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Is it really a shell company? They're not all shells.

By Tiffany Walsh

Companies trying to go public on the Over the Counter Bulletin Board (OTC-BB) have many hoops to jump through before they accomplish that goal. There are several strategic approaches a company can take to go public, and the necessary steps are generally defined by the Securities and Exchange Commission (SEC). However, there is one unclear label that can impact the direction of the company once it goes public – whether the company is labeled a “shell company.” Every public company must indicate on the front cover of every quarterly and annual report it files with the SEC whether the company is a shell. Essentially, this is stating the status of the company - whether the company is a nominal assets or operations company. Determining the company status as a shell is important because it establishes the procedure and guidelines the company will subsequently have to follow. Typically, the procedure and guidelines are tougher on zero operation companies than structurally and profitably sound ones. Therefore, most companies will try to avoid being classified as a shell company. Furthermore, the classification of a shell has a negative connotation that implies a fake company and creates an undue hardship on legitimate, early-stage companies trying to go public. This ultimately triggers an important issue: what are the specific characteristics of a shell company? Unfortunately, there are no clear objective guidelines as to what constitutes a shell for purposes of seeking a listing on the OTC-BB. The definition is so subjective that it makes it virtually impossible for some companies (especially developmental-stage companies) to know if they should be calling themselves shells. Because this step has such a significant impact on the future of these companies, the SEC should narrow and

more clearly define the definition of a shell so legitimate companies with potential will not have to distinguish themselves under the restrictive, disparaging label.

This paper will start with a background discussion that broadly explains the process of going public on the OTC-BB, the relevant filings with the SEC, and the legal definition of a shell company. Then there will be an analysis of the legal implications of the current definition of a shell company, followed by the advantages and disadvantages of allowing a company to objectively determine its status.

BACKGROUND:

PROCESS OF GOING PUBLIC AND RELEVANT FILINGS WITH SEC

There are several different stock exchanges in the United States on which companies strive to get listed. The most prestigious and publically recognized are the Nasdaq, NYSE Amex (formerly the American Stock Exchange) and the NYSE Euronext (formerly the New York Stock Exchange). The less publicly recognized are the Over the Counter Bulletin Board and pink sheets, which, technically speaking aren't actually stock exchanges but for purposes of this paper will be discussed as such. The OTC-BB and pink sheets may be less prestigious than the higher exchanges, but they are much easier to get listed on. To get listed on the OTC-BB, a company can do so by self filing an S-1 or Form 10 document, an initial public offering (IPO), or through a reverse merger.

The S-1 document is the shares registration form for companies. These privately held companies which plan to go public by virtue of the form S-1 filing only have to disclose two years of audited financial statements (or less if the company has existed for less than two years), whereas larger, fifty-million-dollars-plus companies may need to

provide three years or more.¹ “The basis of the filing is a well-written business plan prepared by the company’s management, which is then transformed into a prospectus.”² After filing the S-1, the SEC usually sends it back with a comment letter, indicating the questions and or corrections that need to be made. After making the necessary amendments, the S-1 is refiled with a letter addressing each comment, and the SEC will review it again.³ It is quite typical for a company to receive numerous comment letters with ten to twelve comments each before the SEC is confident that everything is legitimate and correct.⁴ Financing could be obtained before or right after filing the S-1 so it can qualify for the OTC-BB: at least thirty-five to forty nonaffiliated shareholders with a minimum of 100 tradable shares apiece is suggested.⁵ Once the S-1 is effective, the company is finally public, and a market maker is required to apply for the listing on the OTC-BB.⁶

The Form 10 document is similar to the S-1, but it does not describe a securities offering.⁷ No offering is involved, and no shares become tradable by filing Form 10 as a means of going public on the OTC-BB. Although this seems to defeat the purpose of going public, shares can still start trading once the shareholder has held its shares long enough (according to rule 144),⁸ or the company can “file an S-1 resale registration to

¹ Drew Bernstein, Bernstein & Pinkchuk, Accounting: Financial Statement Requirements, Reverse Merger Conference, Toronto (June 29, 2010) (transcript available on the Reverse Merger Conference CD Rom 2010).

² DAVID N. FELDMAN, REVERSE MERGERS; AND OTHER ALTERNATIVES TO TRADITIONAL IPOs 192 (Bloomberg Press 2009) (2006).

