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SEC Footnote 32 and Sham S-1 Registration Statements

The following is written by Laura Anthony, Esq., a going public attorney focused on OTC listing requirements, direct public offerings, going public transactions, reverse mergers, Form 10 and Form S-1 registration statements, SEC compliance and OTC Market reporting requirements.

Over the past several years, many direct public offering (DPO) S-1 registration statements have been filed for either shell or development-stage companies, claiming an intent to pursue and develop a particular business, when in fact, the promoter intends to create a public vehicle to be used for reverse merger transactions. For purposes of this blog, I will refer to these S-1 registration statements the same way the SEC now does, as "sham registrations." I prefer the term "sham registrations" as it better describes the process than the other used industry term of art, "footnote 32 shells."

Footnote 32 is part of the Securities Offering Reform Act of 2005 ("Securities Offering Reform Act"). In the final rule release for the Securities Offering Reform Act, the SEC included a footnote (number 32) which states:

"We have become aware of a practice in which the promoter of a company and/or affiliates of the promoter appear to place assets or operations within an entity with the intent of causing that entity to fall outside of the definition of blank check companies in Securities Act Rule 419. The promoter will then seek a business combination transaction for the company, with the assets or operations being returned to the promoter or affiliate upon the completion of that business combination transaction.

It is likely that similar schemes will be undertaken with the intention of evading the definition of shell company that we are adopting today. In our view, when promoters (or their affiliates) of a company that would otherwise be a shell company place assets or operations in that company and those assets or operations are returned to the promoter or to its affiliates (or an agreement is made to return those assets or operations to the promoter or its affiliates) before, upon completion of, or shortly after a business combination transaction by that company, those assets or operations would be considered 'nominal' for purposes of the definition of shell company."

An entity created for the purposes of entering into a merger or acquisition transaction with an as of yet unidentified target, is called a "blank check company." All registrations by blank check companies are required to comply with Rule 419 under the Securities Act of 1933, as amended ("Securities Act"). Further down in this blog, I have included a discussion of Rule 419, which requires that funds raised and securities sold be held in escrow until a merger or acquisition transaction is completed. An entity relying on Rule 419 would not receive a trading symbol or be able to apply for DTC eligibility until after it completes a merger or acquisition transaction.

A public vehicle with a trading symbol and DTC eligibility has greater value for a target asset or company, and accordingly, some unscrupulous industry players file sham registrations in an effort to avoid Rule 419.

As discussed further below, a shell company is one with no or nominal assets and operations. Although a DPO may legally be completed by a company that meets the definition of a "shell company," a public vehicle which is not and never was a shell company is more valuable to a reverse merger or acquisition target. In particular, as I have written about many times, companies that are or ever were a "shell company" face prohibitions and ongoing limitations related to the use of Rule 144 (for further discussion on Rule 144 related to shell companies see my blog HERE. As with avoiding Rule 419, some unscrupulous industry players file sham registrations in an effort to avoid shell status.

Sham registrations have become increasingly prevalent with the newly public company being offered for sale and for use in reverse merger transactions. In a typical sham registration, 99.9% of the total issued and outstanding shares are offered for sale. Typically the company has a single (or possibly two) owner(s) of the control block and a single (or possibly two) person(s) serving in all officer and director roles. There are usually approximately 30 "free trading" shareholders offering to sell their shares as registered freely tradable shares, to a new group of shareholders associated with the reverse merger target. Generally, the only shares not offered in the transfer are a small number that have been deposited into DTC as part of the DTC application process.

From a legal perspective, the person(s) filing the sham registration is violating Section 17(a) of the Securities Act, which is the counterpart to Rule 10(b)(5) of the Securities Exchange Act of 1934. Section 17(a) prohibits, in conjunction with the offer or sale of securities: (i) the use of any device, scheme or artifice to defraud; or (ii) obtaining money or property using any untrue statement related to, or any omission of, a material fact; or (iii) engaging in any transaction, practice or course of business that would operate as a fraud or deceit on the purchaser. That is, the person(s) filing the sham registration are aware that there is no present intent to pursue the disclosed business, but rather the intent is to sell the public entity to a new business or group. In addition, the participants violate Rule 10(b)(5) of the Exchange Act and Exchange Act recordkeeping and internal control provisions.

Moreover, those involved would be liable for similar state securities law violations. In addition to an action by both the SEC and state regulatory agencies, the public company would be liable for civil actions against purchasers of securities. As with any securities fraud violation, egregious cases can be referred to the Department of Justice or State Attorney for criminal action.

Until now, the SEC has only taken action against the promoter, individual or group behind the sham registration and not the third-party reverse merger target, which has generally been a real business that has innocently purchased one of these public entities to be used in a reverse merger transaction. However, I believe that is about to change. These sham registration public companies are so blatant and easy to identify that a third party can no longer claim innocence in its purchase or use.

