

# SIX SITUATIONS TO AVOID

A case study in compliance and due diligence

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# Background

- The SEC staff has been trying to reach out to smaller transfer agents, to let them know more about how to avoid enforcement actions (or worse).
- The SEC staff has cited to six examples of enforcement actions involving smaller transfer agents.
  - They have suggested that these are the sorts of bad situations that smaller agents are most likely to face.
  - If you can set up processes that are designed to help avoid these situations, your chances of getting into significant regulatory trouble should be substantially reduced.

## Core Points:

- Morals of the stories:
  - protect your self from fraud/unregistered offerings;
  - follow the rules; and
  - fix problems the SEC examination staff noted in prior examinations.
- Where to start?
  - Do your diligence on issuers, especially in connection with issuing un-legended stock certificates or removing legends on stock certificates and
  - Devise a compliance program, improve it on an ongoing basis and stick to it.

# Case Studies in Securities Fraud/Improperly Unregistered Offerings – I

- SEC v. CMKM Diamonds, Inc. et al. (Case No. 2:08-CV-0437-. LRH-RJJ (D. Nev. 2008)).
- Possible lesson – “Apparently knowing participation in facilitating an unregistered public offering for a pump and dump scheme will result in the nuclear option or worse.”

# Case Studies in Securities Fraud/Improperly Unregistered Offerings – II

- The SEC has instituted proceedings against, among others, the issuer, some of its officers, the transfer agent for the issuer, its owner/operator and an attorney providing related opinions.
- Generally, the case relates to an alleged fraudulent, unregistered public offer of shares of a shell company in which more than 500 billion shares were issued and sold through several nominees, with the bulk of the approximately \$60 million raised ultimately finding its way to the two architects of the fraud.

# Case Studies in Securities Fraud/Improperly Unregistered Offerings – III

- The transfer agent and its principal allegedly issued stock certificates without restricted legends based on “obviously incomplete and suspicious and, in some cases, forged documentation.” The SEC also alleged that the principal “either knew, or recklessly ignored red flags suggesting that [associated supporting board resolutions and attorney opinion letters] were facially incomplete and suspicious.”
  - Examples of specific allegations:
    - The transfer agent issued substantial quantities of stock certificates without restrictive legends based purportedly on forged opinion letters, which listed an office that the attorney did not occupy until several months later.
    - Some of the attorney opinion letters did not identify the names of the recipients, specify the number of shares each was to receive or correctly list the company’s name.
    - The agent also issued new shares based on “Rule 144 opinions” relating to previously issued shares.
    - The attorney who purportedly issued some of the opinions in question was ineligible to practice law at that time.
    - In some cases, the person signing supporting board minutes had relinquished all roles at the issuer and was not authorized to sign issuance instructions on file at the transfer agent.
- The SEC complaint also noted that the principal of the agent had received a loan of about \$200,000 from one of the architects of the fraud, and had indirectly received about \$350,000 from some of the nominees selling the issuer’s shares during the fraud. The complaint also noted that the issuer represented more than half of the agent’s business during the period in question.
- The result, this civil action is ongoing, and there have since been criminal charges and arrests

# Case Studies in Securities Fraud/Improperly Unregistered Offerings – IV

- SEC v. Offill et al. (Civil Action No. 3:07-CV-1643 (N.D. Tex. April 9, 2008) and related litigation.
- Possible lesson: A bit unclear, but possibly “Steer clear of suspicious offerings.”

# Case Studies in Securities Fraud/Improperly Unregistered Offerings – V

- This is the most unusual case cited by the SEC because no transfer agent or transfer agent personnel appear to have been charged directly in connection with it.
- The action is against several individuals engaged in alleged unregistered public offerings.
  - The SEC alleged that a group of individuals arranged to conduct private offerings that appeared to be conducted in reliance on Rule 504 under the Securities Act of 1933.
  - In fact the securities were issued to entities that served as underwriters by quickly selling the stock to the wider public in contravention of the requirements of Section 5 of the Securities Act and without being registered as broker-dealers in violation of Section 15 of the Securities Exchange Act of 1934.
  - The complaint refers to the named parties providing instructions to the transfer agent in connection with the transactions with the entities serving as underwriters.
  - Presumably, the SEC is intimating that transfer agents would be wise to monitor for unusual/suspicious transactions along the lines of those discussed in the complaint.

