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NYSE and Nasdaq Propose Additional Listing Requirements for Reverse Merger Companies

Proposed Rules Prompted by Increasing Concern Regarding Private Companies that Merge with Public Shell Companies

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Overview

Reverse merger companies, which are formed when a public "shell company"[1] survives a merger with a private operating company, have recently been subject to numerous federal securities fraud lawsuits and Securities and Exchange Commission ("SEC") enforcement actions and penalties due to concerns relating to accounting irregularities and other disclosure issues. As a response to these concerns, and in an effort to increase transparency and limit risks to investors, the New York Stock Exchange ("NYSE") and The Nasdaq Stock Market LLC ("Nasdaq") have each proposed additional listing application requirements for reverse merger companies seeking to list on their exchanges[2]. The proposed sets of rules effectively create a "seasoning" period prior to listing and generally require that the reverse merger company:

- have its equity securities trade in the United States over-the-counter market or on a national or foreign exchange subsequent to the consummation of the reverse merger for a specified period of time prior to listing;
- file all required information regarding the reverse merger transaction with the SEC, including audited financial statements;
- maintain a minimum stock price of $4 per share for a certain period of time prior to listing; and
- file all required reports with the SEC subsequent to the reverse merger during the "seasoning" period, including certain specified periodic reports.

The NYSE and Nasdaq expect that the "seasoning" period will increase the integrity of the reverse merger company's financial and operations related reporting and allow auditors and company management to adequately evaluate and address accounting irregularities and internal controls deficiencies. In addition, this period would allow for additional market and regulatory scrutiny of these companies and provide time to identify concerns that could otherwise preclude listing eligibility. The SEC is currently reviewing the proposed listing requirements of each securities exchange and may act on each proposal in September 2011.

Background

Reverse Merger Transaction Structure

In a reverse merger transaction, a privately held company merges into a public "shell company" that survives the merger. After the merger, the former shareholders of the private company typically own a majority (or even a supermajority) of the public company's shares. In addition, the management and members of the board of directors of the private company generally assume such roles with the post-merger surviving public company, whose business operations and assets may be entirely those of the pre-merger private company. As such, reverse merger companies quickly gain access to the public markets, though the post-merger surviving company generally enters the trading market without having been subject to registration under the Securities Act of 1933, as amended (the "Securities Act"), at the time of the merger in marked contrast to companies that "go public" by undertaking a traditional initial public offering. Reverse merger companies are thus able to bypass the typical SEC review and underwriter diligence process that occurs in the context of an initial public offering. Since 2007, over 600 private companies have "gone public" through reverse mergers with shell companies, of which more than 150 companies are principally based in the People's Republic of China ("PRC").[3]

Recent Increased Scrutiny and Regulation

Such "backdoor registrations" involving reverse merger companies have led to increased scrutiny by investors, the SEC and other regulators, and self-regulatory organizations, such as the NYSE and Nasdaq, resulting in allegations involving accounting irregularities and disclosure issues in the SEC filings of such companies. At least 24 federal securities fraud class action filings related to Chinese reverse merger companies alone have been made thus far in 2011[4]. In a recent opinion, a federal district court rejected the reverse merger company's motion to dismiss a complaint that alleged that the company failed to disclose certain related-party transactions and materially misstated its financial information in two filings with the SEC[5]. The plaintiffs also alleged that the company's auditor had been disbarred and was unlicensed at the time of its audits. Finding that such allegations raised factual disputes, the court allowed the plaintiffs' case to proceed, in what appears to be the first motion to dismiss opinion in a reverse merger company class action.

The SEC, along with other regulators, such as the Public Company Accounting Oversight Board ("PCAOB"), has actively targeted reverse merger companies and their accountants in the past year. In recent months, the SEC has suspended trading of at least six reverse merger companies[6], in many occasions based on the companies' failure to file certain periodic reports or due to the inaccuracy and incompleteness of reported financial matters. In addition, the SEC imposed sanctions in December 2010 against an accounting firm and one of its partners for, among other things, failing to conduct its audits and review of a reverse merger company's financial statements in accordance with PCAOB rules and standards[7]. The SEC has also revoked the securities registration of at least eight PRC-based companies that became domestic issuers through reverse mergers, as a result of their failure to file required periodic reports[8]. Demonstrating its concern and focus on these types of companies, the SEC released an Investor Bulletin regarding reverse mergers in June 2011, which discusses the risks associated with investing in such companies and describes recent enforcement actions. Furthermore, the PCAOB has identified problems with the audits of reverse merger companies and issued a practice alert in July 2010 that cautioned accounting firms to adhere to specific auditing practices in this field[9].

