

IMPORTANT INFORMATION ON PENNY STOCKS

This statement is required by the U.S. Securities and Exchange Commission (SEC) and contains important information on penny stocks. You are urged to read it before making a purchase or sale.

Penny stocks can be very risky.

- Penny stocks are low-priced shares of small companies not traded on an exchange or quoted on NASDAQ. Prices often are not available. Investors in penny stocks often are unable to sell stock back to the dealer that sold them the stock. Thus, you may lose your investment. Be cautious of newly issued penny stock.
- Your salesperson is not an impartial advisor but is paid to sell you the stock. Do not rely only on the salesperson, but seek outside advice before you buy any stock. If you have problems with a salespersons, contact the firm's compliance officer or the regulators listed below.

Information you should get.

- <u>Before you buy penny stock,</u> [effective January 1, 1993] federal law requires your salesperson to tell you the "<u>offer</u>" and the "<u>bid</u>" on the stock, and the "<u>compensation</u>" the salesperson and the firm receive for the trade. The firm also must mail a confirmation of these prices to you after the trade.
- You will need this price information to determine what profit, if any, you will have when you sell your stock. The offer price is the wholesale price at which the dealer is willing to sell stock to other dealers. The bid price is the wholesale price at which the dealer is willing to buy the stock from other dealers. In its trade with you, the dealer may add a retail charge to these wholesale prices as compensation (called a "markup" or "mark-down").
- The difference between the bid and the offer price is the dealer's "spread." A spread that is large compared with the purchase price can make a resale of a stock very costly. To be profitable when you sell, the bid price of your stock must rise above the amount of this spread <u>and</u> the compensation charged by both your selling and purchasing dealers. If the dealer has no bid price, you may not be able to sell the stock after you buy it, and may lose your whole investment.

Brokers' duties and customer rights and remedies.

• If you are a victim of fraud, you may have rights and remedies under state and federal law. You can get the disciplinary history of a salesperson or firm from the NASD at 1-800-289-9999, and additional information from your state securities official, at the North American Securities Administrators Association's central number: (202) 737-0900. You also may contact the SEC with complaints at (202) 272-7440.

FURTHER INFORMATION

THE SECURITIES BEING SOLD TO YOU HAVE NOT BEEN APPROVED OR DISAPPROVED BY THE SECURITIES AND EXCHANGE COMMISSION. MOREOVER, THE SECURITIES AND EXCHANGE COMMISSION HAS NOT PASSED UPON THE FAIRNESS OR THE MERITS OF THIS TRANSACTION NOR UPON THE ACCURACY OR ADEQUACY OF THE INFORMATION CONTAINED IN ANY PROSPECTUS OR ANY OTHER INFORMATION PROVIDED BY AN ISSUER OR A BROKER OR DEALER.

Generally, penny stock is a security that:

- Is priced under five dollars;
- Is <u>not</u> traded on a national stock exchange or on NASDAQ (the NASD's automated quotation system for actively traded stocks);
- May be listed in the "pink sheets" or the NASD OTC Bulletin Board;
- Is issued by a company that has less than \$5 million in net tangible assets and has been in business less than three years, by a company that has under \$2 million in net tangible assets and has been in business for at least three years, or by a company that has revenues of \$6 million for 3 years.

Use caution when investing in penny stocks:

