Bull's-eye: Regulators Are Hunting, Is Your Company A Target?

Many smaller public companies feel as if regulators are breathing down their necks, are they?

By: Craig V. Butler, Esq.

As an attorney that works with many smaller public companies, and the providers that service them, I have a good feel for what concerns smaller public companies. Unlike in years past, many smaller public companies are feeling like targets, proverbial ducks in a pond, with regulators and others taking aim from close range to pick them off one at time by promulgating new regulations, regulatory warnings, or just flat out filing actions to deregister their securities, with the goal to rid the markets of certain types of smaller public companies. So, is this feeling based in fact or merely an over-active imagination? Well, unfortunately, like many nagging feelings, there is a reason some types of companies feel like they are being scrutinized and/or possibly being regulated out of existence – they are. This article explores the situations of three different types of companies that are feeling the heat by looking at the increased scrutiny and regulation they are facing. Please note, not all companies are the same and some companies that fit in one or more of these categories may not be feeling any of the heat felt by others, but this article is what the majority of the companies with the specific attributes listed below may be feeling based on my interactions with the companies and their service providers. Also, this article uses the terms regulators and regulations broadly. Technically some of the oversight entities are not regulators and the scrutiny being felt isn't always technically a "regulation," but instead a policy shift or merely intense scrutiny. However, what the three types of companies have in common is the need for qualified, experienced service providers (attorneys, auditors, IR/PR, etc.) advising the companies on the ins-and-outs of the different regulations and how to navigate the increased scrutiny successfully to obtain their objective.

Target 1: Shell Companies

Targeting shell companies is nothing new. Obviously shell companies have been around for decades, as have the regulations that govern them; however, in the past 2-3 years those regulations have greatly increased. In October last year I authored an article focusing on the new landscape facing shell companies and shell transactions but it is worth mentioning again the primary challenges facing shell companies from the SEC and others.

In February 2008 the SEC revised Rule 144 and its practical effect on shell companies was enormous. Under Rule 144(i), the Rule is not available for the resale of securities initially issued by "(i) An issuer …. that has "(A) no or nominal operations; and (B) Either: (1) no or nominal operations; (2) assets consisting solely of cash and cash equivalents; or (3) assets consisting of any amount of cash and cash equivalents and nominal other assets; or (ii) an issuer that has been at any time previously an issuer described [above]." See Rule 144(i)(1).

However, an issuer can "cure" its shell status by meeting the following requirements:

(1) is no longer a shell company as defined in Rule 144(i)(1);
(2) has filed all reports (other than Form 8-K reports) required under the Exchange Act for the preceding 12 months (or for a shorter period that the issuer was required to file such reports and materials); and
(3) has filed current "Form 10 information" with the Commission reflecting its status as an entity that is no longer an issuer described in Rule 144(i)(1), and at least one year has elapsed since the issuer filed that information with the Commission. See Rule 144(i)(2).

As stated, the impact of this amendment to Rule 144 was that shareholders of companies that are shell companies, or have ever been a shell company at any time in their past, cannot utilize Rule 144 until the complies with Rule 144(i)(2) and cures that status. The result of this rule change has been companies that are shell companies, or had ever been shell companies, have had to become '34 Act reporting companies (incurring the time and expense of '34 Act reports, notably audits and reviews by a PCAOB-approved auditor) or have turned to less than ideal means. While one can question the rationale of the amendments to Rule 144 and whether the effect of the amendments was what was intended by the SEC, one cannot question the impact as the SEC has affirmed on multiple occasions that the rule is what it is and shareholders of companies that are shell companies, or ever were shell companies, cannot utilize Rule 144 until the company cures that status.

An additional, and possibly related, action has been the SEC's recent request in the comment process for companies to either identify their current or past shell status, or defend their characterization of non-shell status. While the disclosure of shell status has always been a focus of the SEC, recently that has turned into an almost argumentative process with the SEC regarding whether or not a company was previously a shell company at any time in its history. Obviously, the SEC's role in filings is to help ensure a company's disclosure accurately represents the company's history and status. However, in this particular case the "assistance with disclosure" has, at times, turned into arguments with issuers regarding the company's shell status. With the impact of shell status at times being determinative of company shareholders ability to utilize Rule 144, which can many times greatly impact a company's ability to raise funds, the shell status determination is a crucial one.

