

Going Dark: What Companies Need to Know

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Overview

- What is Going Dark?
- Why Go Dark?
- What is the process for Going Dark?
- Is there potential liability for Going Dark?
- What are the benefits of Going Dark?
- What are the downsides of Going Dark?

What is Going Dark?

- Delisting a public company's shares from an exchange (e.g., NYSE, NYSE Amex, Nasdaq) (if applicable) **and**
- terminating/suspending a company's SEC reporting obligations under the Exchange Act

Going Dark vs. Going Private

- Very different transactions
- Going Private usually involves the cash-out of all or almost all of a company's public shares
- Can take many forms (e.g. merger, tender offer or reverse split)
- Often undertaken by controlling stockholders or third party acquirers

Going Dark vs. Going Private

- Going Private transactions usually entail:
 - Extensive consideration by the board of directors
 - Special SEC filings
 - Extensive disclosure regarding the transaction and the parties to the transaction
 - Fairness opinion
 - Stockholder vote
 - Cash consideration

Going Dark vs. Going Private

- By contrast, Going Dark can be accomplished without:
 - Stockholder vote
 - Fairness opinion
 - Cash-out of stockholders
 - Significant SEC filings
 - Substantial costs

Why Go Dark?

- Expenses can total nearly \$2 million even for relatively small companies
 - Preparing and filing periodic reports and other SEC documents
 - Legal and accounting costs
 - SOX 404 compliance
- Minimize management diversion
- Decrease liability
- Greater confidentiality

What is the Going Dark Process?

- To understand the Going Dark process, one needs to understand how a company becomes subject to SEC reporting obligations
- A company will need to take steps to remove each layer of obligation

SEC Reporting Obligations

- Section 12(b) of the Exchange Act – if a company's shares are listed on an exchange
- Section 12(g) of the Exchange Act – if a company has more than 500 record holders and assets in excess of \$10 million
- Section 15(d) of the Securities Act – if a company had a registration statement declared effective
- To go dark, a company must be sure that it is not required to file SEC reports under any of these statutes

Section 12(b) of the Exchange Act

- Applies to any company whose shares trade on an exchange (e.g., NYSE, NYSE Amex, Nasdaq)
- A company may voluntarily delist its shares from an exchange by filing a Form 25 with the SEC
- Must give notice of its intention to file the Form 25 and issue a press release announcing that intention 10 days prior to actually filing the Form 25

Form 25

- Simple form - one page with a couple of checkboxes
- Delisting is effective 10 days after filing the Form 25
- After the delisting is effective, a company is no longer required to file SEC periodic reports (e.g. annual, quarterly and current reports)
- Other SEC reporting obligations (e.g. proxy rules, Section 13/16 reports) remain in effect until 90 days after effectiveness of the delisting (100 days after filing), at which point all SEC reporting obligations are terminated
- **Caution:** A company will still need to comply with SEC reporting obligations after filing a Form 25 if it is subject to Section 12(g) or Section 15(d) of the Exchange Act

Section 12(g) and Section 15(d) of the Exchange Act

- Section 12(g) - Requires a company that has more than 500 stockholders and \$10 million in assets to comply with SEC reporting obligations even if the shares are not listed on an exchange (e.g. OTCBB, Pink Sheets)
- Section 15(d) - Requires a company that has had a registration statement declared effective by the SEC to comply with SEC reporting obligations
- Even if a company delists its shares from an exchange by filing a Form 25, it will still be required to continue its SEC reporting obligations if it is subject to Section 12(g) or Section 15(d) of the Exchange Act

Section 12(g) and Section 15(d) of the Exchange Act

- A company may deregister under Section 12(g) and suspend its obligations under Section 15(d) if it has less than:
 - 300 stockholders of record or
 - 500 stockholders of record and less than \$10 million in assets for each of its last three fiscal years
- “Holders of record” differ from beneficial holders

