



UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549

February 3, 1989

The Honorable John D. Dingell
Chairman, House Committee on Energy and Commerce
2125 Rayburn House Office Building
Washington, D.C. 20515

Dear Chairman Dingell:

At the hearing before the House Committee on Energy and Commerce on December 20, 1988, regarding the Securities and Exchange Commission's Staff Study on Self-Funding, you asked for information on market manipulation in the "penny stock" market. The Commission has begun to mobilize its efforts to protect small investors from penny stock fraud and manipulation and I am pleased to enclose materials describing some of our initiatives.

"Penny stocks" are low-priced securities traded over-the-counter. These securities are frequently those of a "shell" company which has no operating history, few employees, few assets, and, in many cases, no legitimate prospects for business success. Penny stocks are often traded in a market subject to domination and control by a single market maker. Penny stock fraud may occur either when the proceeds of the initial sale of penny stocks are diverted to the promoters, or when the penny stocks are utilized in artificial schemes designed to manipulate their prices.

The Commission is concerned that penny stock frauds are increasing and spreading geographically. These activities are no longer centered in the Rocky Mountain area, where these problems have existed for a number of years. With the growth of new technology and less expensive long distance telephone costs, manipulators of penny stocks are now able to operate nationwide. Commission investigations and enforcement actions relating to fraudulent penny stock schemes have expanded to other areas of the country, including Miami, Atlanta, Seattle, Chicago, Los Angeles, and parts of the Northeast.

The Commission's broker-dealer examination program has uncovered strong evidence that broker-dealer misconduct in penny stocks is continuing. In the summer of 1988, the Commission's broker-dealer examination program undertook a special sweep of examinations targeted at penny stock firms. Of the 17 examinations initially done, 14 resulted in enforcement referrals. Possible violations uncovered included abusive distribution and trading of blank check offerings, excessive undisclosed markups, parking securities in nominee accounts, failure to supervise securities salespersons, and selling by unregistered salespersons. The Commission's broker-dealer examination program will continue to target penny stock firms this year.

In recent years, the Commission has initiated a number of injunctive actions and administrative proceedings against individuals involved in a wide array of misconduct in connection with the penny stock market. In 1988, the Commission initiated more than 25 enforcement actions involving fraud or abuse in the penny stock market. Since 1986, the Denver Regional Office alone has initiated more than thirty cases involving penny stock abuse. In addition, in 1988 the Commission suspended over-the-counter trading in well over 100 penny stocks.

In the fall of 1988, the Commission formed a Task Force on Penny Stock Manipulation under the leadership of Joseph I. Goldstein, an Associate Director of the Commission's Division of Enforcement. The Task Force includes representatives of each of the Commission's operating divisions as well as representatives of the Commission's regional offices. The purpose of the Task Force is to identify the problems posed by penny stock manipulation, to consider regulatory solutions to those problems, and to consider how to educate investors regarding the dangers of penny stock fraud. The Task Force is also concerned with seeking to improve coordination and information-sharing with other law enforcement agencies in order to strengthen the Commission's regulatory and enforcement programs.

One aspect of the Task Force's work involves consideration of regulations designed to prevent fraud in this market. The Task Force has found that one of the key ingredients in fraudulent penny stock schemes is the use of high pressure and misleading sales practices by broker-dealers. High pressure unsolicited telephone calls to unsophisticated small investors appear to be the primary means used by penny stock firms to locate new customers. The Commission is in the process of proposing a rule designed to deal with this problem, and hopefully will consider that rule within the next few weeks.

The Task Force also has focused on increasing investor awareness of fraudulent penny stock schemes. One of the Task Force's efforts in this area has involved writing and distributing a flyer entitled Beware of Penny Stock Fraud!, which sets forth warning signs of penny stock fraud, provides basic information about penny stocks, and provides guidance on steps investors should take before making penny stock investments. This flyer has been published as part of the Commission's "Information to Investors" series and is routinely being sent to persons writing or calling the Commission with complaints relating to penny stock fraud. In addition, the Commission's Regional Administrators have sought the assistance of banks and utility companies in their localities, asking them to include the flyer with their monthly billing or income statements. Also, the Commission's Director of Public Affairs has written various publications -- particularly those directed at elderly persons who are frequently victims of this fraud -- asking them for assistance in publicizing the problems of penny stock fraud. Materials describing some of the Task Force's initiatives in this area are enclosed at Tab A.

In the enforcement area, Commission staff have increasingly been involved in joint investigations of fraudulent penny stock schemes with other law enforcement agencies. Of particular interest is the recent thirty-six count indictment announced in Salt Lake City on January 18, 1989, relating to manipulation in the securities of Protecto Industries, a shell corporation. This indictment involved the joint efforts of the U.S. Attorney for the State of Utah, the Federal Bureau of Investigation (FBI), and the Commission's Salt Lake and Denver offices. The press release relating to this joint operation is enclosed at Tab B.

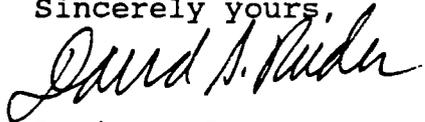
Other enforcement-related activities involve meetings that the Task Force has arranged to promote cooperation and coordination of law enforcement efforts among the various local, state and federal regulatory and law enforcement authorities. Gary Lynch, Director of our Enforcement Division, has met with FBI Director William Sessions and with Attorney General Richard Thornburgh, both of whom have agreed to cooperate in pursuing penny stock fraud manipulations. Meetings have also been held or are scheduled with the National Association of Securities Dealers, Inc., with representatives of the North American Association of State Securities Administrators, and with state regulatory authorities in a variety of locations throughout the country. The Commission's Miami Branch Office has organized a Florida Penny Stock Task Force that includes representatives of the Internal Revenue Service, the FBI, state securities

authorities, and the U.S. Attorney's Office. The Commission's staff also has conducted training for FBI agents and has held a non-public conference for international securities enforcement officials who are investigating or prosecuting cases against Tommy Quinn, an American who is alleged to have engaged in international penny stock manipulation. Information describing these activities is enclosed at Tab C.

Finally, included for your information are copies of newspaper and magazine articles discussing the penny stock fraud problem generally and the Commission's efforts to combat penny stock fraud. These are enclosed at Tab D.

We will continue to pursue penny stock fraud actively and would be pleased to cooperate with you and your staff in addressing this issue.

Sincerely yours,

A handwritten signature in cursive script that reads "David S. Ruder".

David S. Ruder
Chairman

Enclosures