Changes to SEC Rules Regarding Shell Companies and the Use of Form S-8 Registration Statements

New SEC policies are intended to combat the misuse of such Form S-8 Registration Statements.

DAVID M. LOEV AND JOHN S. GILLIES

Shell companies have been able to utilize Form S-8 Registration Statements, which become effective immediately upon filing, to issue shares free of restrictive legend for services rendered, which services are not in connection with capital raising transactions or investor relations activities. The Securities and Exchange Commission has been concerned about the misuse of such S-8 Registration Statements by shell companies, as those companies do not perform business operations and rarely have employees. In an effort to address the misuse of such Form S-8 Registration Statements, the Commission has enacted new policies to combat the misuse of such Form S-8 Registration Statements.

THREE RELEASES ISSUED AUGUST 2005

Effective August 22, 2005, through Release Nos. 22-8587 and 34-52038 and International Release No. 1293 (the "Release"),[1] the Securities and Exchange Commission (the "SEC" or the "Commission"):

- made certain changes to the Commission's definition of a "shell company;"
- prohibited the ability of a shell company to register securities pursuant to a Form S-8 Registration Statement until and unless certain conditions are met;
- added disclosure of shell company status on the cover page of the SEC's Forms 10-Q, 10-QSB, 10-K, 10-KSB and Form 20-F filings; and
- amended the SEC's Form 8-K to add new Item 5.06 and added new Exchange Act of 1934 Rules 13a-19 and 15d-19 relating to Form 20-F, which require companies which have ceased being shell companies to disclose certain information with the Commission.

The purpose of these amendments was to "protect investors in shell companies and to deter fraud and abuse in our public securities markets through the use of shell companies."[2] The Commission had stated that the rule changes were its "latest effort in its ongoing campaign against fraud and abuse in the market for highly speculative securities, especially securities which trade at low share prices."[3] The Commission adopted the rule changes in connection with powers given to it by Congress in the Securities Enforcement Remedies and Penny Stock Reform Act, adopted in 1990.[4]

The Commission said that "companies and their professional advisors often use shell companies for

[1] Use of Form S-8, Form 8-K, and Form 20-F by Shell Companies, Securities Act and Exchange Act Release Nos. 33-8587 and 34-52038; International Series Release No. 1293; File No. S7-19-04 (August 22, 2005, except Item 5.06 of Exchange Act Form 8-K, which is November 7, 2005) (Final Rule).

[2] Use of Form S-8, final rule at 42.

[3] Use of Form S-8 and Form 8-K by Shell Companies, (Securities and Exchange Commission Release Nos. 33-8407 and 34-49566; File No. S7-19-04 (Proposed rule).

[4] PL 101-429, 104 Stat. 931 (1990).

David M. Loev is a corporate and securities attorney in Houston, Texas and John S. Gillies is an Associate at David M. Loev, Attorney at Law. Information regarding their practice can be found at www.loevlaw.com.

many legitimate purposes";[5] however, "[the new rules] target regulatory problems that [it] has identified where shell companies have been used as vehicles to commit fraud and abuse the regulatory process."[6] In the Release, the Commission went on to say that it has seen S-8 Registration Statements used to circumvent the registration and prospectus delivery requirements of the Securities Act of 1933 (the "Securities Act"), and that because shell companies do not operate businesses and rarely have employees, it "see[s] little legitimate basis for shell companies to use Form S-8."[7] As a result, the Release makes shell companies ineligible from using a Form S-8 Registration Statement until 60 days after they cease being a shell company, and it has filed the required information with the Commission (described below under "Use of Form S-8 Registration Statement by Shell Companies").

Additionally, the Commission went on to say that the same rules regarding shell companies shall apply to situations in which a reporting shell company affects a "reverse merger" with a private company, either by the private business merging into the shell company, or the shell company merging into the former private company.[8] In these transactions, the reporting company has an obligation to file current reports on Form 8-K, under Item 1.01, Entry into a Material Definitive Agreement, Item 2.01 Completion of Acquisition of Disposition of Assets, and Item 5.01 Changes in Control of Registrant, as well as audited and pro forma financial information for the acquisition.

BACKGROUND ON FORM S-8 REGISTRATION STATEMENTS

For a company to qualify for use of a Form S-8 Registration Statement it must be subject to the reporting requirements of Section 13 or 15(d) of the Securities and Exchange Act of 1934 and have filed all reports and other materials required to be filed by such requirements during the preceding 12 months. Securities which may be registered on a Form S-8 include securities under any employee benefit plan to its employees or employees of its subsidiaries or parents. For the purposes of Form S-8, the term "employees" includes any employee, director, general partner, trustee (where the entity is a business trust), officer or consultant or advisor.[9]

Companies, however, are only able to register securities for consultants or advisors if those consultants or advisors are natural persons, they provide bona fide services to the registrant, and the services 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 company's securities. Additionally, the term "employee" includes insurance agents who are exclusive agents of the registrant, its subsidiaries or parents, or derive more than 50% of their annual income from those entities.