I believe the SEC is going to begin imposing trading suspensions and/or registration revocations against the public companies after a purchaser has taken over with a valid operating business. Industry insiders are aware that the SEC is taking action to prevent any active trading market from developing from these vehicles, and it is my belief that the SEC is gearing up to file an example-setting case that will include the purchaser of one of these sham public vehicles. The risk to the sham public vehicle purchaser goes beyond a trading suspension or registration revocation, and could include aiding and abetting liability for the sham registration itself.

Action to Prevent Active Trading Market

As I've blogged about many times, the SEC views broker-dealers as gatekeepers in the compliance with federal securities fraud. For more on this topic, see my blog HERE about the ongoing issues of depositing penny stocks with broker-dealers.

In the past few weeks, regulators have imposed a barrier to the deposit of securities purchased from a participant in a sham registration or issued by a company involved in a sham registration. Although I do not have a copy of the memo, based on a source, the SEC has provided certain penny stock broker-dealers with a memo outlining red flags indicating that a company may have been involved in a "sham registration" and warning against the deposit and offer of sale of shares issued by such company.

Sham registration red flags include:

- A company formed immediately preceding filing a registration statement and commencing its public offering;
- Proposed business consisting of actual activities in a described line of business, without concrete expenditures, contracts, operating assets, or other indicia of actual operations in that business;
- A relatively small S-1 registered public offering—e.g., $40,000;
- The registration statement prepared by legal counsel who has a history of several similar registration statements with similar business and offering profiles as set forth above;
- Low costs of offering, including legal fees—e.g., $3,500 for the entire organization, audit, and SEC registration work;
- Cash invested to organize and launch the offering but not enough to conduct substantial activities in the proposed business;
- The entire offering sold offshore—e.g., Ukraine;
- No actual business conducted after the offering to employ the offering proceeds in the proposed business;
- A significant portion of the stock sold in the registered public offering sold back into the United States to U.S. residents, frequently at prices equal to, at a slight premium to, or a low multiple of the public offering price;
- The terms, prices, and closing of the sale at the same terms or even closed through a common escrow stock back into the United States. The offshore "registered" stock flowing back into the US through some orchestrated mechanism (in some cases a single escrow closed simultaneously with, and contingent upon, the closing of the reverse merger) so that all or a substantial amount of the publicly sold stock passes to persons aware of or acting in concert with the group controlling the reverse merger company;
- A reverse merger with an operating business in which the owners of the operating business take over management, acquire a substantial majority of the outstanding stock, and undertake only the business of the acquired enterprise, abandoning the proposed business activities initially described in the prospectus;

Without respect to when the stock was first DTC eligible, when it first obtained a trading symbol, or the date on which the public offering was completed, material public trading in the company's securities does not commence with material volume until the reverse merger. Typically the stock sold in the offshore public offering is not traded in any public market that develops. Instead, the trading market is prepared to launch with DTC eligibility and trading symbol in place for trading to commence when the reverse merger is complete, using stock that has been acquired by US persons from the offshore initial purchasers in the registered offering; and

Stock acquired by US purchasers from the offshore investors now being presented for resale.

The SEC warns broker-dealers that even when the legitimacy of the current business is not an issue, any trading market established after a sham registration is at issue and that the fundamental free tradability of such shares is problematic. As a result, some broker-dealers are simply refusing to deposit and resell securities issued in companies with indicia of a sham registration.

Examples of SEC Enforcement Actions

On April 16, 2015, the SEC filed an action against 10 individuals involved in a scheme to manufacture at least 22 public companies without relying on Rule 419 or properly disclosing shell company status (the "McKelvey Case"). The number of provisions in which the SEC claimed violations, and therefore sought relief, included a full laundry list of any and all possible actions. The language in the McKelvey case was also much stronger than in prior actions filed by the SEC for similar violations.

On February 3, 2014, the SEC initiated administrative proceedings against 19 companies that had filed S-1 registration statements. The 19 registration statements were all filed within an approximate 2-month period around January 2013. Each of the companies claimed to be an exploration-stage entity in the mining business without known reserves, and each claimed that they had not yet begun actual mining. Each of the 19 entities used the same attorney. Each of the entities was incorporated at around the same time using the same registered agent service. Each of the 19 S-1's read substantially the same.

Importantly, each of the 19 S-1's lists a separate officer, director and sole shareholder, and each claims that this person is the sole control person. The SEC complains that contrary to the representations in the S-1, a separate single individual was the actual control person behind each of these 19 entities and that person is acting through straw individuals, as he is subject to a penny stock bar and other SEC injunctive orders which would prevent him from legally participating in these S-1 filings. In addition, the SEC alleges that the claims of a mining business were false. The SEC believes that the S-1's were filed to create public companies to be used for either reverse merger transactions or worse, pump-and-dump schemes.

