SEC Warns Investors On Reverse Merger Companies

Having recently suspended trading in more than a dozen reverse merger companies, on June 9, 2011, the U.S. Securities and Exchange Commission (the "SEC") issued an Investor Bulletin cautioning investors about purchasing shares in companies that enter U.S. markets through so-called reverse mergers or back-door listings. The Investor Bulletin warns of potential risks of investing in such companies and identifies some of the recent enforcement actions that the SEC has brought against a number of listed reverse merger companies, including many companies based in the People's Republic of China ("PRC companies") that became domestic issuers through the reverse merger process. The Investor Bulletin can be found at the following Internet address: http://sec.gov news/press/2011/2011-123.htm.

From a non-U.S. issuer's perspective, the Investor Bulletin demonstrates the SEC's increased regulatory focus on the reverse merger practice and its participants. While a reverse merger is often perceived to be a quicker and cheaper method of going public than a traditional underwritten IPO, we believe that the recent regulatory steps taken by the SEC and the negative publicity surrounding the reverse merger process greatly weakens the perceived time and cost benefits of going public through a reverse merger rather than a traditional IPO. Non-U.S. companies, not just PRC companies, that may be considering gaining access to U.S. public markets through the reverse merger process might want to carefully reconsider the benefits and risks of the process and reevaluate going public via a traditional IPO.

The Investor Bulletin was an apparent reaction by the SEC to the recent vocal negative media spotlight placed on the reverse merger industry and corresponding severe share price declines of a number of post-reverse merger companies, particularly PRC companies. The Bloomberg Chinese Reverse Mergers Index, which tracks 78 companies that gained U.S. listings through the reverse merger process, plunged 48% in 2011 through June 17.

The publication of the Investor Bulletin continues a series of steps the SEC has taken to address its concerns about the misuse of shell companies as vehicles to commit fraud, to prevent shell companies from abusing the regulatory process and to indirectly regulate the reverse merger practice. Some of the SEC's new and amended securities rules adopted since 2005 include:

- adding a definition of a "shell company";
- prohibiting the use of a free writing prospectus by a shell company;
- amending Rule 144 to impose a longer restriction period for resale of securities of a former shell company;
- maintaining the presumptive underwriter provision in a Rule 145 business combination transaction with a shell company;
- restricting the ability of a current or former shell company to use the Form S-3 to conduct a primary offering;
- prohibiting a current or former shell company from using the Form S-8 until 60 days after the termination of the shell company status and filing of Form 10 information with the SEC; and
- requiring a shell company to disclose shell company status on the cover page of its periodic reports.

The SEC joins other securities authorities, such as the Hong Kong Stock Exchange, in treating reverse mergers with disfavor.

In a reverse merger, an existing public "shell company," which has few, if any assets, acquires a private operating company — usually one that is seeking access to funding in the U.S. capital markets, and the private operating company's shareholders exchange their shares for a majority of the shares of the public shell company. Because (in contrast to the traditional IPO process) the consummation of a reverse merger transaction does not require SEC review and registration and the transaction is often not subject to the same level of due diligence review, the reverse merger practice presents a greater opportunity for potential for fraud and lack of accurate and complete information about the reverse merger companies and transparency as to their management.

Investors should also consider that some of the non-U.S. companies that access the U.S. markets through the reverse merger process have been using small U.S. auditing firms, some of which may not have the resources to meet their auditing obligations when all or substantially all of the private company's operations are located in another country.

This problem is further aggravated by these smaller auditing firms outsourcing the audit and review work to foreign accounting firms, which themselves may not be fully complying with the required auditing standards. Accordingly, these auditing firms may not be able to identify all of the circumstances where the post-reverse merger companies may be failing to comply with the relevant accounting standards. Since December 2010, more than 25 listed PRC companies have disclosed auditor resignations or accounting problems to the SEC.

Some commentators have also noted that an interesting "pattern" has emerged from litigation related to reverse merger companies in that a number of PRC companies hired the same auditors and used the same investment banks for their reverse mergers, which may indicate that these auditors and banks are encouraging the companies to pursue listing in the U.S. when the companies are not ready to comply with the requirements of being publicly traded in the U.S.

Since 2007, more than 150 Chinese companies have been listed in the U.S. through back-door listings. Many of these companies trade on the less regulated markets such as the Pink Sheets, the Over-The-Counter Bulletin Board (the "OTCBB") and NYSE Amex. The Pink Sheets and the OTCBB generally provide thinly traded liquidity prone to episodic volatility and market failure due to their high potential for predatory activity.

If at the time of the reverse merger, the public shell company is quoted on an over-the-counter market, typically the shares of the post-reverse merger company will be permitted to continue to be quoted on the over-the-counter market without going through the FINRA's review process and will not be subject to the same requirements as the companies listed on an exchange.[1]

Investors should also consider that while the securities of a post-reverse merger company that are listed on an exchange may receive greater regulatory scrutiny due to compliance with the exchange's initial and continued listing standards and its rules, as well as with the U.S. federal securities laws, there is no assurance that a security listed on an exchange market will trade on that exchange indefinitely.[2]

[1] In addition, unless a company that is quoted on an over-the-counter market is reporting under the Securities Exchange Act of 1934 (which is not always required in the over-the-counter market), investors may find it difficult to discern whether a particular company is a reverse merger entity and may have trouble obtaining information about the management, operations, financials and other important aspects of the formerly private company.

[2] In May 2011, Nasdaq proposed additional "seasoning" listing requirements for companies going public through reverse mergers.

Chicago Office +1.312.583.2300	**Frankfurt Office** +49.69.25494.0	**London Office** +44.20.7105.0500
Los Angeles Office +1.310.788.1000	**New York Office** +1.212.836.8000	**Palo Alto Office** +1.650.319.4500
Shanghai Office +86.21.2208.3600	**Washington, DC Office** +1.202.682.3500	**West Palm Beach Office** +1.561.802.3230