³ *Id.*

⁴ See Steve Siesser, Lowenstein Sandler, Cross-Border Financing Opportunities: Tapping Canadian Investors for Capital, Reverse Merger Conference, Toronto (June 29, 2010) (transcript available on the Reverse Merger Conference CD Rom 2010) (“The SEC has recognized that they are drilling down now and sometimes give ten or twelve comments, which slows down the process.”).

⁵ Feldman, *supra* note 2, at 196.

⁶ *Id.*

⁷ *Id.* at 197.

⁸ See 17 C.F.R. § 230.144 (2009).

release some shares from restriction immediately following the day when the Form 10 filing is completed and effective.”⁹ This all seems rather counterproductive if a company can just avoid the extra work by initially filing the S-1, but there are benefits of doing the process the long way and filing the Form 10 first. There are restrictions on financing with the S-1: from the filing of the S-1 to the point when the SEC makes the registration statement effective, there are limitations to the companies ability to raise additional capital by issuing new equity, and that process can take anywhere from two to six months.¹⁰ Form 10 eliminates this drawback, so the company can finance itself while waiting to go public and can file the S-1 resale registration with the money it received.¹¹ If no comment letter is received, the application is affective automatically sixty days after it’s filed. If there are some comments, they need to be cleared by the end of the sixty-day period, and once the form is declared effective, the company can trade on the OTC-BB.¹² The Form 10 shells are a great way to go public because they are easy to set up and maintain, and because it’s a non operating entity, the audit fees and legal fees will be substantially lower.¹³

⁹ Feldman, *supra* note 2, at 198.

¹⁰ Interview with Paul Pedersen, Tribune Ventures, in Lansing, Mich. (June 12, 2010) (discussing multiple ways to go public).

¹¹ Interview with David Feldman, Managing Partner, Feldman LLP, in Toronto (June 28, 2010).

¹² *See generally* Feldman, *supra* note 2, at 199 (stating,

If the SEC chooses not to comment, the form is effective after the sixty days have elapsed and the company is thereafter public and subject to the Exchange Act reporting requirements. If the SEC does comment, the form still becomes effective sixty days after its original filing date, provided the amendments have been filed and all comments have been cleared before sixty days pass.)

¹³ *See* Catherine Ratelle, Evotech Management Corporation, Introduction to Form 10 Shells, Reverse Merger Conference, Toronto (June 29, 2010) (transcript available on the Reverse Merger Conference CD Rom 2010) (discussing advantages and disadvantages of Form 10 shells).

An IPO is when a company sells new stock (primary offering), diluting the previous shareholders' holdings, through a broker dealer to raise more money for the company.¹⁴

Very simplistically, a reverse merger is when a larger, private company merges into the smaller company; the "shell" corporation survives and assumes the private company's assets and liabilities.¹⁵ The private company's shares are exchanged for the shares of the public shell,¹⁶ so the new owners of the public shell are now shareholders from the private company. The operating business of the private company stays intact, and the business of the shell ceases to exist.¹⁷

ANALYSIS:

LEGAL DEFINITION OF A SHELL COMPANY

The Securities Act Rule 405 and Exchange Act Rule 12b-2 "define a 'shell company,' other than an asset-backed issuer, with no or nominal operations and either no or nominal assets, assets consisting solely of cash and cash equivalents, or assets consisting of any amount of cash and cash equivalents and nominal other assets."¹⁸

¹⁴ Interview with Paul Pedersen, Tribune Ventures, in Lansing, Mich. (June 12, 2010) (discussing multiple ways to go public).

¹⁵ See Feldman, *supra* note 2, at 44 ("In a merger, reverse or otherwise, two corporations join together. One becomes the 'surviving corporation'; the other becomes the 'non-surviving corporation.' The surviving corporation swallows up the assets and liabilities of the nonsurviving corporation, and the latter simply ceases to exist.").

¹⁶ *Id.* at 45.

¹⁷ See generally Feldman, *supra* note 2, at 45-46 ("[T]he newly formed subsidiary of the shell, as the nonsurviving corporation, disappears and the private company, as the surviving corporation, becomes a wholly owned subsidiary of the shell, with the owners of the formerly private company owning the majority of the shares of the shell following the deal's closing.").

¹⁸ Use of Form S-8, Form 8-K, and Form 20-F by Shell Companies, Exchange Act Release Nos. 33-8587; 34-52038; International Series Release No. 1293 at 9 (Aug. 22, 2005) [hereinafter SEC Report].

