REGULATORY EFFORTS OF THE UNITED STATES IN MITIGATING INFORMATION ASYMMETRY IN REVERSE MERGER COMPANIES

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ABSTRACT

Reverse merger is a listing method which has been growing in popularity. The transaction basically involves the acquisition of a private company by a public company, but in this case, the private company ends up as the controller of the public company. This method of going public offers one of the many advantages of this method is the avoidance of most of the regulatory requirements usually present in an IPO. However, as a downside, information asymmetry in reverse merger firms tends to be higher than that of IPO firms. This leads to numerous fraud cases linked to reverse merger firms. This paper tries to assess regulatory efforts by the SEC and their effects in the reduction of reverse mergers. Such regulatory efforts, namely Rule 419, the 2005 rule changes on the uses of SEC Forms S-8, 8-K and 20F and the ratification of the listing rules by NYSE, NASDAQ and NYSE Amex have their own qualities and drawbacks in providing investors with sufficient protection. Rule 419 showed that the SEC tried to keep reverse mergers legitimate and safe for investors, by providing some information to investors. The 2005 SEC Rule, on the other hand provided a comprehensive requirement which has the most advanced impact to the disclosure of information, as it ensures the disclosure of reverse mergers and avoided the misuse of disclosure forms. The Exchanges Rules, on the other hand presented itself with many possible drawbacks in the side of the companies, while doing very little in contributing for the reduction of information asymmetry.
PREFACE

This thesis is written in the purpose of graduating from the LL.M in International Business Law Program.

Thank you for my supervisors, Prof. dr. E.P.M. Vermeulen and Ms. Li Jing MPhil for their kind guidance in the writing process of this thesis. I would also like to thank my beloved family and friends for their support in writing this thesis.
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CHAPTER I

Introduction

Companies share the common dream of being able to expand their businesses. One way to achieve such dream is with better access to capital, which can be accomplished when their shares are traded publicly. Within this reasoning, companies are listing themselves in stock exchanges in the process of going public. Hence, it can be considered that going public is among the most important events for a firm.\(^1\) The consideration of going public is often based on the numerous advantages offered, such as:\(^2\)

a. Capital access;
b. Liquidity;
c. Growth through acquisition and strategic partnership;
d. Stock option for executives; and
e. Confidence in Management.

On the other hand, before listing themselves in stock exchanges, companies must also be aware of the drawbacks of being a public company. Such drawbacks include:

a. Emphasis on short-term results;\(^3\)
b. Limitation of control;\(^4\)

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\(^3\) Feldman 1, *supra* note 2, p.11-15.

c. Public disclosure and Lawsuit risks;\(^5\) and

d. Considerably larger expenses.\(^6\)

As it is in other countries, the traditional route to achieve a public status is by going through an initial public offering, or more commonly known as an IPO. In this IPO process, a company hires an underwriter, which is typically an investment bank. The underwriter gives advice, distribute the securities which are going to be offered and take principal positions in order to conduct the IPO and issue the securities to the public for the first time. The company, which is now the issuer, enters into an agreement with the underwriter which governs the arrangement between the issuer and the underwriter. Moreover, there is a certain amount which is to be paid to the underwriter.\(^7\)

This traditional IPO process is undergone by the majority of companies intending to go public. However, it is a well known fact that this process is both lengthy and expensive. Moreover, conducting an IPO highly depends on the characteristics of the company and the underwriting availability. Sure, there are self-underwriting options that a company can undergo in conducting an IPO but less capital is able to be raised with this option, not to consider the higher risk involved in this alternative. Owing to this fact, companies seek other ways to conduct this going public process (or the listing process). Some of the alternatives include roll-ups, sell-outs, reverse leveraged buyouts and reverse mergers/acquisitions.\(^8\)

This paper will concentrate on the latter, which is reverse mergers/takeovers, also known as backdoor listing.


\(^6\) Ibid.


Generally, reverse merger is known to have its own advantages when compared with an IPO. Such advantages are as follows:\(^9\)

a. Lower cost

It is to be noted that this benefit is highly relative, depending on the relevant jurisdiction. Nevertheless, generally, services which must be obtained by a company in conducting an IPO is usually higher than that of reverse merger.

b. Speedier process

The process of conducting an IPO is generally more time consuming, where there are plenty of preliminary processes to be undergone, such as securing an underwriter, and all the mandatory steps which are to be taken in order to get a green light for the IPO. Meanwhile, a reverse merger in general can be completed in two to three months.

c. No dependency on IPO market

It is a known fact that an IPO has to be conducted at the right time, when the so-called IPO window is open. Fund raising goals of a company conducting an IPO during a period the IPO window is closed, or even only slightly open, may not be met. Therefore all the expenses that have been incurred for this may go to waste. Reverse merger, on the other hand, is not dependent on the IPO market and can be conducted any time. This characteristic is highly preferable for companies.

d. No dependency on underwriters

In an IPO, securing an underwriter is highly important. However, this matter is sometimes very difficult for some types of company, which may not be very

\(^9\) Feldman 1, supra note 2. p.-10.
appealing to investment banks who usually act as underwriters. This may be caused by the business line of the company itself not being favored at the time of the planned IPO. Moreover, there are actually cases that the underwriter who has been secured for an IPO withdraws their underwriting or change the offering price for some certain reason such as market receptivity. Reverse merger offers an alternative for this company to not be dependent on an underwriter to conduct go public.

e. Less dilution

In an IPO, especially when a significant amount of working capital needs to be raised, there is a tendency that a bigger portion of the company’s shareholding is going to be held by the public, therefore there is a better tendency of dilution of the existing shareholder’s holding in the company. Therefore, maintaining the desired share ownership will be easier in a reverse merger scheme where the funds raised are relatively smaller than in an IPO.

However, along with the above advantages, reverse merger also has some disadvantages which have to be put into consideration. Such disadvantages include:¹⁰

a. Less funding

Relatively, less funding is raised during a reverse merger. Therefore, in most cases, it is necessary to conduct further financing efforts after the reverse merger is completed.

b. Harder to obtain market support

This disadvantage may come as a result of having no underwriters. In IPOs, there is always the underwriter who will endeavor to obtain market support. The company will have to use other means of creating a ‘buzz’ in attracting investors.

¹⁰ Feldman 1, supra note 2. p.11-14.
c. Notoriety of Reverse Merger

Due to the nature of the transaction and the past (and also present) fraud cases which is linked to reverse mergers, it has gained a slightly bad reputation. This causes a significant amount of scrutiny which is directed to reverse merger companies.

A significant problem usually associated with reverse mergers to the point that the transaction gained notoriety in the eyes of various parties, such as regulators, academics and investors is the amount of information asymmetry associated with the transaction.11 The condition of information asymmetry is characterized by the existence of a discrepancy of information possessed by different parties. In the case of an IPO, it exists between the potential investors and the owners of the security, where the potential investors possess inferior knowledge as opposed to the owners of the information.12

The foregoing problem has created a bad image for reverse merger, as the protection for investors is generally viewed as insufficient, due to the more opaque nature of the transaction itself (this matter will be further discussed in the following chapters), when compared to an IPO. More companies, on the other hand, have been involved in this transaction. Since January 2007, 600 companies have gone public by means of a backdoor registration.13 In line with that fact, more and more fraud allegations have been directed towards reverse merger companies and such allegations often point out to the fact that reverse merger was undertaken by these companies.

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In the past years, these problems seem to persist in foreign companies, specifically, Chinese companies listing in notable stock exchanges in the United States. This matter can be construed as a pressing one, as the American litigation scene in 2011 was dominated by shareholder lawsuits towards Chinese companies. With an increase in shareholder lawsuits that reached 20 percent from 2010 to 2011, it was indicated that there is a wave of fraud in the United States.\textsuperscript{14} The danger of fraud in reverse merger companies raises the question of whether the easements offered by reverse mergers which make them preferable to IPOs create a whole new problem which jeopardizes the protection of investors. It might be that by avoiding cumbersome regulatory process, companies are putting investors in a risky position.