# Case Studies in (Not) Following the Rules – I

- In the Matter of Phlo Corporation, James Hovis and Anne Hovis (Securities Exchange Act of 1934 Release No. 55562 (March 30, 2007))
- Possible lesson – “You need to work with the system...”

# Case Studies in (Not) Following the Rules – II

- In 2002, Phlo Corporation, a public company then traded on the NASD's OTC bulletin board, registered to act as its own transfer agent.
- Phlo was engaged in a dispute with DTC regarding whether DTC's operations facilitated naked shorting of Phlo's stock, and informed DTC that the only transfers Phlo would process were ones that would transfer record ownership to the beneficial owner, despite a recent SEC determination that issuers and transfer agents do not have the authority to preclude DTC participants and their customers from depositing securities with DTC.
- Eventually, the SEC became involved, and a representative of Phlo, in dealing with the SEC staff, among other things:
  - became "very loud and somewhat irrational" in a conversation with SEC staff members;
  - did not respond to a OCIE request letter for a "for cause" examination until after the due date for delivery of documents.
  - continued to delay in providing the requested materials for months.
- The SEC: "[t]his attitude demonstrates a lack of understanding of the duty of a transfer agent to comply with regulatory directives and inquiries." The SEC found, among other things, that Phlo had shown "deliberate disregard" for the turnaround rules and its obligation to comply with SEC staff requests for records, and predicated its penalty upon a need to deter others from acting this way.
- The result: Revocation of registration as a transfer agent, a bar against a Phlo employee from association with a transfer agent, a fine of \$100,000 against the Phlo employee and cease and desist orders.

# Case Studies in (Not) Following the Rules – III

- In the matter of Silverado Stock Transfer, Inc. and Sharon L. Baldino (Securities Exchange Act Rel. No. 49680 (May 11, 2004)).
- Possible lesson: “Follow the rules and fix compliance problems that have been noted by the SEC staff in examinations.”

# Case Studies in (Not) Following the Rules – IV

- The transfer agent in question was first examined by OCIE in 1999, and the SEC staff noted to the agent that they had found violations of the obligations of the transfer agent to maintain support for its reliance on the small transfer agent exemptions of Rule 17a-4 and to comply with the fingerprinting requirements of Rule 17f-2.
- In 2003, OCIE conducted a second examination and found that the transfer agent had not fixed the issues noted in 1999. In addition, the examiners noted violations of Rules:
  - 17Ac2-2 (filing Form TA-2 with the SEC),
  - 17Ad-5 (response to certain written inquiries);
  - 17Ad-6(a)(1) (records of the business day each item is received and made available to the presentor);
  - 17Ad-6(a)(10) (current transfer journal);
  - 17Ad-6(c) (retention of cancelled certificates and accompanying documentation);
  - Rule 17Ad-10(e) (maintenance of a control book); and
  - 17Ad-12 (safeguards relating to funds and securities).
- The SEC also noted that the transfer agent and its owner/principal had failed to provide certain records requested by the SEC staff in February 2003 until November 2003.
- The result: The agent's registration with the SEC was revoked, the owner/principal was barred from association with a transfer agent, and a penalty of \$25,000.

## Case Studies in (Not) Following the Rules – V

- In the matter of Executive Registrar & Transfer, Inc. and John J. Donnelly (Administrative Proceeding Release No. 366 (December 18, 2008)).
- Possible lesson: “Follow the rules and don’t make the same mistakes twice.”