LEGAL IMPLICATIONS OF THE CURRENT DEFINITION

Every public company must indicate on the front cover of each of its quarterly and annual reports filed with the SEC whether the company is a shell.¹⁹ Most companies will try to avoid being classified as a shell company because of the negative connotations and extra filing requirements that come along with the label.²⁰ However, it is difficult for companies to even know whether they should be checking the “shell box” on their quarterly and annual reports because the definition of a shell is so vague. The current definition defines a shell as one with no or nominal operations,²¹ but what exactly does the term “nominal” mean? The SEC does not define it. The definition further defines a shell as one with no or nominal assets²² but again fails to define what nominal assets are. This vague definition triggers creativity among some small companies to enhance their operations and assets so they can step around the term “nominal” and avoid being classified as a “shell.”²³ It is well to their advantage to do so too because otherwise, their strategic direction in going public could be drastically affected.

There are a couple of rules implemented by the SEC to help define what constitutes a shell. Footnote 32 of “Use of Form S-8, Form 8-K, and Form 20-F by Shell Companies,” which is part of the final rule passed by the SEC in June 2005, makes clear that a company placing assets or operations within an entity with the intent of causing that entity to fall outside the definition of a blank check company (shell company) and

¹⁹ See generally SEC Report at 27 (“Accordingly, we are adopting amendments to Form 10-Q, Form 10-QSB, Form 10-K, Form 10-KSB, and Form 20-F to add a box on the cover page of those forms that the registrant must mark to indicate whether or not it is a ‘shell company.’”).

²⁰ Author’s personal experience (The negative connotation that accompanies a shell label is not expressed in writing, but it is a perceived negativity that professionals in the corporate securities field have.).

²¹ SEC Report at 8.

²² *Id.*

²³ Interview with Paul Pedersen, Tribune Ventures, in Lansing, Mich. (June 12, 2010) (discussing multiple ways to go public).

acquires the money back through a separate business transaction after the reverse merger, cannot get around the definition.²⁴ Those assets or operations will be considered “nominal” for purposes of classifying the company a shell.²⁵ This rule certainly helps define more clearly what a shell is or at least what a company cannot do to get around the classification; however, Footnote 172 of the SEC’s 2008 amendments to Rule 144 makes the definition confusing yet again. Footnote 172 seems to indicate that “having even the simplest of operations is enough for a company to avoid being deemed a shell.”²⁶ According to footnote 172, one can only infer that even “nominal” operational companies can avoid the definition of a shell. In fact, it appears a shell company is actually a zero operations company only – the word “nominal” in terms of operations is deemed meaningless in concurrence with footnote 172.

²⁴ See SEC Report 10-11 n.32 (2009) (stating,

[W]e have become aware of a practice in which a promoter of a company and/or affiliates of the promoter appear to place assets or operations within an entity with the intent of causing that entity to fall outside of the definition of “blank check company” in Securities Act Rule 419. The promoter will then seek a business combination transaction for the company, with the assets or operations being returned to the promoter or affiliate upon the completion of that business combination transaction. It is likely that similar schemes will be undertaken with the intention of evading the definition of a shell company that we are adopting today. In our view, where promoters (or their affiliates) of a company that would otherwise be a shell company place assets or operations in that company and those assets or operations are returned to the promoter or its affiliates (or an agreement is made to return those assets or operations to the promoter or its affiliates) before, upon completion of, or shortly after a business combination transaction by that company, those assets or operations would be considered “nominal” for purposes of the definition of shell company.);

see also Feldman, *supra* note 2, at 154-55.

²⁵ See SEC Report at 11.

²⁶ Feldman, *supra* note 2, at 158; see Revisions to Rules 144 and 145, Exchange Act Release No. 33-8869; File No. S7-11-07 at 48 n.172 (Dec. 6, 2007) (stating,

Rule 144(i) does not prohibit the resale of securities under Rule 144 that were not initially issued by a reporting or non-reporting shell company or an issuer that has been at any time previously such a company, even when the issuer is a reporting or non-reporting shell company at the time of sale. Contrary to commenters’ concerns, Rule 144(i)(1)(i) is not intended to capture a “startup company,” or, in other words, a company with a limited operating history, in the definition of a reporting or non-reporting shell company, as we believe that such a company does not meet the condition of having “no or nominal operations.”).

