contact-us/contact-your-regulator/) for your state securities regulator at <http://www.nasaa.org/about-us/contact-us/contact-your-regulator/>.
- **"Reg A"** 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 file a printed copy of an "offering circular" with the SEC containing financial statements and other information.

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 [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. Even in the absence of fraud, a lack of public information about a company can make investing in its stock more risky because the prices that are quoted for the stock are less likely to accurately reflect the risks and opportunities associated with the company and its business. In addition, stocks of such companies may trade only in small volumes.

Of potentially greater concern is that 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.

Fraud involving microcap stocks often depends on spreading false information. Here's how some fraudsters carry out their scams:

- **Email 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 [Tips for Online Investing: 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, e-mail messages, or high-end glossy mailers you may receive, touting a microcap company. The federal securities laws require the publications to disclose who paid them for the promotion, 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 - Know Your Rights](#).
- **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 interest they create. Once these fraudsters sell their shares and stop hyping the stock, the price typically falls, and investors lose 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 OffShore 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 and share the resulting profits with company insiders. The flow of unregistered stock into the U.S. eventually causes the price to drop, leaving unsuspecting U.S. investors with 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 provide you written information about the company and its business, finances, and management. Be sure to carefully read any 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 the SEC. 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 SEC's EDGAR database at <http://www.sec.gov/edgar.shtml>, you can find out whether a company files with the SEC and get any reports in which you're interested. For companies that do not file on EDGAR, use the SEC's [online form](https://www.sec.gov/cgi-bin/request_public_docs) at [https://www.sec.gov/cgi-bin/request\\_public\\_docs](https://www.sec.gov/cgi-bin/request_public_docs) or email the SEC's [Public Information Office](mailto:publicinfo@sec.gov) at [publicinfo@sec.gov](mailto:publicinfo@sec.gov) 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](http://www.nasaa.org/) at <http://www.nasaa.org/> 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.
- **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](http://www.ffiec.gov/nicpubweb/nicweb/nichome.aspx) site at [www.ffiec.gov/nicpubweb/nicweb/nichome.aspx](http://www.ffiec.gov/nicpubweb/nicweb/nichome.aspx), the [Office of the Comptroller of the Currency](http://www.octd.treas.gov) at [www.octd.treas.gov](http://www.octd.treas.gov), or the [Federal Deposit Insurance Corporation](http://www.fdic.gov) at [www.fdic.gov](http://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](http://www.nass.org) website at [www.nass.org](http://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 [submit a complaint](#) to the SEC at <http://www.sec.gov/complaint/select.shtml> 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 the SEC 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, ask your broker if she has any information on the company: she may have a 'Rule 15c2-11 file' containing basic facts about the company. However, in reviewing the Rule 15c2-11 file, it is also important to keep in mind that this information may have become inaccurate or out-of-date, and your broker is not responsible for ensuring that the information in the file remains accurate and timely.
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. FINRA maintains a [BrokerCheck website](#) at <http://www.finra.org/Investors/ToolsCalculators/BrokerCheck/index.htm> where you can check the professional background of individual brokers and firms, as well as investment adviser firms and representatives.

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. 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](#) at <http://www.sec.gov/complaint/callform.htm> to help you. You'll find these and other useful publications on the [Office of Investor Education and Advocacy](#) 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.
- **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 - Know Your Rights](#) and [The Fleecing of Foreign Investors: Avoid Getting Burned by "Hot" U.S. Stocks..](#)

### 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?
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](http://www.sec.gov/complaint/select.shtml) at <http://www.sec.gov/complaint/select.shtml>.

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.

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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