Securities and Corporate Law Developments

CORPORATE FINANCE DEVELOPMENTS

SEC ADOPTS AMENDMENTS AND PROPOSES RULE CHANGES TO COMBAT MICROCAP FRAUD

In its continuing effort to prevent and fight fraud in microcap securities, the Securities and Exchange Commission ("SEC" or "Commission") has adopted amendments, which became effective on April 7, 1999, to Form S-8 under the Securities Act of 1933 (the "Securities Act")[1/] and to Rule 504.[2/] Form S-8 is a simplified form for public companies to register securities issued under employee benefit plans. Rule 504 is the so-called "Seed Capital" exemption from registration available under Regulation D. In addition, the Commission proposed further amendments to Form S-8 [3/] and reproposed amendments to Rule 15c2-11 of the Securities Exchange Act of 1934 ("Exchange Act")[4/], which governs the publication of quotations for securities other than on a national securities exchange or Nasdaq.

According to the SEC, microcap securities generally are characterized by low share prices, low trading volume and little or no analyst coverage. They are typically quoted on the

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[1/] Registration of Securities on Form S-8, Securities Act Release No. 33-7646 (Feb. 25, 1999), 64 Fed. Reg. 11,103 (Mar. 8, 1999).

[2/] Revision of Rule 504 of Regulation D, the "Seed Capital" Exemption, Securities Act Release No. 33-7644 (Feb. 25, 1999), 64 Fed. Reg. 11,090-01 (Mar. 8, 1999).

[3/] Registration of Securities on Form S-8, Securities Act Release No 33-7647 (Feb. 25, 1999), 64 Fed. Reg. 11,118-01 (Mar. 8, 1999).

[4/] Reproposed Amendments to Rule 15c2-11, Exchange Act Release No. 34-41,110 (Feb. 25, 1999), 64 Fed. Reg. 11,124 (Mar. 8, 1999).

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OTC Bulletin Board or in the Pink Sheets. Fraud in microcap securities frequently involves a "pump and dump" scheme by which a broker, promoter or other person holding substantial amounts of an issuer's securities disseminates misleading information to generate investor interest and trading in the securities, thereby increasing demand and "pumping" up the price of the security. The party orchestrating the fraud then "dumps" his securities onto the market at the inflated price. Since there is no longer need to stimulate interest in the security at that point, the market for it collapses and innocent investors suffer the loss. In addition, microcap fraud schemes frequently employ such practices as high-pressure cold calling, unauthorized trading in a customer's account and stock price manipulation.

SEC Chairman Arthur Levitt noted that the Commission has taken a four-pronged approach to address fraud in microcap securities.[5/] It has: 1) intensified inspections and examinations of broker-dealers who trade in microcap securities; 2) increased coordination of enforcement efforts with states and self-regulatory organizations; 3) proposed and implemented regulations to strengthen disclosure and oversight of microcap stocks; and 4) increased investor education efforts regarding microcap stocks and microcap fraud. The amendments and proposed amendments to the regulations discussed in this newsletter fall into the third area. According to Chairman Levitt, these regulations "will increase the amount of information available to investors [and] close avenues which have been exploited by some to ruthlessly and irresponsibly promote a certain stock."[6/]

As discussed in greater detail below, the Form S-8 amendments are intended, among other things, to prevent issuers from using nominal "consultants and advisors" as conduits to evade the registration requirements of Section 5 of the Securities Act. The SEC believes that the Rule 504 amendments will deter some "pump and dump" schemes by limiting the circumstances in which securities issued pursuant to that exemption are freely tradable. Finally, the reproposed amendments to Exchange Act Rule 15c2-11 would prevent broker-dealers from issuing inflated price quotations for microcap stocks by requiring market makers in those stocks to review certain issuer information before starting to place priced quotes.

A. Form S-8 Amendments and Proposed Amendments

1. Form S-8 Amendments[7/]

Form S-8 is the short-form Securities Act registration statement for offers and sales of securities to the issuer's employees in a compensatory or incentive context. Form S-8 allows an issuer to use

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[5/] Statement of Chairman Arthur Levitt, Open Commission Meeting, Feb. 19, 1999 <http://www.sec.gov/news/extra/microal.txt>.