There is no doubt that the current definition of what constitutes a shell is unclear, and unfortunately, this creates an undue burden on many small companies. Because the definition is vague, many cautious market makers and lawyers will advise clients that any early-stage company without substantial assets should check the shell box and conduct themselves under the rules governing shell companies just to be on the safe side.²⁷ The reason is so the SEC doesn't come back and tell the company it's actually a shell and now has to re-file many of the documents in accordance with one; a shell company has different time frames and further documents to file than a company not deemed a shell. Thus, knowing in advance whether a company has to comply with shell requirements is vital.

After a reverse-merger transaction, the shareholders of the larger private company acquiring the shares of the public one has a holding period on selling their newly acquired shares. Under Rule 144, if the public company was *not* classified a shell, then the public company's shareholders can start selling their shares six months after acquisition.²⁸ However, if the public company being acquired was classified as a shell, then the public company's shareholders must wait a twelve-month holding period following the reverse merger before they can start selling their shares.²⁹ This puts shell company shareholders at a disadvantage because they will have to wait an additional six months before they can start selling their shares in the market.

²⁷ Telephone Interview with Peter Smith, Corporate Securities Attorney at Law (June 2, 2010).

²⁸ See 17 C.F.R. § 230.144 (2009).

²⁹ See 17 C.F.R. § 230.144 (2009); see also Feldman, *supra* note 2, at 178

(People with shares in a shell now have a chance to sell under Rule 144 for the first time, starting one year after a reverse merger and release of the super 8-K . . . [F]ormer shells have to wait until one year after a merger, whereas non-shell shareholders can start selling in six months.).

Rule 144 is not the only drawback for shell companies after a reverse-merger transaction; the merging company also has to file an 8-K document if it is acquiring a company that is classified a shell.³⁰ The form 8-K, required following a reverse merger, is similar to a prospectus if there was a traditional IPO and encompasses all of the same information that would be in the Form 10.³¹ Under the Form 8-K requirement, if a company was classified a shell at the time of the transaction, the acquiring company has only four business days after the reverse merger to file the document.³² The four-day window creates an extreme amount of pressure because filing the Form 8-K is no quick process. Timing is absolutely critical; there is no forgiveness with the SEC if the four-day deadline isn't met.³³ In fact, the four-day limitation to file the Form 8-K is such a drawback that some companies refuse to acquire any company that is classified a shell, especially because a reverse merger that's not involved with one does not have to follow this rule.³⁴

Another disadvantage for shell companies is the eliminated use of Form S-8 documents. This form is used to register shares for those who are employees or

³⁰ SEC Report at 7.

³¹ See Feldman, *supra* note 2, at 173; accord Drew Bernstein, Bernstein & Pinkchuk, Accounting: Financial Statement Requirements, Reverse Merger Conference, Toronto (June 29, 2010) (transcript available on the Reverse Merger Conference CD Rom 2010) (“Once a company files the 8-K, it will be required to file Form 10-K at the end of the calendar fiscal year, and quarterly financial statements that are unaudited”).

³² See 17 C.F.R. § 249.208 (2009); accord SEC Report at 21; accord Drew Bernstein, Bernstein & Pinkchuk, Accounting: Financial Statement Requirements, Reverse Merger Conference, Toronto (June 29, 2010) (transcript available on the Reverse Merger Conference CD Rom 2010).

³³ See Drew Bernstein, Bernstein & Pinkchuk, Accounting: Financial Statement Requirements, Reverse Merger Conference, Toronto (June 29, 2010) (transcript available on the Reverse Merger Conference CD Rom 2010) (Information in the 8-K will include audited financial statements, unaudited interim financial statements, Proforma information, audited financial statements of the accounting acquirer which would be presented for the full three years required by the regulation S-X or the period of its existence if shorter, and two years required for a smaller reporting company.).

³⁴ See 17 C.F.R. § 249.208 (2009); see also Drew Bernstein, Bernstein & Pinkchuk, Accounting: Financial Statement Requirements, Reverse Merger Conference, Toronto (June 29, 2010) (transcript available on the Reverse Merger Conference CD Rom 2010).

consultants of a public company.³⁵ While the company is classified a shell, and for sixty days after it ceases to be a shell company, it cannot provide this form of compensation to its employees or consultants.³⁶ The rule was implemented to deter fraudulent companies from going public on the OTC-BB. Some companies create company “costs” by giving the company’s money to the insiders of the company and play it off as a consulting fee instead of putting the money toward legitimate business expenses³⁷ – essentially, the basis of a non-operational company. Nonetheless, the eliminated use of Form S-8 has created repercussions for legitimate companies that are broadly forced under the definition of a shell. When a small company is prohibited from compensating its employees with registered stock, it discourages involvement from skillful and experienced people who could help the company move forward – creating yet another obstacle for companies labeled a shell.