The SEC played hardball with this group, as well. An S-1 generally contains language that it may be amended or modified (or even withdrawn) until it is declared effective by the SEC. A pre-effective S-1 is not deemed filed by the SEC or a final prospectus for Section 5 of the Securities Act. Upon initiation of the SEC investigation, all 19 S-1 filers attempted to withdraw their S-1 registration statements. The SEC suggested that each withdraw their requests to withdraw the S-1 and cooperate fully with the investigation. The entities did not comply. Accordingly, in addition to claims related to the filing of false statements in the S-1, the SEC has also alleged that "Respondent's seeking to withdraw its Registration Statement constitutes a failure to cooperate with, refusal to permit, and obstruction of the staff's examination under Section 8(e) of the Securities Act."

Separately on January 15, 2015, the SEC filed an action against the individual behind each of the sham registrations, the attorney and the auditing firm for "a scheme to create sham public shell companies."

Sham registrations are not new, just more prevalent. In September 2012, the SEC filed an action against a group of promoters for creating 15 sham public companies. One-off actions are consistently being filed, as well.

Rule 419 and Blank Check Companies

The provisions of Rule 419 apply to every registration statement filed under the Securities Act of 1933, as amended, by a blank check company. Rule 419 requires that the blank check company filing such registration statement deposit the securities being offered and proceeds of the offering into an escrow or trust account pending the execution of an agreement for an acquisition or merger.

In addition, the registrant is required to file a post-effective amendment to the registration statement containing the same information as found in a Form 10 registration statement, upon the execution of an agreement for such acquisition or merger. The rule provides procedures for the release of the offering funds in conjunction with the post-effective acquisition or merger. The obligations to file post-effective amendments are in addition to the obligations to file Forms 8-K to report both the entry into a material non-ordinary course agreement and the completion of the transaction. Rule 419 applies to both primary and resale or secondary offerings.

Within five (5) days of filing a post-effective amendment setting forth the proposed terms of an acquisition, the company must notify each investor whose shares are in escrow. Each investor then has no fewer than 20 and no greater than 45 business days to notify the company in writing if they elect to remain an investor. A failure to reply indicates that the person has elected not to remain an investor. As all investors are allotted this second opportunity to determine to remain an investor, acquisition agreements should be conditioned upon enough funds remaining in escrow to close the transaction.

The definition of “blank check company” as set forth in Rule 419 of the Securities Act is a company that:

Is a development-stage company that has no specific business plan or purpose or has indicated that its business plan is to engage in a merger or acquisition with an unidentified company or companies, or other entity or person; and

Is issuing “penny stock,” as defined in Rule 3a51-1 under the Securities Exchange Act of 1934.

Shell Companies

The definition of "shell company" as set forth in Rule 405 of the Securities Act (and Rule 12b-2 of the Securities Exchange Act of 1934) means a company that has:

- No or nominal operations; and
- Either: No or nominal assets;
- Assets consisting solely of cash and cash equivalents; or
- Assets consisting of any amount of cash and cash equivalents and nominal other assets.

Clearly the definitions are different. Although a shell company could also be a blank check company, it could be a development-stage company or start-up organization or an entity with a specific business plan but nominal operations. Until recently, however, the SEC has firmly held the position that Rule 419 applies equally to shell and development-stage companies.

In fact, the SEC Staff Observations in the Review of Smaller Reporting Company IPO's published by the SEC Division of Corporate Finance contain the following comments:

"Rule 419 applies to any registered offering of securities of a blank check company where the securities fall within the definition of a penny stock under the Securities Exchange Act of 1934. We frequently reviewed registration statements of recently established development stage companies with a history of losses and an expectation of continuing losses and limited operations. These companies often stated that they may expand current operations through acquisitions of other businesses without specifying what kind of business or what kind of company. In other cases, the stage of a company's development, when considered in relation to the surrounding facts and circumstances, may raise questions regarding the company's disclosed business plan. We generally asked companies like these to review Rule 419 of Regulation C. We asked these companies either to revise their disclosure throughout the registration statement to comply with the disclosure and procedural requirements of Rule 419 or to provide us with an explanation of why Rule 419 did not apply."

The SEC will now allow a shell company, as long as it is not also a blank check company, to embark on an offering using an S-1 registration statement without the necessity to comply with Rule 419. As noted above, an entity can be a shell company, but not a blank check company, as long as it has a specific business purpose and plan and is taking steps to move that plan forward, such as a start-up or development-stage entity.

Conclusion

I regularly caution reverse merger clients against companies that appear in violation of footnote 32 or appear to have originated via a sham registration. However, I continue to believe in reverse merger transactions, DPO's for legitimate companies in all stages of their development and the overall small business public

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Securities Law Blog is written by Laura Anthony, Esq., a going public lawyer focused on OTC Listing Requirements, Direct Public Offerings, Going Public Transactions, Reverse Mergers, Form 10 Registration Statements, and Form S-1 Registration Statements. Securities Law Blog covers topics ranging from SEC Compliance, FINRA Compliance, DTC Chills, Going Public on the OTC, and OTCQX and OTCQB Reporting Requirements. Ms. Anthony is also the host of LawCast.com, the securities law network.

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