New York Law Journal
SERVING THE BENCH AND BAR SINCE 1888
WWW.NYLJ.COM
An ALM Publication
VOLUME 246—NO. 109
WEDNESDAY, DECEMBER 7, 2011

Outside Counsel

Expert Analysis

# The SEC: Killing Dead Flies With a Sledge Hammer

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Section 12(j) of the Securities Exchange Act of 1934 authorizes the Securities and Exchange Commission to conduct a hearing on the record, and thereafter suspend or revoke the registration of any security registered with the commission under the Exchange Act. This order is to be based on a finding that the issuer has failed to comply with the provisions of the Exchange Act and such sanction is necessary or appropriate to protect investors. The section goes on to prohibit broker-dealers from effecting transactions or inducing the purchase or sale of a security where the SEC has revoked or suspended the registration of that security. These proceedings are based upon a failure to file the quarterly and annual reports required under the Exchange Act.[1]

In recent years, the SEC has increased the use of these Section 12(j) proceedings. In its fiscal year ending Sept. 30, 2008, the SEC brought 113 such proceedings, constituting 17 percent of all enforcement actions brought that year. In its fiscal year ending Sept. 30, 2009, it brought 141 such proceedings, constituting 14 percent of all enforcement actions. In its fiscal year ending Sept. 30, 2010, it brought 106 such proceedings, constituting some 16 percent of all enforcement actions.[2] For these three years, these proceedings totaled 360 out of 1,206 enforcement actions, nearly 18 percent of all SEC enforcement actions.

This article questions whether such administrative proceedings are against real companies; whether bringing them is a prudent use of the SEC Enforcement Division's limited staff; the effect of these cases on key officers, directors and major shareholders of these companies; and whether the same results could be more easily achieved.

### Real Companies?

Are these proceedings against real companies, or are they an opportunity for the Enforcement staff to win easy cases and maintain their over 90 percent successful prosecution rate? If so, while nominally serving the purpose of enforcing the Exchange Act's issuer reporting requirements, these cases are brought mostly against companies that are no longer functioning or whose Exchange Act registered stock has been cancelled in a bankruptcy proceeding, i.e., these issuers are dead.

I randomly selected five proceedings under Section 12(j) that were instituted in May and June 2011. These proceedings involved 38 issuers.[3] They are: *In the Matter of Advanced Refractive Technologies Inc. et al.*[4]; *In the Matter of Saf T Lok Inc. et al.*[5]; *In the Matter of Sanctuary Woods Multimedia Corp., et al.*[6]; *In the Matter of D'Brit Corp.*[7]; and *In the Matter of Samaritan Pharmaceuticals Inc. et al.*[8]

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The *Advance Refractive* proceeding involved eight issuers. Two settled.[9] and default orders were entered as to the other six.[10] As to the six companies that defaulted; two were void Delaware corporations; one was a revoked Nevada corporation; one was a dissolved Florida corporation; one was a delinquent Delaware corporation; and one was a defaulted corporation.[11] In the release announcing the defaults, the SEC said that the last reports filed by five of the companies showed material losses, and one of the companies had filed a petition under Chapter 7 of the Bankruptcy Code.

The *Saf T Lok* proceeding involved seven issuers. One issuer settled.[12] The other six issuers defaulted.[13] The Default Order found that Saf T Lok was a dissolved Florida corporation; Sames was a forfeited Delaware corporation; Scientific Radio was a dissolved New York corporation; and SDC was a void Delaware corporation. The Default Order noted that Saf T Lok, Sames, Scientific Radio, and SDC had reported material losses in their last SEC filings. It went on to note that Scientific had filed a petition under Chapter 11 of the Bankruptcy Code, and Sames had filed a petition under Chapter 7 of the Bankruptcy Code.

The *Sanctuary Woods* proceeding involved seven issuers. All of them defaulted.[14] In the Default Order, the SEC noted that four were void Delaware corporations, one was a forfeited Texas corporation, and one was a suspended California corporation. The Default Order noted that five of them had reported material losses in their last filings with the SEC. Sanctuary and Scientific had filed petitions under Chapter 7 of the Bankruptcy Code, and Security had filed a petition under Chapter 11.

The *D'Brit* proceeding involved eight issuers. Dateq Information Network Inc. settled.[15] The other seven defaulted.[16] The Default Order noted that Dair, Dev-Tech and Digital Products were dissolved Florida corporations; D'Brit was a void Delaware corporation; D.C. Trading was a void Delaware corporation; and Delsoft was a revoked Georgia corporation. The Default Order noted that four of them had reported material losses in their last SEC filings and that Digital and Dollar had filed petitions under Chapter 11 of the Bankruptcy Code.