ADVANTAGES OF AN OBJECTIVE DEFINITION

Because of the investors involved and the strategic elements of planning corporate structure in advance, a more objective definition would help a company be more effective in deciphering early on whether the company is a shell.³⁸ Ultimately, the SEC and the

³⁵ See 17 C.F.R. § 239.16b (2009). See generally SEC Report at 16 (“In response to comments, we also are permitting certain shell companies that were formed solely to effect business combination transactions to use Form S-8 immediately after they cease being shell companies and file ‘Form 10 information.’”).

³⁶ See generally SEC Report at 13

([A] company that ceased being a shell company would be eligible to use Form S-8 to register offerings of securities sixty calendar days after it filed information equivalent to what it would be required to file if it were registering a class of securities under Section 12 of the Exchange Act through the use of Form 10, form 10-SB, or Form 20-F, as applicable to that company.).

³⁷ See, e.g., *id.* at 15 (“[W]e continue to see the misuse of Form S-8 to register the sale of shares to purported employees or other nominees, who often are designated as ‘consultants’ but who often do not provide services for which the company may offer securities in a transaction registered on Form S-8.”).

³⁸ See generally Telephone Interview with Peter Smith, Corporate Securities Attorney at Law (June 2, 2010) (“There are laws that need to be objectively measurable; allowing absolute certainty so people know,

company would have fewer comments to deal with after filing Form S-1 and Form 10 because the company would know in advance if it should be following the requirements of a shell to expedite the overall process.

An objective definition will obligate those companies that are, in fact, shells to classify themselves as such. This will reduce fraudulent activity because companies will be less capable of pushing the boundaries as to what constitutes “nominal.” A bright-line rule would effectively disable company creativity that Footnote 32 attempts to restore.³⁹ Because of the creativity in avoiding the shell classification, a negative connotation has also been attached to shell companies as being fake or fraudulent.⁴⁰ This negative connotation hurts companies as investors lose confidence in investing in a shell. Therefore, an objective definition will hopefully eliminate this perceived notion as well because the fraudulent activity would be reduced.

An objective definition could also potentially change the perceived value of companies that eventually plan to do a reverse merger. Because the current definition is so subjective, there are many companies on the OTC-BB that deviously got around the

in advance, what side of it they are on. I would argue that the regulations dictating what is or is not a ‘shell company’ need to be clearly and objectively defined.”).

³⁹ See, e.g., SEC Report at 10-11 n.32 (2009) (stating,

We have become aware of a practice in which a promoter of a company and/or affiliates of the promoter appear to place assets or operations within an entity with the intent of causing that entity to fall outside of the definition of “blank check company” in Securities Act Rule 419. The promoter will then seek a business combination transaction for the company, with the assets or operations being returned to the promoter or affiliate upon the completion of that business combination transaction. It is likely that similar schemes will be undertaken with the intention of evading the definition of a shell company that we are adopting today. In our view, where promoters (or their affiliates) of a company that would otherwise be a shell company place assets or operations in that company and those assets or operations are returned to the promoter or its affiliates (or an agreement is made to return those assets or operations to the promoter or its affiliates) before, upon completion of, or shortly after a business combination transaction by that company, those assets or operations would be considered “nominal” for purposes of the definition of shell company.).

⁴⁰ See Andrew Richardson, Deputy Director, Corporate Finance, British Columbia Securities Commission, Reverse Merger Conference, Toronto (June 29, 2010) (transcript available on the Reverse Merger Conference CD Rom 2010).

classification of a shell. Many private companies that want to go public know this and are hesitant to do a reverse merger with a shell because they would rather go public with a clean and transparent vehicle.⁴¹ That said, a privately owned company that plans to acquire an existing company on the OTC-BB through a reverse merger should do its due diligence on the other company and ensure everything is on the up and up.⁴² If the company seems sketchy and has false expenses, this can change the perceived value of the company during the reverse-merger transaction.⁴³ A merging company will not be willing to pay top dollar for a sleazy company or pay top dollar for a transaction that could potentially come back to haunt it – it wants a clean and transparent vehicle. Unfortunately, there are legitimate companies that ultimately suffer because of this perceived value. The legitimate companies that went public via the OTC-BB and are unable to continue making the company thrive will have little choice but to remove itself from the OTC market. Because this removal is typically done through a reverse merger, if the company is attached with the shell label, the perceived value of that company is negatively affected. An objective definition would give privately owned companies confidence during the reverse-merger transaction, to know the company it is merging