[6/] *Id.*

[7/] In addition to the amendments discussed in this newsletter, the Commission adopted other amendments to Form S-8 relating to the use of the form for the registration of shares issued upon exercise of stock options by family members of employee optionees. These amendments, and amendments to Securities Act Rule 701 (governing employee benefit plans of private companies) are discussed in a separate newsletter dated May 24, 1999).

employee benefit plan documents provided by the employer (which could include a simplified prospectus) and periodic reports incorporated by reference to satisfy disclosure requirements. The Commission believes that the compensatory purpose of the securities offering and the employee's familiarity with the employer's business justifies this abbreviated disclosure requirement. The Commission's staff permitted consultants and advisors to receive securities registered on Form S-8 only if they provided bona fide services to the issuer not in connection with the offer or sale of securities in a capital raising transaction.

Securities registered on Form S-8 are not "restricted," so they can be freely resold to persons who are not affiliates of the issuer. The Commission adopted the Form S-8 amendments in part to respond to the abuse of the form to distribute securities to the public in contravention of the registration requirements of the Securities Act. Specifically, the SEC became aware of instances in which securities registered on Form S-8 and offered or sold to nominal consultants, who in some cases performed limited or no additional services to the issuer, were then resold to the public at the issuer's direction. In effect, the issuers used the consultants as underwriters in such instances, and employed Form S-8 to effect a public offering without the protections afforded by the registration and prospectus delivery requirements of the Securities Act. The Commission's position is that this practice violates the registration requirements of the Securities Act and, by misrepresenting that the securities were issued as compensation rather than to raise capital for the issuer, the antifraud provisions the Securities Act and the Exchange Act.

In addition, the Commission observed that issuers have misused Form S-8 to register securities issued to consultants and advisers for stock promotion services. Such transactions are not permitted to be registered on Form S-8.

In order to prevent the abuses of Form S-8 described above, the SEC amended the instructions to Form S-8 and the Securities Act definition of "employee benefit plan."[8/] As adopted, offers and sales of securities to consultants and advisors can be registered on Form S-8 only if:

- the consultants and advisors are natural persons;
- they provide bona fide services to the registrant; and
- the services they provide are not in connection with the offer or sale of securities in a capital-raising transaction, and do not directly or indirectly promote or maintain a market for the registrant's securities.

These amendments codify the position that the Commission's staff had taken in response to interpretive inquiries. As a general rule, a consultant or adviser's eligibility to receive securities registered on Form S-8 will continue to depend primarily on the character of the services provided;

[8/] In amending Securities Act Rule 701, *see* Rule 701-Exempt Offerings Pursuant to Compensatory Arrangements, Securities Act Release No. 33-7645 (Feb. 25, 1999), 64 Fed. Reg. 11,095 (Mar. 8, 1999), the Commission harmonized its interpretation of the term "consultants and advisors" under that Rule with the Form S-8 amendments, and that term will now be interpreted consistently in both contexts.

Form S-8 registration will be unavailable where the consultant's services are primarily capital-raising or promotional. Thus, the Commission will not permit registration on Form S-8 to either traditional employees or consultants and advisors where the issuer or promoter either directs the resale of the securities in the public market or receives proceeds from such sales, directly or indirectly. In addition, brokers, dealers and investor relations consultants, whose activities are inherently capital-raising or promotional, cannot receive securities registered on Form S-8. The Commission will also interpret the amendments to prohibit the issuance of securities registered on Form S-8 to persons who arrange certain types of merger transactions that are frequently associated with microcap fraud.

The Commission has not adopted proposed amendments that would require disclosure in Part II of Form S-8 of the names of consultants and advisors who are to receive securities registered on that form, the number of securities they will receive and the specific services they will provide to the issuer. The SEC has extended the comment period on these proposals in connection with the proposed amendments discussed below.