It is then necessary to assess the nature of the information asymmetry in reverse mergers. Once it has been identified that such the discrepancy of information possessed between transaction promoters and investors comes hand in hand with the transaction itself, the growing concern of regulators will become understandable and therefore efforts in minimizing the dangers of fraud need to be assessed. It is known that regulatory efforts in this matter have been undertaken by the Securities and Exchange Commission of the United States of America ("\textbf{SEC}" or the "\textbf{Commission}"). The growing concern of practitioners with regards to the increase of regulatory scrutiny makes it necessary to examine whether these regulatory efforts have been correctly addressed in achieving a balance between investor protection and capital access. With the abovementioned problem, this paper will therefore try to tackle several questions, such as:

1. In what way does information asymmetry occur in reverse merger transactions?
2. What regulatory framework does the United States have in providing investors with better protection with regards to reverse mergers?
3. Is such regulatory framework sufficient in addressing the information asymmetry problems related to reverse mergers?

In answering the above questions, this thesis will be organized as follows. The first part will discuss how reverse mergers are conducted. The second part will describe the information asymmetry related to reverse mergers. The third part will explain the regulations which have been enacted by the United States government through the SEC with regards to reverse mergers. Finally, the last chapter will determine whether the information asymmetry problem was correctly addressed in such regulations.
CHAPTER II

The Mechanism of Reverse Mergers

This part will try to explain how reverse mergers are generally conducted.

A. Parties Involved in Transaction

1. Public Shell Company

To obtain the general idea of public shell companies ("Public Shell" or "Shell Company"), which are a vital part in the reverse merger transaction, we can refer to the definition provided by the United States Securities and Exchange Commission in June 2005. The definition of a shell company stipulated in Rule 405 (Definition of Terms) is as follows:

“A registrant, other than an asset-backed issuer as defined in item 1101 (b) of Regulation AB, that has:

1. No or nominal operations; and
2. Either:
   i. No or nominal assets;
   ii. Assets consisting solely of cash and cash equivalents; or
   iii. Assets consisting of any amount of cash and cash equivalents and nominal other assets.”

These companies may either be a former operating public company ("Formerly Operating Public Shell") which ceased operations and liquidated its assets or a company which was formed for the sole purpose of creating a Public Shell from scratch without ever having any operations. On the former case, the stocks of the Formerly Operating Public Shell may still be traded in the stock exchange,

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although not frequently.\textsuperscript{16} The latter type of shell, meanwhile, is better known as a Special Purpose Acquiring Company (“SPAC”).

Formerly Operating Public Shell in the matter of reverse merger shall be differentiated from SPACs. SPAC is a Public Shell which is formed in order to raise capital for a business that will be acquired in the future.\textsuperscript{17} Due to the frequent unavailability of Formerly Operating Public Shells in the market, or when available, the high cost of acquiring Formerly Operating Public Shells, the creation of SPACs is often preferred in reverse merger schemes. The creation of SPAC enables deal promoters to ensure that the company purchased is clear and its specification can be tailor-made for the purpose of the relevant deal.\textsuperscript{18}

In the deal structure of backdoor listing, surely the value of the Public Shell is a vital matter. In order to determine this, there are numerous items that matters. Such items are namely:\textsuperscript{19}

a. Method of Creation

The aforementioned creation of the public company, whether it was a Formerly Operating Public Shell or a SPAC plays a vital role in the determination of the price of a public shell. Nevertheless, aside from the method of establishment of the company, the method of going public, whether by means of an IPO or any other methods has to be taken into consideration. It is also an important matter, in the event where the Public Shell which is going to be purchased is a Formerly Operating Public Shell, the cause of the cessation of the company’s operation should be identified.

\textsuperscript{16} Ibid.


\textsuperscript{18} Feldman 1, supra note 2. p.179.

\textsuperscript{19} Feldman 1, supra note 2. p.32.
b. Assets and Liabilities

This matter, which can be clarified by means of a financial due diligence, is of high importance as it is included in the value of the Public Shell.

c. Trading Condition

The nature of the trading activity of the Public Shell’s stocks in the market may differ, especially among Formerly Operating Public Shells and SPACs. SPACs, in this case, have fewer tendencies to be traded in the market while Formerly Operating Public Shells usually continue to trade, although in a relatively less frequent manner. With regards to this trading condition, there is usually a positive correlation between the trading activity and the value of the Public Shell.

An active trading condition of such formerly operating Public Shells, however, has its downside. There is a propensity for the investors who purchased the stocks of the public shell during the period of their active operation to sell-off their stocks after the completion of the merger or the acquisition. Another downside is that there are more tendencies for insider trading in an actively traded Public Shell.

In views of the above possibilities related to trading activity, it is possible to conclude that SPACs which are not actively traded in the market offer more certainty and more controllable trading circumstances following the closing of the deal.

d. Size of Shareholder Base

In this matter, the more shareholders that a company has, the more valuable that company is.
e. Company Cleanliness

This matter is correlated to the past history of the Public Shell or the management of the shell. This can be determined by means of a thorough due diligence.

2. Private Companies

Private Companies who decides to use the method of reverse merger for going public has some typical characteristics. This matter has been covered by several literatures, identifying some of the characteristics often associated with Private Companies who choose to undergone reverse merger. Below are some of those characteristics:

a. Small-Sized Companies

The size of the company, in this case being smaller-sized companies, when compared to their IPO-undergoing counterparts, would less likely afford hiring underwriters to support their IPO. Moreover, the high fixed-costs related to conducting an IPO may deter smaller companies from undergoing the action.

b. Young Companies

On the similar circumstances as small companies, young companies also tend to experience limitations on hiring underwriters.

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C. Poorer Performing Companies

When faced with the subject of company performance, hypothetically, a high performing company would promise higher growth, making them highly attractive for underwriters to back them up for IPOs and therefore opening wide their IPO window. Poorer performing companies, on the other hand would have difficulties in attracting investors as much as high performing companies and have to resort to other means to go public.\(^\text{23}\)

d. High–Tech Industries

The choice of conducting a public offering may create a risk of the entry of competitors, which is notably higher than that of conducting a private offering. Pioneering an offering for a high-technology might trigger other competing companies to follow the step of conducting a public offering, therefore giving a competitive advantage to the competitors.\(^\text{24}\)

e. Insider Ownership Maintenance

As reverse merger does not change the ownership structure of a company as drastic as an IPO does, companies whose insider shareholders are more inclined to maintain their control of the company would more likely to choose reverse merger as their method of going public.\(^\text{25}\)

\(^{23}\) Ibid.


f. Lower Balance Sheet Liquidity and Higher Leverage

Companies undergoing reverse merger as an alternative to IPOs may have lower balance sheet liquidity which continues following the completion of the reverse merger transaction. Moreover, they also have higher leverage.\(^{26}\)

g. Higher Information Asymmetry

As a result of the absence of a prospectus which is require in an IPO, there is more information asymmetry with the investors in a reverse merger company. Private companies undergoing reverse merger are more opaque than companies undergoing IPOs.\(^{27}\) This matter will be further discussed in the next chapter.

B. Transaction Structure

Basically, the reverse merger process is when a private company (the “Private Company”) takes over a Public Shell and goes public instantly. The term “reverse” is used because the public shell is the survivor in this kind of transaction, maintaining the trading status of the public shell in the capital market.\(^{28}\) There are several possible schemes to complete this transaction, namely a reverse takeover, or reverse triangular merger, which is the most common one due to some advantageous characteristics.


\(^{27}\) Carpentier, supra note 11. p.5.

\(^{28}\) Feldman 1, supra note 2. p.36.
1. Reverse Triangular Merger

This method is highly preferred to complete backdoor listing transactions as there are no requirements for the approval of the shareholders of the Public Shell. The steps of this scheme are as follows:

a. The public shell forms an empty wholly-owned subsidiary (the “Shell Subsidiary”);

b. The Subsidiary merges to the Private Company, requiring the approval of the shareholders of the Private Company and the Public Shell (represented by the board of the Public Shell) as the shareholders of the Shell Subsidiary, with the Private Company as the survivor of the transaction;

c. Shares exchange, of the Private Company and the Public Shell;

d. The Shell Subsidiary disappears and the Private Company becomes a fully owned subsidiary of the Public Shell;

e. Shareholders of the Private Company become the majority shareholder of the Public Shell.