Clearing firms and DTC also have their take on shell companies, which is basically to either not process an application for DTC-eligibility (clearing firms) or not approve an application for eligibility (DTC). While there are no direct prohibitions on shell companies getting DTC-eligibility, the process is a difficult one and can be very expensive, to the point of many shell companies not attempting to get DTC-eligibility and putting that onus on the post-transaction company in a reverse merger (see below).

Outlook: Nothing is going to get easier for shell companies. The regulations are likely to get even stricter at some point and shell companies need to search for the right merger candidate and gain operations. The operations should comport with those suggestions listed below for post-reverse merger public companies.

Target 2: Reverse Mergers

Where to begin? It might be easier to list the agencies and authorities that are not targeting reverse merger transactions and companies rather than those that are. With the SEC, DTC, PCAOB, and clearing firms all targeting reverse merger companies in different ways the reverse merger process has become fraught with pitfalls. Finding qualified, experienced service providers to assist companies through this regulatory jungle is crucial.

Let's start with the SEC, and these are just a few examples. In June 2011, the SEC issued an Investor Bulletin on reverse merger companies (http://www.sec.gov/investor/alerts/reversemergers.pdf). The Bulletin is self-explanatory, however, it is worth noting a few things. First, is this statement: "[a]s with any investment, investors should proceed with caution when considering whether to invest in a reverse merger company. Many companies either fail or struggle to remain viable following a reverse merger. Also, as with other kinds of investments, there have been instances of fraud and other abuses involving reverse merger companies." With all the caveats about reverse merger companies being no worse than investments in other like non-reverse merger companies, one wonders the purpose of the investor bulletin in the first place. However, the next statement goes a long way towards clarifying the purpose: "Another consideration is that some of the foreign companies that access the U.S. markets through the reverse merger process have been using small U.S. auditing firms, some of which may not have the resources to meet its auditing obligations when all or substantially all of the private company's operations are in another country. As a result, such auditing firms might not identify circumstances where these companies may not be complying with the relevant accounting standards. This can result in increased risks for investors." This statement appears to get to the core of the warning: foreign companies, primarily Chinese companies, accessing U.S. markets through reverse mergers. I am not questioning the SEC's right and obligation to warn investors of potentially dangerous transactions, but I am questioning the broad scope of the warning. In the process of questioning the legitimacy of certain foreign companies accessing the U.S. markets through the reverse merger process, the SEC threw into question the whole reverse merger marketplace, which many times serves to provide investors and shareholders of failed companies another possibility at liquidity by having the public shell acquire new operations, and also can serve the purpose of good, legitimate private companies getting access to public markets sooner than what the 9-12 month direct initial public offering route provides. There are, undoubtedly, reverse merger companies that are a considerable investment risk to investors, whether those companies be reporting or non-reporting companies; however, they are no more or less of a risk than many other reporting and non-reporting companies that achieved their status as a public company through a non-reverse merger method.

Second, regarding the SEC, there may be instances where public companies that went public through a reverse merger are not given the same leeway as other companies. For instance, I am aware of one reverse merger company that is a '34 Act reporting company, but is delinquent in its filings by one annual report and two quarterly reports. The company recently received a letter from the SEC that if the company did not get current within 15 days the SEC Enforcement Division may start de-registration and de-listing proceedings. Yes, it is a company with its primary operations in China. While I do not doubt the SEC's authority to question and threaten a '34 Act company that is delinquent in its '34 Act reporting requirements, and ultimately deregister and de-list its registered securities, it does seem odd that many other delinquent '34 Act reporting companies are trading on OTC Markets and are currently years delinquent in their reporting requirements but have never received such a letter from the SEC. Is this due to this one company being a reverse merger company and/or a company with its operations based in China? I don't know, but it does seem suspicious.

Regarding clearing firms and DTC, companies that undergo reverse mergers do not appear to be directly discriminated against as a result of the reverse merger transaction itself, but those companies will have an uphill battle if they undergo a corporate change transaction, such as a name change or stock split, that is common to reverse merger companies post-transaction. In my experience, those corporate changes will not stop a reverse merger company from achieving DTC-eligibility, but it will cause a delay of at least 6 months in getting DTC-eligibility, and if companies that have DTC-eligibility are not careful after a reverse merger transaction they may find their eligibility chilled or globally-locked and needing to prove itself in different ways than companies that did not undergo a reverse merger.

