



Reverse Merger as a Method of Going Public: Regulatory Approach in U.S.

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Abstract: Reverse Mergers have grown as viable and profitable means of attaining public status in U.S. With a tightening of the laws surrounding the technique, the prospects of fraud have become minimal and reverse mergers have become a promising vehicle to take small companies public in U.S. In this direction the American markets Model for the small business issuer sets an example. The present article analysis the regulations in U.S. in detail with focus on compliance issues.

Keywords: Reverse Merger, Shell Company, SEC, SOX, IPO

I. Introduction

In Global capital markets, IPO have been the traditional and predominant path to go public. However the recent developments have created opportunities for alternatives to IPOs. The most popular alternative has always been the Reverse Merger. Because of the unique features of the Reverse Merger commonly known as backdoor listings are complex inter-corporate transactions by which unlisted private-held companies achieve a listing status through merger with the publicly-listed shell companies. Though a Reverse merger transaction is usually structured as a takeover of the private firm by the public company but in essence, the vendors of the private firm obtain control of the enlarged public shell at the conclusion of the event, therefore a case of Reverse Merger. This unique transaction represents two perspectives on the same. First From the public company's perspective, Reverse Merger represents major corporate restructurings which typically involve a change of name, business activities, board of directors and management. Second, from the private company's perspective, Reverse Mergers are also an alternative route for going public.

In U.S., a Reverse Merger is looked as a fast-track method by which a private company becomes a public company. Reverse mergers are also commonly referred to as Reverse Takeovers, or RTO's in U.S. Any Reverse Merger transaction in U.S. will begin with identifying a 1934 Exchange Act shell company (the "Public Shell Company") which has no or minimal operations and is listed on the OTC Bulletin Board. The actual transaction begins when Public Shell Company and the private Company enters into a letter of intent indicating the parties preliminary intentions to engage in a reverse merger transaction subject to the satisfactory completion of due diligence by both parties. Pursuant to this, In an share exchange, the private Company will exchange all of its shares of stock for shares of the Public Shell Company. As a result of the share exchange, the private Company will become a wholly owned subsidiary of the Pubic Shell Company.

After completing the reverse Merger transaction, the Company must have to file its two years of audited financial statements prepared in accordance with Generally Accepted Accounting Principles ("GAAP"), up to date reviewed quarterly statements. These financial statements must be filed in a "Super 8-K" with the SEC within four days of the closing date of the transaction. The "Super 8-K" must include among other things, the terms of the transaction, a description of the operations of the Company and the financial statements. The shareholders of the Company will now control the OTC Bulletin Board company which has its shares quoted on the OTC Bulletin Board. If the shell intends to trade on a major exchange such as NASDAQ, then in that case a shareholder approval and a full proxy under exchange rules is must. Even most exchanges require a "new listing" application following a name change. This is nothing but complying with all the initial listing standards following the merger. Thus a straight forward Reverse Merger intending to get listing on recognized stock exchanges of U.S. makes the entire process complicated and onerous. Therefore most of the shells delist from NASDAQ and move to the OTC Bulletin Board prior to the merger in order to avoid stringent regulatory compliance.

II. Regulatory Approach

As far the regulatory regime is concerned in U.S. The reforms began with passing of Penny Stock Reform Act in 1990¹. This prescribed disclosure norms for offerings by blank check companies and to impose disparate treatment on these offerings. In pursuance to the same Rule 419 was passed by SEC, which is considered to be corner stone of .US. regulatory mandate for Reverse Meager shells. Rule 419 specifically addressed a situation where a founder of a blank check company wanted to use it to first raise money in a public offering, and then look for a company with which to complete a reverse merger. Rule 419 sought to eliminate the four major concerns about abusive blank checks: promoters milking the shells for cash, abusive trading practices, and no time limit existed to find a Reverse Merger candidate, and investors were not generally given an opportunity to review or vote on a proposed merger².