The last proceeding is *Samaritan Pharmaceuticals* and involved eight issuers. Two settled.[17] Five defaulted,[18] and the proceeding is open as to one issuer. The Default Order noted that Samaritan and Seneca are revoked Nevada corporations, Sento is an expired Utah corporation; and Shoe Pavilion is a void Delaware corporation. All five had reported losses in their last filings with the SEC, and Shoe Pavilion had filed a petition under Chapter 11 of the Bankruptcy Code.

Several facts appear from this review: At least 23 of the 38 companies had reported material losses in their last filings with the SEC. Twenty-six issuers had their corporate charters revoked, suspended, expired, voided or dissolved. Four issuers had filed petitions under Chapter 7 of the Bankruptcy Code, and four issuers had filed petitions under Chapter 11 of the Bankruptcy Code. In essence, these companies were "dead" issuers before the proceedings were instituted.

Is this a prudent use of limited staff? From my personal contacts with the SEC Enforcement

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staff conducting these Section 12(j) proceedings, I gather that at least four attorneys are engaged full-time in these proceedings. This is in addition to the staff members of the Division of Corporation Finance who send out letters to delinquent filers and process any responses before forwarding the matter to the Enforcement Division. In addition, there are the Administrative Law Judges who are assigned to adjudicate these proceedings.

### Impact

What is the impact on key officers, directors and major shareholders? The SEC staff points out that in none of these cases have they named any officers, directors or major shareholders. Yet the cases do affect these people. Items 401(f) and 407 of Regulation SK require disclosures of certain enforcement actions involving key officers and directors. If any of the key officers, directors or major shareholders of a company against which the SEC issued an order under Section 12(j) sought to become an officer or director of a publicly held company or a company that was about to go public, Items 401(f) and 407 might require disclosure of this enforcement action. Even if these items did not apply, counsel might want to make such disclosure anyway.

Exchange Act §15(b)(6) authorizes the SEC to bring a proceeding to suspend or prohibit such persons from being associated with a broker-dealer, particularly if they were a controlling person of a company that was found to have violated the federal securities laws. In addition, as a result of a Section 12(j) proceeding against an issuer, these people might also be subject to a statutory disqualification as defined in Exchange Act §3(a)(39). If so, and they sought to be associated with a broker-dealer that is required to be a member of a self-regulatory organization, that self-regulatory organization would be required under Exchange Act Rule 19h-1 to give the SEC notice of such association if it permitted that person to become associated with a member firm. Of course, the self-regulatory organization itself could refuse to give such notice and effectively bar that person from being associated with such broker-dealer. However, if the self-regulatory organization did give the notice, the SEC itself could direct that such person be denied the privilege of association with such broker-dealer.

Finally §9(b) of the Investment Company Act of 1940 and §203(d) of the Investment Advisers Act of 1940 could be the basis to prohibit from association or limit the affected person's ability to associate with an investment company as an employee, officer or principal underwriter or adviser to such investment company or to be associated with an investment adviser registered with the SEC.

### Is There a Better Way?

First we need to understand how broker-dealers can make priced quotations for securities of companies where there is no publicly available current information. Exchange Act Rule 15c2-11(a) requires that a broker-dealer making priced quotations have certain reasonably current information about the issuer's financial condition, CEO and directors, and about the shares being quoted. However, there is an exception to this requirement. Exchange Act Rule 15c2-11(e)(2) (the piggyback exception) allows a broker-dealer to make quotations in a security, even if he lacks the basic information otherwise called for in the rule if the security has been the subject of both bid and ask quotations at specified prices on each of at least 12 days within the previous 30 calendar days and with no more than four business days in succession without such a two-way quotation.[19]

I believe there are three better ways to deal with the dead companies that have securities registered with the SEC under the Exchange Act. The first would be to suspend trading in the registered securities of these companies for 10 days pursuant to Section 12(k) of the Exchange Act. The 10-day trading suspension would remove the availability of the piggyback exception that allows making a market or quoting these securities.

The second approach would be for the SEC to institute enforcement actions (but nowhere near the 360 proceedings instituted in fiscal years 2008, 2009 and 2010) against those broker-dealers publishing quotations for the securities of these dead companies under the anti-fraud provisions of the Exchange Act and the Securities Act of 1933, and would include the companies that disseminate these quotations under an aiding and abetting theory.[20]

The premise of such violations would be that the quoting and disseminating of quotations for securities of issuers that do not have and for a substantial period have not had publicly available information is misleading at best. It is clearly fraudulent to quote securities of issuers who are subject to liquidation under Chapter 7 of the Bankruptcy Code or who pursuant to a plan of reorganization under Chapter 11 of the Bankruptcy Code have had their publicly outstanding stock canceled under Section 1141 of the Bankruptcy Code.