- 1. <u>Do not make a hurried investment decision.</u> High-pressure sales techniques can be a warning sign of fraud. The salesperson is not an impartial advisor, but is paid for selling stock to you. The salesperson also does not have to watch your investment for you. Thus, you should think over the offer and seek outside advice. Check to see if the information given by the salesperson differs from other information you may have. Also, it is illegal for salespersons to promise that a stock will increase in value or is risk free, or to guarantee against loss. If you think there is a problem, ask to speak with a compliance official at the firm, and, if necessary, any of the regulators referred to in this statement.
- **2.** Study the company issuing the stock. Be wary of companies that have no operating history, few assets, or no defined business purpose. These may be sham or "shell" corporations. Read the prospectus for the company carefully before you invest. Some dealers fraudulently solicit investors' money to buy stock in sham companies, artificially inflate the stock prices, then cash in their profits before public investors can sell their stock.
- 3. <u>Understand the risky nature of these stocks.</u> You should be aware that you may lose part or all of your investment. Because of large dealer spreads, you will not be able to sell the stock immediately back to the dealer at the same price it sold the stock to you. In some cases, the stock may fall quickly in value. New companies, whose stock is sold in an "initial public offering," often are riskier investments. Try to find out if the shares the salesperson wants to sell you are part of such an offering. Your salesperson must give you a "prospectus" in an initial public offering, but the financial condition shown in the prospectus of new companies can change very quickly.

- 4. Know the brokerage firm and the salesperson with whom you are dealing. Because of the nature of the market for penny stock, you may have to rely solely on the original brokerage firm that sold you the stock for prices and to buy the stock back from you. Ask the National Association of Securities Dealers, Inc. (NASD) or your state securities regulator, which is a member of the North American Securities Administrators Associations, Inc. (NASAA), about the licensing and disciplinary record of the brokerage firm and the salesperson contacting you. The telephone numbers of the NASD and NASAA are listed on the first page of this document.
- 5. <u>Be cautious if your salesperson leaves the firm.</u> If the salesperson who sold you the stock leaves his or her firm, the firm may reassign your account to a new salesperson. If you have problems, ask to speak to the firm's branch office manager or a compliance officer. Although the departing salesperson may ask you to transfer your stock to his or her new firm, you do not have to do so. Get information on the new firm. Be wary of requests to sell your securities when the salesperson transfers to a new firm. Also you have the right to get your stock certificate from your selling firm. You do not have to leave the certificate with that firm or any other firm.

YOUR RIGHTS

<u>Disclosures to you.</u> Under penalty of federal law, [effective January 1, 1993] your brokerage firm must tell you the following information at two different times -- <u>before</u> you agree to buy or sell a penny stock, and after the trade, by <u>written confirmation.</u>

• The bid and offer price quotes for penny stock and the number of shares to which the quoted prices apply. The bid and offer quotes are the wholesale prices at which dealers trade among themselves. These prices give you an idea of the market value of the stock. The dealer must tell you these price quotes if they appear on an automated quotation system approved by the SEC. If not, the dealer must use its own quotes or trade prices. You should calculate the spread, the difference between the bid and offer quotes, to help decide if buying the stock is a good investment.

A lack of quotes may mean that the market among dealers is not active. It thus may be difficult to resell the stock. You also should be aware that the actual price charged to you for the stock may differ from the price quoted to you for 100 shares. You should therefore determine, before you agree to a purchase, what the actual sales price (before the **markup**) will be for the exact number of shares you want to buy.

- <u>The brokerage firm's compensation for the trade.</u> A <u>markup</u> is the amount a dealer adds to the wholesale offer price of the stock and a <u>markdown</u> is the amount it subtracts from the wholesale bid price of the stock as <u>compensation</u>. A markup/markdown usually serves the same role as a broker's commission on a trade. Most of the firms in the penny stock market will be dealers, not brokers.
- <u>The compensation received by the brokerage firm's salesperson for the trade.</u> The brokerage firm must disclose to you, as a total sum, the cash compensation of your salesperson for the trade that is known at the time of the trade. The firm must describe in the written confirmation the nature of any other compensation of your salesperson that is unknown at the time of the trade.