The above scheme can be illustrated in the following graph:
After examining the process of the reverse triangular merger on the above explanation, another advantage of this process is that the Private Company remains intact and therefore free to proceed with their business and any change of control provisions which they have with their suppliers and other counterparts in any contracts are not triggered.\(^{29}\)

### 2. Reverse Takeover

Another means of conducting the backdoor listing is by a reverse takeover. With the same ‘players’ as with the ones in a reverse triangular merger set forth above, except without the creation of a subsidiary of the Public Shell, the process of a reverse takeover is set out below:

a. A Public Shell takes over a Private Company;
b. The Purchase Price Consideration of the acquisition shall be the shares of the Public Shell, leaving the Private Company as the holder of the shares in the Public Shell.

In essence, the reverse takeover scheme can be seen as a share exchange. The above scheme can be illustrated in the chart below:

To determine which reverse merger scheme is suitable, there are several factors to be put into consideration. The share exchange scheme seems to be simpler than the reverse triangular merger scheme. However, to be able to undergo this transaction, the approval of all of the shareholders has to be obtained. To be precise, in the share
exchange transaction, the shareholders are the ones conducting the transaction. However, the problem gets more complicated when the number of shareholders of the Private Company is large. The reverse triangular merger, on the other hand only need a majority vote of the shareholder. Aside from such problem, even when the number of shareholders is not very significant, the reverse triangular merger is still preferable as there is a smaller chance that minority shareholders of the Private Company will demand compensation for the signature that he is granting. In other words, the reverse takeover/share exchange scheme puts minority shareholders in the Private Company in a better bargaining position.  

C. Follow-Up Financing

Following the completion of the reverse merger scheme as of the above, it is still necessary for the Private Company to raise funds, keeping in mind that their method of going public simply does not raise funds as an IPO will. Therefore, additional financing will be needed. For the case of reverse merger, the most common method of financing which undergone is Private Investment in Public Equity (“PIPE”) Financing.  

According to Sjostrom, PIPE Financing can be identified as:

“A type of financing transaction undertaken by a public company, normally with a small number of sophisticated investors.”

In the United States, PIPE Financing is conducted by issuing common stock or securities which are convertible into common stocks for investors, making use of exemptions of the SEC registration requirements. Such issues or conversions are then


31 Sjostrom, supra note 15. p.749.
registered in the private placement. When the company registers such resale of the PIPE shares, the investors will be allowed to resell the stocks after the resale registration statement is active.\textsuperscript{32} The issuance of PIPE securities is made pursuant to Section 4(2) of the Securities Act or regulation D under the Securities Act, which allows private issuance of stocks for accredited investors, surpassing the requirement of a public offering.\textsuperscript{33}

There is one important aspect that differ PIPE Financings from regular private equity placement. Shares acquired in PIPE deals are more liquid than that of traditional private equity placements, as PIPE shares are registered in the appropriate authority.\textsuperscript{34} Further, duration of the resale restriction is usually shorter than that of traditional private placement. Investor types which usually take part in a PIPE financing are hedge funds, venture capital funds and private equity funds. These types of investors seek equity investments with substantial risk premiums.\textsuperscript{35}

There is another method of raising capital following the completion of a reverse merger transaction, which is a seasoned equity offering (“SEO”). An SEO, also known as a secondary equity offering, is the sales of stock after the initial public offering.\textsuperscript{36} This method is commonly used using an underwriter, in order to market their seasoned equity offering.\textsuperscript{37}

\textsuperscript{32} Sjostrom, supra note 15. p.745.


According to Chen (2009), however, SEOs have been surpassed by PIPEs, with respect to both dollar volume and number of transaction. This is understandable, as PIPE financing has its own advantage over SEOs. In relation to time consumption, PIPE is a better option as it is more time-efficient, as the closing of the transaction and the drawdown of the capital can be conducted prior to the completion of the registration procedure. Further, as there is direct involvement in the due diligence process, undervaluation, particularly in firms with high information asymmetry, can be substantially eliminated.  

Conclusion

Reverse Mergers essentially involve Shell Companies, whether in the form of a Formerly Operating Company or an SPAC, and a Private Company. The technique can either be a reverse triangular merger or a reverse takeover (or a share exchange). The choice of transaction scheme depends on the shareholding structure of the Private Company itself. Upon the completion of the reverse merger transaction itself, the financing phase commences. The financing scheme which is most commonly used following a reverse merger transaction in is the PIPE Financing and Seasoned Equity Offerings.

38 Chen, supra note 33. p.106.
Chapter III

Information Asymmetries Related To Reverse Merger

More companies in the United States are listing themselves in stock exchanges using the technique of reverse merger. The number of reverse merger deals completed in 2010 was an astonishing 246 deals, which represented a 25 percent increase from the previous year. Within this number of deals, 81 deals were completed with Chinese companies. Therefore, the reverse merger is a listing technique often used by companies from the China to list in major stock exchanges in the US. This fact, however, has been a growing concern of the SEC due to the amount of fraud accusations which have surfaced in connection to this matter. The number of cases submitted in US courts against Chinese companies has been on the rise, with one company in 2009, 10 companies in 2010 and a staggering rise to 39 companies in 2011. The fact that a company underwent a reverse merger became a subject matter of concern when these companies face fraud allegations. Brief descriptions of some of those fraud cases are provided below.

China Natural Gas

China Natural Gas, Inc (NASDAQ:CHNG) ("CNG") is a Delaware-incorporated Chinese energy company for natural gas pipelines, based in Xi’an, China. On 2005, CNG entered


the US stock exchange by means of a reverse merger. The fraud case circulates around related party transactions in the form of an acquisition and several loans amounting to more than US$ 14 Millions. These transactions, designed to benefit the Chairman and CEO, Ji Qinan and his family was concealed from the board, investors and auditors. Such transactions contained elements of third party transactions but failed to be reported in a timely and proper manner to the SEC. On 14 May 2012, SEC filed a civil lawsuit against CNG and Ji Qinan under Civil Action No. 12-cv-3824.43

China Agritech

China Agritech, Inc. (“CA”) (NASDAQ:CAGC) is a Chinese operating agricultural company, who is a leading developer, manufacturer and distributor of fertilizer products.44 A promising fact about CA is that the environmentally friendly manner in which they produced their fertilizers, in line with the ‘global warming’ trend at that moment, appealing to investors.45 CA eventually conducted a reverse merger as a way to go public in February 2005 by merging with Basic Empire Corp., a dormant company based in Nevada.46 However, what seemed to be highly promising turned out to be an investor’s nightmare.

On February 2011, Lucas McGee Research released a report detailing the misrepresentations and misstatements surrounding CA. These revelations stated that CA’s product samples were yet to be found. It went as far as the absence of equipments and actual activities in CA’s alleged plant in China and the exaggeration of CA’s

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revenues. These allegations, however, was claimed to be made by some short-selling party hoping to spread rumors to drop the stock price. Counter allegations were soon to be made by Glickenhaus & Co, an asset manager firm who invested in CA. Glickenhaus paid a visit to CA’s activity center in Beijing and found that it is actually an operating company.

With these continuing speculations on the legitimacy of CA, an investigation was launched by the SEC. Eventually, on February 11, 2011, a shareholder class action lawsuit was filed against CA in the U.S. District Court for the Central District of California.

**Keyuan Petrochemicals**

Keyuan Petrochemicals (“KP”) (OTC:KEYP) is a petrochemical manufacturer based in Ningbo, China. It conducted a reverse merger with Silver Pearl Enterprises, Inc. in April 2011. Experiencing more or less the same fate with the aforementioned companies, KP was sued in yet another shareholders class action lawsuit on 18 November 2011 in the U.S. District Court for the Central District of California.

Chinese companies listed in the US stock market are not the only ones ‘enjoying’ the spotlight of fraud accusations. There are also cases involving companies, which do not

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necessarily originate in China. Below are some fraud cases in the US which does not involve Chinese Companies.

**Advanced Refractive Technologies**

Advanced Refractive Technologies, Inc. (US:ARFR) ("ARFR"), is a company focusing on the identification, development and marketing of ophthalmic applications.⁵² This California-based company came to the stock market by means of a reverse merger.⁵³ The SEC initiated an administrative proceeding against ART on May 19, 2011, in the release number 64517, where it revoked the registration of securities for ARFR.⁵⁴

**Digital Youth Network**

Digital Youth Network Corp. (PINX:DYOUF) ("DYN") is a company engaged in interactive marketing, based in Vancouver, Canada, which conducted a reverse merger.⁵⁵ In a similar case to ARFR, was delisted by the Commission on June 8, 2011 in the release number 64620.