A phenomenal changes were , transfer of money raised in public offering to be transferred in escrow account until a merger is undertaken, completing the merger within 18 months from the date of offering, creation of opt-out option for those investors who did not like the proposed merger . And if the 80% did not opt in then the merger could not be completed. However this 80 percent approval is rather vague and at times inconsistent. In addition to this opt out the blank check has to prepare, file, and obtain SEC approval of a prospectus-like document providing detailed information about the company (including audited financial statements) that will merge into the blank check company. The rule also laid down specific requirements to be met for a particular merger to “qualify” for release of the funds, including the fact that the value of the private business merging in must be equal to at least 80 percent of the amount being raised in the blank check’s IPO. Further exemptions were also created under the rule specifying thresholds³.

This Rule 419 had a dramatic and positive effect on abusers of Reverse Merger transactions, eliminating many bad players from the market. At the same time many genuine transactions and quality players were also hurt by it. This gave birth to new trends in U.S. such as, merging with public shells that had been created through the sale or liquidation of operating public companies since they were not restricted by Rule, Birth of SPACs, and filing of Form 10-SB, under the Securities Exchange Act of 1934, rather than conduct a public offering that would be subject to Rule 419. And interestingly merger with a Form 10-SB shell was accepted to be legal and viable option by the authorities.

Later SEC gradually started to comment upon the reverse Merger Transactions .In 1999, it was clarified under the Exchange Act that, Within fifteen days of the reverse merger (the "Fifteen-Day Notice Window"), the issuer was supposed to file a report on Form 8-K containing notice of the transaction along with audited financial statements of the pre-transaction private company covering the three most recently completed fiscal years. Unaudited interim financial statements as well as pro forma financial data demonstrating the effects of the transaction were also to be included on Form 8-K. If the pre-transaction private entity's financial statements were unavailable, the post-transaction reporting company had a sixty-day grace period from the date of the initial Form 8-K (the "Sixty-Day Grace Window") during which it had to file the requisite financial information. Combining the Fifteen-Day Notice Window with the Sixty-Day Grace Window (or subsequently, the Four-Day Notice Window with the Seventy-One-Day Grace Period), issuers had a total of seventy-five days after a reverse merger to file audited financial statements. During that seventy-five day period, stockholders could have had little or no information from which to determine the value of their securities⁴.

In early 2005, the SEC made significant comments to Rule 419 shells, but allowed Form 10-SB shells to effectively sail through registration with few or no comments. Thus Form 10-SB shells were more preferred than shells under Rule 419. Later Passage of SOX in 2002 brought major changes in the securities market of U.S. by making public companies more transparent and accountable. For the same it brought more stringent auditing and compliance regulations for public companies. In 2004 SEC proposed set of new amendments to SOX to regulate the Reverse Merger transactions. This included Form S-8, Form 8-K and Form 20-F, all together known as 2005 SEC rule making .

The SEC’ 2005 Rules had four major parts:

First, it defined “shell company” as a company, that has: (A) No or nominal operations; and (B) Either: (1) No or nominal assets; (2) Assets consisting solely of cash and cash equivalents; or (3) Assets consisting of any amount of cash and cash equivalents and nominal other assets⁵; however the term “nominal” was left unexplained by the SEC. This vagueness in the definition encourages many small companies to enhance their operations and assets so that they can fall out of the term “nominal ” and avoid being a shell company. Though

¹ David Franklin Levy , *The Impact Of The Remedies Act On The Sec's Ability To Obtain Inunctive Relief*, THE AMERICAN UNIVERSITY LAW REVIEW [Vol. 44:645], 1994, Pp-676-677.

² Use of Form S-8 and Form 8-K by Shell Company, 17 CFR Parts 230, 239, 240 and 249 [Release Nos. 33-8407; 34-49566; File No. S7-19-04] RIN 3235-AH88, Securities and Exchange Commission, available at <http://www.sec.gov/rules/proposed/33-8407.htm> (Last accessed February 7, 2015).

