

INFORMATIONAL

SEC Interpretive Guidance

SEC Issues Staff Interpretation On The “Free Trading” Status Of Blank Check Company Securities Under Certain Scenarios**SUGGESTED ROUTING**

The Suggested Routing function is meant to aid the reader of this document. Each NASD member firm should consider the appropriate distribution in the context of its own organizational structure.

- Legal & Compliance
- Senior Management
- Trading & Market Making

KEY TOPICS

- Blank Check Companies
- Freely Tradeable Securities

Executive Summary

A unit of the NASD Regulation, Inc. (NASD RegulationSM) Market Regulation Department recently asked the Securities and Exchange Commission (SEC) for interpretive guidance regarding initial distribution or the redistribution in the aftermarket of the shares issued by “blank check” companies¹ and whether these distributions were in compliance with SEC Rules.

NASD Regulation’s request for guidance and the SEC’s response are included with this *Notice*.

Questions/Further Information

Questions regarding this *Notice* may be directed to Ken Worm, Assistant Director, Market Regulation Department, NASD Regulation, at (301) 978-2097.

Background

The Market Regulation Department’s OTC Compliance Unit (Unit) reviews Form 211 filings submitted by potential Market Makers to determine whether they are in compliance with Rule 15c2-11(a) of the Securities Exchange Act of 1934 (Exchange Act) and NASD Rule 6740 before Market Makers are permitted to initiate or resume quotation of a non-Nasdaq[®] security in any quotation medium. During the course of these reviews, the Unit’s staff has raised concerns regarding certain factual scenarios where either the initial distribution or the redistribution in the aftermarket of the shares issued by blank check companies may violate Section 5 of the Securities Act of 1933 (Securities Act) based on the nature of the initial distribution of the securities of certain issuers. As a result of these concerns, the Market Regulation Department

requested guidance from the Division of Corporation Finance (Division) of the SEC on whether certain factual scenarios may present potential violations of Section 5 of the Securities Act. In response to the NASD Regulation staff request, the Division issued a staff interpretation dated January 21, 2000, on the “free trading” status² of securities initially issued by blank check companies in a number of factual scenarios.

As an initial matter, it is important to emphasize that the restrictions on trading of securities of blank check companies, as described in the Division’s response letter, are not limited to the scenarios described within this *Notice*. Based on the Division’s response letter as well as subsequent conversations with Division staff, in most, if not all, cases, the resale of securities of blank check companies is restricted and such securities can only be resold through registration under the Securities Act. In addition, Rule 144 would not be available to promoters or affiliates of blank check companies or to their transferees either before or after a business combination with an operating company or other person.

Moreover, NASD Regulation staff will require a Market Maker, when seeking NASD Regulation clearance pursuant to NASD Rule 6740 to initiate or resume quotation of a security of a blank check company, to provide an independent opinion from its own counsel detailing why the sale of such securities would not violate the registration requirements of the Securities Act. In addition, the NASD Regulation staff will continue to scrutinize closely such filings and will vigorously pursue disciplinary action and/or refer the staff’s findings to the SEC for further action.

Specific Factual Scenarios Presented To The SEC

In its November 1, 1999 letter to the Division, NASD Regulation staff requested guidance on whether the following factual scenarios presented potential violations of Section 5 of the Securities Act.

Scenario 1: The issuer transfers a nominal amount of its shares (less than 10 percent of the total float) as a gift to between 20 and 50 individuals under Section 4(2) of the Securities Act. After the gift recipients have held their shares for two years, a broker/dealer submits a Form 211 citing the gifted shares as the only free-trading securities. The application does not disclose whether the recipients are sophisticated investors, although the individual who controls the issuer frequently has gifted shares of other companies to the same individuals on other occasions.

Scenario 2: The issuer transfers a significant amount of its shares to one individual under Section 4(2) of the Securities Act. That individual subsequently gifts a nominal amount of the shares to between 20 and 50 individuals. After the gift recipients have held their shares for two years, a broker/dealer submits a Form 211 citing the gifted shares as the only free-trading securities. The application does not disclose whether the recipients are sophisticated investors, although the individual who gifted the shares frequently has gifted shares of other companies to the same individuals on other occasions.