2. Proposed Amendments to Form S-8

In addition to the amendments to Form S-8 discussed above, the SEC issued for public comment a new proposal intended further to prevent issuers from abusing Form S-8. The current rules permit use of Form S-8 by any company that (1) immediately before the time of filing is required to file Exchange Act reports and (2) has filed all reports and other required materials during the preceding 12 months.

The proposed amendments would apply more stringent requirements to all companies and would significantly restrict the availability of Form S-8 for companies formed by merger of a non-public company into a public shell company. Under the proposal, Form S-8 would be available only to companies that had timely filed all of their Exchange Act reports within the preceding twelve calendar months. Moreover, registration of securities on Form S-8 would be unavailable to companies formed by merger of a non-public company into an Exchange Act reporting company having only nominal assets at the time of the merger before such companies file their first Exchange Act annual report. That proposal arises out of the SEC's perception that the period prior to such companies filing an annual report containing audited financial statements is particularly rife with abuse.

B. Amendments to Rule 504, the "Seed Capital" Exemption from Registration

Rule 504 of Regulation D is an exemption from Securities Act registration enacted in 1982 to reduce the regulatory restraints on small business capital formation. Prior to amendment, Rule 504 permitted a non-reporting issuer to offer and sell up to $1 million of securities in any 12-month period to an unlimited number of persons, regardless of their sophistication or experience and without delivery of any specific information. General solicitation and advertising were permitted for Rule 504 offerings, and the securities issued could be traded freely by non-affiliates of the issuer who were not otherwise acting as underwriters. Rule 504 offerings were required to be registered in each state in which they were offered unless a state exemption from registration was available.

According to the Commission, the amendments respond to the use of Rule 504 to perpetrate "pump and dump" schemes in which prearranged sales were made to nominees in states having no

registration or prospectus delivery requirements for Rule 504 offerings. The nominees would place the securities with broker-dealers who would create an artificial market demand and sell them to unsuspecting investors, then permit the market to collapse once they had sold their inventory.

Under the amended rule, which is similar to Rule 504 as it existed prior to 1992, up to $1 million of securities may be sold in private offerings in any 12 month period. Securities issued in private offerings pursuant to Rule 504 cannot be freely traded, and the offerings may no longer involve general solicitation and advertising. An issuer will be able to issue freely tradable securities in a Rule 504 offering and engage in general solicitation or advertising only if it (1) registers the offering under a state law that requires the public filing and delivery of a disclosure document to investors before sale or (2) effects the offering under a state law exemption that permits general solicitation and general advertising so long as sales are made only to "accredited investors." The Commission believes that the amended rule strikes an equitable balance between protecting investors and allowing small businesses to issue freely tradable securities to obtain seed capital.

C. Reproposed Amendments to Rule 15c2-11 Governing Certain Market Maker Quotations

The SEC believes that market makers often facilitate microcap fraud by raising the profile of a security simply by publishing quotations in response to increased demand. Even if the market maker is not an active participant in the fraud, those orchestrating the scheme can point to the quotations to validate their claims about the security's worth. Through its reproposed amendments to Exchange Act Rule 15c2-11, which governs the publication of quotations for securities other than on a national securities exchange or Nasdaq, the Commission hopes to impose requirements on market makers that will prevent quotations for fraudulent securities from being published.

In its present form, Rule 15c2-11 requires market makers to review basic issuer information, which they must reasonably believe to be accurate and from a reliable source, prior to publishing quotations for that issuer's securities. Under the current rule, however, all market makers are allowed to publish quotations for a security without reviewing any information once one market maker has published quotations for the security for at least 30 days. This is commonly referred to as "piggybacking" onto the first market maker's quotes. Unless the Commission suspends trading in the security, market makers can then issue quotes indefinitely without reviewing any updated information.