³ ESCROW AGREEMENT, *Exhibit 99a, Securities Exchange Commission*, available at http://www.sec.gov/Archives/edgar/data/1513904/000107878211003344/s1a4_ex99.htm (Last accessed February 7, 2015).

⁴ Aden R. Pavkovtt , *Ghouls and Godsend's? A Critique of "Reverse Merger"* Policy, 3 BERKELEY BUS. L.J. 475 2005-2006, Pp 499-500.

⁵ Rule 144, available at <http://www.rule144solution.com/shellcompany.asp> (Last accessed February 7, 2015).

footnote 32⁶ added little clarification by including transaction which places assets or operations within an entity with the intent of causing that entity out of the definition. But footnote 172⁷ by providing that “Even having the simplest of operations is enough for a company to avoid being deemed a shell” ended up making shell companies as actually a zero operations company only. Since then Footnote-32/172 shells have been manufactured by less than reputable parties and these attempts through Footnote 32/172 Shell Company hurt the reputation of legitimate blank check vehicles, Rule 419 blank check companies and Form 10 blank check companies and reverse merger transactions which are important component to capital markets.

Second, it prohibited use of Form S-8 under the Securities Act by reporting shell companies, however a company that ceases to be a shell company or a former shell company must wait for 60 days it changes its status to use Form S-8. This prohibition was very appropriate because use of Form S-8 by a shell company would be inappropriate and would pose significant risks to the market⁸.

Third, it brought an amendment to Form 8-K, requiring a shell company, when reporting an event that causes it to cease to be a shell company, to file with the Commission the same type of information that it would be required to file to register a class of securities on Form 10 or Form 10-SB under the Exchange Act, such as risk factors and management’s discussion and analysis. And all this needs to be filed immediately within four days of closing the transaction. As a result of this rule, shell companies would no longer have a waiting window for filing financial information about the company. Filing of prompt and detailed disclosure in Form 8-K filings would provide required and relevant information to the investors of the merged entity after the Reverse Merger transaction. Eventually this requirement would also control the possibilities fraudulent and manipulative activity by shell companies and makes Reverse Merger transactions more transparent and accountable⁹.

Fourth, Amendment was made to the definition of “succession” under the Exchange Act for transactions involving shell companies. This included a change in control of a shell company. As a result of this, a private entity that acquires a reporting shell company would succeed to the reporting obligations of the shell company and become a reporting company. This made the back door registration transactions or Reverse Merger transaction more codified and clear. Interestingly Form 8-K has to be filed even if there is mere change in the control of a shell, even when there is no Reverse Merger.

Fifth, Amendment to Form 20-F: According to this rule, some foreign private issuers¹⁰ that are registered with the Commission would come within the proposed definition of “Shell Company.” Therefore Shell companies which are foreign private issuers would be subject to the use of Form S-8 Similarly like a domestic shell company, in case if a foreign private shell company loses its foreign private issuer status after engaging in a transaction with a domestic operating business, the surviving entity would have to file a Form 8-K within four days upon completion of the transaction. As a result of this rule, foreign private issuer shell companies will have the same disclosure requirements as those for domestic shell companies. Therefore four business compliance is mandatory for foreign private issuers no matter what form they use to report.

In 2008, an amendment was brought in order to prohibit the use of Rule 144. As per the rule, shareholders of a shell could sell their shares starting on year after a Reverse Merger and release of the form 8-K. This appeared

⁶ Footnote 32 of SEC Release Nos. 33-8587; 34-52038; International Series Release No. 1293, says that, “We have become aware of a practice in which a promoter of a company and/or affiliates of the promoter appear to place assets or operations within an entity with the intent of causing that entity to fall outside of the definition of “blank check company” in Securities Act Rule 419. The promoter will then seek a business combination transaction for the company, with the assets or operations being returned to the promoter or affiliate upon the completion of that business combination transaction. It is likely that similar schemes will be undertaken with the intention of evading the definition of Shell Company that we are adopting today. In our view, where promoters (or their affiliates) of a company that would otherwise be a shell company place assets or operations in that company and those assets or operations are returned to the promoter or its affiliates (or an agreement is made to return those assets or operations to the promoter or its affiliates) before, upon completion of, or shortly after a business combination transaction by that company, those assets or operations would be considered “nominal” for purposes of the definition of shell company.”

