

Penny stock

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Penny stocks, also known as **cent stocks** in some countries, are common shares of small public companies that trade at low prices per share. In the United States, the SEC defines a penny stock as a security that trades below $5 per share, is not listed on a national exchange, and fails to meet other specific criteria.[1] In the United Kingdom, stocks priced under £1 are called **penny shares**. In the case of many penny stocks, low market price inevitably leads to low market capitalization. Such stocks can be highly volatile and subject to manipulation by stock promoters and pump and dump schemes. Such stocks present a high risk for investors, who are often lured by the hope of large and quick profits. Penny stocks in the USA are often traded over-the-counter on the OTC Bulletin Board, or Pink Sheets.[2] In the United States, the Securities and Exchange Commission and the Financial Industry Regulatory Authority (FINRA) have specific rules to define and regulate the sale of penny stocks.

Contents

Concerns for investors

Many penny stocks, particularly those that trade for fractions of a cent, are thinly traded. They can become the target of stock promoters and manipulators.[3] These manipulators first purchase large quantities of stock, then artificially inflate the share price through false and misleading positive statements. This is referred to as a "pump and dump"[4] scheme. The pump and dump is a form of microcap stock fraud. In more sophisticated versions of the fraud, individuals or organizations buy millions of shares, then use newsletter websites, chat rooms, stock message boards, fake press releases, or e-mail blasts to drive up interest in the stock.[5] Very often, the perpetrator will claim to have "inside" information about impending news to persuade the unwitting investor to quickly buy the shares. When buying pressure pushes the share price up, the rise in price entices more people to believe the hype and to buy shares as well. Eventually the manipulators doing the "pumping" end up "dumping" when they sell their holdings.[6] The expanding use of the Internet and personal communication devices has made penny stock scams easier to perpetrate.[7]

Notable cases

One notable example is rapper 50 Cent's use of Twitter to cause the price of a penny stock (HNHI) to increase dramatically. 50 Cent had previously invested in 30 million shares of the company, and as a result made $8.7 million in profit.[8] Another example of an activity that skirts the borderline between legitimate promotion and hype is the case of LEXG. Lithium Exploration Group's market capitalization soared to over $350 million after an extensive direct mail campaign. The promotion drew upon the legitimate growth in production and use of lithium, while touting Lithium Exploration Group's position within that sector. According to the company's December 31, 2010 form 10-Q (filed within months of the direct mail promotion), LEXG was a lithium company without assets. Its revenues and assets at that time were zero.[9][10] Subsequently, the company did acquire lithium production/exploration properties, and addressed concerns raised in the press.[11] Penny stocks are not always purchased by manipulators and promoters, they can be given by the company as another way of payment to promote the ticker. The ticker is the stock abbreviation that allows ease of access to market operators, investors, etc. The "pump and dump" tactic is also known as a supernova and, unlike regular stocks, penny stocks usually move on momentum of the price action. Penny stocks are known to be volatile not only because the margin between the "buy" and "sell" price but how the SEC (Security Exchange Commission) regulates the stock as well. For example, if a stock's price spikes up too fast it can be halted by the SEC for further investigations before it becomes available again. Even with SEC halt, the stock can still move up or down trend and the people who invest in it would have no control over their shares until the company is released to the public again by the SEC.

Regulation

In the United States, regulators have defined a penny stock as a security that must meet a number of specific standards. The criteria include price, market capitalization, and minimum shareholder equity. Securities traded on a national stock exchange, regardless of price, are exempt from regulatory designation as a penny stock,[12] since it is thought that exchange traded securities are less vulnerable to manipulation.[13] Therefore, Citigroup (NYSE:C) and other NYSE listed securities which traded below $1.00 during the market downturn of 2008-2009, while properly regarded as "low priced" securities, were not technically "penny stocks". Although penny stock trading in the United States is now primarily controlled through rules and regulations enforced by the Securities and Exchange Commission and FINRA, the genesis of this control is found in State securities law. The State of Georgia was the first state to codify a comprehensive penny stock securities law.[14] Secretary of State Max Cleland, whose office enforced State securities laws[15] was a principal proponent of the legislation. Representative Chesley V. Morton, the only stockbroker in the Georgia General Assembly at the time, was principal sponsor of the bill in the House of Representatives. Georgia's penny stock law was subsequently challenged in court. However, the law was eventually upheld in U.S. District Court,[16] and the statute became the template for laws enacted in other states. Shortly thereafter, both FINRA and the SEC enacted comprehensive revisions of their penny stock regulations. These regulations proved effective in either closing or greatly restricting broker/dealers, such as Blinder, Robinson & Company, which specialized in the penny stocks sector. Meyer Blinder was jailed for securities fraud in 1992, after the collapse of his firm.[17] However, sanctions under these specific regulations lack an effective means to address pump and dump schemes perpetrated by unregistered groups and individuals.

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External links

- The Lowdown on Penny Stocks (http://www.nasdaq.com/investing/lowdown-on-penny-stocks.stm)
- Penny Stock Rules (https://www.sec.gov/answers/penny.htm) by SEC.gov

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