In addition to the items listed above, your brokerage firm must send to you:

- Monthly account statements. In general, [effective January 1, 1993] your brokerage firm must send you a monthly statement that gives an estimate of the value of each penny stock in your account, if there is enough information to make an estimate. If the firm has not bought or sold any penny stocks for your account for six months, it can provide these statements every three months.
- A Written Statement of Your Financial Situation and Investment Goals. In general, unless you have had an account with your brokerage firm for more than one year, or you have previously bought three different penny stocks from the firm, your brokerage firm must send you a written statement for you to sign that accurately describes your financial situation, your investment experience, and your investment goals, and that contains a statement of why your firm decided that penny stocks are a suitable investment for you. The firm also must get your written consent to buy the penny stock.

<u>Legal remedies.</u> If penny stocks are sold to you in violation of your rights listed above, or other federal or state securities laws, you may be able to cancel your purchase and get your money back. If the stocks are sold in a fraudulent manner, you may be able to sue the persons and firms that

caused the fraud for damages. If you have signed an arbitration agreement, however, you may have to pursue your claim through arbitration. You may wish to contact an attorney. The SEC is not authorized to represent individuals in private litigation.

However, to protect yourself and other investors, you should report any violations of your brokerage firms' duties listed above and other securities laws to the SEC, the NASD, or your state securities administrator at the telephone numbers on the first page of this document. These bodies have the power to stop fraudulent and abusive activity of salespersons and firms engaged in the securities business. Or you can write to the SEC at 450 Fifth St., N.W., Washington, D.C. 20549; the NASD at 1735 K Street, N.W., Washington, D.C. 20006; or NASAA at 555 New Jersey Avenue, N.W., Suite 750, Washington, D.C. 20001. NASAA will give you the telephone number of your state's securities agency. If there is any disciplinary record of a person or firm, the NASD, NASAA, or your state securities regulator will send you this information if you ask for it.

MARKET INFORMATION

<u>The market for penny stocks.</u> Penny stocks usually are not listed on an exchange or quoted on the NASDAQ system. Instead, they are traded between dealers on the telephone in the "over-the-counter" market. The NASD's OTC Bulletin Board also will contain information on some penny stocks. At times, however, price information for these stocks is not publicly available.

<u>Market domination.</u> In some cases, only one or two dealers, acting as "market makers," may be buying and selling a given stock. You should first ask if a firm is acting as a <u>broker</u> (your agent) or as a dealer. A <u>dealer</u> buys stock itself to fill your order or already owns the stock. A <u>market maker</u> is a dealer who holds itself out as ready to buy and sell stock on a regular basis. If the firm is a market maker, ask how many other market makers are dealing in the stock to see if the firm (or group of firms) dominates the market. When there are only one or two market makers, there is a risk that the dealer or group of dealers may control the market in that stock and set prices that are not based on competitive forces. In recent years, some market makers have created fraudulent markets in certain penny stocks, so that stock prices rose suddenly, but collapsed just as quickly, at a loss to investors.

<u>Mark-ups and mark-downs.</u> The actual price that the customer pays usually includes the mark-up or mark-down. Markups and markdowns are direct profits for the firm and its salespeople, so you should be aware of such amounts to assess the overall value of the trade.

The "spread." The difference between the bid and offer price is the spread. Like a mark-up or mark-down, the spread is another source of profit for the brokerage firm and compensates the firm for the risk of owning the stock. A large spread can make a trade very expensive to an investor. For some penny stocks, the spread between the bid and the offer price may be a large part of the purchase price of the stock. Where the bid price is much lower than the offer price, the market value of the stock must rise substantially before the stock can be sold at a profit. Moreover, an investor may experience substantial losses if the stock must be sold immediately.

Example: If the bid is \$0.04 per share and the offer is \$0.10 per share, the spread (difference) is \$0.06, which appears to be a small amount. But you would lose \$0.06 on every share that you bought for \$0.10 if you had to sell that stock immediately to the same firm. If you had invested \$5,000 at the \$0.10 offer price, the market maker's repurchase price, at \$0.04 bid, would be only \$2,000; thus would lose \$3,000, or more than half of your investment, if you decided to sell the stock. In addition, you would have to pay compensation (a "mark-up, "mark-down" or commission) to buy and sell the stock.

