Securities Lawyer 101
Securities Law & Going Public Transactions

Hamilton & Associates Law Group
Attorneys | Counselors | Advisors
Telephone 561-416-8956 | Email

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Depository Trust & Clearing Company Q&A

Q: What is the Depository Trust & Clearing Company ("DTCC")?
A: It is the only stock depository in the United States.

Q: How do public companies obtain DTCC eligibility?
A: Issuers must satisfy specific criteria established by DTCC to receive initial DTCC eligibility after their going public transaction is complete, and to remain DTCC eligible. Even after the securities become DTCC eligible, DTCC may limit or terminate its services.

Q: Why is the DTCC so important to public companies and companies going public?
A: When DTCC provides services as the depository for an issuer's securities, its securities can trade electronically. Without DTCC eligibility, it is almost impossible for an issuer to establish an active market in its stock. This is especially important for private companies going public who are seeking to raise capital.

Q: How will a DTCC Chill or Global Lock impact trading of my company's stock?
A: DTCC Chill restricts DTCC's services, including limiting a DTCC participant's ability to deposit or withdraw chilled securities. A DTCC Chill may last a few days or for an extended period of time depending upon the problems that caused the chill and the issuer's willingness to address them. A "Global Lock" is a termination of all of DTCC's services to an issuer. Like a DTCC Chill, a Global Lock may last a few days or for an extended period of time, depending on the reason for the action. If the fundamental issue cannot be corrected, then the security will be removed from DTCC's depository, and transactions in the security subject to the Global Lock will no longer be eligible for clearing at any registered clearing agency. When this happens, clearance and settlement of open market trades is significantly delayed because trades can only occur upon physical delivery of stock certificates between the buyer and seller's brokerage firms. In such circumstances it could take weeks for trades to clear and settle.

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DTCC does not always disclose the reason for a chill or lock, not does it suggest how long it will be in effect. Generally, two people are needed to help an issuer remove a chill. These people are a DTCC Market Participant and a securities lawyer acceptable to DTCC.

Proposals for DTCC Chills and Global Locks Withdrawn

On December 18, 2013, the DTCC submitted a proposed rule change to the Securities and Exchange Commission ("SEC"), which regulates its activities. Its aim was to "specify procedures available to issuers of securities deposited at DTC for book entry services when DTC imposes or intends to impose restrictions on the further deposit and/or book entry transfer of those securities…"

In plain English, the new rule would provide that in most cases, issuers would receive advance notice of planned DTCC chills or global locks, and would be able to protest the imposition of the chill or lock proposed. Emergency actions would still be possible, but issuers could protest them after the fact. It also set a limit for the duration of DTC chills and locks: six months in the case of issuers who are SEC registrants, and one year in the case of non-registrants.

DTCC had explained its proposals earlier, in a White Paper released in September 2013.

Following the submission of the rule change to the SEC, there was a comment period. DTCC responded with two amendments to the proposals. More comments were offered through the summer of 2014. We at Hamilton & Associates submitted two comments to the SEC, and blogged about the proposed rule here, here and here. We applauded the depository's efforts to create a standardized appeal process for issuers who believed DTCC actions were unwarranted. We further suggested that DTCC publish a central list of chilled or locked stocks. Issuers do not always tell their investors about these events, an omission that can result in confusion about the company's status with the depository.

Months passed, and the proposed rule had still not become effective. Then on August 18, 2014, at the height of the summer vacation season and three days before the end of the deadline for Commission action, the SEC announced that DTCC had withdrawn the proposed rule and its amendments. No further announcement was made, and the withdrawal escaped general notice.

DTCC has not commented on the withdrawal, and we are left to wonder what the reasons for it may have been. In the SEC's announcement, there was no suggestion that the old proposal might be substituted with a new one, so it seems issuers and investors will once again be left with inadequate information about deposit chills and global locks, and issuers may once again find these actions difficult to protest.

DTCC Chill Removal Specialists

Recently, quite a few websites have popped up claiming their operators can remove DTCC Chills and Global Locks. The irony is that most of these service providers participate in the activities that can cause the loss of DTCC's services in the first place. Some of these quick fixes are offered by the same lawyers who render flawed tradability opinions and the same transfer agents who knowingly or blindly accept the opinions that cause DTCC difficulties in the first place.

Similarly, stock promoters with pump and dump websites now tout that they can remove DTCC Chills despite the fact that their own dubious services have resulted in DTCC problems.

