

VII. *The SEC's Operation Shell Expel*

A. Introduction

On June 3, 2013 the Securities and Exchange Commission (“SEC”) suspended trading in sixty-one microcap shell companies.¹ This suspension was a continuation of “Operation Shell Expel,” the SEC’s effort to combat fraudulent practices involving microcap shell companies on the over-the-counter (“OTC”) market.² This latest suspension follows an even more extensive initiative in 2012, in which the SEC suspended trading by 379 dormant shell companies.³ The SEC targets microcap shells because they often play a key role in suspicious reverse mergers and more blatantly fraudulent pump-and-dump schemes.⁴ Operation Shell Expel requires suspended shell companies to provide updated financial information in order to regain their trading status.⁵ Scrutinizing microcap companies in this way dissuades scam artists from taking advantage of them.⁶

This article analyzes the SEC’s efforts to combat microcap fraud and the effectiveness of Operation Shell Expel. Part B examines microcap stocks generally and how they may be used for fraudulent purposes in pump-and-dump schemes and reverse mergers. Part C explains how trading suspension works and how it compares to other alternatives at the SEC’s disposal. Part D evaluates criticism of Operation Shell Expel and its preventative method of targeting microcap fraud.

¹ Press Release, SEC, SEC Suspends Trading of 61 Cos. Ripe for Fraud in Over-The-Counter Mkt. (June 3, 2013), <http://www.sec.gov/News/PressRelease/Detail/PressRelease/1365171575084#.Uit5w2SDQXw> [hereinafter 2013 SEC Press Release].

² *Id.*

³ Press Release, SEC, SEC Microcap Fraud-Fighting Initiative Expels 379 Dormant Shell Cos. to Protect Investors from Potential Scams (May 14, 2012),

<https://www.sec.gov/News/PressRelease/Detail/PressRelease/1365171489086#.Uit6p2SDQXw> [hereinafter 2012 SEC Press Release].

⁴ 2013 SEC Press Release, *supra* note 1.

⁵ 2012 SEC Press Release, *supra* note 3.

⁶ *Id.*

B. Abuses Involving Over-the-Counter Microcap Shell Companies

Shell corporations have “no active business,” existing “only in name.”⁷ Microcap companies have a low capitalization, meaning the value of their total stock is less than \$250 to \$300 million.⁸ Shares of shell corporations are often sold as microcap stock because such companies have a low capitalization, and usually lack “assets, operations, [and] revenues.”⁹ Microcap stock is frequently sold on the OTC market, which is overseen by the Financial Industry Regulatory Authority (“FINRA”) and the SEC.¹⁰ The OTC market is different than national securities exchanges because it includes the OTC Pink marketplace, which is “an open marketplace for a broad spectrum of equity securities, with no financial standards or reporting requirements.”¹¹ Without regulatory boundaries, shell corporations traded on such markets are susceptible to fraudulent schemes.¹² Two common potential abuses of shell corporations are reverse mergers and pump-and-dump schemes.¹³

1. The Structure of Reverse Mergers

Reverse mergers can be a legitimate use of shell companies, but are nonetheless disfavored by the SEC.¹⁴ In a reverse merger, an existing public shell company acquires a private company.¹⁵ Through this merger, the private company’s shareholders get a controlling interest in the public shell company and typically take over the board

⁷ BLACK’S LAW DICTIONARY 394 (9th ed. 2009).

⁸ SEC, MICROCAP STOCK: A GUIDE FOR INVESTORS (Sept. 18, 2013), <http://www.sec.gov/investor/pubs/microcapstock.htm>.

⁹ *Id.*

¹⁰ *Id.*

¹¹ *Id.*

¹² Max Stendahl, *SEC Halts Trading in 61 Companies in Fraud Crackdown*, LAW 360 (June 3, 2013, 11:59 AM), <http://www.law360.com/articles/446773/sec-halts-trading-in-61-companies-in-fraud-crackdown>.

¹³ *Id.*

¹⁴ See David N. Feldman, *Comments on Seasoning of Reverse Merger Companies Before Uplisting to National Securities Exchanges*, 2 HARV. BUS. L. REV. 140, 142, 144 (2012).