Scenario 3: The issuer transfers a significant amount of its shares to one individual

under Section 4(2) of the Securities Act. That individual holds the shares for two years and then subsequently gifts a nominal amount of the shares to between 20 and 50 individuals. After the gift recipients have held their shares a few months, a broker/dealer submits a Form 211 citing the gifted shares as the only free-trading securities. The application does not disclose whether the recipients are sophisticated investors, although the individual who gifted the shares frequently has gifted shares of other companies to the same individuals on other occasions.

Scenario 4: A small number of shareholders (less than 10) hold all of the free-trading shares of an issuer. A broker/dealer submits a Form 211 indicating that the concentration of ownership in the hands of so few shareholders will not result in an ongoing distribution because it expects the market for the security to develop slowly.

Scenario 5: A small number of shareholders (less than 10) control nearly all (more than 90 percent) of the free-trading shares in the issuer. The remaining nominal amount of free-trading shares (less than 10 percent) are widely dispersed among a larger number of shareholders (50 or more individuals). A broker/dealer submits a Form 211 indicating that the concentration of ownership in the hands of so few shareholders will not result in an ongoing distribution because it expects the market for the security to develop slowly and considers the number of total shareholders to be determinative.

Scenario 6: An issuer controlled by one individual issues shares to another company controlled by the same individual pursuant to Rule 701 of the Securities Act. The issuer files a Form 10 with the SEC that became effective by default. The second company then sells all its shares in the issuer through a brokerage firm. A second broker/dealer submits a Form 211 indicating that the shares sold through the first broker/dealer are all free-trading securities.

Scenario 7: A reporting shell company merges with a private company and the former controlling shareholder of the reporting shell company sells his shares to numerous individuals more than three months after he ceases to be an affiliate of the post-merger company. A Market Maker submits a Form 211 citing the post-merger shares sold by the former control person as the only free-trading shares.

Division Response

In its response letter, the Division indicated that each of the scenarios initially suggests the availability of Rule 144 or Section 4(1) of the Securities Act following the lapse of some period of time after the issuance of shares in the blank check company, regardless of whether a merger has occurred. The Division noted that in several of the scenarios, promoters of the issuers also appear to be in the business of creating blank check companies, then gifting or selling the securities of the companies without registration, either directly or through intermediaries.

Section 4(1) exempts transactions not involving issuers, underwriters,

or dealers. The availability of this exemption depends upon the facts and circumstances of each particular situation. The Division indicated that transactions in blank check company securities by their promoters or affiliates, especially where they control or controlled the "float" of the "freely tradable" securities, are not the kind of ordinary trading transactions between individual investors of securities already issued that Section 4(1) was designed to exempt.³ Moreover, the Division noted that purchasers who are mere conduits for a wider distribution of securities may be deemed "underwriters." When such purchasers sell their securities, they assume the risk of possible violation of the registration requirements of the Securities Act and consequent civil liabilities. Persons engaged in the business of buying and selling securities who function in this capacity are subject to careful scrutiny.⁴

The Division noted in its response that both before and after the business combination or transaction with an operating entity or other person, the promoters or affiliates of blank check companies, as well as their transferees, would be considered "underwriters" of the securities issued. As a result, the securities involved can only be resold through registration under the Securities Act.⁵ Similarly, Rule 144 would not be available for resale transactions in this situation, regardless of technical compliance with that rule, because these resale transactions appear to be designed to distribute or redistribute securities to the public without compliance with the registration requirements of the Securities Act.⁶

Accordingly, the Division concluded that each of the scenarios illustrates what it

believes to be a scheme to evade the registration requirements of the Securities Act. Consequently, the resale of the shares in scenarios 1 through 7 would require registration. In addition, with regard to scenario 6, the Division noted that Rule 701 is not available for issuances to companies or entities, but only to individuals. In view of the business of a blank check company which generally has few or no employees, it seems unlikely that reliance upon this exemption would be appropriate; therefore, Rule 701 generally would not be available to blank check companies when issuing shares to their consultant or advisors.