Section 12(g) and Section 15(d) of the Exchange Act

- To deregister, a Company must file a Form 15 disclosing the number of its holders of record
- Section 15(d) obligations can never be terminated – only suspended
- Thus, if the number of stockholders of a company subsequently increases to more than 300, a company's SEC reporting obligations will be reinstated

Foreign Private Companies

- May deregister under Rule 12h-6 if:
 - its daily U.S. trading volume over a 12 month period represents 5% or less of its average daily worldwide trading volume or
 - it has less than 300 stockholders of record in the U.S. or worldwide
- Other requirements:
 - has been subject to SEC reporting obligations for at least 12 months
 - current with all of its SEC filings and filed at least one annual report

Foreign Private Companies

- its shares must be listed in one or more foreign markets that together represent 55% of its worldwide trading for one year prior to deregistering
- no registered offerings during 12 months prior to deregistration
- File a Form 15F to deregister
- Terminates a company's SEC reporting obligations – not just suspends it as for domestic companies

Filing of Form 15

- Simple form – one page
- Only necessary to file if company was subject to Section 12(g) at one time
- May not be filed until the effectiveness of a Form 25 (if applicable) – i.e. 10 days after filing the Form 25
- Effective 90 days after filing
- Duty to file periodic reports is suspended immediately upon filing of the Form 15
- Required to comply with other SEC reporting obligations until effectiveness of the Form 15

Sample Timeline

- Day 1: Issue press release and file Form 8-K announcing intention to delist from exchange and go dark
- Day 10: File a Form 25 with the SEC
- Day 20: Delisting is effective. File a Form 15 with the SEC (if the company was subject to Section 12(g) prior to its listing on an exchange)
- Day 21: Stock begins (or continues) trading on the Pink Sheets

Sample Timeline (cont'd)

- Day 100: Form 25 becomes effective
 - deregistered under Section 12(b)
 - no further SEC obligations under Section 12(b)
- Day 110: Form 15 becomes effective
 - deregistration under Section 12(g)
 - suspension of reporting obligations under Section 15(d) (if applicable)

Traps for the Unwary

- A company's Section 15(d) reporting obligations may not be suspended during any fiscal year in which the SEC has declared effective a company's:
 - registration statement or
 - post-effective amendment for Section 10(a)(3) purposes
- SEC has granted no-action relief for companies that have withdrawn all of their effective registration statements requiring updates under Section 10(a)(3) (e.g., Form S-3s) before filing their Form 10-K
- If the Form 10-K has been filed, the company will be required to make all mandated filings for that fiscal year, including the Form 10-K due after the close of the fiscal year unless it obtains no-action relief from the SEC.

Traps for the Unwary

- When it files a Form 15, a company must have a good faith belief that it has less than 300 stockholders of record.
- The number of holders of record can change between the time the company decides to go dark and the filing of Form 15 for various reasons:
 - broker distributions or “kick-outs” to beneficial owners
 - ordinary trading or
 - intentional actions of stockholders
- SEC reporting obligations are reinstated if the number of record holders subsequently increases to more than 300
- A company should make sure that it is not in danger of going back over 300 holders before filing the Form 15.

Is there Potential Liability for Going Dark?

- Concern: Will stockholders bring suit against the board of directors for breach of fiduciary duty?
 - Decrease in liquidity
 - Decrease in share price
- Few cases dealing with this issue

Liability

- Cases don't address delisting for legitimate business purpose
- Usually involve some type of extenuating circumstance:
 - Defendants were controlling stockholders, directors and/or officers who could control the company
 - Lack of board independence
 - No special committee appointed
 - Going Dark decision was for an inequitable purpose or for a self-interested reason

Minimizing Potential Liability

- Many companies have “gone dark” for legitimate business purposes without litigation
- Consider whether there exists any potential conflicts of interests of directors or stockholders (e.g. avoiding Section 13/16 reports)
- If necessary, appoint special committee of non-interested directors with its own legal and financial advisors
- Avoid purchases of company shares by affiliates in the open market after the deregistration