<u>In addition to the amount of the spread</u>, the price of your stock must rise enough to make up for the compensation that the dealer charged you when it first sold you the stock. Then, when you want to resell the stock, a dealer again will charge compensation, in the form of a markdown. The dealer subtracts the markdown from the price of the stock when it buys the stock from you. Thus, to make profit, the bid price of your stock must rise above the amount of the original spread, the markup, and the markdown.

<u>Primary offerings.</u> Most penny stocks are sold to the public on an ongoing basis. However, dealers sometimes sell these stocks in initial public offerings. You should pay special attention to stocks

of companies that have never been offered to the public before, because the market for these stocks is untested. Because the offering is on a first-time basis, there is generally no market

information about the stock to help determine its value. The federal securities laws generally require broker-dealers to give investors a "prospectus," which contains information about the objectives, management, and financial condition of the issuer. In the absence of market information, investors should read the company's prospectus with special care to find out if the stocks are a good investment. However, the prospectus is only a description of the current condition of the company. The outlook of the start-up companies described in a prospectus often is very uncertain.

<u>For more information about penny stocks</u>, contact the Office of Filings, Information, and Consumer Services of the U.S. Securities and Exchange Commission, 450 Fifth Street, N.W., Washington D.C. 20549, (202) 272-7440.

REQUIREMENTS FOR TRANSACTIONS IN PENNY STOCKS

A. Background

In 1989, the SEC adopted Rule 15c2-6 under the 1934 Act. Referred to as the "Cold Calling Rule", Rule 15c2-6 was intended to prevent the use of fraudulent, high pressure telephone sales campaigns to sell low price securities to unsophisticated investors. In 1990, Congress passed the Securities Enforcement Remedies and Penny Stock Reform Act of 1990 ("Penny Stock Reform Act"), which mandated that the SEC adopt rules requiring brokers to provide customers with certain trade and market information prior to effecting a transaction in a penny stock. Pursuant to the authority given to it in the Penny Stock Reform Act, the SEC amended Rule 15c2-6, redesignated it as Rule 15g-9, and adopted several other rules which are meant to assist in the prevention of fraud in the sale of low-priced/over-the-counter securities ("penny stocks").

B. Definition of Penny Stock (Rule 3a51-1)

A "penny stock" is defined as any equity security not in one of the categories specifically excluded by Section 3(a)(51)(A) of the 1934 Act or SEC Rule 3a51-1. The following categories are excluded from being designated as penny stocks:

- 1. reported equity securities such as those listed on the NYSE, most securities listed on the AMEX and regional exchanges as well as those authorized for quotation on NASDAQ;*
 - 2. shares of mutual funds;
 - 3. put or call options issued by the Options Clearing Corp.
 - 4. securities priced at five dollars or more;**
- 5. securities subject to last sale reporting and (a) registered on a national securities exchange and purchased or sold in a transaction executed on the exchange or (b) authorized for quotation on NASDAQ;
- 6. any security whose issuer has (a) net tangible assets in excess of \$2 million if the issuer has been in continuous operation for three years, (b) net tangible assets in excess of \$5 million if the issuer has been in continuous operation less than three years, or (c) average revenues of at least \$6 million for the last 3 years (ie., total revenue of at least \$18 million for the three year period.)

^{*} A reported security is defined in SEC Rule 11Aa3-1(a) as any exchange listed or NASDAQ security for which transaction reports are required to be made on a real time basis pursuant to an effective transaction reporting plan.

^{**} In most cases the price of the security will be determined by the price at which a security is purchased or sold in a particular transaction, excluding any commission, markup or markdown.

