SEC Moves Forward and Approves Tougher Listing Standards for Reverse Merger Companies

Earlier in November, the **Securities and Exchange Commission** approved new rules (the "**New Reverse Merger Rules**") that make it more difficult for companies that have effected a "**reverse merger**" (also known as a "reverse takeover") to go public and meet the required listing standards of the three major U.S. exchanges – the NYSE, NYSE Amex and NASDAQ. The rulemaking follows many months (even years) of SEC analysis of reverse merger companies and warnings to investors regarding what the SEC considers significant risk in investing in these entities, including a June 2011 SEC Investor Bulletin about investing in companies that enter U.S. securities markets through reverse mergers. Those risks include the company's failure or struggle to remain viable following a reverse merger, fraud and other abuses, and, with respect to foreign companies in particular, the use of smaller U.S. auditing firms which are unable to identify non-compliance with the relevant accounting standards. The **New Reverse Merger Rules** look to curb some of those risks by giving investors a better opportunity to assess the reverse merger company prior to investing in it.

A reverse merger is a transaction in which a private company (either U.S. or foreign) is acquired by an existing public "shell company." Via the merger, the private operating company is able to "go public" by merging into the public shell, giving the operating company stockholders equity in the shell company, and thereby providing theoretical access to funding in the U.S. capital markets (unlike public companies which have a deeper potential funding pool from their access to public investors, private companies generally have much more limited access from private forms of equity). Additional attractions of the reverse merger are that it is quicker and cheaper than a standard initial public offering, with lower legal and accounting fees and no registration required under the Securities Act of 1933. The shell company is a public reporting company with minimal or no operations, while the private company is an actual operating company. The private company shareholders typically exchange their private company shares for a majority of the shell company shares – enough to gain a controlling interest in the voting power and outstanding public shell company shares. In addition, generally, the board of directors and management of the public company are supplanted by that of the private operating company. Finally, the assets and business operations of the post-merger surviving public company are primarily, if not solely, those of the former private operating company.

Investors can find reverse merger companies listed on different exchanges and can buy and sell their shares, just like those of other operating companies. However, the SEC has been concerned about the inability of investors, auditors and regulators to obtain reliable information from reverse merger companies, particularly those based overseas. As a result of such concern, the SEC has taken a number of steps to better regulate reverse merger companies and to provide investors with less risk and more information when making an investment decision in a reverse merger company.

The **New Reverse Merger Rules**, in particular, work to increase the time investors have to analyze the reverse merger company, as well as the amount of company information and trading history available to an investor, prior to investing. The **New Reverse Merger Rules** raise the standards the reverse merger company need to satisfy before being eligible for listing on a U.S. exchange. Under the **New Reverse Merger Rules**, a post-reverse merger company will be prohibited from applying to list on the NYSE, NYSE Amex or NASDAQ until:

- The company has completed a one-year "seasoning period" by trading in the U.S. over-the-counter market or on another regulated U.S. or foreign exchange following the reverse merger, and filed all required reports with the SEC, including audited financial statements; and
- The company maintains the requisite minimum share price for a sustained period, and for at least 30 of the 60 trading days, immediately prior to its listing application and the exchange's decision to list.

However, if the post-reverse merger company is listing in connection with a substantial firm commitment underwritten public offering, or if the reverse merger was effected at a date where at least four annual reports with audited financial information have been filed with the SEC prior to its listing, then, in general, the reverse merger company would be exempt from these special requirements.

Clearly, the SEC is taking their concerns over reverse mergers seriously, particularly those companies with overseas operations. In the summer of 2010, the SEC launched an initiative to determine whether certain companies with foreign operations – including those that were the product of reverse mergers – were accurately reporting their financial results, and to assess the quality of the audits conducted of these companies. Since that time, the SEC and U.S. exchanges have suspended or halted trading in numerous companies based overseas citing a lack of current and accurate information about the firms and their finances, including companies that were formed by reverse mergers. In addition, this year, the SEC has revoked the securities registration of several reverse merger companies due to a failure to make required periodic filings which normally contain material information for investors, and there have been a number of enforcement actions involving reverse merger companies based on issues related to (i) the accuracy and completeness of information contained in public filings; (ii) failure to properly disclose auditor, legal counsel and director resignations; (iii) failure to disclose the lack of the required review of interim financial statements by an independent public accountant; (iv) questions regarding the size of operations and number of employees, material customer contracts, and the existence of two separate and materially different sets of corporate books and accounts; and (v) failure to file certain periodic reports with the SEC.

The **New Reverse Merger Rules** should help the SEC, as well as investors and companies considering reverse merger transactions (or those which have already effected reverse merger transactions), to avoid the disclosure and filing issues that have resulted in the enforcement actions and de-registrations mentioned above. In addition, those companies looking to access the U.S. public markets via a reverse merger transaction should pay particular attention to the **New Reverse Merger Rules** and plan accordingly.

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