The previous cases provide an illustration of the clear disadvantage of Reverse Merger, which is the high potential of fraud cases, arising due to high information asymmetry. The question that presents itself is how far the extent of information asymmetry in reverse merger is and why investors are greatly warned when investing in companies that go

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through a reverse merger process. The latter one was evidenced by the issuance of a bulletin by the SEC specifically warning investors of the dangers of investing in the aforementioned companies.\(^{56}\) This chapter will try to assess how companies who undergo a reverse merger pose more risks with regards to information asymmetry.

One of the most obvious factors is the nature of the disclosure regime required for reverse merger, when compared to an IPO. In this matter we may compare firms of the same development stage and value, but one of such firms chooses to undergo an IPO (the “**IPO Firm**”) and the other opts for a reverse merger (the “**Reverse Merger Firm**”). Both firms will have the same level of opacity prior to undergoing their listing method of choice. The current owners of firms have extensive information regarding various aspects of the firm, such as the internal operation, economic potential, and the industriousness of management and employees.\(^{57}\)

In the case of an IPO, or a public company in general, there are factors which enhance the existence of information asymmetry between insiders and the public and the reluctance to reduce it by providing sufficient information to the public. First of all, the organization of the company bears its own complexity, with variables such as leadership, culture, technology, products and strategy. Further, the information provided to public investors is screened by insiders who have the incentives to misrepresent them. Thirdly, notwithstanding the legal obligation of the insiders to disclose information, some material information is not subject to rigorous disclosure requirements. Ultimately, there are potentially great returns for the incomplete disclosure of information and the existence of a certain degree of information asymmetry gives a chance for opportunistic behavior for insiders.\(^{58}\)

Firstly, the IPO Firm will be required to submit a prospectus. A prospectus refers to:

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\(^{58}\) *Ibid.*
“any prospectus, notice, circular, advertisement, letter, or communication, written or by radio or television, which offers any security for sale or confirms the sale of any security;...”

The Reverse Merger Firm, on the other hand, will not go through this requirement. In such sense, investors for the IPO will have the luxury of the information which they need in making an investment decision, while for the investors for the Reverse Merger Firms will not. The lack of informed investment decision which occurs in this case shows that in consideration of the prior similar level of information asymmetry, towards the completion of the listing procedure undertaken by the respective companies, the information asymmetry in the IPO Firm is appreciably reduced.

As discussed in the previous chapters, one of the essences of a reverse merger is the avoidance of initial listing requirements. However, following the completion of the transaction, there are continued listing requirements which cannot be avoided. In respect of the involvement of regulators, control measures which are placed on the IPO firm are still of better quality than those placed on the Reverse Merger Firm. As a result of the absence of a clear definition of Reverse Merger in securities regulation in general, the involvement of regulator in a Reverse Merger transaction is of an indirect nature. At most, there are disclosure procedures to be undergone in the continued listing requirement, as this type of transaction most of the time constitutes a material change in the Public Shell and such matters usually require disclosure. Nevertheless, the disclosure required in this matter rarely implies review and approval from the securities authority. On the other hand, for the IPO firm, generally there are layered disclosures, with the registration statement, which are filed to the relevant securities authority and the prospectus, which are delivered to the prospective investors. The approval of the securities authority which is required in order to


61 Carpentier, supra note 11. p.8.
go through with the transaction provides some sort of control to the transaction, protecting investors better.

The lack of intermediaries in a Reverse Merger transaction also plays a role in the information asymmetry. It has been brought up in the previous chapter that Reverse Merger transaction requires minimum involvement of investment banks as underwriters, and this comes as a disadvantage. No underwriting means that there is no assurance from underwriters which gives investors the slight indication of the quality of the stocks being traded.

The structure of the information asymmetry also differs in an IPO Firm and a Reverse Merger Firm. In an IPO, the information asymmetry only occurs between the investors and the IPO Firm, while Reverse Mergers involve more parties as stakeholders of the transaction, such as the Shell Company, the Reverse Merger Firm and the investors. While in an IPO the information asymmetry is reduced with the delivery of the prospectus, there are less means of reducing information asymmetry in a Reverse Merger.

Information Asymmetries in IPOs

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62 Ibid. p.10.
The opaque nature of Reverse Merger firms heightened with the nature of the disclosure procedures sometimes gives a bad reputation to Reverse Merger. It is known among regulators, academics and practitioners in North America that Reverse Merger is associated with fraud.\(^{63}\) Some of the fraud method which is often linked with Reverse Merger is the ‘Boiler Room’. Boiler rooms refer to a high-pressure selling technique which frequently uses the telephone for speculative or even fraudulent securities.\(^{64}\) This is highly feasible, due to the severity of the agency problem which exists within Reverse Merger Firms. Aside from boiler rooms, Reverse Merger is also more prone to insider trading. Other than the opacity which is an obvious reason for this, the public shells used in the transactions are already prone to insider trading. Moreover, the past association between blind pools and penny stock experimentation with Reverse Merger also causes this bad reputation to occur.

\(^{63}\) Ibid. p.11.

Another issue which concerns the large information asymmetry is the pricing inaccuracy which often occurs in when valuing Reverse Merger Firm stocks. The information asymmetry that exists in these cases would distort the accurate valuation of the stocks. In an ideal circumstance, with an opaque firm, rational investors would associate a higher cost of capital and therefore lower the value of the stocks. This cost of capital is affected by the level of liquidity of the relevant stock, and the liquidity is often improved with disclosure.

Nevertheless, the question of whether the lack of disclosure is a determinant factor in pricing inaccuracy is still ambiguous, as this matter is also affected by the level of competition which exists with regards to the stock. With the discrepancy of information possession, the exploitation of information by informed traders becomes lower when the competition is higher. This theory occurs as information owned by informed traders will be reflected in prices more quickly and such prices will reflect the fundamental value of the securities itself.

Therefore, IPO Firms have an advantage on this matter due to the extent of disclosure they carry out. However, taking irrational investors into consideration, whose trading consideration are not always based rate of return calculations as with the rational investor.

It may be concluded from the previous explanation that the extent of information asymmetry occurring in Reverse Merger presents itself as a disadvantage for investors. The fact that Reverse Merger is not clearly defined in capital market regulations provides a ‘wiggle room’ for transacting parties to avoid horrendous disclosure requirements prior to their listing. The bad reputation obtained from regulators may encourage such institutions to become very wary of the best way of limiting this ‘wiggle room’.

Financial authorities in numerous jurisdictions have attempted to put on protective measures to ensure some level of disclosure in Reverse Merger transactions in the hopes of protecting investor’s interest.

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65 Carpentier, supra note 11. p.13.

Conclusion

It can be concluded in this chapter that information asymmetries in reverse merger is considerably higher than that of IPOs. This fact is caused by the more ‘multidimensional’ nature of reverse merger transactions, when compared to an IPO. This, along with the lack of disclosure requirements, regulatory control, bad reputation and intermediary role in the transaction, contributes to the fact that information asymmetry in reverse merger is more disadvantageous to investors. Heightened with the frequent mispricing of reverse merger stocks, views towards reverse mergers are often associated with fraud.
 CHAPTER IV

US Regulatory Framework on Reverse Mergers

It has already been established in the previous chapter that information asymmetry comes higher in reverse mergers, partly due to the insufficiency of disclosure requirements and regulatory control. Having been presented with the amount of fraud cases, the SEC has been aware of the necessity for further regulatory efforts. The Commission recognizes the risks related to the company’s viability after the completion of the transaction and various instances of abuse and fraud which surrounds these types of companies. It therefore started regulating reverse merger transactions. Several points on the regulation for reverse merger companies are as follows:

A. Rule 419: Offerings by Blank Check Companies

One of the most notable triggers of the enactment of Rule 419 is the case involving Onnix Financial Group, Inc (the “Onnix Case”). This case occurred during the 1980s, where financial fraud was prevalent in the stock market. The Onnix Case constituted blatant fraudulent usage of blank check companies, to the point that it affected a large number of investors and reached beyond national borders.67 The Onnix Case made authorities question the legitimacy of corporate actions involving blank check companies.