# Case Studies in (Not) Following the Rules – VI

- The principal/owner of the transfer agent in question had been subject to a cease and desist order from the SEC in the context of an affiliated transfer agent against violations of:
  - Sections 17(a)(3) and 17A(d)(1) of the Securities Exchange Act of 1934 and
  - Rules 17Ac2-1 (Form TA-1); 17Ac2-2 (Form TA-2); 17Ad-2 (turnaround); 17Ad-6 (recordkeeping); 17Ad-7 (record retention); 17Ad-10 (master securityholder file and control book); 17Ad-13 (internal accounting controls report); 17Ad-15 (written standards for signature guarantees); 17Ad-16 (notice to securities depositories); 17Ad-17 (lost shareholders) and 17f-2 (fingerprinting). The transfer agent was also required to maintain procedures to assure compliance with these provisions.
- In five SEC staff examinations of the transfer agent in question subsequent to the issuance of the cease and desist order, the SEC staff found deficiencies with respect to all but one of the statutes and rules that were the subject of the cease and desist order.

# Case Studies in (Not) Following the Rules – VII

- In the words of the Administrative Law Judge, “[t]he proven violations involve serious misconduct. [The transfer agent’s] violations of the transfer agent rules and its failure to cure repeated deficiencies outlined by [the SEC] are ongoing. The sanctions imposed for [the agent’s] transfer agent violations are accordingly severe.”
- The result: A cease and desist order against the agent, along with revocation of the agent’s registration as a transfer agent, and the owner/operator was barred from associating with a registered transfer agent.

# Case Studies in (Not) Following the Rules – VIII

- In the Matter of Holladay Stock Transfer, Inc. and Sharon M. Owens (Securities and Exchange Act Release No. 39797 (March 25, 1998)).
- Possible lesson – “Review proposed Rule 144 transactions carefully to make sure that the facts support the removal of the legend; follow the rules.”

# Case Studies in (Not) Following the Rules – IX

- According to the SEC settlement order, the transfer agent and owner/operator:
  - Removed the legend from a certificate for a proposed Rule 144 transaction that facially did not meet the standards of the Rule.
  - Transferred 11 certificates that did not appear on the master securityholder file, in violation of Rule 17Ad-10.
  - Improperly reported on Form TA-2.
  - Did not comply with the fingerprinting requirements of Rule 17f-2.
  - Failed to file an accountant's report pursuant to Rule 17Ad-13.
  - Improperly increased the aggregate outstanding shares of an issuer by 4,500 shares.
- The result: A cease and desist order, a censure, a civil penalty of \$5,000, and obligations to install appropriate compliance procedures and to arrange for an external compliance review.

# So – what can you do about fraud/unregistered public offerings?

- Fraud:
  - Use your judgment – do the issuer and transactions feel right?
  - Do the directors/officers have a prior history or bad reputation?
  - Is the issuer up to date on its public filings? Do the disclosures match up?
  - Opinion review – do you know the attorney, is he/she currently licensed to practice or are there other red flags about the opinion?
  - Do the supporting resolutions, certificates etc. make sense?
  - Consider liability...

# So – what can you do about compliance?

- Compliance:
  - Make coordinating compliance part of someone’s job description – i.e., create a “chief compliance officer.” Make part of your evaluation and the compensation of that individual dependent on his or her efforts on compliance, and give that person adequate responsibility and support to handle the job.
  - Devote adequate resources to compliance.
  - Try to put at least the basic elements of your “compliance program” in writing, with time lines etc.
  - Keep in mind that some of the transfer agent rules specifically require written policies and procedures (e.g., Rule 17Ad-17).
  - When the SEC staff notes deficiencies, address them promptly.
  - Keep up to date on regulatory/legal developments and make sure that you review your compliance program with a critical eye for improvement.

# So – what can you do about compliance? II

- Possible written procedures
  - General procedure giving overview of how your firm’s compliance program works
  - Annual compliance calendar
  - Issuer due diligence and restricted legend procedures
  - Written procedures at least with respect to those functions where the SEC rules require it (e.g., 17AD-17 and 17AD-19)
  - Written procedures for other aspects of compliance that are material to your program

QUESTIONS?