Shell companies are ineligible from using a Form S-8 Registration Statement until 60 days after they cease being a shell company and have filed required information with the SEC.

Companies can also register the exercise of employee benefit plan options and subsequent sale and the acquisition of company securities pursuant to intra-plan transfers among plan funds, which belong to employees or former employees as well as executors, administrators or beneficiaries of the estates of deceased employees, guardians, or members of a committee for incompetent former employees, or similar persons duly authorized by law to administer the estate or assets of former employees.[10]

Form S-8 Registration Statements become effective upon filing and any amendments to Form S-8 Registration Statements become effective upon filing. Because the Form S-8 Registration Statement becomes effective upon filing, the Commission is not able to review Form S-8's and there is no delay between the time when they are filed and when selling security holders can sell free trading securities in the public market.[11] The Commission has historically found that Form S-8's have been misused by shell companies to register shares which do not fall under the accepted issuances described above. As a result, the Commission has effected the rule changes described below.

[5] Donaldson, William H., Speech by SEC Chairman: Shell Company Rules: Opening Statement before the SEC Open Meeting, Washington D.C., June 29, 2005.

[6] Use of Form S-8, final rules at 3.

[7] Id. at 4.

[8] Id.

[9] SEC Form S-8 at 2 (http://www.sec.gov/about/forms/forms-8.pdf).

[10] Use of Form S-8, final rules at 4.

[11] Id.

DEFINITION OF "SHELL COMPANY"

Through Rule 405 of the Securities Act of 1933 and Rule 12b-2 of the Securities and Exchange Act of 1934, the Release added the definition of a "shell company" as a company (other than an asset-backed issuer), which has "no operations; and either no or nominal assets; assets consisting of solely cash and cash equivalents; or assets consisting of any amount of cash and cash equivalents and nominal other assets" ("Shell Company").[12] For the purposes of the Commission's definition, the determination of the company's assets is based on those assets that would be reflected on the company's balance sheet, prepared in connection with U.S. generally accepted accounting principals.[13]

The Commission stated that the language "or assets consisting of any amount of cash and cash equivalents and nominal other assets," was added to be consistent with the intended meaning of the proposed definition and best describes the types of companies involved in the schemes it was attempting to address in the Release.[14] Additionally, in a footnote to the Release, the Commission stated that it "believe[s] that a former operating company that meets the assets and operations standards in the definition of Shell Company would be subject to the rules" adopted in the Release as well.[15]

The Commission has historically found that Form S-8's have been misused by shell companies to register shares which do not fall under the accepted issuances.

Excluded from the Commission's definition of "Shell Company" however are certain companies which the Commission believes should be able to use Form S-8's immediately and not have to wait the sixty days described above. These companies have been defined as "business combination related shell companies" and include shell companies formed by an entity which is not a Shell Company, solely for the purpose of changing that entity's domicile solely within the U.S.; or a Shell Company formed by a non-Shell Company solely for the purpose of completing a business combination transaction between one or more entities, other than the Shell Company, none of which are shell companies.[16]

USE OF FORM S-8 REGISTRATION STATEMENT BY SHELL COMPANIES

As part of the Release, the Commission amended Form S-8 under the Securities Act of 1933, to prohibit shell companies from registering securities under Form S-8.[17] This was done, according to the Commission to stop the inappropriate misuse of Form S-8 to register the sale of shares to "purported employees or other nominees, who often are designated as 'consultants' but who often do not provide services," which constitutes fraud and abuse of the use of a Form S-8. According to the Commission, this often leads to the unregistered resales of securities in the public market, which deny the protection of the rules and regulations of the Securities Act of 1933 to purchasers of the company's securities in the public market.[18]

The Commission's new S-8 rules prohibit any company that is a Shell Company or was a Shell Company within the past sixty days from registering securities pursuant to a Form S-8. The Release does however allow former shell companies, that have filed information in a Report on Form 8-K filing similar to that information which is required by Form 10, Form 10-SB or Form 20-F (as described in further detail below), and waited until the sixty-day period has elapsed.[19] Additionally, the Release also provides that a "business combination shell" may use Form S-8 immediately upon ceasing to be a Shell Company and filing Form 10 Information.[20]

The Commission also points out that the prohibition on the use of Form S-8 does not outright prevent a Shell Company from registering securities underlying employee benefit plans under the Securities Act of 1933, as shell companies are still eligible to register those securities on a registration statement other than a Form S-8, including Form SB-2, Form S-1 or Form F-1.[21] While the Commission did say that it was aware that other registration statements lack the ease of registration that a Form S-8 does, they believe that "the benefits of this amendment in preventing misuse of Form S-8, deterring fraud, and protecting investors

[12] Id. at 9-10.
[13] Id. at 10.
[14] Id.
[15] Id. at 10, fn. 31.
[16] Id. at 12, fn.. 35, for the SEC's new definition, is the same as Securities Act Rule 165(f)(1) which defines "business combination transaction" as any transaction specified in Securities Act Rule 145(a).
[17] Use of Form S-8, final rule at 2.
[18] Id. at 15.
[19] Id. at 16.
[20] Id. at 17.
[21] Id.

substantially justify the potential disadvantages for shell companies."[22]

AMENDMENT TO FORM 10-Q, FORM 10-QSB, FORM 10-K AND FORM 10-KSB

The Commission also amended the cover page of Form 10-Q, Form 10-QSB, Form 10-K and Form 10-KSB to require reporting companies that fall under the definition of a Shell Company, to check a box disclosing such on the cover page of those forms.[23] This was done, according to the Commission, to make it easier for market participants and regulators to identity those transactions involving shell companies.