The SEC promulgated Rule 419 on April 28, 1992. Such rule that was established under the Securities Act of 1933 was not designed to ward off reverse merger practices in the US. Instead, it was enacted to give better protections to investors and to make the process of reverse merger safe and legitimate.68 In order to assess the effect of this

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68 Feldman 1, supra note 2. p.43-44.
rule to the practice of reverse mergers, we can start on the definition of blank check companies itself and review the correlation of such types of companies in the reverse merger transaction.

According to section a.2 of the Rule 419:

“For purposes of this section, the term "blank check company" shall mean a company that:

i. Is a development stage company that has no specific business plan or purpose or has indicated that its business plan is to engage in a merger or acquisition with an unidentified company or companies, or other entity or person; and

ii. Is issuing "penny stock," as defined in Rule 3a51-1 under the Securities Exchange Act of 1934.”

In accordance to such definition, the term ‘penny stock’ is often defined as speculative stocks of very small companies which are worth less than US$5 (five United States Dollars). 69 The above definition of blank check companies leads to the indication that the Rule 419 applies to companies which are often used as Public Shells is reverse merger transactions.

The scenario of the usage of Rule 419 is when a blank check company intends to conduct an offering, and use the proceeds to complete a reverse merger process by being the Public Shell. This rule limits the usage of such proceeds. Therefore, fraudulent activities which can be committed by the promoters of these reverse merger transactions can be substantially hindered. The SEC has provided in this rule the sufficient protection to legitimize reverse merger transactions.

With relations to the offering itself, the rule requires a certain extent of disclosure for the registration statement, which must include these following items:

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1. any provisions relating to the deposit of funds in the escrow or trust agreements and the effects to purchasers thereof; and

2. information provision of any acquisition and the confirmation of the purchasers of their investment of the securities.\(^{70}\)

The rule regulated that proceeds which originate from the offering have to be deposited into an escrow account or a bank account which is established by a broker or dealer which fulfills a certain category. In relation to this matter, only under certain circumstances are the funds deposited in the escrow account allowed to be withdrawn. Such conditions are:\(^{71}\)

1. The blank check company must conduct an acquisition of a business valued no less than 80 percent of the maximum offering;

2. The purchasers of the securities issued by the blank check shall express their consent by means of a reconfirmation after the receipt of a document detailing the company which is going to be acquired.

3. The acquisition has to be completed within an 18 months time frame, or the funds raised from the purchasers are supposed to be returned to them promptly.

It is apparent that from this rule attempted to protect investors from fraudulent reverse merger promoters and therefore providing a safety net for investors who are interested in investing these public shells. In other words, with the Rule 419, the investors become aware of what they are getting into.

To actually comply with the requirements of Rule 419 was not easy. The SEC was very strict in reviewing Rule 419 IPOs. To top it off, the time frame which was prescribed turned out to be very hard to keep up with in completing a reverse merger, given the stringency of SEC’s review in the transaction. Following the effective date of Rule 419, reverse merger promoters tried to find various ways to escape the requirements

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\(^{71}\) Feldman 1, supra note 2. p.45.

Hence, the enactment of the Rule 419 actually inspired the common practice of reverse merger today. With such problems arising, it can be concluded that regulatory efforts undergone by the SEC, although correctly based, has been less than successful in completely providing sufficient investor protection against fraudulent transaction promoters. Therefore, with the ever-expanding number of fraud cases related to reverse merger, better regulation to legitimize and guarantee the safety of a reverse merger transaction is needed.

B. SEC Rule on Use of Form S-8, Form 8-K and Form 20-F by Shell Companies

After the enactment of Rule 419, promoters of fraudulent transactions had tried to find various ways to utilize loopholes in the regulations to enable shady transactions. Therefore, a new rule was needed to close such ‘loopholes’. Eventually, on 21 July 2005, The SEC enacted the Rule on the Use of Form S-8, Form 8-K and Form 20-F by Shell Companies (\textit{“2005 SEC Rule”}). The provisions of the 2005 SEC Rule became effective on 22 August 2005. This rule was enacted in the objective of preventing fraud and abuse in the securities market through the vessel of reporting shell companies.

Similar to the previous rules enacted by the SEC, namely the Rule 419 for Black Check Companies, the 2005 SEC Rule did not attempt to banish the usage of shell companies altogether. The Commission did not fail to recognize the various legitimate uses of Shell Companies in restructuring transactions. Hence, this rule merely attempted to deter such aforementioned fraud and abuses.\footnote{United States of America, Securities and Exchange Commission Release No. 33-8587 of July 21, 2005. \textit{Use of Form S-8, Form 8-K and Form 20-F by Shell Companies}. (hereinafter \textit{“2005 SEC Rule”}). p.2.}
1. **Defining a “Shell Company”**

The primary matter which is regulated in the 2005 SEC Rule is the definition of a shell company. A shell company is defined therein as a registrant (a listed company) with no or nominal operations and either no or nominal assets consisting solely of cash and cash equivalents and nominal other assets.\(^ {74}\) In the previous section, we have discussed the definition of Blank Check Companies under Rule 419. The distinction on the definition lies in the emphasis placed on the two definitions. We can recall that the Rule 419 definition emphasized on the presence of a business plan while the 2005 SEC Rule definition emphasized on the operations and the asset of a company. Identification on the distinction of those two definitions can be seen in the below chart:

![Diagram showing the definition of shell company](image)

Another matter which concerns the definition stipulated in the 2005 SEC Rule is the explanation of the term ‘nominal’. Upon the initial proposal of this rule, the

\(^ {74}\) *Ibid.*
Commission was aware of the confusion which would surface in relation to the usage of the term ‘nominal’. Commentators of the initial proposal expressed suggestions for the usage of an objective test, more specifically a quantitative test as a guidance for the usage of the term. The SEC acknowledged the possibility of further specifying the definition of the term ‘nominal’. However, the possibility that was presented with specifying the term halted the Commission from doing so and remained in its position of keeping the original definition, in the idea that a more specific definition would encourage fraudulent transaction promoters to circumvent the objective of the 2005 SEC Rule.\(^{75}\)

In addition to the definition of shell companies which poses to be quite problematic in its potential for ambiguity, the SEC also provided a definition for “Business Combination Related Shell Company”. According to the 2005 SEC Rule, a Business Combination Related Shell Company is:

\[\begin{align*}
\text{a. A shell company formed by an entity that is not a shell company solely for the purpose of changing that entity’s domicile solely within the United States; or} \\
\text{b. A shell company formed by an entity that is not a shell company solely for the purpose of completing a business combination transaction among one or more entities other than the shell company, none of which is a shell company.}\n\end{align*}\] \(^{76}\)

The purpose of defining the business combination related shell company is to create an exception for the applicability of the certain amendments for the usage of the forms reregulated by the 2005 SEC Rule.

\(^{75}\) Ibid. p.4.

\(^{76}\) Ibid.
2. Form S-8

Form S-8, also recognized as the Registration Statement under the Securities Exchange Act of 1933 to be offered to employees pursuant to certain plans, is a form used to disclose stock option plans extended to employees. Nevertheless, this form was often misused in order to avoid the delivery of a registration statement and prospectus, as registration statements made under this form were immediately effective upon filing. Due to the nature of this form, it was often misused by shell companies to raise capitals. As shell companies have little operations, most often is that they do not have a significant number of employees. Therefore, stock option plans are often the least of their concern. The SEC stated that they often see the misuse of Form S-8 to report sale of shares to purported employees or other nominees. Such sold shares are then further distributed to other purchasers as unregistered sales.

