

A Biweekly
Newsletter of
Federal Securities,
Corporate &
Banking Law
Developments

SEC PROPOSES RESTRICTIONS ON SHELL COMPANY ACTIVITIES

Use of public "shell" companies, whether to raise capital or to take private operating companies public, will become more difficult under proposed SEC rules.

The term "shell company" typically refers to a public company still in existence that no longer has any substantial activities or assets (hence the term "shell").

In a technique known as a "reverse merger," a private operating company merges into a public shell company. The public company, usually owned by the same investors that own the private company, would be the surviving company. And, just like that, a private company becomes a public company without going through the usual SEC review process.

Of course, private companies become public without SEC review all the time, such as when a private company grows its stockholder base above 500 persons and finds itself subject to SEC registration and reporting requirements.

However, the SEC has expressed concern that:

- shell companies, after being combined with private operating companies, may not have provided enough information about its new business to the public before raising capital;
- investors may be purchasing shell companies and then raising capital using a short-form S-8 registration statement rather than the more detailed ones that are required in public offerings; and
- shell companies, after combining with private companies, may be using the short-form S-8 registration statement to

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issue stock to employees without having made enough public information available.

To remedy these possible abuses, the SEC proposes:

- i. that shell companies, after combining with a private operating company, file a Form 8-K statement with the SEC within 4 business days, disclosing:
 - detailed business information;
 - financial information;
 - securities ownership; and
 - other material information;
- ii. to prohibit shell companies from using a short-form S-8 registration statement to distribute stock; and
- iii. to restrict shell companies, after combining with a private operating company, from using a short-form S-8 for distributing stock under its employment benefit plans for the first 12 months post-merger unless the new operating company files significant information with the SEC.

Investors considering the use of a "shell company" should be prepared to meet significant SEC disclosure requirements.

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WASHINGTON
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■ OTHER SEC DEVELOPMENTS

- Insiders that file stock trading and stock ownership reports with the SEC must obtain a new “passphrase,” and first time filers must obtain passwords electronically, under proposed SEC rules expected to be adopted on April 26, 2004. These rules follow earlier rules requiring electronic filing of these reports by insiders. The new “passphrases,” which must be obtained even by insiders who already have passwords, allow insiders to regenerate expired passwords and retrieve forgotten ones.
- The SEC recently approved NASD and NYSE rules requiring broker-dealers, brokerage houses and similar companies to develop business continuity plans in case of an emergency or significant business disruption. The plans must address, among other things, data back-up and recovery, mission-critical systems and alternate communication strategies between the company and its employees and customers. Also, the plan must state how the broker-dealer will ensure that a customer can still access funds and securities even if the broker-dealer cannot continue in business after a calamity.

■ BANK REGULATORY DEVELOPMENTS

- The FDIC recently followed the SEC lead in requiring that publicly-held banks for which the FDIC acts as the federal securities regulator (i.e., those without holding companies) must begin filing their insider stock trading reports electronically. The new rules will be effective as of June 11, 2004.
- A mutual holding company that went public was refused permission by the OTS to repurchase its stock within one year of its IPO, because the reasons for the repurchase did not qualify as “extraordinary circumstances.” Under OTS rules, no repurchases are permitted

in the first year following the IPO unless there are “extraordinary circumstances” and compelling and valid business reasons. The company’s desire to fund its stock benefit plans, respond to market conditions and avoid dilution upon issuance of stock options were not considered to be “extraordinary circumstances.”

■ ACCOUNTING DEVELOPMENTS

- The accounting firm of Ernst & Young has been prohibited by the SEC from accepting any new public company audit clients for six months. This is because E&Y’s consulting arm had a business partnership with an audit client, violating auditor independence rules. E&Y and the client jointly sold the client’s software to other E&Y clients, earning E&Y \$425 million as compared to its \$1.7 million in audit fees from the software client. Under the SEC ruling, E&Y must also pay back the audit fees and hire an outside consultant.

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