Use Of Form S-8, Form 8-K, And Form 20-F By Shell Companies, [Release Nos. 33-8587; 34-52038; International Series Release No. 1293; File No. S7-19-04], 17 CFR Parts 230, 239, 240 and 249, Securities And Exchange Commission, Pp, 10-11, available at <http://www.sec.gov/rules/final/33-8587.pdf> (Last accessed February 7, 2015).

⁷ Footnote no. 172 of SEC Release No. 33-8869, states: “Rule 144(i) does not prohibit the resale of securities under Rule 144 that were not initially issued by a reporting or non-reporting shell company or an issuer that has been at any time previously such a company, even when the issuer is a reporting or non-reporting shell company at the time of sale. Contrary to commenters’ concerns, Rule 144(i)(1)(i) is not intended to capture a “startup company,” or, in other words, a company with a limited operating history, in the definition of a reporting or non-reporting shell company, as we believe such a company does not meet the condition of having “no or nominal operations.” Revisions To Rules 144 And 145, [Release No. 33-8869; File No. S7-11-07], 17 CFR Parts 230 and 239, Securities And Exchange Commission , available at <http://www.sec.gov/rules/final/2007/33-8869.pdf> (Last accessed February 7, 2015).

⁸ Gail Cohen, *Demand Media, Differences in S-1 & S-8 Filing*, available at <http://smallbusiness.chron.com/differences-s1-s8-filing-33577.html> (Last accessed February 7, 2015).

⁹ Use of Form S-8 and Form 8-K by Shell Company, 17 CFR Parts 230, 239, 240 and 249 [Release Nos. 33-8407; 34-49566; File No. S7-19-04] RIN 3235-AH88, Securities and Exchange Commission, available at <http://www.sec.gov/rules/proposed/33-8407.htm> (Last accessed February 7, 2015).

¹⁰ The term “foreign private issuer” is defined in Exchange Act Rule 3b-4(c), 17 CFR 240.3b-4(c). A foreign private issuer is a non-government foreign issuer, except for a company that (1) has more than 50% of its outstanding voting securities owned by U.S. investors and (2) has either a majority of its officers and directors residing in or being citizens of the United States, a majority of its assets located in the United States, or its business principally administered in the United States.

to be critical change and resulted in acceptance of shells and Reverse Mergers by the U.S. regulators. The most significant change to be appreciated was, only former shells have to wait until one year after a merger, whereas non-shells shareholders can begin selling them in six months. However, operating companies merging with shell companies and investors purchasing securities from such issuer or otherwise at the time of the reverse merger or after such date will have to wait for the one year anniversary of the filing of the Form 10 information with the SEC before a holder can rely on sales under Rule 144 and availability of under Rule 144 for shareholders of a former shell company was made limited because Rule 144 exemption was made available only to a public company that was a shell company only if the company is current on all of its periodic reports required to be filed with the SEC during the 12 months before the date of the shareholder's resale¹¹.

Unfortunately the SEC has not taken any step to amend Rule 144(i), nor has there been any further public guidance for former shell companies trying to comply with their obligations under Rule 144(i) — despite the fact that the SEC itself said that the result of Rule 144(i) was probably not intended. As the U.S. economy continues to recover at a slow pace, more and more businesses may consider returning to the often more streamlined and cheaper reverse merger route of becoming a public reporting company. Yet, without further clarification or modification, Rule 144(i) remains the law of the land¹².

