

KILLING DEAD flies with A SLEDGE HAMMER

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I was recently involved in a case brought by the Securities and Exchange Commission to revoke the registration of a company's common stock. But the company's publicly held common stock had been revoked by a bankruptcy court order issued some seven years before the SEC proceeding began.

This piqued my curiosity. Why was the SEC bringing this proceeding, and how many other similar cases had they brought? How much was this costing the public—both in terms of SEC staff time and other enforcement opportunities lost because the staff was pursuing these companies? And were there better ways to get the same result?

Cases Against Dead Companies

In its three fiscal years ending in 2010, the SEC brought some 360 enforcement actions to revoke the registration of common stock of numerous companies. This was nearly 18% of the total 1206 enforcement actions brought by the SEC in that period.

The proceedings were brought under Section 12(j) of the Securities Exchange Act of 1934, which authorizes the SEC to suspend or revoke the registration of a company that fails to file the quarterly and annual reports required under the Act if the SEC finds that such suspension or revocation is in the public interest or necessary for the protection of investors. The SEC staff argues that these proceedings are necessary to protect the investing public from trading in securities of

companies about which there is no current information. This sounds noble, but is it really? Or is it an opportunity for the staff to win easy cases and keep their percentage of successful enforcement actions over 90%?

I selected three enforcement actions brought in May and June 2011. (I purposely excluded the case where I was involved.) These proceedings named 24 companies. Seventeen defaulted—that is, they did not file any answer or otherwise contest the proceeding. Of the 17 defaulted companies, the SEC reported that 14 companies had had their charters as a corporation revoked or dissolved or otherwise no longer existed as a legal entity. Thirteen had filed for protection under Chapter 11 of the Bankruptcy Code that allows a company to reorganize. It also allows the companies to have their outstanding publicly held stock cancelled as a matter of law. Five companies had filed under Chapter 7 of the Bankruptcy Code that provides for the liquidation of the company.

In other words, some 71% of the companies failed to contest the SEC's proceedings; 58% were legally non-existent; 54% were in reorganization under the Bankruptcy Code; and 21% were being liquidated under the Bankruptcy Code. Why is the SEC pursuing these dead companies?

Impact on Key Officers and Directors
In the actions I have reviewed, the Division of Enforcement did not name as a respondent

any of the officers, directors or key shareholders of these companies. Yet these people will be affected because they were or are associated with a company that has been the subject of an SEC enforcement action.

The most significant impact will be upon their ability to be an officer or director of a publicly held company or a company seeking to go public. In their SEC filings these companies will feel obligated, and some cases may be required, to disclose this person's prior association with a company that was the subject of an enforcement action and to discuss what the action was about. If any of these people seek to become associated with a mutual fund, a brokerage firm or an investment adviser, they may have to seek an SEC order waiving their "statutory disqualification" because they were associated with a company that was the subject of an SEC enforcement action.

Cost to the Taxpayers

In the case in which I was involved and in the three cases referred to before at least four full-time staff attorneys in the SEC's Enforcement Division were involved in prosecuting the cases. In addition, at least one staff lawyer is engaged in writing to companies that are delinquent in their SEC filings and in following up with these companies before referring the matter to the SEC's Enforcement Division. Finally, SEC Administrative Law Judges have to handle these proceedings—scheduling and conducting conferences and hearings, reviewing and ruling on motions and issuing orders disposing of these proceedings.

Is There a Better Way?

Three alternative approaches could achieve the same results and cost much less than these numerous enforcement proceedings. The current SEC rule allows a broker-dealer to publish a priced quotation for a security that has traded in 12 of the last 30 days and where there has been no more than 4 days

since the last priced quotation—the "piggy-back exception." In other words, a broker-dealer need have no information about a company yet can still make priced quotations for that company's stock.

The first alternative approach would be to suspend trading in the securities of these dead companies. The SEC has the power to suspend trading in a security for up to ten days if it believes doing so is in the public interest. Such suspension would stop broker-dealers from quoting prices for the securities of these dead companies. These brokers would not have the information required under the SEC rule to make priced quotations in such securities, and would not be able to rely upon the piggyback exception.

The second alternative is to bring an enforcement action—either an administrative proceeding or injunction action—against the broker-dealers that publish priced quotations in the securities of dead companies and the companies that distribute these quotations. These proceedings would allege that the broker-dealers are violating the rules against fraud by publishing quotations for companies either that no longer exist or for which there is no available financial information. Named as defendants might be those companies that distribute these price quotations for the broker-dealers, because these distributors are aiding and abetting the broker-dealers in defrauding the public. Unlike in civil law suits, the SEC can bring a proceeding against a party for aiding and abetting a fraud.

A third approach would be to cut off the ability of these broker-dealers to publish quotations in the securities of dead companies, i.e., eliminate or restrict the use of the piggyback exception. The SEC proposed a rule in 1999 that would have the effect of stopping priced quotations in stocks of dead companies, but it has yet to act upon that proposal.