In addition, both the NYSE and Nasdaq have halted the trading of several reverse merger companies in 2011, in some occasions due to their failure to timely file required reports with the SEC[10]. Nasdaq has also identified situations in which promoters and others appeared to manipulate the price of company stock to meet initial listing bid price requirements or where companies have gifted stock to artificially satisfy minimum holder requirements.

Proposed NYSE Listing Requirements

On July 22, 2011, the NYSE submitted to the SEC a rulemaking proposal containing proposed additional listing requirements that would apply to any company that is formed by a "reverse merger", which is defined as "any transaction whereby an operating company becomes an Exchange Act reporting company by combining with a shell company which is an Exchange Act reporting company, whether through a reverse merger, exchange offer, or otherwise." Significantly, a "reverse merger" under such proposed rules does not include the acquisition of an operating company by a listed company which qualified for initial listing as a special purpose acquisition company, commonly known as a SPAC.

The proposed rules establish a minimum one year "seasoning" period prior to a listing on the NYSE and generally require that the reverse merger company:

- have its equity securities trade in the United States over-the-counter market, on another national securities exchange, or on a regulated foreign exchange for at least one year following the consummation of the reverse merger and prior to a NYSE listing;

- file all required information regarding the reverse merger transaction with the SEC as follows: (i) in the case of a domestic issuer, the reverse merger company must file with the SEC a Current Report on Form 8-K ("Form 8-K") containing all of the information required by Item 2.01(f) of Form 8-K, including all required audited financial statements, or (ii) in the case of a foreign private issuer, the reverse merger company must file all of the information described in (i) above on Form 20-F;

- maintain a minimum stock price of at least $4 per share "on both an absolute and an average basis for a sustained period" (which period is undefined) through such company's NYSE listing; and

- timely file with the SEC all required reports since the consummation of the reverse merger, including the filing of at least one annual report on Form 10-K or 20-F "containing audited financial statements for a full fiscal year commencing on a date after the date of filing with the Commission of the filing" described in the second bullet point above.

The NYSE has also reserved the right to impose "more stringent requirements" on particular reverse merger companies "based on, among other things, an inactive trading market in the Reverse Merger Company's securities, the existence of a low number of publicly held shares that were not subject to transfer restrictions, if the Reverse Merger Company had not had a Securities Act registration statement or other filing subjected to a comprehensive review by the Commission, or if the Reverse Merger Company had disclosed that it had material weaknesses in its internal controls which had been identified by management and/or the Reverse Merger Issuer's independent auditor and had not yet implemented an appropriate corrective action plan." Finally, unlike Nasdaq, these proposed rules would not apply to a reverse merger company if its listing is in connection with an "Initial Firm

Commitment Underwritten Public Offering", as such term is defined in the NYSE Listed Company Manual, under certain circumstances.

On July 22, 2011, NYSE Amex (formerly the American Stock Exchange) also proposed its own set of additional listing application requirements for reverse merger companies. Such proposed rules are nearly identical to the NYSE proposed rules, but do not contain a $4 minimum stock price requirement[11].

The SEC is expected to act on the NYSE and NYSE Amex proposed rules by September 26, 2011, subject to potential extension.

Proposed Nasdaq Listing Requirements

On May 26, 2011, Nasdaq submitted to the SEC its revised rulemaking proposal containing proposed additional listing requirements for reverse merger companies. The proposed rule changes apply to any company that was formed by a reverse merger, defined as "any transaction whereby an operating company becomes public by combining with a public shell, whether through a reverse merger, exchange offer, or otherwise." To determine whether an entity is a "public shell", Nasdaq intends to analyze a number of factors, including, among others, "whether the Company is considered a "shell company" as defined in Rule 12b-2 under the Act; what percentage of the Company's assets are active versus passive; whether the Company generates revenues, and if so, whether the revenues are passively or actively generated; whether the Company's expenses are reasonably related to the revenues being generated; how many employees support the Company's revenue-generating business operations; how long the Company has been without material business operations; and whether the Company has publicly announced a plan to begin operating activities or generate revenues, including through a near-term acquisition or transaction."

The proposed rules establish a minimum six month "seasoning" period prior to a listing on Nasdaq and generally require that the reverse merger company:

- have its equity securities trade in the United States over-the-counter market, on another national securities exchange, or on a foreign exchange for at least six months prior to listing;
- file with the SEC "all required information about the transaction, including audited financial statements for the combined entity";
- maintain "a Bid Price of $4 per share or higher on at least 30 of the most recent 60 trading days"; and
- timely file with the SEC all required reports as follows: (i) "in the case of a domestic issuer, its most recent two periodic financial reports with the Commission or Other Regulatory Authority (Forms 10-Q or 10-K) containing at least six months of information about the combined entity; or (ii) in the case of a Foreign Private Issuer, comparable information as described in (i) above on Forms 6-K, 20-F or 40-F."