A third approach is to prohibit the quoting and the trading of these securities in the first place. None of them is listed on a stock exchange. However, each is quoted in the over-the-counter market by reason of the piggyback exception in Exchange Act Rule 15c2-11. Eliminate or reduce the utility of the piggyback exception, and you prevent the harm to the public by the entering of quotations for securities of dead issuers. This is the same harm that the Enforcement Division asserts as the basis for these Section 12(j) proceedings.

The SEC has already proposed amendments to Rule 15c2-11 that would effectively eliminate the piggyback provision for securities of dead issuers.[21] As proposed, in the case of issuers who are delinquent in their filings with the SEC, a broker-dealer could not submit priced quotations on such securities beginning four months after the end of the issuer's last fiscal year for which no annual report was filed with the SEC. The proposal would also require that a broker-dealer that has not made a quotation at a specified price for a security for five or more consecutive business days since his last quotation may not make priced quotations for that security without having received the information about the issuer specified in the rule. In other words, if a broker-dealer had not been making priced quotations for a security, it could not start making priced quotations for that security unless it had the information specified in the rule about the issuer. These would effectively stop the piggyback quotation of the securities of dead issuers.

1. Exchange Act Rule 13a-1 (annual report) 17 CFR 240.13a-1, and Rule 13a-13 (quarterly report) 17 CFR 240.13a-11.

2. See Year by Year SEC Enforcement Statistics, http://www.sec.gov/news/newsroom/imager/enfstats.pdf, Dated March 2, 2011.

3. I appeared in a Section 12(j) proceeding instituted during this time period. However, I am not including that proceeding in this discussion.

4. Order Instituting Proceedings, Securities Exchange Act Release No. 64379 (May 3, 2011).

5. Order Instituting Proceedings, Securities Exchange Act Release No. 64505 (May 16, 2011).

6. Order Instituting Proceedings, Securities Exchange Act Release No. 64574 (May 31, 2011).

7. Order Instituting Proceedings, Securities Exchange Act Release No. 64610 (June 6, 2011).

8. Order Instituting Proceedings, Securities Exchange Act Releaser No. 64664 (June 14, 2011).

9. Settlement Order as to Gener8xion Entertainment Inc. Securities Exchange Act Release No. 64517 (May 19, 2011), and Bluebook International Holding Co., Securities Exchange Act Release No. 64531 (May 23, 2011).

10. Default Order revoking Exchange Act Registration of Advanced Refractive Technologies Inc., CBCom Inc., Group Long Distance Inc., HiEnergy Technologies Inc., Holter Technologies Holding, A, G. and Inchorus Com, Securities Exchange Act Release No. 64567 (May 31, 2011).

11. Default Order revoking Exchange Act Registration of Advanced Refractive, CBCom, Group Long Distance, HiEnergy, Holter and Inchorus, Securities Exchange Act Release No. 64567 (May 31, 2011).

12. Scirptel Holding Inc., Settlement Order, Securities Exchange Act Release No. 64566 (May 31, 2011).

13. Saf T Lok, Salesrepcentral.com Inc., Sames Corp., Scientific Radio Systems Inc. SDC International, and Seneca Acquisition Corp. Default Order, Securities Exchange Act Release No. 64685 (June 16, 2011).

14. Sanctuary, Satellite Auction Network Inc., Scientific Measurement Systems Inc., Scorpion Technologies Inc., Scott Science and Technology Inc., Security Environmental Systems Inc., and Sensotron Inc., Default Order, Securities Exchange Act Release No. 64827 (June 7, 2011).

15. Settlement Order, Securities Exchange Act Release No. 64801 (July 5, 2011).

16. D'Brit, Dair Ventures Inc., D. C. Trading & Development Corp., Delsoft Consulting Inc, Dev-Tech Corp., Digital Products Corp. and Dollar Time Group Inc., Default Order, Securities Exchange Act Release No. 64815 (July 6, 2011).

17. Simex Technologies Inc., Settlement Order, Securities Exchange Act Release No. 64866 (July 13, 2011) and Sola resources Corp., Settlement Order, Securities Exchange Act Release No. 64951 (July 25, 2011).

18. Samaritan Pharmaceuticals, Saeana Inc., Sento Corp. Shoe Pavilion Inc., and Shoe Pavilion Inc., Default order, Securities Exchange Act Release No. 65129 (Aug. 15, 2011).

19. 17 CFR 240.15c2-11(e)(2).

20. Section 21(e) of the Exchange Act authorizes the SEC to bring enforcement proceedings against any person who "knowingly or recklessly provides substantial assistance to another person in violation of" the Exchange Act or the rules thereunder.

21. See Securities Exchange Act Release No. 41110, 64 Federal Register 11124 (March 8, 1999).