The 2005 SEC Rule stipulated that shell companies are not entitled to file an S-8 form. More specifically, the usage of form S-8 was limited to entities with the following conditions:

a. immediately before the time of filing the registration statement, the entity is subject to the requirement to file reports pursuant to the Periodical Reports requirements of the Exchange Act;

b. the entity has filed all reports and other materials required to be filed by Periodical Reports requirements of the Exchange Act during the preceding 12 months (or for such shorter period that the registrant was required to file such reports and materials);

c. the entity is not a shell company and has not been a shell company for at least 60 days before filing the registration statement; and

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d. If the entity has been a shell company at any time, it has filed current “Form 10 information” with the Commission at least 60 days previously reflecting its status as an entity that is not a shell company.\(^{78}\)

The prohibition on the usage of this form S-8 required shell companies to use other forms such as Form SB-2, Form S-1 or Form F-1 which are considerably less simple than form S-8. This enables the Commission to impose more control on offerings made by shell companies. The involvement of parties in preparing the form also comes as a consideration of the SEC. Form S-8 was estimated to require 50% involvement by the company’s internal staff, while the other alternative forms only require 25% involvement of internal staff. Therefore, involvement of internal parties was hoped to be minimized by the usage of the other forms.\(^{79}\)

3. Form 8-K

Form 8-K is a form filed by a public company to the SEC which is used to report unscheduled material events or corporate changes that could be important to shareholders and the SEC.\(^{80}\) Following the amendment enacted by the 2005 SEC Rule, events requiring the filing of Form 8-K are as follows:\(^{81}\)

a. Entry into and termination of a material definitive agreement;

What is referred to as a material definitive agreement according to the guidelines of Form 8-K is “an agreement that provides for obligations that


are material to and enforcement against the registrant, or rights that are material to the registrant and enforceable by the registrant against one or more parties to the agreement, in each case whether or not subject to conditions”. However, material definitive agreement referred to in this matter does not include those entered into in the ordinary course of business of the company.

b. Bankruptcy or receivership;

c. Completion of acquisition or disposition of a significant amount of assets;

d. Results of operations and financial condition;

e. Creation of a material direct financial obligation or an obligation under an off-balance sheet arrangement of a registrant;

f. Triggering events that accelerate or increase a direct financial obligation or an obligation under an off-balance sheet arrangement;

g. Cost associated with exit or disposal activities;

h. Material impairments;

i. Notice of delisting or failure to satisfy a continued listing rule or standard; transfer of listing;

j. Unregistered sales of equity securities;

k. material modification to rights of security holders;

l. changes in Registrant’s certifying accountant;

m. Non-reliance on previously issued financial statements or a related audit report or completed interim review;

n. Change in control of registrant;

o. Departure of directors of certain officers; election of directors; appointment of certain officers; compensatory arrangements of certain officers;
p. Amendments to articles of incorporation or bylaws; change in fiscal year
q. Temporary suspension of trading under registrant’s employee benefit plans;
r. Amendments to the Registrant’s Code of Ethics, or Waiver of a provision of the code of ethics;
s. Change in Shell Company Status;
t. Submission of matters to a vote of security holders;
u. Shareholder director nominations;
v. ABS Informational and Computational Material (for asset backed securities);
w. Change of Servicer or Trustee (for asset backed securities);
x. Change in Credit Enhancement or other External Support (for asset backed securities);
y. Failure to make a required distribution (for asset backed securities);
z. Securities Act updating disclosure (for asset backed securities);

aa. Regulation FD disclosure; and/or

bb. Other events deemed important.

The additional reporting event which was enacted through the 2005 SEC Rule is the cessation of being a shell company. The surviving entity in the transaction which causes such cessation was required to make a more specific and detailed filing upon completion of such transaction by means of Form 8-K. Such filing shall be submitted within four business days upon the completion of such transaction. Matters to be included in such filings are the information, which includes financial information, which would be required in a registration statement on Form 10 or Form 10-SB to register a class of securities under
Section 12 of the Exchange Act, with that information reflecting the surviving entity and its securities upon consummation of the transaction.\textsuperscript{82} Information included in forms 10 and 10-SB includes all information which is included in a prospectus in the case of traditional IPOs. Such information includes:\textsuperscript{83}

a. two years of audited financial information (three years, for companies who cannot benefit from the disclosure scheme of Regulation S-B;

b. full business description;

c. risk factors;

d. related party transactions;

e. executive compensation;

f. comparative period-to-period analysis of financial results;

g. description of capital stock;

h. discussion of prior securities offerings;

i. material contracts, company’s charter and bylaws; and

j. full five-year biography of officers and directors along with their shareholding information.

Prior to the enactment of the 2005 SEC Rule, there was an additional 71-day window for the filing of required financial information, between the filing of the initial Form 8-K for a specific event and the required filing of financial information related to such transaction. The problem is that this 71-day window is often used to engage in fraudulent and manipulative activity. The Commission recognized the common usage of this window and therefore attempted to deter such kind of usage. Ergo, such window was eliminated by the 2005 SEC Rule.\textsuperscript{84}

\textsuperscript{82} 2005 SEC Rule. supra note 73. p.7.

\textsuperscript{83} Feldman 1, supra note 2. p.135.

C. **Investor Bulletin**

As a follow up to the persisting problems arising in relations to frauds and abuses from reverse merger firms, even after the enactment of the 2005 SEC Rule, on June 9, 2011 the SEC published an investor’s bulletin on reverse mergers ("Reverse Merger Bulletin"). The comprehensive Reverse Merger Bulletin was intended to inform investors about various aspects which must be taken into consideration when investing in reverse merger firms.

The Commission identified that the risk of investing in reverse merger firms are their viability and auditing deficiencies. Further, the Reverse Merger Bulletin provides an explanation on how to identify reverse merger firms by looking into their risk factor disclosures and urged investors to take extra caution when investing in reverse merger firms.

D. **Regulatory Efforts by Stock Exchange Institutions**

On 2011, stock exchanges, namely New York Stock Exchange ("NYSE"), NASDAQ and NYSE Amex Equities ("NYSE Amex") (collectively the “Stock Exchanges”) in the US expressed their concern on the growing number of fraudulent activities involving reverse merger companies. Therefore, they contemplated to enact more stringent requirements for reverse merger firms. After the exchanges submitted individual proposals to the SEC, who took in comments from various parties and responded to each proposal by means of a notice to each of the aforementioned exchanges, on 9 November 2011, the SEC issued a press release regarding the approval of additional exchange rules regarding reverse merger companies.85

1. **NYSE**

The SEC Release Number 34-65709 was published on 8 November 2011 ("SEC Notice to NYSE"), approving the proposal of the NYSE regarding the enactment of Section 102.01F on the NYSE Listed Company Manual. Such section was titled "Policy on Listing Reverse Merger Companies". The section regulated the eligibility of Reverse merger Firms for listing in the NYSE through a number of requirements.

Firstly, this section provided a more extended definition of shell companies. Despite including the definition stipulated under The 2005 SEC Rule, NYSE also took other factors into consideration when defining a shell company. Such factors include the percentage of the company’s active and passive assets; the revenue of the company and whether the revenue was actively or passively generated; the number of employees working in the company’s revenue-generating business operations and the company’s plan on beginning operating activities or generating revenues, including acquisition or transaction in the near future. The foregoing considerations taken by the NYSE leaves little room for circumvention, as opposed to the nature of the definition provided in the The 2005 SEC Rule, which has been discussed in the previous section. In this case, the NYSE provided itself with the discretion of determining whether a company is or is not a shell company.

It is stipulated in Section 102.01F of the NYSE Listed Company Manual that Reverse merger Firms who intends to list in the NYSE is given the same requirements as other companies. Such requirements include certain financial standards, distribution criteria and aggregate market value of publicly-held shares imposed to public companies listed in the NYSE. 

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87 Ibid.
Besides imposing a standard which applies universally to all NYSE listed companies, the section also obliged Reverse merger Firms to comply with additional, more specified requirements for NYSE listing. Such requirements consist of the seasoning period, stock price maintenance and compliance to disclosure requirements.

a. **Seasoning Period**

It is required by the section that Reverse merger Firms planning to list in the NYSE has to go through a seasoning period. This means that the combined entity (which is the entity resulting from the reverse merger process) 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.