Benefits of Going Dark

1. Significantly lower operating costs
2. No SOX 404 compliance
3. Management can focus more on the business
4. Reduces potential liability for officers and directors
5. D & O insurance costs will likely decrease

Benefits of Going Dark (cont'd)

6. Shares can still trade on the Pink Sheets
7. Less public scrutiny and disclosure
8. More confidentiality regarding business activities
9. Simplified corporate governance
10. Greater freedom to explore extraordinary corporate transactions

Downsides of Going Dark

1. Decreased trading volume and effect on stock price
2. Affiliates cannot sell their restricted shares unless there is adequate public information
3. Possible insider trading violations if affiliates possess non-public material information
4. Still subject to anti-fraud provisions of federal and state securities laws
5. Litigation risk

Downsides of Going Dark

6. Reinstatement of SEC reporting obligations if more than 300 holders
7. Lack of public exposure
8. Shares are less useful for acquisitions and employee compensation
9. Can result in conflicted transactions
10. Stockholders may think the company is in play or hiding something

Trading in the Pink Sheets

- Can trade on the Pink Sheets after going dark
- Does not subject a company to SEC reporting obligations
- Various market tiers:
 - Adequate public information (approximately 26% of Pink Sheet companies)
 - Limited information (11%)
 - No information (63%)

OTCQX Alternative

- Premium tier of the OTC market
- Designed in part to attract smaller companies that are delisting but want to maintain liquidity of their shares
- Required to follow an Alternative Listing Standard that provides investors with adequate information about the company's financial and business operations
- US and International tiers

DADs

- Domestic companies are required to appoint a Designated Advisor for Disclosure, or DAD
- Usually a law firm with expertise in securities law
- Must confirm that the company has made adequate current information publicly available
- Annual and quarterly confirmations

OTCQX Qualifications - US

- Minimum bid price of \$0.25 for 90 days
- 50 beneficial stockholders owning at least 100 shares each
- Dissemination of quarterly and audited annual reports
- Also a premium tier, which has a few additional requirements

OTCQX International

- Designed for international companies listed on an exchange in their home country
- Allows international companies to access US investors
- Required to appoint a Principal American Liaison (PAL) to assist in the listing process and ongoing disclosure
- Not required to be registered with SEC – can rely on Rule 13g3-2b for disclosure purposes
- Current companies include AG, Air France – KLM, BASF SE and Roche

OTCQX Expenses

- Lower public company expenses than for an exchange listing
 - No SOX 404 fees (annual savings of \$500,000)
 - Reduced legal, accounting and printing expenses (annual savings of \$500,000)
 - Much lower listing fees

OTCQX – Additional Benefits

- OTCQX reporting enables companies to satisfy public information requirements for purposes of:
 - Rule 144
 - Insider trading
- OTCQX reporting standards were designed to meet the minimum requirements of Rule 144
- Posting on the OTCQX web site likely satisfies the public availability requirement
- Also meets the requirements of Rule 15c211

Final Thoughts

- Principal decision: does remaining a public company outweigh the benefits of going dark?
- Some companies are too small to benefit from being a public company
- However, stockholders prefer liquidity and SEC disclosure

Final Thoughts

- Factors to consider before Going Dark:
 - Stock price
 - Public float
 - Company performance
 - Compliance costs (including SOX 404)
 - Accounting requirements
 - Currency for acquisitions and employees
 - Creditor and customer requirements
 - Relationship with stockholders
 - Prestige

Contact Information

Ellenoff Grossman & Schole LLP is a New York City-based law firm comprised of more than 55 experienced professionals, 30 of whom are experienced securities attorneys. The firm offers a broad range of legal services in the capital formation process. Founded in 1992, the firm specializes in many areas of commercial law, including Corporate/Securities (PIPEs, IPOs, SPACs) and Broker-Dealer Regulation. In 2008, the firm was the most active SPAC law firm in the United States and the 6th most active IPO law firm. The firm also represents more than 30 public companies. The firm was the first Designated Advisor for Disclosure (DAD) approved by the OTCQX.

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