According to the release, the Commission intends the reproposed amendments to make broker-dealers "stop, look and listen" before they begin to quote a covered OTC security. The securities covered by the proposed amendment would be those that are typically the subject of microcap fraud; i.e., securities quoted on the OTC bulletin board operated by the NASD, in the Pink Sheets, and other similar quotation mediums.[9/] Among other things, the amendments would:

[9/] The universe of securities that would be subject the reproposed Rule is relatively limited. Excluded from its coverage are securities with a bid price of at least $50 per share, securities of issuers whose audited financial statements reflect net tangible assets in excess of $10 million, non-convertible debt, non-participatory preferred stock, investment grade asset backed securities and securities with a worldwide average daily trading volume of at least $100,000 during each month of the six calendar months preceding

- limit the Rule primarily to priced quotations;
- eliminate the Rule's piggyback provision and require all broker dealers to review current issuer information before publishing priced quotations for a security;
- require broker-dealers publishing priced quotations for a security to review specific current information about the issuer annually and upon the occurrence of certain specified events;
- require broker-dealers to document their compliance with the Rule; and
- require broker-dealers publishing quotes in compliance with the Rule to provide issuer information upon request to customers, prospective customers, information repositories and other broker-dealers.

The SEC intends these amendments to enhance the integrity of quotations for microcap stocks, to improve the quality of information about smaller, lesser-known issuers, and to foster greater access to this information by investors.

Finally, in order to assist broker-dealers in complying with Rule 15c2-11 in both its current form and under the reproposed amendments, the reproposing release contains an appendix setting forth the factors they should consider in carrying out their review obligations under the Rule. Under both the current Rule and the reproposed Rule, broker-dealers are prohibited from publishing a quotation unless they have reviewed specific information about the issuer and reasonably believe that the information is accurate in all material respects and was obtained from a reliable source. Because of "piggybacking," the burden of this requirement generally falls only on the first broker-dealer publishing quotations for a particular security under the current rule. The appendix describes the inquiry necessary to form the required reasonable belief and identifies the types and sources of information the SEC believes to be reliable.

Perhaps most importantly, the appendix lists numerous examples of "red flags" that the Commission considers to be indications that some of the information required under the rule may be inaccurate and to cause a broker-dealer to inquire as to whether it has a reasonable basis to believe it has complied with Rule 15c2-11. Among the 28 red flags listed in the appendix are:

- SEC or foreign trading suspensions;
- concentration of ownership of the majority of outstanding, freely tradable stock;
- companies in which assets are large and revenue is minimal without any explanation;
- shell corporation's acquisition of a private company;
- significant write-up of assets upon company obtaining a patent or trademark for a product;

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the date of publication of a quotation.

- significant asset consists of securities of OTC Bulletin Board or Pink Sheet companies;
- unusual auditing issues;
- extraordinary gains in year to year operations.

The list of red flags is not exhaustive. The appendix states that if the broker-dealer discovers any red flags in the issuer's information at any stage in the review process, it cannot publish a quote unless and until the red flags are reasonably addressed. The appendix is particularly important because it not only reflects how the Commission will interpret the amended Rule if it is adopted, but how it views broker-dealers' obligations under the current Rule. As such, it may represent an important signal of how the Commission will view the conduct of broker-dealers in connection with the microcap fraud schemes it prosecutes.

Impact of the Amendments and Proposed Amendments

The amendments and proposed amendments discussed above reflect the Commission's intent closely to scrutinize the avenues by which fraudulent microcap securities find their way into the market and the people who bring them there. Thus, issuers compensating their consultants and advisers with Form S-8 securities should be prepared to provide proof of the services that they provided, that those services were unrelated to the promotion of the issuer's securities and that the Form S-8 securities were not issued to raise capital for the issuer.

The amendments to Rule 504 should accomplish the SEC's goals as well. Small businesses legitimately relying on the Rule may find it more difficult to use, although the SEC's decision not to make all securities issued pursuant to the Rule restricted softens that concern somewhat. The Rule 15c2-11 release, and particularly the appendix to that release, reflect the Commission's willingness to take enforcement action against those broker-dealers that ignore available information and permit themselves to be used to facilitate microcap fraud. From a business standpoint, compliance with the proposed amendments would significantly impact broker-dealers' basic responsibilities for knowing the issuers in whose securities they make markets, as well as their record keeping requirements.

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