¹⁵ SEC, INVESTOR BULLETIN: REVERSE MERGERS 1 (June 2011), <http://www.sec.gov/investor/alerts/reversemergers.pdf> [hereinafter INVESTOR BULLETIN: REVERSE MERGERS].

of directors and management of the shell company.¹⁶ Thereafter, the acquired company is public and able to trade on appropriate markets.¹⁷ Reverse mergers allows companies to go public while avoiding the formal reporting requirements normally required during an initial public offering (“IPO”).¹⁸

Private operating companies may chose to go public through a reverse merger rather than an IPO for several reasons, including the lower costs and faster transaction times.¹⁹ With reverse mergers, legal and accounting fees are lower: a reverse merger may be achieved for less than \$1 million, while IPOs tend to cost millions of dollars.²⁰ Reverse mergers often take three to four months to complete compared to over nine to twelve months for an IPO.²¹ Furthermore, the public shell company acquirer only has to report the merger in a Form 8-K filing to the SEC, whereas IPOs have registration requirements under the Securities Act of 1933.²² Such requirements protect investors from noncompliant disclosures on which they may base their investment.²³ Companies going public through an IPO must file a registration statement with the SEC that is subsequently reviewed by the SEC for compliance.²⁴ Additionally, if a shell company was continuously quoted on the OTC market before the merger, the resulting company may be able to avoid filing a Form 211 with the FINRA after the merger.²⁵ Allowing companies to avoid this step enables them to avoid significant administrative expenses, because Form 211 requires disclosure regarding the company’s recent offerings, business, and relations with regulatory agencies.²⁶

¹⁶ *Id.*

¹⁷ *Id.* at 2 (“[I]f a company being acquired in a reverse merger was continuously quoted OTC before the takeover, the post-merger company may be able to rely on that status to permit its shares to continue to be quoted. . . .”).

¹⁸ *Id.* at 1.

¹⁹ *Id.* (“A reverse merger is often perceived to be a quicker and cheaper method of ‘going public’ than an initial public offering (IPO).”).

²⁰ *Id.* at 1; Feldman, *supra* note 14, at 141.

²¹ Feldman, *supra* note 14, at 141.

²² INVESTOR BULLETIN: REVERSE MERGERS, *supra* note 15, at 1.

²³ SEC, INVESTOR BULLETIN: INVESTING IN AN IPO 1, <http://www.sec.gov/investor/alerts/ipo-investorbulletin.pdf>.

²⁴ *Id.*

²⁵ INVESTOR BULLETIN: REVERSE MERGERS, *supra* note 15, at 2.

²⁶ *Form 211*, FINRA, <http://www.otcbb.com/aboutotcbb/forms/form211.pdf>.

There are inherent risks to investors who choose to invest in reverse merger companies.²⁷ The SEC warns that, unless the company is reporting under the Exchange Act, it may be challenging for investors to determine which companies went public through a reverse merger.²⁸ According to some practitioners, reverse merger companies are disfavored because “they are presumptively faltering or questionable companies.”²⁹ In the past, scam artists were able raise funds through public offerings of shell companies and ultimately keep the investors’ money.³⁰ This type of fraud has largely been prevented by the passage of the Penny Stock Reform Act of 1990 and Rule 419 under the Securities Act of 1933, which places restrictions on shell companies that are going public and requires that cash raised through shell company IPOs be placed in escrow.³¹ More recently, a number of Chinese companies had gone public in the U.S. using reverse mergers, and several were later accused of engaging in accounting fraud.³² Although accounting fraud by Chinese companies is not exclusively tied to reverse mergers,³³ such allegations encouraged the SEC to examine microcap fraud generally.³⁴ As a result, the SEC halted trading in a number of reverse merger companies where the companies were not providing current and accurate information.³⁵

2. The Structure of Pump-and-Dump Schemes

Scam artists have also used microcap shell companies for pump-and-dump schemes.³⁶ In a pump-and-dump scheme, a person owning stock in a particular company promotes that company’s stock

²⁷ INVESTOR BULLETIN: REVERSE MERGERS, *supra* note 15, at 2.

²⁸ *Id.* at 1; Feldman, *supra* note 14, at 144.

²⁹ Timothy P. Harkness, *Chinese Companies Under Fire: The Recent Boom in U.S. Securities Cases Against Chinese Public Companies*, BUS. L. CURRENTS, 2012 WLNR 28943550 (2012).

³⁰ Feldman, *supra* note 14, at 143.

³¹ *Id.*

³² *Id.* at 144.

³³ Harkness, *supra* note 29.

³⁴ Feldman, *supra* note 14, at 144.

³⁵ Press Release, SEC, SEC Approves New Rules to Toughen Listing Standards for Reverse Merger Cos. (Nov. 9, 2011), <http://www.sec.gov/news/press/2011/2011-235.htm>.