Moreover, the Division was advised by staff of the SEC's Division of Market Regulation that Rules 101 and 102 of Regulation M⁷ impose restrictions on issuers, selling shareholders, and distribution participants when they effect transactions in securities that are part of a distribution. Generally, a distribution exists when a sufficient magnitude of shares is being sold and special selling efforts are employed to sell these shares. If a distribution exists, the persons involved in the distribution are prohibited from bidding for or purchasing the securities in distribution. The rule covers the persons selling securities, their affiliates, and others participating in the distribution. Persons selling in the manner described in the scenarios above should carefully analyze the facts surrounding the sales to determine whether the security being sold is in a distribution for purposes of Regulation M. This analysis specifically should consider the actions taken by any persons assisting with the transactions. In particular, selling through a Market Maker into an illiquid market raises heightened concerns regarding compliance with Regulation M.⁸

Compliance Guidance

Based on the Division's response letter as well as subsequent conversations with Division staff, in most, if not all, cases, the resale of securities of blank check companies is restricted and such securities can only be resold through registration under the Securities Act. In addition, Rule 144 would not be available to promoters or affiliates of blank check companies or to their transferees either before or after a business combination with an operating company or other person.

Moreover, NASD Regulation staff will require a Market Maker, when seeking NASD Regulation clearance pursuant to NASD Rule 6740 to initiate or resume quotation of a security of a blank check company, to provide an independent opinion from its counsel detailing why the sale of such securities would not violate the registration requirements of the Securities Act. Member firms are reminded that, in complying with these requirements, a Market Maker cannot reasonably rely on a legal opinion provided by the issuer or the issuer's counsel, or by counsel acting for any individual or entity involved in the transaction.⁹ To ensure reliability of the opinion, the Market Maker must obtain an independent opinion from its own counsel.¹⁰ The NASD Regulation staff will continue to closely scrutinize such filings and will vigorously pursue disciplinary action and/or refer the staff's findings to the SEC for further action.

Endnotes

¹A blank check company is a development stage company that has no specific business plan or purpose or has indicated its business plan is to engage in a merger or acquisition with an unidentified company or companies, or other entity or person.

²The concept of "freely tradable" securities is used to describe securities that are exempt from the registration requirements pursuant to Section 4(1) of the Securities Act because no issuer, underwriter, or dealer is engaged in the transaction.

³See *SEC v. Cavanagh*, 1 F. Supp. 2d 337 (S.D.N.Y. 1998).

⁴See SEC Release No. 33-4552 (Nov. 6, 1962).

⁵This view is analogous to one the SEC has expressed with respect to business combinations under Rule 145 where affiliates of parties to the transaction are viewed to be "underwriters." Further, the nature of these types of resale transactions

are closely analogous to shares from an unsold allotment held by professional underwriters. Generally, these securities are only resaleable through registration. Shares purchased by non-affiliates in a registered transaction such as one offered in compliance with Rule 419, however, would not be subject to this restriction.

⁶SEC Release No. 33-5223 (Jan. 11, 1972).

In view of the objectives and policies underlying the Act, the rule shall not be available to any individual or entity with respect to any transaction which, although in technical compliance with the provisions of the rule, is part of a plan by such individual or entity to distribute or redistribute securities to the public. In such case, registration is required.

⁷17 CFR 242.101 - 102.

⁸See SEC Release No. 34-38067 (Dec. 20, 1996).

⁹See James L. Owsey, 54 S.E.C. Docket 739, SEC Release No. 34-32941 (June 18,

1993) (citing *SEC v. Datronics Engineers, Inc.*, 490 F. 2d 250, 253-254) (4th Cir. 1973).

¹⁰*SEC v. Harwyn Indus. Corp.*, 326 F. Supp. 943, 954-55 (S.D.N.Y. 1971). The Market Maker's duty to seek independent counsel stems from its obligation to make a "searching inquiry" and to conduct a meaningful investigation of the surrounding circumstances in order to ensure that it is not engaged in the distribution of an unregistered security on behalf of an issuer, any person in a control relationship with an issuer, or an underwriter. See *Stead v. SEC*, 444 F. 2d 713 (10th Cir. 1971) cert. denied, 404 U.S. 1059 (1972); see also SEC Release No. 33-4445, *Distribution by Broker-Dealers of Unregistered Securities* (Feb. 2, 1971).

©2000, National Association of Securities Dealers, Inc. (NASD). All rights reserved. Notices to Members attempt to present information to readers in a format that is easily understandable. However, please be aware that, in case of any misunderstanding, the rule language prevails.