However, it should be noted that even if a company meets these proposed requirements, Nasdaq may nevertheless deny listing based on its authority "to apply additional or more stringent criteria in order to maintain the quality of and public confidence in the market, to prevent fraudulent and manipulative acts and practices, to promote just and equitable principles of trade, and to protect investors and the public interest."

The SEC is expected to act on the proposed rules by September 12, 2011, subject to potential extension.

Rationale for Proposed Rules

The NYSE and Nasdaq believe that the "seasoning" period created by their proposed rules will reduce investor risk by providing increased scrutiny of reverse merger companies by the markets and regulators prior to listing. Such period will provide greater assurance that the reverse merger company's SEC reports are accurate and reliable since auditors and the company will have reviewed at least several quarters of the company's operating results prior to listing. In addition, a "seasoning" period will allow the company's auditors and management to identify and address financial irregularities or internal control problems before they are listed on these exchanges. Nasdaq suggests that during the "seasoning" period, the Financial Industry Regulatory Authority, Inc. and other regulators would be able to effectively review trading patterns of reverse merger companies to reveal potentially manipulative trading. Furthermore, a "seasoning" period would lead to an increased likelihood that a reverse merger company has "a more bona fide shareholder base" and will help assure that the initial listing bid price was not obtained through manipulative trading practices. Finally, the NYSE points out that that the new rules "will increase transparency to issuers and other market participants with respect to the factors considered by NYSE Regulation in assessing reverse merger companies for listing."

Conclusion

Given the growing concerns related to reverse merger companies that enter the trading market in the United States without the SEC's review and underwriters' due diligence that is associated with a typical initial public offering registered under the Securities Act, the NYSE and Nasdaq have each proposed listing requirements that are designed to better identify and correct financial irregularities and other disclosure issues often associated with these companies by requiring a "seasoning" period prior to listing. The exchanges expect that this period will permit regulators to identify issues that may preclude listing and allow the reverse merger companies to create reliable reporting track records that promote confidence among potential investors.

Private companies seeking to effectuate a reverse merger and list on the NYSE or Nasdaq should be mindful of these potential listing rule changes as well as the enhanced scrutiny surrounding reverse mergers, which often involves extended SEC review of post-merger filings and regulatory inquiry into the trading of the securities of the reverse merger company, all of which suggest that the ostensible benefits of a reverse merger as an alternative to a traditional initial public offering may not outweigh the costs, particularly when ongoing compliance costs and the delay in listing associated with the seasoning period are factored into the analysis.

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[1] A " shell company" is a public reporting company with few or no operations. See Securities Act Release No. 8587 (July 14, 2005).

[2] See Exchange Act Release No. 65034 (August 4, 2011) and Exchange Act Release No. 64633 (June 8, 2011).

[3] See Public Company Accounting Oversight Board, Activity Summary and Audit Implications for Reverse Mergers Involving Companies from the China Region: January 1, 2007 through March 31, 2010, Research Note # 2011-P1 (March 14, 2011), http://pcaobus.org/Research/Documents/Chinese_Reverse_Merger_Research_Note.pdf.

[4] Securities Class Actions Filings - 2011 Mid-Year Assessment, Cornerstone Research, at page 1, http://securities.stanford.edu/clearinghouse_research/2011_YIR/Cornerstone_Research_Filings_2011_Mid_Year_Assessment.pdf.

[5] See Henning v. Orient Paper, Inc. CV 10-5887-VBF (AJWx), 2011 U.S. Dist. LEXIS 79135 (C.D. Cal. July 20, 2011).

[6] SEC Investor Bulletin: Reverse Mergers (June 9, 2011) at pages 3-4, http://www.sec.gov/investor/alerts/reversemergers.pdf.

[7] In re Moore Stephens Wurth Frazer and Torbet, Order Instituting Public Administrative and Cease-and-Desist Proceedings, Securities Act Release No. 9166 (December 20, 2010).

[8] Letter from Mary L. Shapiro to Hon. Patrick T. McHenry, dated April 27, 2011, at page 3, http://s.wsj.net/public/resources/documents/BARRONS-SEC-050411.pdf.

[9] See Public Company Accounting Oversight Board, Auditor Considerations Regarding Using the Work of Other Auditors and Engaging Assistants from Outside the Firm, Staff Audit Practice Alert No. 6 (July 12, 2010), http://pcaobus.org/Standards/QandA/2010-07-12_APA_6.pdf.

[10] See, e.g. Press Release, NYSE Euronext, NYSE to Suspend Trading in Duoyan Printing, Inc. (March 28, 2011), http://www.nyse.com/press/1301307616164.html.

[11] See Exchange Act Release No. 65033 (August 4, 2011).

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