Later, due to a trend of Chinese Reverse Mergers in U.S. SEC established more rigorous conditions for companies going public through a Reverse Merger to comply before they can be listed on the three major U.S. exchanges (i.e., the NYSE Amex, NYSE and NASDAQ).

The additional requirements issued by three major stock exchanges of U.S. in 2011 such as seasoning period, minimum stock price maintenance and disclosure of information were passed by the SEC. As far as seasoning period is concerned the combined entity has to be traded for at least a year in either the U.S. over-the-counter market, on another national securities exchange or on a regulated foreign exchange following the completion of the relevant transaction. For stock price maintenance, Reverse Merger Companies are also required to maintain a certain closing stock price, which is a minimum of US\$ 4 for a maintained period of time, which in any event shall not be less than 30 (thirty) of the most recent 60 (sixty) trading days prior to the date of the Reverse Merger Company's initial listing application with the stock exchange. Besides the above mentioned requirements, there were other requirements specified by the stock exchanges for the Reverse Merger companies in order to be listed through them. These additional requirements were pertaining to the disclosure of information. Such as disclosures under Forms 8-K and 20-F and filing of at least one annual report.¹³

The new rules approved by the SEC establish more rigorous conditions that companies going public through a Reverse Merger and also strengthen investors' confidence and their ability to rely upon. These rules are believed to bring more transparency to issuers and market with regard to Reverse Merger companies and finally will help in reducing the regulators' concerns over such companies.

Thus Since 2005 the SEC has played a critical role in declaring Reverse Mergers as legitimate and valid in corporate structuring. These rules passed by SEC have made people, who think that Reverse Merger transactions involve only unscrupulous operations to think differently. These SEC's new rules are designed to strengthen investors' confidence and their ability to rely upon. These rules are believed to bring more transparency to issuers and market with regard to Reverse Merger companies and finally will help in reducing the regulators' concerns over such companies.

Furthermore, the popular and successful reverse Mergers in U.S. such as Blockbuster, Ted Turner, New York Stock Exchange, Actinium Pharmaceuticals, Inc., REO Motor Car, RAE Systems and CKX stand as a testimony to this trend of legality and acceptability of Reverse mergers in U.S. All this seems to have worked. The increased use of Reverse Merger transactions by both the domestic and foreign companies in America suggest a revitalized view of the benefits of the method. In particular, the Chinese's companies and the German biotechnology companies have been ailing this technique of going public in U.S. with increased number.

III. Conclusion

Reverse Mergers have grown as viable and profitable means of attaining public status in U.S. With a tightening of the laws surrounding the technique, the prospects of fraud have become minimal and reverse mergers have again become a promising vehicle to take small companies public in U.S. Perhaps the American markets Model for the small business issuer sets an example. But in 2007, it was observed by many American financial analysts that, American securities markets were losing the competitive edge they once held globally. This challenges America's growth ability both domestically and internationally. One of the key reasons cited was

¹¹ Laura Anthony, *Rule 144 Seller's Representation Letter*, available at <http://www.reverse-merger.com/tag/restricted-stock> (Last accessed February 7, 2015).

¹² Julie Holden, *SEC Still Quiet On Rule 144(i) Evergreen Requirement*, Law 360, a LexisNexis® Company, available at <http://troygould.com/wp-content/uploads/2014/08/Pub-065.pdf> (Last accessed February 7, 2015).

¹³ Self-Regulatory Organizations; New York Stock Exchange LLC; Notice of Filing of Proposed Rule Change Amending Sections 102.01 and 103.01 of the Exchange's Listed Company Manual to Adopt Additional Listing Requirements for Companies Applying to List After Consummation of a "Reverse Merger" with a Shell Company, SEC, Release No. 34-65034; File No. SR-NYSE-2011-38), August 4, 2011

downfall of IPOs. It is significant to note that the highest onerous factor for such a downfall was placed on the over-regulation of the American Securities market because compliance with the Sarbanes-Oxley Act of 2002 was considered to be too onerous, which had forced companies to spend more on accountants than on research. Not surprisingly, the Interim Report also claimed that regulatory burden and section 404 of SOX as heavy factors behind the so-called decline. Thus in U.S. regulation is being implemented too zealously.