There are only two people who can help you remove a DTCC Chill, a securities attorney acceptable to DTCC, who can render a tradability opinion concerning the issuer's unrestricted shares held by DTCC, and a DTCC Market Participant, who can ask that DTCC provide its services with respect to a security. Anyone else claiming he can secure DTCC eligibility or remove a DTCC Chill is unqualified to do so.

How Is DTCC Eligibility Lost?

DTCC chills and freezes occur when there is a suspicion or indication that the issuer or persons associated with the issuer have violated the securities laws. Additionally, DTCC Chills often follow offerings made under Rule 504 of Regulation D which result in the issuance of free trading securities.

Factors that may cause an issuer's securities to lose DTCC eligibility include:

i. having multiple name changes and reverse splits;

ii. issuing improperly free trading shares which have not been registered with the SEC in reliance upon Rule 504, 144 or upon conversion of debt;

iii. engaging in a reverse merger with a company that has been involved in a state receivership or custodianship action or other action which resulted in a state court order to obtain control of a public shell company;

iv. engaging in a reverse merger with a public shell company which resulted in the issuance or transfer of unregistered free trading shares;

v. being involved in improper investor relations activities including spam campaigns, pump and dump schemes, or other fraudulent activities; and
iv. being subject to an SEC investigation or being associated with stock promoters, brokers, lawyers or accountants that have been subject to investigations by the SEC, FINRA or the Justice Department.

DTCC Conspiracy Theories on the Rise

When DTCC eligibility is limited or terminated, companies often express astonishment and scream foul play asserting various conspiracy theories. We have all read about issuers who self-righteously proclaim that their loss of DTCC was due to conniving short sellers, nefarious clearing firms and the purported "agenda" of the Securities and Exchange Commission ("SEC") to eliminate small broker dealers and penny stock companies.

When DTCC eligibility is lost, issuers will often tell their stockholders, they have no idea what happened. Since only the company can direct its transfer agent to issue free trading shares, most often it knows exactly why DTCC limited or suspended its services. Many officers and directors of microcap companies are facing the harsh reality that reliance upon a legal opinion will not provide them with an effective defense to securities violations.

DTCC's Office of Corporate and Regulatory Compliance monitors unusually large deposits of microcap securities that are deposited into DTCC when there is a suspicion or indication that the issuer or persons associated with the issuer have violated the securities laws. With Microcap stocks, this behavior typically involves the deposit of large blocks of unrestricted securities in reliance upon flawed legal opinions rendered in connection with convertible notes, reverse merger transactions or Rule 504 offerings. Where any of the foregoing are present, the issuer should expect a review by DTCC and should be prepared to provide a competent legal opinion from an independent securities attorney.

Because DTCC may choose to refer securities violations it discovers to the SEC's Division of Enforcement, issuers need to consult with qualified legal counsel at all stages of the DTCC process, particularly when information must be provided by the issuer.

Issuers expecting to obtain and maintain DTCC eligibility need to recognize that they may be penalized if they go public in a reverse merger with a public shell company or use the services of securities professionals.

DTCC Identifies Cyber-Attacks as Most Significant Risk to Financial Markets

On August 7, Depository Trust & Clearing Corporation (DTCC) released a report identifying threats to the stability of the financial markets. DTCC considers cyber-attacks that can bypass U.S. and E.U. industry security systems and laws to be the most significant danger to our markets today.

Distributed Denial of Service ("DDoS") Attacks DDoS attacks have increased in the past year. DDoS attacks typically attempt to flood the bandwidth and network connectivity between a financial institution and the broader Internet. These attacks are carried out by sending a large volume of requests from compromised machines to the institution's website.

Advanced Persistent Threats Advanced Persistent Threats (APT) are stealthier because APT attacks are not public. Their objective is not to disrupt Internet-facing communications, but rather to infiltrate an institution's systems and monitor or ex-filtrate data to a server outside the firm. APT attacks are very difficult to detect, unlike DDoS attacks, which are visible and often publicized prior to an attack. In an APT attack the infected malware could be sent by a variety of means including e-mail attachments or compromised websites. The attackers often use social networking tools to perform reconnaissance and identify key employees at a firm. The attackers then compromise the machines of those individuals, and propagate horizontally and vertically within the target organization.

Contact Us

Give us a call for more information about Periodic Reporting, Going Public, Crowdfunding, SEC Registration statements, direct public offerings or securities law!

Hamilton & Associates Law Group, P.A.
101 Plaza Real South, Suite 202 North
Boca Raton, FL 33432

Phone: (561) 416-8956
Fax: (561) 416-2855
Email: info@securitieslawyer101.com

Visit us on the web at:
www.securitieslawyer101.com
www.gopublic101.com
www.jobsact101.com