⁴¹ See generally Robert Castle, Northland Securities, The Capital Pool Company Program: Canada's Alternative Listing Option, Reverse Merger Conference, Toronto (June 29, 2010) (transcript available on the Reverse Merger Conference CD Rom 2010) (“US companies that want to go public want a clean and transparent vehicle to do so. A private company that wants to go public on the stock exchange should evaluate all forms of exchanges, including the CPC process if they ultimately want to go through that path.”).

⁴² See Gordon McBean, Euro Pacific Capital, Recovery in China: Exploring Market Activity and Current Trends, Reverse Merger Conference, Toronto (June 29, 2010) (transcript available on the Reverse Merger Conference CD Rom 2010). See generally Feldman, *supra* note 2, at 162

(Due diligence is as important for shell owners as for private companies – in fact, in some ways more important. Directors of a shell have a fiduciary responsibility to the shell's public shareholders to carefully review the private company, especially when shareholder approval of the proposed transaction will not be obtained.).

⁴³ See generally Telephone Interview with Peter Smith, Corporate Securities Attorney at Law (June 2, 2010) (“There is often a negative connotation that goes along with being a ‘shell’ that new companies would like to avoid. It's not so much that it affects the value of the company, but it affects the ‘perceived’ value and imposes additional rules and restrictions.”).

with is not a detrimental shell that could come back to haunt it - confidence that the public company was unable to sneak its way around the classification. Thus, the perceived value would eventually increase because there would be fewer trading shells available,⁴⁴ and the actual shell companies would be readily determinable by a bright-line definition.

DISADVANTAGES OF AN OBJECTIVE DEFINITION

The SEC didn't want to classify "nominal" because it "wanted to give individual practitioners the flexibility to determine the definition rather than having a specific quantitative cutoff."⁴⁵ This is also true for the SEC, as it also wants the flexibility to determine the definition. Enforcing an objective definition would make it more difficult for the SEC to control skeptical companies that give the impression they are legitimate when, in fact, they're not. The definition, as is, gives the SEC leeway to force the deceptive companies that try to get around the definition, to comply with the stricter procedures of a shell company if the SEC gets a "bad vibe." If the definition was solely objective, then this is more difficult to regulate and potentially more "bad guys" who are illegitimate companies will be enabled to go public. According to the SEC, specifying the meaning of "nominal" in the definition of a shell "would make circumventing the intent of our regulations and the fraudulent misuse of shell companies easier."⁴⁶ In other words, the SEC will know the company is fraudulent but will be unable to classify it as a shell because on its face, the company does not fit the precise definition – that is why the SEC wants to maintain the subjectivity.

⁴⁴ Interview with David Feldman, Managing Partner, Feldman LLP, in Toronto (June 28, 2010).

⁴⁵ Feldman, *supra* note 2, at 172.

⁴⁶ SEC Report at 11.

However, this is not a good argument given the repercussions the subjective definition entails. It is the SEC's priority to prevent illegitimate companies from going public;⁴⁷ if the SEC has a bad feeling about the true intentions of a company, it is the SEC's responsibility to step in and demand further documentation to prove the company's legitimate status. The SEC shouldn't take the easy route by implementing such a vague definition that it can choose through its intuition the interpretation of the word "nominal" in determining if the company is legitimate or if it's a shell. If the SEC is uncomfortable with a company going public because the company encompasses shell-like characteristics, then there should be a more thorough review to further scrutinize the company and ensure there are no bad intentions.

Another reason why the SEC wants to keep the definition of a shell company subjective is because the SEC wants to make it easier for companies to get on the OTC-BB.⁴⁸ The traditional American free market belief dislikes the idea of stringent requirements, as it would make it a lot harder for companies to go public.⁴⁹ In fact, the reason for the OTC-BB flexibility is because Americans and entrepreneurs need to take risks, and this needs to be recognized with smaller public companies so they won't be shut down.⁵⁰ Thus, the argument goes, if the definition of a shell was objectively defined and more guidelines were implemented in accordance with an amended definition, this

⁴⁷ <http://www.sec.gov/about/whatwedo.shtml> ("The mission of the U.S. Securities and Exchange Commission is to protect investors, maintain fair, orderly, and efficient markets, and facilitate capital formation.").

