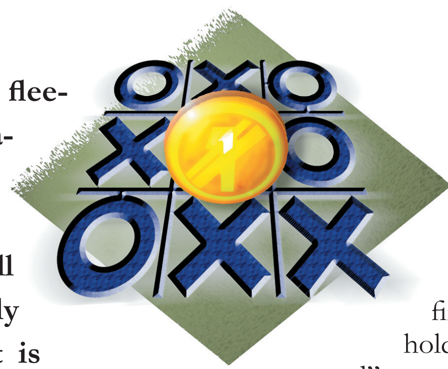
Going Dark: The Harsh Reality of Voluntary Deregistration

By John Deysher



Investors weren't the only ones fleeing the stock market last year. Companies also headed for the exits. And a growing number of investors are taking the hit as hundreds of small companies "go dark" or voluntarily deregister their shares. The result is often a falling share price and investors left in the dark about the firm's finances and prospects.

What does it all mean?

When a firm "goes dark" it deregisters with the Securities and Exchange Commission (SEC) and delists its shares. Deregistered firms are no longer required to make SEC filings such as annual reports, proxies, 10-Ks, 10-Qs and other important documents. And they're no longer required to have annual meetings or elect outside directors.

To deregister, a firm files Form 15-12G (Securities Registration Termination) with the SEC stating its intent to deregister, usually by a certain date. Once that date arrives, the stock exchange or NASDAQ prohibits future trading in the shares. The firm's shares are then relegated to the pink sheets, where liquidity is usually much lower. Although the actual process takes some time, the firm's share price typically will decline immediately after the "going dark" announcement, since many institutions are prohibited from owning shares of firms that don't file with the SEC or trade on the exchanges or NASDAQ.

Who Approves?

Unfortunately, the going dark process does not require shareholder approval. As long as a firm has less than 300 shareholders of record, the board of directors can make the decision.

Although you may think even small firms would have more than 300 shareholders, the key phrase is "shareholders of record"—meaning the number of shareholders the firm has on its books. Often times this vastly understates the number of true owners. For example, Acme Widget may have 299 shareholders of record. But the shareholders of record may include firms like Merrill Lynch, AG Edwards and Morgan Stanley who hold shares on behalf of thousands of customers who chose to hold their securities in "street name" instead of taking physical delivery. In other words, a brokerage firm owning a million shares on behalf of thousands of individual customer-shareowners is actually treated as one shareholder of record, the same as an individual owning a thousand shares.

A better measure of the actual number of shareholders is "beneficial owners," which includes all shareholders—including those holding shares in street name. Using this measure, many firms that delist would be prohibited from doing so because the number of beneficial owners exceeded 300.

Some institutional investors have petitioned the SEC to close the loophole, arguing that the definition of "shareholders of record" is obsolete. When the law was originally written in 1965, most investors took physical delivery of their shares. Nowadays, most investors hold their shares in street name, so "shareholders of record" probably understates the number of actual owners in many cases. The SEC is now holding public hearings on this and will analyze their findings in due course.

Dark and Darker

As shown in Table 1, the "going dark" phenomenon has gathered steam in recent years.

Many financial professionals believe the increase is a consequence of the passage of Sarbanes-Oxley legislation in the Fall of 2002, which in turn was in response to numerous corporate financial scandals.

Sarbanes-Oxley—or SOX, as it's known in the trade—imposed new and significant reporting requirements on public companies that can be quite costly. Public firms must now report in greater detail not only their financials but also their methods for compiling and verifying them.

It's not unusual for small firms to pay an additional $500,000 to $1 million per year in SOX compliance costs, such as accounting, legal and consulting fees. To many small company managers, this is real money that may be spent in better ways, such as growing the business or paying down debt. This is especially true if the firm does not avail itself of the primary benefits of being public—the ability to sell shares to the general public or use them to make acquisitions.

SOX Backfires

Paradoxically, the SOX legislation that was supposed to foster additional transparency and protect shareholders interests now appears to be having the opposite effect. Many small firms are delisting to avoid compliance, which leaves shareholders in the dark. For these firms, the burdens of operating as a registered company now outweigh the benefits.

As might be expected, the SEC is dismayed with firms that deregister in order to avoid SOX compliance. Hence, the public hearings mentioned earlier and the possibility of more accurate shareholder counts that would prevent deregistration for many firms.

But what should an investor do who becomes a "victim" of deregistration?

As an investment firm that traffics in the shares of small, thinly traded companies, we have some experience in this area. In early 2004, we were monitoring the prospects of Southern Energy Homes (SEHI), a small, well-run manufactured home producer that was bumping along the bottom of the manufactured housing cycle. Warren Buffett had just purchased two key industry players—Oakwood Homes and Clayton Homes. SEHI had traded as high as $15 in late 1996 and was now muddling along at $2 on NASDAQ. The balance sheet was intact, management was rationalizing operations and owned a big stake. In short, we liked what we saw.

Table 1. The Rising Trend of Voluntary Delistings

Year	Number of Delistings
1998	28
1999	30
2000	14
2001	43
2002	67
2003	198
2004	114
2005	138 (thru Dec. 15)

Source: The SEC EDGAR archives (2004-2005); Wharton School study, Nov. 2004 (1998-2003).

In January 2004, SEHI announced their plans to deregister to reduce costs. Immediately the shares fell by 30% as shareholders ran for the exits, not wanting the uncertainty of owning a non-filing company.

At this point we called management with four questions about whether SEHI would continue to:

1) Make news announcements of important events such as earnings releases, etc.? Answer: Yes, they would issue press releases on important events.
2) Make quarterly and yearly financial statements available on a timely basis? Answer: Yes, they would post financial statements and notes on their Web site.
3) Hold annual meetings including election of outside directors? Answer: Yes, they would have yearly elections of directors including independents.
4) Have annual results audited by a reputable CPA firm? Answer: Yes, they would have annual results audited to high standards.

Basically, SEHI told us they would continue to act as a public company without the regulatory costs of being one. Disclosure would approximate SEC requirements.

Liking what we heard as well as the fundamentals we built a position in quick order.

Over the next 18 months, SEHI's results and share price improved substantially. We also got lucky. SEHI has several plants within hours of some of the areas hardest hit by Hurricane Katrina. FEMA placed a significant home order with SEHI. Shares that we purchased for $2.20 after the delisting were sold at $7.10 about 18 months later.

Shareholder Action Plan

The lessons here are several:

- If a company you own announces plans to deregister, don't panic. If the fundamentals are intact, the shares are probably worth owning. Even in the less liquid pink sheets, shares of firms with improving fundamentals will appreciate. However, you should call the firm immediately to assess their plans for ongoing communication with outside shareholders. Ask the same questions we did of Southern Energy Homes—which gave the right answers. If you receive answers that indicate communication will be lessened, there may be some governance issues relating to the treatment of outside shareholders. For example, we would find it difficult to own shares of a company that provided only an annual report and had no annual meetings or election of directors.

- Make sure the fundamentals are intact. Use the deregistration announcement as an opportunity to perform a thorough review of company prospects. Often a firm will deregister to help hide a deteriorating financial condition, bad accounting or other ailments
- Fortune favors the bold. To be a successful investor you must have the courage of your convictions. That means if you've done your homework, don't be afraid to step up to the plate, especially in the face of consensus opinion that's going the other way. Southern Energy Homes was a good investment for us. We did the due diligence, liked what we saw and bought shares at low prices when they were being given away. It doesn't always work this way, of course, but you'll improve your odds if you investigate before you invest and then act on your findings. ➤

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