³⁶ 2012 SEC Press Release, *supra* note 3.

through false or misleading statements.³⁷ This false promotion “pumps” the company’s share price.³⁸ Once the stock price has increased, the perpetrator then “dumps” the shares that he or she holds.³⁹ The sale of the individual’s shares causes the stock price to fall and investors to lose their investments.⁴⁰ The individual is left with a gain from his selling shares at the increased stock price.⁴¹

C. Operation Shell Expel: Trading Suspension

1. How It Works

Pursuant to the Securities Exchange Act of 1934, the SEC has the power to suspend trading of companies.⁴² The SEC may exercise this power as required for the public interest or the protection of investors.⁴³ Suspension may last up to ten business days.⁴⁴ During this suspension, no trading may occur in the suspended stock.⁴⁵

Once the suspension of a company ends, broker-dealers may not solicit investors to buy or sell stock in the company until the broker-dealer files a Form 211 with the FINRA.⁴⁶ In the Form 211, the broker-dealer must represent that he has satisfied the requirements of Rule 15c2-11 promulgated under the Securities Exchange Act of 1934 and FINRA Rule 6432.⁴⁷ Rule 15c2-11

³⁷ SEC, “PUMP-AND-DUMPS” AND MARKET MANIPULATIONS (Mar. 12, 2013), <http://www.sec.gov/answers/pumpdump.htm>.

³⁸ *Id.*

³⁹ *Id.*

⁴⁰ *Id.*

⁴¹ *Id.*

⁴² Securities Exchange Act of 1934, 15 U.S.C. § 78j(12)(k)(1) (1934).

⁴³ *Id.*

⁴⁴ *Id.*

⁴⁵ See SEC, INVESTOR BULLETIN: TRADING SUSPENSIONS 2 (May 2012), <http://www.sec.gov/investor/alerts/tradingsuspensions.pdf> [hereinafter INVESTOR BULLETIN: TRADING SUSPENSIONS].

⁴⁶ *Id.*

⁴⁷ Securities Exchange Act of 1934, 15 U.S.C. § 78j(15)(l)(2) (1934). The purpose of Rule 15c2-11 “is to require all market makers initiating quotations for unlisted securities in a quotation medium to review information about the issuer, and to review updated information annually if they are publishing priced quotations.” SEC, *Reproposal of Amendments to Rule 15c2-11 Fact Sheet* (Feb. 19, 1999), <http://www.sec.gov/>

requires the broker-dealer to review and maintain documents about the company, including “(1) the company’s state of organization, business line, and names of certain control affiliates; (2) the title and class of the securities outstanding; and (3) the company’s most recent balance sheet and its profit and loss and retained earnings statement.”⁴⁸ The broker-dealer filing the Form 211 “must have a reasonable basis for believing the information is accurate and that it comes from reliable sources.”⁴⁹ There is no requirement that the Form 211 be approved by the FINRA, and it may not receive such approval if there are unresolved questions.⁵⁰ Therefore, a suspension requires a company to take affirmative steps towards compliance in order to resume trading.⁵¹

2. Past Success

Suspension may help prevent fraud by drawing attention to the suspended shell companies and increasing the availability of information about the companies.⁵² In one case, the SEC uncovered a \$4.4 million market manipulation scheme through a trading suspension.⁵³ The SEC harbored concerns about the representations made by the company in its press releases and consequently suspended trading, ultimately discovering the underlying fraud through the suspension of the company’s OTC stock.⁵⁴ This particular scheme involved a stockbroker, Harary, who created a

news/extra/micro15c.txt. FINRA Rule 6432 creates a “procedure for demonstrating compliance with SEA Rule 15c2-11.” FINRA, *Requirements Applicable to Market Makers* (2013), http://finra.complinet.com/en/display/display.html?rbid=2403&element_id=4514&print=1.

⁴⁸ INVESTOR BULLETIN: TRADING SUSPENSIONS, *supra* note 45, at 2.

⁴⁹ FINRA, *When Trading Stops: What You Need to Know About Halts, Suspensions and Other Interruptions* (Feb. 7, 2013), <http://www.finra.org/Investors/ProtectYourself/InvestorAlerts/TradingSecurities/P177011>.

⁵⁰ INVESTOR BULLETIN: TRADING SUSPENSIONS, *supra* note 45, at 2 (“If there are continuing regulatory concerns about the company, its disclosures, or other factors, such as a pending regulatory investigation, a Form 211 application may not be approved.”).

⁵¹ *See id.*

⁵² *See id.*

⁵³ Press Release, SEC, SEC Charges Two With Sec. Fraud in \$4.4 Million Mkt. Manipulation and Kickback Case (Sept. 24, 2007), <http://www.sec.gov/news/press/2007/2007-197.htm>.

⁵⁴ *Id.*

market for the stock of two shell companies.⁵⁵ Harary worked with Zemsky, who purchased the companies and sold their shares.⁵⁶ Harary simulated demand by purchasing the stock for the customers at his stockbroking firm.⁵⁷ He ultimately sold his stock for more than \$4.4 million in proceeds.⁵⁸ His customers were left with worthless shares in the shell companies and lost approximately \$3.8 million collectively.⁵⁹ The SEC's suit, however, was successful: Harary and Zemsky paid just over \$4 million and were both subject to various bans on trading.⁶⁰ This case demonstrates the SEC's successful use of trading suspension to detect and discipline fraud.

