

## **MICROCAP FRAUD: The Underside of the Bull Market**

As we enter the new millennium, investors are still riding the wave of an active stock market and positive returns. Today's market promotes an environment where every investor feels he or she can make big returns. The investing public is confident that the next Microsoft or AOL is right around the corner, in its infancy waiting to be "nurtured" along. Such an attitude by investors can lead unscrupulous individuals to tout the stock of microcap companies in an effort to take advantage of this optimistic investing environment. The North American Securities Administrators Association estimates that investors lose over \$6 billion a year to investment fraud, including microcap schemes.

### **What is a Microcap Company?**

Microcap companies and their stocks are shares of 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. The stock of microcaps often trade on the OTC Bulletin Board, the Pink Sheets, or the Pink Sheet 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.

Microcap fraud usually takes one of two forms. The first- often known as the "pump and dump" scheme- involves fraudulent sales practices, including high pressure tactics from "boiler room" operations where a small army of sales personnel cold call potential investors using scripts to induce them to purchase house stocks (stocks which the firm makes a market in or has a large inventory). The information conveyed to investors often is at best exaggerated and at worst completely fabricated.

Fraudsters have moved to the internet hyping stocks through company web sites, bulletin boards, chat rooms, or on-line investment newsletters. The promoters of these companies, and often company insiders, typically hold large amounts of stock and make substantial profits when the stock price rises following intense promotional efforts. Once the price rises, the promoters, insiders and brokers sell, realizing their profits. The stock price eventually collapses after the hype ceases, which leaves the investors with worthless shares- hence the "pump and dump".

The second form of microcap fraud is a variation on the "pump and dump" scheme. Unscrupulous brokers often engage in "bait and switch" tactics, unauthorized trading, "no net sales" policies (where investors are discouraged or actually prevented from selling their stocks) and churning (excessive trading in their accounts in order to generate commissions for the broker). Either form has the same result- an investor with an enormous loss, and a broker with a fat wallet.

Microcaps and the possibility of fraud involved with them are probably best detected through a prospectus. If the stock being touted is a recent public offering, ask to see the prospectus or other up-to-date information before you invest. Read these documents carefully. A prospectus must be filed with the Securities and Exchange Commission ("SEC") and/or the Arizona

Securities Division. The unavailability of a prospectus should be a major red flag.

The prospectus can be revealing, and the following are some areas to look at:

- **SEC Trading Suspensions and State Regulatory Actions.** 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. Similarly, the Arizona Securities Division will take action against a company it believes to be violating the Securities or Investment Adviser Acts. Information about stock and broker-dealers registered in Arizona can be found by calling the Division or through its web site. Investor can also check with the SEC and National Association of Securities Dealers (“NASD”) for suspensions and enforcement actions against firms.
- **Assets are Large but Revenues are Small.** Some microcap companies 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 the company stock which 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 Amount of the Stock.** A characteristic of many “pump and dump” fraud cases is where insiders own a significantly large portion of the stock. Stock concentrated in the hands of one or a small group of people can lead to manipulation of the stock’s price at the expense of subsequent investors.

In addition to requesting and reviewing a prospectus, avoiding microcap fraud involves taking several precautionary steps. Investors can protect themselves against microcap fraud by doing the following:

- ***Beware*** of high pressure, unsolicited phone calls, a key tool in the touting of fraudulent investment schemes. 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 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 not be who he says he is or providing accurate information.
- ***Question microcap sales pitch*** featuring the name of reputable “clearing” broker –dealers.

These firms merely service microcap transactions. They do not guarantee or vouch for such offerings.

- ***Check out the broker.*** The Arizona Securities Division can help. Ask a broker for their CRD number and, before you actually put your money into the company, call the Arizona Securities Division at **602-542-4242** or toll free, **1-866-VERIFY-9** (outside metro Phoenix and Arizona) to find out if the broker has a disciplinary record. A simple inquiry into whether the person and firm touting the investment are licensed in Arizona can speak volumes.

If you have questions concerning a microcap security or salesperson or promoter selling a microcap security, call or write the Arizona Securities Division at **602-542-4242**. You can also visit the Division web site at **[www.azinvestor.gov](http://www.azinvestor.gov)**.

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