Hence the U.S. regulatory Regime is a classic example of Over-regulation of Capital market. May be because investor's protection is the hall mark of U.S. securities Law. However by providing a legal mechanism and conditions of operation, U.S. regulators have been able to hold on to their small companies, which play a critical role in job creation and sustainability of capital markets. This needs to be appreciated and U.S. continues to have a standardized benchmark for regulation of Reverse mergers in the globe inspiring many such as Canada, U.K., Australia, and Sweden.

IV. Suggestions

- a) There has been much "hand-wringing" over the current condition of America's capital markets and their growth ability both domestically and internationally. The recent concerns are based on observations that foreign competitors have been absorbing a larger portion of the "public market pie" than in past years, despite America's reputation as one of the leading financial centers in the world. The reasons for the downward trend in foreign investments in the U.S. and the increase in American investments abroad remain a subject of discussion, but the focus of the blame seems to be the American regulatory process therefore a fresh look at section 404 of SOX in terms of relaxing certain provisions is needed. However investor protection being the hall mark of the American securities market cannot be compromised at any cost
- b) The biggest primary challenge is that, as per the definition of a shell company, shell is one with no or nominal operations, and the question is what exactly does the term "nominal" mean? Surprisingly The SEC has not made any efforts in clarifying what "nominal" would mean. This vagueness in the definition encourages many small companies to enhance their operations and assets so that they can fall out of the term "nominal" and avoid being a shell company. Therefore the term "nominal" should be clearly defined quantitatively by the SEC. This clarification may be quite helpful in defining what cannot be done by the companies in order to evade being a shell since shell companies have greater obligations in US.
- c) Form 8-K by placing requirements for disclosure of information by a company which ceases to be a shell company along with elimination of 71 days window for providing financial information is a major help in preventing frauds. But the legitimate payers continue to be burned and affected by these rules. Therefore instead of prohibition a better alternative can be provided by the SEC.
- d) The 2011 requirements such as seasoning period, minimum stock price maintenance and disclosure of information are a mile stone in US as far as legitimizing reverse mergers are concerned and to minimize the occurrences of frauds provided their impact upon the genuine and bona fide payers is observed and mitigated by the SEC through creating some exceptions for them.
- e) Since the condition to the availability of Rule 144 provided in Rule 144(i)(2) does not apply to shares of a public company that was not a shell company. This makes a reverse merger into a public shell company unattractive. Therefore this provision must be reconsidered by the SEC
- f) A new venture exchange should be set up for OTC securities with a blue sky preemption
- g) For Regulation A+ aftermarket trading there should be a blue sky preempted and there should also be a speedy path to full SEC reporting after a Regulation A+ offering and no limit to be imposed on how much one can invest
- h) key holding period for Rule 144 should be shortened to 3 months
- i) There should be a simplified SEC regulations or none for the Private placement brokers ("finders").
- j) Form 8-K for "current reporting" should be eliminated for smaller reporting companies (SRCs)
- k) XBRL financial reporting should be optional for SRCs due to the cost with minimal benefit¹⁴
- l) As far as the accredited investor are concerned, the income and net worth minimums should remain the same, but accredited investor status be expanded to those who pass an exam or are licensed attorneys, accountants, registered reps, financial advisors, etc.

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¹⁴ David Feldman on Nov 24, 2014 in Congress, Reverse Mergers, Regulation A+ and IPO Alternatives, SEC, Small and Microcap, from the final report of SEC-Government Business forum on small business capital formation. <http://www.davidfeldmanblog.com/category/reverse-mergers-and-ipo-alternatives>.

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