3. Alternative: Criminal Enforcement

There is also a viable criminal route that the SEC may use to enforce laws against pump-and-dump schemes. Under the Securities Exchange Act of 1933, the SEC has the power to bring action against companies that violate any rule or regulation under the authority of the SEC.⁶¹ The SEC may work with the Attorney General who may institute criminal proceedings against such companies.⁶² The SEC has successfully pursued criminal action against perpetrators of pump-and-dump schemes.⁶³ In *United States v. Clark*, the SEC brought an action for crimes of conspiracy, wire fraud, and securities fraud.⁶⁴ The defendant, Clark, was sentenced to 151 months imprisonment for his crimes related to a pump-and-dump scheme.⁶⁵ This result demonstrates the effectiveness of the SEC's criminal enforcement powers against such fraudulent practices.

⁵⁵ *Id.*

⁵⁶ *Id.*

⁵⁷ *Id.*

⁵⁸ *Id.*

⁵⁹ *Press Release, SEC, supra* note 53.

⁶⁰ *Id.*

⁶¹ Securities Exchange Act of 1933, 12 U.S.C. § 77a(20)(b) (2006).

⁶² *Id.*

⁶³ *See, e.g., SEC v. Gordon*, 822 F. Supp. 2d 1144 (N.D.O.K. 2011); *United States v. Clark*, 717 F.3d 790 (10th Cir. 2013).

⁶⁴ *Clark*, 717 F.3d at 823.

⁶⁵ *Id.* at 798 (“Mr. Clark ultimately was convicted of fourteen of the twenty-one counts for which he was indicted. He was sentenced to 151 months’ imprisonment” and this court affirmed the conviction”).

4. A Preference for Prevention

The SEC's goal in targeting shell companies is to counter fraud and safeguard investors.⁶⁶ According to Christopher Ehrman, Co-National Coordinator of the SEC's Microcap Fraud Working Group, "[o]nce a company ceases its filings and investors no longer have current information about it, there is no good reason for that empty shell to remain exposed on our public markets."⁶⁷ According to the SEC, suspending trading forces a company to "prove they're still operational," which "essentially render[s] them useless to scam artists now that they're no longer flying under the radar."⁶⁸ The SEC's method of targeting shell companies is preventative: instead of waiting for criminals to enact fraudulent schemes before bringing an expensive criminal action, this operation seeks to avert the fraud and harm to investors in the first place.⁶⁹

D. Criticism of Operation Shell Expel

Some critics have claimed that the SEC's operation protects investors who, through their own diligence, could have detected the fraudulent scheme.⁷⁰ This is because many of the suspended companies have not filed proper documents in several years and are not currently in operation.⁷¹ Under a similar rationale, others criticize the SEC for acting too late.⁷² Additionally, the SEC's targeting of shell companies may be too simplistic—it suspends companies that are very clearly non-operational, whereas fraud is more likely to occur in less conspicuous shell companies.⁷³ While it is possible that the SEC is merely protecting investors who could best protect themselves, and that Operation Shell Expel is not efficiently determining which shell companies are truly at risk for fraudulent schemes, the SEC maintains that its program has successfully

⁶⁶ 2013 SEC Press Release, *supra* note 1.

⁶⁷ *Id.*

⁶⁸ *Id.*

⁶⁹ *See id.*

⁷⁰ Al Lewis, *A Penny For Your Stock*, FOXBUSINESS (June 6, 2013), <http://www.foxbusiness.com/industries/2013/06/07/penny-for-your-stock>.

⁷¹ *See id.*

⁷² *See id.*

⁷³ *See id.*

brought shell companies under scrutiny “before they could be manipulated for fraudulent activity to harm investors.”⁷⁴

E. Conclusion

The SEC’s Operation Shell Expel has suspended several shell companies from the OTC market. These suspended companies could have been used in fraudulent activities such as pump-and-dump schemes, and reverse mergers accompanied by inadequate financial reporting. There may be more efficient methods to detect which shell companies are vulnerable to such schemes; however, the SEC’s program has proven to be effective in at least one case, where the suspension enabled the SEC to detect a large-scale market manipulation. Given that suspending a shell company’s shares eliminates any viable means to commit fraud, it seems likely that the SEC’s operation has both directly and indirectly prevented some criminal uses of shell companies. Thus, although it is difficult to measure the extent of Operation Shell Expel’s success, it appears to have created an overall improvement in market integrity for investors.

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⁷⁴ 2013 SEC Press Release, *supra* note 1.

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