This new requirement obviously initiated mixed receptions from various parties. Such receptions which was included in the in the SEC Notice to NYSE included some support and several objections for such seasoning period. Such objections are mostly based on the lack of evidence showing that such seasoning period would significantly deter fraud connected to reverse merger companies.

b. **Stock Price Maintenance**

The section also stipulated that in addition to having being traded for over one year, Reverse Merger Companies are required to maintain a certain closing stock price, which is a minimum of US$4 (four United States Dollars), 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 in the NYSE.\(^\text{88}\) However, such requirement was also valid

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\(^{88}\) *Ibid.*
for the same aforementioned period prior to the actual listing of the Reverse Merger Company. Therefore, the price of the stock has to be sustained for a longer period of time. The said scenario can be illustrated as follows:

![Diagram showing the process of stock price maintenance and listing.]

c. **Compliance to Disclosure Requirements**

Apart from the aforementioned requirements, the NYSE in the section also provided certain requirements with relations to disclosure of information. For one thing, Reverse Merger Companies are required to comply with the disclosure requirements imposed by the Commission, such as the information which is supposed to be disclosed under Forms 8-K and 20-F.\(^89\)

However, in addition to that, Reverse Merger Companies are required to file all required filings to the Commission in a timely manner. Emphasis was made on the requirement to file at least one annual report to the Commission. This

\(^89\) *Ibid.*
annual report shall contain the audited financial statements for a full fiscal year which commences on the date after the date of the filing of Form 8-K or 20-F with regards to the consummation of the Reverse Merger transaction.\cite{footnote90}

2. **NASDAQ**

In NASDAQ’s case, the SEC published the Release Number 34-65708 on November 8, 2011 ("SEC Notice to NASDAQ"), which approves the proposal of NASDAQ regarding the enactment of additional rules to be imposed to reverse merger companies in the NASDAQ Listing Rules.\cite{footnote91} The NASDAQ regulation on reverse merger ("NASDAQ Reverse Merger Rules") was incorporated to the NASDAQ Listing Rules as from November 8, 2011 under Rule 5110(c).

The matters regulated by the NASDAQ Reverse Merger Rules are similar to those regulated by NYSE, especially with regards to the requirements such as the seasoning period, stock price maintenance and compliance to disclosure requirements. The definition of the term Reverse Merger and the determination of whether or not a company is a shell company are also almost identical.

3. **NYSE Amex**

The foregoing requirements for Reverse Merger Companies enacted by both NYSE and NASDAQ was also adopted by NYSE Amex in the same manner, which involved submitting a proposal and receiving comments from various parties, which was eventually published by the NYSE in the Release Number 34-65710 on

November 8, 2011 (“SEC Notice to NASDAQ”). The additional requirements imposed by NYSE Amex to Reverse Merger Companies are included in Section 101 of the NYSE MKT Company Guide.

While the requirements for seasoning period and disclosure are exactly identical as those enacted by NYSE and NASDAQ, a slight distinction can be seen in the stock price maintenance requirement in the NYSE Amex. As previously explained before, the minimum stock price which has to be maintained by Reverse Merger Companies in the NYSE and NASDAQ is US$4 (four United States Dollars). NYSE Amex, meanwhile based its minimum stock price on the initial listing requirement, which are US$3 (three United States Dollars) for companies intending to list in accordance to Section 101 (1), (b) and (d) and US$2 (three United States Dollars) for companies intending to list under Section 101 (d). The difference of such listing standards are determined by the size, income, distribution, total value of market capitalization of the company.

Conclusion

Regulation towards reverse merger dates back to the enactment of Rule 419 regarding the offering of blank check companies. Rule 419 promoted the safeguarding of offering proceeds in a certain escrow account in order to avoid the misuse of such funds for fraudulent transaction. Such rule enables shareholders to rescind their investment following the announcement of a combination.


93 NYSE Amex. NYSE Amex Company Guide. Retrieved from: http://nyseamexrules.nyse.com/AMEXTools/PlatformViewer.asp?searched=1&selectednode=chp%5F1%5F1%5F1%5F1%5F1%5F1%5F1%5F1%5F1%5F1%5F1%5F1&CiRestriction=reverse+AND+merger&manual=%2FAmex%2Fcompany%2Fcompany%2Dguide%2F. (hereinafter “NYSE Amex Company Guide”). §101(e).

94 Riemer, supra note 67. p.934.
certain disclosure forms in 2005 provided a definition of shell companies. It regulated the usage of forms S-8, 8-k and 20-F in order to provide investors with better protection when investing in a shell company. Along with issuing an Investor Bulletin in 2011, the Commission also approved more stringent listing rules in major US stock exchanges like NYSE, NASDAQ and NYSE which is directed to Reverse Merger Companies.
Chapter V

The Effectiveness of Reverse Merger Regulations in Reducing Information Asymmetry

As discussed in the previous section, the SEC has been shown to put a certain emphasis on reverse merger transactions. This fact is proven by the many efforts taken by the Commission to regulate reverse mergers. Such efforts involve the enactment of certain rules such as Rule 419 of 1992 and the 2005 SEC Rule. These regulations are mainly focused on regulating shell companies (or penny stock companies, in Rule 419’s case) by limiting their movements in taking actions which would lead up to reverse mergers and public offerings. Moreover, the Commission has also taken the step to enable three important stock exchanges in the United States, namely the NYSE, NASDAQ and NYSE Amex, to impose additional listing requirements for reverse merger companies.

Aside from enacting regulations, the SEC has taken enforcement measures in suspending the trading activities of numerous companies on grounds such as accounting frauds. In connection to such enforcement measures, the Commission also took some preventive enforcement measures. Recently, on May 14, 2012, the SEC announced the suspension of 379 non-reporting shell companies. Such suspension was the most massive suspension in the history of the Commission.95 According the SEC’s release on the matter, such action was taken in order to prevent the shell companies from being taken by fraudsters and used to harm investors through reverse mergers or pump-and-dump schemes, so they explained.96

Such operation was known in SEC as “Operation-Shell-Expel” and recognized shells as “tools


for bad guys”. It is shown here that there are mixed signals emitted by the SEC. These were apparent in the issuance of regulations, where the SEC pursued to ensure the safety and legitimacy of reverse mergers. Meanwhile, with the recent trading suspension, the Commission positioned itself to antagonize reverse mergers. Therefore, the stance of the Commission in the matter of reverse mergers has yet to be clarified by a single action.

Nevertheless, we have yet to determine whether the actions taken by the SEC has succeeded in minimizing the information asymmetry which is inevitably associated with reverse mergers. To be able to do such determination, we have to decide by exposing the impacts of the aforementioned rules enacted by the Commission in regulating reverse mergers.

A. The Impact of Rule 419

Rule 419 was enacted under the Securities Act of 1933 in 1992 to regulate offerings blank check companies. This rule required the proceeds of such offerings to be deposited to an escrow account and only withdrawn in certain conditions. Furthermore, this rule also provided a time limit for the consummation of a merger, which is 18 months and the requirement to obtain investor approval for the consummation of the merger, which was disclosed. The original purpose of the enactment of this rule is to hinder fraudulent activities by reverse merger transaction promoters, which, at that time, use blank check companies as shells. Apart from using such shells, past promoters used to consummate the reverse merger transaction using the funds generated from the offering, while milking the shells for cash.

In the matter of deterring fraud by means of decreasing information asymmetry, the rule was seemingly successful. This was caused by the requirement to inform the investors of the merger, and the confirmation of the investors which must be obtained.


98 Feldman 2. supra note 72.
With these requirements, surely the investors were better informed about the usage of their investments. In this manner, information asymmetry was slightly tackled.

But the issues of such rules were not just that. Upon the enactment of such rule, as it was impossible to take the cash out prior to the completion of the reverse merger, therefore, it became more difficult to conduct fraudulent activities. Nevertheless, when promoters are attempting to complete an offering which can be justified under this rule, they found a few obstacles, such as the amount of scrutiny given by the Commission when trying to conduct this. Aside from that, the time limit imposed by this rule was not exactly unproblematic, as it was very difficult to properly complete a reverse merger process with such amount of scrutiny from the SEC.\textsuperscript{99} Moreover the time limit imposed by this rule made it impossible to conduct an effective negotiation for the completion of a transaction, even a legitimate ones.\textsuperscript{100}

Eventually, instead of contributing to the reduction of fraudulent activities, the rule has contributed to the practice of reverse mergers which was used today, that is using formerly operating company in the process. The new rule also contributed to the emergence of SPACs (which we have discussed in the second chapter). The idea itself was to create a hybrid blank check offering, which is exempt from Rule 419 as it was created so that the companies must have more than five million dollars in assets, hence it falls outside the definition of penny stock.\textsuperscript{101}

This occurred because the promoters would surely try to find ways to circumvent from the available rules, as the rules available failed to enable a reasonable level of practicality to complete a transaction. In other words and by judging from the initial purpose of this rule, the goal of making reverse merger safe and legitimate for investor was not reached by the Commission. Yes, the investor were better informed at that point, but not exactly protected in the long run.

