The Reverse Merger: Easy Way in or Illegitimate Access to U.S. Capital Markets?

By Marshall P. Horowitz and Brandon Batt

On April 4, 2011, Commissioner Luis A. Aguilar of the Securities and Exchange Commission (SEC) presented a captivating speech in which he argued that "real capital formation" is only created when investors have access to accurate and adequate information to invest in a particular company and the company then uses that capital investment to foster real, organic growth. He argued that reverse mergers are often not being used for legitimate purposes and therefore hurt our economy's ability to generate real capital formation. This theory is one of the foundations of both the 2010 Dodd-Frank Wall Street Reform and the Consumer Protection Act, in which Congress responded to the public market's need for increased disclosure and expanded investor protections.

The reverse merger of a private company into a public shell company has received negative attention from the SEC due to the ease in which foreign companies are gaining access to U.S. public markets. Reverse mergers have been problematic for investors and regulators alike because they may allow an unsophisticated (and sometimes fraudulent) company to sell securities to the public without undergoing extensive diligence by underwriters or providing adequate disclosures to investors. Since 2006, more than 600 private companies have executed a reverse merger, and more than 150 of them have involved Chinese or China-based companies.

Notwithstanding the more stringent rules promulgated by the SEC a few years ago, Aguilar declared that the SEC has noticed "increasing problems" with companies involved in these transactions. Over the past few years, the SEC has investigated many instances of fraud on the markets perpetrated by companies that entered the market through a reverse merger. The lack of substantive disclosures required by an IPO or other securities registration provides an opportunity for dishonest or fundamentally weak companies to gain access to public markets that they otherwise would not have had.

In his speech, Aguilar pointed out that, "two companies that were numbers one and two on the Investor's Business Daily 100 have now been shown to have significant issues." The Commissioner stated that there were two trading suspensions imposed on Chinese companies in March 2011 alone. Another extreme example involved a CEO of a company that had gone public through a reverse merger who was later discovered to be a fictitious person. Additionally, several Chinese companies that have gone public in the U.S. through reverse mergers have been the focus of class actions alleging securities fraud. The amount of the losses claimed in these lawsuits is in the billions of dollars.

Investors in these companies are at a higher risk of trading securities based on fraud and other irregularities. Investors should be cautious that a company's financials may not be sound or audited under U.S. GAAP standards. Aguilar stated that "systematic concerns with the quality of the auditing and financial reporting" currently exist with Chinese reporting companies in the U.S. markets. Although each public company must have a U.S. independent accounting audit of its financials, occasionally the U.S. auditor will simply certify its audit based on the audit conducted by the foreign accounting firm without "conducting any of its own work," said Commission Aguilar. This "shortcut" of a company's accounting disclosures violates Public Company Accounting Oversight Board standards and has the potential to mislead an unsophisticated investor into believing the company's audit was actually performed by a U.S. auditor pursuant to U.S. GAAP standards. Although the SEC's acceptance of the International Financial Reporting Standards has increased over the past few years, the standards in the U.S. continue to be governed by U.S. GAAP.

Despite the concerns noted above, a reverse merger remains a viable option for fundamentally strong private companies drawn to the relative ease and the reduction in costs when compared to a traditional IPO. For instance, the total costs of an IPO typically range between five and 10 percent of the offering, whereas a simple reverse merger may cost significantly less. Once public, a company's stock enjoys greater liquidity and allows its original investors to "cash in" on their ownership interests.

Whereas an IPO can take six months to a year to complete, a reverse merger can be completed in a few weeks to a few months. This reduction in time is partly due to the fact that a reverse merger allows a company to go public without the need to provide substantive disclosure or raise any capital. Also, generally, reverse mergers incur less dilution to the company's equity, thereby allowing the company's founders and prior investors to retain more ownership in the now-public company.

Public companies enjoy a greater array of options related to mergers and acquisitions and financing terms. For foreign companies, breaking into the U.S. public markets (as opposed to in their home country) is a popular alternative to avoid regulations for raising capital in the public markets of their home countries.

Before going public, private companies should carefully consider the decision to go public. A company should consider whether its business fundamentals (for example, financial stability and management) are strong enough to attract outside investors and coverage from Wall Street that will in turn bring additional investors to the company. Management must be prepared for additional regulatory and compliance requirements, which can be significant, expensive and often suffocating to an under-performing company. Commentators have argued that many companies (both U.S. and foreign) are simply not sophisticated enough to take their companies public in the U.S., and often the desire for quick cash trumps the lack of a fundamental understanding of securities regulations.

For example, many companies are ill-informed and unprepared to comply with the Sarbanes-Oxley Act of 2002 (SOX) and other applicable SEC requirements. A 2009 study by the SEC reported that assessment of internal controls compliance can alone average a cost of approximately $690,000 for companies with a market capitalization of $75 million or less.

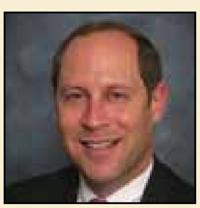
Foreign companies should also be aware of the recent stigma attached to reverse mergers and the aversion some investors may have towards the company once in the market. This aversion by the market may affect investment in the company, which in turn could make SOX and SEC compliance even more burdensome for an inexperienced company.

Once a decision to go public has been made, the company should have a known strategy for success that should permeate every aspect of its business, from its public disclosures to corporate culture. A company should be cautious from the beginning to make sound business decisions and to "act" like a public company in furtherance of its objective to build an image of responsibility and dependability.

If the company's management and current advisors are not familiar with the responsibilities of "going public," proper advisors should be engaged. Engaging the help of a respectable law firm practicing in this area and a recognized national independent accounting firm will help the company assure investors that legal and accounting tasks and issues are properly addressed and resolved. Investors likely will be more comfortable with a "newcomer" to the market that is surrounded by experienced legal counsel and independent auditors.

While Aguilar raised many valid concerns in his recent speech, reverse mergers remain an attractive option for companies to obtain public company status more easily than via an IPO. When fraudulently used, the reverse merger can carry the potential for abuse and improper behavior, and the threat to investors is substantial. Those instances will continue to be prosecuted by the SEC, and investors should be cautious of these dangers as the reverse merger is not likely to disappear.

As long as companies are aware of the increased responsibilities and costs, the reverse merger will likely continue to benefit fundamentally sound companies that operate in a respectable manner. In other words, stay out of the kitchen if you can't stand the heat.



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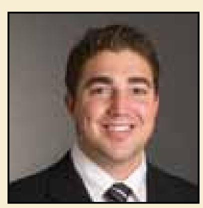

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