Regarding the Public Company Accounting Oversight Board (PCAOB), the organization has issued a staff alert bulletin regarding Chinese reverse merger companies and whether the audits on those companies comply with PCAOB standards. The findings were that a number of those audits did not meet the required standards. Obviously, this report was directed at Chinese reverse merger companies and not on reverse mergers in general, but is worth mentioning as these types of reports and news bleed over into the reverse merger market in general.

Outlook: The regulations affecting post-reverse merger companies are increasing. However, the reverse merger market is booming. I anticipate the spotlight and increased regulatory scrutiny on reverse mergers will continue for some time, continuing to focus primarily on Chinese and other Asian operating companies getting listed on U.S. markets via the reverse merger. However, many of the pitfalls affecting reverse mergers can the navigated successfully, but it is crucial that both shell companies and the private vend-in company hire experienced, reputable service providers (attorneys, auditors, IR/PR, etc.) to not only guide them through this process, but also advise the company post-transaction, as many of the pitfalls affecting reverse merger transactions are months or years after the transaction. Doing everything a company can to help ensure the post-reverse merger company has the best chance of success in a hot spotlight environment is critical.

Target 3: Penny Stock Companies

This may seem like a broad category since technically a "penny stock" company is just a company whose stock price is less than $5 (a simplistic definition), but it is worth noting some of the changes in the industry are affecting all smaller public companies, regardless of size (at least that fall into the "penny stock" category). First, one need look no further than trying to deposit a stock certificate for a penny stock with a broker to see how much the industry has changed. You will quickly realize after receiving a 15 page application and a request for $300 to $500 to open an account (and possibly a legal opinion even though the stock has no restrictive legend) that things are not as easy as they once were in the penny stock world. Second, lengthy applications and broker fees are an understandable reaction to increased regulatory scrutiny, however, in June of this year, Penson, the clearing firm that services the majority of brokers that specialize in penny stock companies, announced a new policy that it would not process deposit requests from the brokers it services for any over-the-counter traded company whose stock trades at $0.10 or less, and it would not submit DTC-eligibility requests for any over-the-counter public company whose stock trades at $0.10 or less. The effect of this change is that it greatly limits the brokers where shareholders of penny stock companies that trade at $0.10 or less can deposit the stock of the company. This serves to not only greatly limit those companies ability to raise money, but also puts them in a bad light with their existing shareholders that have difficulty finding a broker to deposit their shares.

Recently, I have heard industry professionals express concerns about whether market makers are able to fulfill their market making obligation when they won't accept certificates for deposit, or worse, market makers using the difficulty in depositing shares to help manipulate markets in penny stocks. Both are effects obviously contrary to the regulators intentions.

Outlook: These types of encroachments on the ability of shareholders to deposit stock of penny stock companies are likely to continue, but hopefully not to the point of completely restricting the ability of those shareholders to deposit their shares. One bright spot has been that over the last 6 months or so, as Penson has become very restrictive on OTC penny stock companies, both in terms of DTC-eligibility and stock clearing, competition from self-clearing broker firms and other smaller clearing firms willing to clear stock from penny stock companies has increased, offering shareholders of penny stock companies more options. Hopefully that will continue as Penson's recent consolidation of other players in the industry had greatly reduced the options, but that appears to be changing with increased activity from competitors.

Conclusion

There is no disputing the fact that different types of small public companies have been targets of regulators and others in the industry. While these new "regulations" can be restrictive, they can be navigated with the proper plan in place and the proper personnel to achieve the plan. These regulations are not likely to decrease, only increase in the future. Many times the problem with these companies is their unwillingness to do what it takes to navigate the process successfully and, therefore, attempt to circumvent the system, which most times leads to not only a great deal of headache, but also more expenses than what would have been required had the company sought out the correct qualified personnel in the first place.

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The Lebrecht Group, APLC provides comprehensive advice on a variety of corporate and securities law matters. Please contact us if you have any questions.

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