⁴⁸ See Adam Gottbetter, Gottbetter Partners, U.S. Legal & Regulatory Update, Reverse Merger Conference, Toronto (June 29, 2010) (transcript available on the Reverse Merger Conference CD Rom 2010).

⁴⁹ Interview with Paul Pedersen, Tribune Ventures, in Lansing, Mich. (June 12, 2010) (discussing multiple ways to go public).

⁵⁰ Adam Gottbetter, Gottbetter Partners, U.S. Legal & Regulatory Update, Reverse Merger Conference, Toronto (June 29, 2010) (transcript available on the Reverse Merger Conference CD Rom 2010).

would ultimately make it more difficult for some companies to go public – particularly the smaller companies that take the larger risks.

However, this may not be a bad thing when it comes to deterring fraudulent activity. For example, in Canada, the TSX Venture Exchange has strict regulations that make it a lot harder to go public,⁵¹ yet it's because of these strict regulations that Canada deals with fewer fraudulent companies than the US.⁵² So it's a tradeoff: lesser fraudulent activity for more regulation and a more expensive process. This tradeoff is debatably a disadvantage and an advantage, depending on how it is viewed. Cromwell Coulson, of the Pink OTC Markets, views more regulation as a disadvantage: "having too much regulatory operational structure of the market place makes all risk seem bad, and that's not right, you need risk capital and risk markets."⁵³ Adam Gottbetter, Gottbetter Partners, appears to disagree with the statement all together that more regulation deters fraud: "The SEC is acting tough like enforcement makes less fraud but I don't necessarily agree. The SEC hasn't detected any of the major frauds in the last ten years."⁵⁴ In any event, creating a more narrow definition as to what constitutes a shell may be possible without making it too difficult for companies to go public. This could potentially

⁵¹ Cf. Paul De Luca, Bennett Jones, Legal Aspects of the Capital Pool Company Program, Reverse Merger Conference, Toronto (June 29, 2010) (transcript available on the Reverse Merger Conference CD Rom 2010) ("The biggest difference between the U.S. and Canada is the U.S. has the SEC and Canada has multiple divisions. The result of that, depending on where you are in Canada, you may have to go through multiple security commissions."). *Contra* Kenneth Sam, Dorsey & Whitney, Legal Aspects of the Capital Pool Company Program, Reverse Merger Conference, Toronto (June 29, 2010) (transcript available on the Reverse Merger Conference CD Rom 2010) ("Canada seems a bit easier to deal with regulators and they are a bit more user friendly. Transactions are completed more promptly, quickly and efficiently in Canada.").

⁵² *Contra* Adam Gottbetter, Gottbetter Partners, U.S. Legal & Regulatory Update, Reverse Merger Conference, Toronto (June 29, 2010) (transcript available on the Reverse Merger Conference CD Rom 2010) ("The SEC is acting tough like enforcement makes less fraud but I don't necessarily agree. The SEC hasn't detected any of the major frauds in the last ten years.").

⁵³ Cromwell Coulson, Pink OTC Markets, U.S. Legal & Regulatory Update, Reverse Merger Conference, Toronto (June 29, 2010) (transcript available on the Reverse Merger Conference CD Rom 2010).

⁵⁴ Adam Gottbetter, Gottbetter Partners, U.S. Legal & Regulatory Update, Reverse Merger Conference, Toronto (June 29, 2010) (transcript available on the Reverse Merger Conference CD Rom 2010).

decrease the amount of fraudulent activity on the OTC-BB as well because stricter regulations close loop holes that crooked companies use to get access to the public market.

CONCLUSION:

The current definition of a shell company is far too vague, and because of this unclear definition many companies think they are obligated to declare themselves a shell company and end up suffering numerous legal implications. If there was a more objective definition, then companies would know, in advance, how to strategize their course of action in going public. This could reduce fraudulent activity because companies will be less capable of pushing the boundaries as to what constitutes “nominal.” Furthermore, the perceived value of companies planning to do a reverse merger could increase because shells would be objectively and readily determinable by a bright-line definition. In closing, the current definition of a shell company should be narrowed, and certainly more objective, because the indefinite term “nominal” will continue creating more work and problems for the SEC and also for small, privately owned companies that plan to go public in the future.