AMENDMENT TO FORM 8-K

Through the adoption of the Release, the SEC added new Item 5.06 to Form 8-K, which requires shell companies to report information on the transactions which cause them to cease being shell companies.[24] Additionally, if the Shell Company completes a transaction with another entity, whereby the Shell Company is not the surviving entity, the surviving entity would succeed to the Shell Company's obligation to comply with new Item 5.06 and therefore report the information describing the transaction as described below.[25]

This information, which is required to include audited and pro forma financial statements, is to include that information which would be required by a traditional registration statement on Form 10 or Form 10-SB ("Form 10 Information").[26] The time period for the Shell Company to file the Form 10 Information is four days, the same time period given to the majority of events reported under Form 8-K and not the usual seventy-one days allowed for a business acquisition reported on Form 8-K.[27] The Commission stated that it felt the four day time period is appropriate as "shell companies and their counsel control the pace and timing of these transactions" and because "shell companies should complete a transaction that is required to be reported only when they can timely provide investors with adequate information to make informed decisions."[28]

The Commission stated in the Release that they considered imposing a trading ban on a company's securities until the Shell Company has filed the required Form 10 Information, but, the Commission felt that the required Form 8-K filing would have the same effect as informing investors before the trading ban was lifted, with none of the practical implementation issues which a trading ban would present.[29] The required filing of Form 10 Information will provide investors with disclosures equivalent to that information provided to investors in reporting companies that register under the Exchange Act of 1934, thereby putting investors in the same place information wise, as they would be if the company had become a reporting company by filing a Form 10 or Form 10-SB.[30]

A "business combination shell" may use Form S-8 immediately upon ceasing to be a Shell Company and filing Form 10 Information.

By making companies file Form 10 Information under Item 5.06, the Commission feels that it "will allow market participants and regulators to more easily identify Form 8-K filings regarding Shell Company transactions and to more completely understand the terms of those transactions."[31] Additionally, as described above, "business combination related shell companies" are not subject to the requirements of Item 5.06.[32]

AMENDMENTS RELATING TO FOREIGN ISSUERS

The Release included new Exchange Act of 1934 rules 13a-19 and 15d-19, which require that if a foreign private issuer was a Shell Company prior to entering into a transaction which causes it to cease being a Shell Company, it must report the same information required in a registration statement on Form 20-F in a report on 20-F.[33] This information must be filed within four days of the company ceasing to be a Shell Company. In connection with these rules changes, the Commission included a new check box on Form 20-F, which requires that a foreign private issuer must disclose whether it is a Shell Company on the cover

[22] Id.
[23] Id. at 27.
[24] Id. at 6.
[25] Id. at 22.
[26] Id. at 21.
[27] Id.
[28] Id.
[29] Id.
[30] Id. at 22.
[31] Id.
[32] Id. at 23.
[33] Id. at 25.

page of Form 20-F, similar to those changes made to Form 10-Q, 10-QSB, 10-K and 10-KSB, described above.[34] Additionally, because the Shell Company disclosure required by Form 20-F is in the nature of a current report, the Commission did not allow extensions for the filing of the required post-Shell Company disclosure information under Exchange Act of 1934 Rule 12b-25.[35]

The new rules will make it much harder for promoters to take advantage of inadequate information in the marketplace to "pump and dump" the securities of shell companies they promote.

CONCLUSION

The Commission affected the rules described above to make sure that investors have current public information regarding the securities of shell companies and former shell companies before making investments in those companies. The Commission had found that in the past, promoters would take advantage of a company's lack of adequate financial information to promote a company's stock and sell their shares at artificially high prices.[36] The new rules define a "shell company;" create a prohibition against a shell company registering securities pursuant to a Form S-8 Registration Statement until after the expiration of sixty days from that date it ceases to be a shell company and unless certain disclosure information is filed regarding the company; require disclosure of shell company status on the cover page of the SEC's Forms 10-Q, 10-QSB, 10-K, 10-KSB and Form 20-F filings; and add new Item 5.06 to Form 8-K as well as Exchange Act of 1934 Rules 13a-19 and 15d-19 relating to Form 20-F.

The new rules, together with the requirement that companies which have ceased being shell companies disclose certain information with the Commission; will make certain that investors will have adequate public information regarding their potential investment in former shell companies and will make it much harder for promoters to take advantage of inadequate information in the marketplace to "pump and dump" the securities of the shell companies they promote.

[34] Id.
[35] Id. at 26.
[36] Use of Form S-8, proposed rule.