C. <u>Transactional Exemptions</u> (Rule 15g-1)

Besides creating classes of securities that are not subject to the penny stock reporting and disclosure requirements, the SEC has created exemptions from the requirements in Rules 15g-2 through 15g-6 and Rule 15g-9 for certain transactions in securities which normally would qualify as penny stocks. The following transactions are exempt from Rules 15g-2 through 15g-6 and Rule 15g-9:

- 1. any penny stock transaction by a broker dealer whose commissions, commission equivalents, mark-ups and mark-downs from penny stock transactions during each of the last three months and during eleven or more of the preceding twelve months (or during the immediately preceding six months) did not exceed five percent of its total commission equivalents from transactions in securities in those months, <u>and</u> who has not been a market maker in the penny stock that is the subject of the transaction for the last twelve months;
 - 2. transactions in which the investor is an institutional accredited investor;
- 3. transactions that qualify for an exemption under Regulation D or Section 4(2) of the 1933 Act;***
- 4. transactions in which the customer is the issuer or a director, officer, general partner, or 5% shareholder of the issuer that is the subject of the transaction; and,
 - 5. transactions not recommended by the broker-dealer.****

D. Schedule 15G Risk Disclosure Document (Rule 15g-2)

It is unlawful for a broker-dealer to effect a transaction in a penny stock with to for the account of a customer unless the broker-dealers distributes a risk disclosure document to the customer prior to effecting the customer's first transaction in a penny stock. The required risk disclosure document (which is set forth in Schedule 15G, and included at the end of this section) discloses certain risks associated with investment in penny stocks, describes the penny stock market, provides a brief description of a broker-dealer's obligations under the Penny Stock rules and informs customers generally of certain of their rights and remedies under the federal securities laws.

Broker-dealers are also required to obtain a signed and dated acknowledgement from a customer demonstration that the customer has actually received the required risk disclosure document prior to his or her first transaction in a penny stock. A broker-dealer is required to maintain a copy of the customer's written acknowledgement for at least three years following the date on which the risk disclosure document was provided to the customer, the first two year of which must be in an easily accessible place.

^{***} regulation D offerings under Rule 504, 505, and 506 are exempt from Rules 15g-1 through 15g-6. Offerings under Rules 505 and 506 are exempt from Rule 15g-9, while offerings under Rule 504 must comply with Rule 15g-9.

^{****} Transactions not recommended by the broker dealer is a broader term than unsolicited transactions, and thus unsolicited can still be subject to the penny stock disclosure requirements.

E. <u>Disclosure of Quotations and Other Information Relating to the Penny Stock Market</u> (Rule 15g-3)

Prior to effecting a transaction in a penny stock, a broker-dealer must disclose to its customers, either orally or in writing, the inside bid and ask quotation for the penny stock and the number of shares to which such bid and ask quotations apply. The information must also be given or sent to the customers in writing at or prior to the time the customer receives a written confirmation. If current quotation prices are not available, the broker-dealer must provide customers with other similar market information relating to the prices of the penny stock. The rule sets forth the different procedures for the disclosure of quotations in principal transactions, on the one hand, and agency and riskless principal transactions, on the other.

In a transaction effected with a customer on a principal basis, the dealer must disclose its offer price if: (1) during the last five days the dealer has effected at least three bona fide sales to the other dealers at its offer price for the security at the time of the sales; and, (2) the dealer reasonably believes in good faith at the time of the transaction that its offer price accurately reflects the price at which it would be willing to sell a round lot to another dealer. The dealer must disclose its bid price if (1) during the last five days the dealer has effected at least three bona fide purchases from other dealers at its bid price at the time of the purchases; and, (2) the dealer reasonably believes in good faith at the time of the transaction that its bid price accurately reflects the price at which it would be willing to buy a round lot from another dealer. If the criteria above can not be met, the dealer must disclose to its customers the price at which it last purchased or sold the stock in a bona fide transaction with another dealer, and the fact that it has not effected inter-dealer purchases or sales of the penny stock consistently at its bid or offer price.

In a transaction executed with a customer on an agency or riskless principal basis (if not a market maker), the broker-dealer must disclose the best independent inter-dealer bid and offer prices, as represented by the quotations of at least of at least three market makers, or by all market makers if there are less than three.

F. <u>Disclosure to Customers of Compensation Earned by the Broker-Dealer and Salesperson</u> (Rule 15g-4 and 15g-5)

Prior to effecting a transaction in a penny stock, a broker-dealer must provide the customer, either orally or in writing, with a description of the aggregate amount of compensation (ie., commission or commission equivalent) that the broker-dealer and any salesperson associated with the broker-dealer has received. The information also must be provided to the customer in writing at or prior to the time the written confirmation is sent to the customer. If a portion of the salesperson's compensation is based on sales volume levels or other contingencies, the customer must be advised of the basis upon which the compensation is calculated in the written notice described above.

G. Account Statements for Penny Stocks (Rule 15g-6)

A broker-dealer that has sold penny stocks to a customer must furnish a monthly account statement to the customers (unless one of the exemptions in the rule applies) which discloses the identity and total number of shares of each penny stock held in the customer's account and the estimated market value of those securities. In addition, the statement must contain a conspicuous

legend that is identified with the penny stocks listed in the statement that contains the following language:

IF THIS STATEMENT CONTAINS AN ESTIMATED VALUE, YOU SHOULD BE AWARE THAT THIS VALUE MAY BE BASED ON A LIMITED NUMBER OF TRADES OR QUOTES. THEREFORE, YOU MAY NOT BE ABLE TO SELL THESE SECURITIES AT A PRICE EQUAL TO OR NEAR TO THE VALUE SHOWN. HOWEVER THE BROKER-DEALER FURNISHING THIS STATEMENT MAY NOT REFUSE TO ACCEPT YOUR ORDER TO SELL THESE SECURITIES. ALSO, THE AMOUNT YOU RECEIVED FROM A SALE GENERALLY WILL BE REDUCED BY THE AMOUNT OF ANY COMMISSIONS OR SIMILAR CHARGES. IF AN ESTIMATED VALUE IS NOT SHOWN FOR A SECURITY, A VALUE COULD NOT BE DETERMINED BECAUSE OF A LACK OF INFORMATION.

H. The Cold Calling Rule (formerly Rule 15c2-6; now Rule 15g-9)

Rule 15g-9 imposes sales practice and suitability requirements on any broker-dealer who sells penny stock to or effects the purchase of any penny stock for any person who is not an established customer of the firm. An established customer is a customer who has effected a securities transaction or deposited funds in his or her account more than one year prior to the penny stock transaction, or who has made three purchases of penny stocks which occurred on separate days and involved separate issues.

1. Prior Account Approval by Broker-Dealer

Prior to effecting a penny stock transaction, the broker-dealer must have approved the person's account for transactions in penny stocks. In order to approve a persons' account for transactions in penny stocks the broker-dealer must:

- (a) obtain from the person information concerning the person's financial situation; investment experience and investment objectives;
- (b) reasonably determine, based on such information, that transactions in penny stocks are suitable for the person and that the person has sufficient knowledge and experience in financial, matters that the person may be expected to be a capable of evaluating the risks of transactions in penny stocks:
- (c) deliver to the person a written statement setting forth the basis on which the suitability, knowledge and experience determinations were made by the broker-dealer, stating in a highlighted format that it is unlawful for the broker-dealer to effect a transaction in a penny stock unless the broker-

dealer has received, prior to the transaction, a written agreement to the transaction from the person; and stating in a highlighted format

immediately preceding the customer signature line that the broker-dealer is required to provide the person with the written statement, and that the person should not sign and return the written statement if it does not accurately reflect the person's financial situation, investment experience, and investment objectives;

(d) obtain from the person a manually signed and dated copy of the written statement described above.

A Rule 15g-9 Customer Suitability Statement is included at the end of this section.

2. Written Customer Agreement to Penny Stock Transaction

Prior to the transaction, the broker-dealer also must receive from the person a written agreement stating the identity and quantity of the penny stock to be purchased.