\textsuperscript{99} Ibid.

\textsuperscript{100} Riemer, supra note 67. p.944.

\textsuperscript{101} Ibid. p.945.
B. The Impact of the 2005 SEC Rule

The 2005 SEC Rule was enacted on July 21, 2005 by the Commission, with the same purpose with Rule 419, which is deterring frauds and abuses which occur using shell companies. Such purpose showed the distinction of the focus of this 2005 SEC Rule with the focus of Rule 419, where under the 2005 SEC Rule, shell companies became the object of scrutiny.

The Important matter regulated under this Rule is the usage of Forms S-8, 8-K and 20-F, which were more than often abused by shell companies. The Rule banished the usage of Form S-8 for shell companies. Form S-8, which was originally used to register stock option plans for employees were often abused to report offerings to parties other than the employees. Form 8-K, which is often regarded as the ‘Super 8-K’, is used to disclose information pertaining to unscheduled material events which would bear importance to the shareholders and the Commission. Shell Companies’ usage of this mighty disclosure form was amended by the 2005 SEC Rule to include disclosure of events that caused the cessation of such companies being shell companies. Form 20-F, on the other hand, was used by foreign private issuers to submit an annual report within six months after the end of the company’s fiscal year or if there is a change in the date of the end of the fiscal year.102

Another vital matter which was the focus of this Rule is the definition of shell companies, the details of which was provided in the previous chapter. It is true that the SEC provided quite a definition of shell companies. However, problems remain present in the absence a clear definition of the term ‘nominal’, which the Commission refused to provide in order to prevent future circumventions of the rule.

Judging from the nature of this 2005 SEC Rule which was briefly described above and in more details described in the foregoing chapter, in my views, it can be determined that the idea of the rule is good and correctly focused. Slight problems occurring from

the usage of the term ‘nominal’ hopefully will be better addressed by means of interpretations and no-action relief from the Commission.\textsuperscript{103}

The idea of this rule on preventing the misuse of SEC forms is excellent in deterring frauds and providing a better system for the disclosure of information for the interest of investors. In general, the extent of the disclosure of information which became mandatory will surely keep the investors to be better informed. In the case of Form S-8, it was correctly addressed in preventing the misuse of such form, by directing shells companies to use other forms which are considerably more complicated than Form S-8 and minimizing the involvement of internal staff on the preparation of forms, which would somewhat hinder foul play in the preparation of the forms. The amendment of the regulation regarding this Form S-8, moreover will have a slim chance of posing any difficulties to legitimate players. As for Form 8-K, the nature of the information which is required to be disclosed is surely beneficial to provide investors with proper information regarding the consummation of reverse merger or other transactions which caused the cessation of the company from being a shell company. The elimination of the 71-day window for the delivery of financial information will prevent fraudulent activities with regards to such financial information to be undertaken. Therefore, I can conclude that the provisions of the 2005 SEC Rule embodies a correct balance, in a way that it sufficiently provide a certain amount to investors, without going out of the way in imposing an excessive amount of trouble for transaction promoters.

C. The Impact of Exchange Regulations

Additional listing requirements imposed by three of the biggest American stock exchanges, NYSE, NASDAQ and NYSE Amex (the “Exchanges”) were enacted in November 2011. These requirements include a mandatory seasoning period, minimum stock price maintenance and disclosure of information.

\textsuperscript{103} Feldman 1, supra note 2. p.138.
Firstly, the requirement of providing disclosure requirement in the additional listing rules was quite repetitive from the previous rules enacted by the SEC. Yes, this additional requirement would strengthen the SEC requirement, but it is still repetitive, if I may say.

1. **Is a Seasoning Period Really Necessary?**

   The seasoning period requirement, which extended to one year after the completion of the reverse merger transaction, was not too well received by various parties. While several parties were supporters to the idea, some did not see the clear point of such requirement.

   First of all, the seasoning period imposed by the Exchanges may extend for a period of more than two years. This is caused by the actual wording of the requirement, which puts a certain emphasis on the fiscal year of the company. It could be implied that the seasoning period must include one full year of periodic SEC reports including an annual report on Form 10-K. If the reverse merger was completed on the beginning of the company’s fiscal year, and the company has to deliver an annual report for the full financial year after the filing of such information, about the completion of the reverse merger in Form 10-K, such financial year being the one for the next year.  

   A seasoning period would be assumed to provide investors with better protection. Hermes Equity Ownership Services Limited, a commenter on the proposals for rule changes of the Exchanges expressed that while the proposed additional requirements was acceptable, more stringent listing requirements were still needed in order to reduce fraud risks and other regulatory concerns may arise when companies seek to go public in a quick and inexpensive manner.

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by conducting a reverse merger with a shell company. The Commission, in reviewing whether this requirement was reasonably addressed, viewed that the length of the seasoning period will enable analysts to have a sufficient period of time to check and ensure the validity of financial or other information which have been made available to the company.

However, non-supporters of the requirement failed to see the reasoning on how imposing a seasoning period would help deter fraud. Feldman questioned the presence of a concrete proof, with objective data and research which proves that seasoning periods would correctly address the existing problems. Surely there were numerous cases of frauds related to Reverse Merger Companies. However, it was yet to be determined, according to Feldman, whether the existing problem was actually a systemic problem or not. The justification which came as a background of the requirement for a seasoning period was the troubles faced by Chinese Reverse Merger Companies. A commenter of the NASDAQ’s proposal for these additional requirements noted that Chinese companies facing fraud allegations did not necessarily go public using the method of reverse merger. There were actually companies that went public using traditional public offerings facing the very same allegations. Therefore, it would not be correct to address the problems by focusing on their going public methods of choice.

105 SEC Notice to NASDAQ, supra note 91. p.6.

106 Ibid. p.13.


109 United States of America, Securities and Exchange Commission Release No. 34-65709 of November 8, 2011. Self Regulatory Organizations; New York Stock Exchange LLC; Notice and Order Granting Accelerated Approval to Proposed Rule Change, as Modified by Amendment No. 2, Amending Section 102.01 and 103.01 of the Exchange’s Listed Company Manual Adopting Additional Listing Requirements for Companies Applying to List
The seasoning period requirement will surely limit the alternatives available for the scheme for completing a reverse merger transaction. Conducting a reverse merger with a non-trading Over the Counter shell company will fall out of preference, as opposed to a trading shell. This is because a non-trading shell will need a few months before trading can commence. Another matter which may limit the practice of reverse merger is that transaction promoters will have to adjust the timing to conduct the transaction. Companies will have to complete their reverse mergers towards the end of their financial year. Completing a transaction early on their financial year will mean that they have wait for almost two years before they can be listed in the Exchanges.\textsuperscript{110}

The enactment of this requirement would incur changes in the behavior of companies in completing a reverse merger transaction. Firstly, the OTC Market and OTC Bulletin will be used more and longer, as companies need to be traded here prior to listing themselves in the Exchanges. Smaller companies will resort to being traded here for a longer period of time before subjecting themselves to the more burdensome listing requirements of the Exchanges. SPACs will also be used, as they were listed using the method of a full underwritten public offering.\textsuperscript{111}

2. The Perils of a Minimum Stock Price Maintenance

As described in the previous chapter, the additional listing rules enacted by the Exchanges include a requirement for a reverse merger company to maintain the


stock price for a period of 30 of the most recent 60 trading days prior to the date of the application of the listing in the Exchanges and the date of the actual listing of the company in any of the Exchanges. The difference on this requirement between the Exchanges is the minimum price. NYSE and NASDAQ imposed a US$4 (four United States Dollars) minimum price, while NYSE Amex ranges such minimum stock price from $2 (two United States Dollars) to $3 (three United States Dollars), depending on the reverse merger company itself.

A concern raised with connection to this requirement is that with a minimum stock price, some companies struggling to keep their stock prices from falling below the minimum price would resort to some manipulative schemes. This, however, was very hard to undertake as the maintenance period made it difficult to go about the price manipulation.112

A proven result for this is a ‘race-to-the-bottom’ effect. The Exchanges will compete for a lower minimum stock price to maintain the appeal of their exchange. As we are aware of, the minimum stock price imposed by NYSE Amex is lower than that of NASDAQ and NYSE. On April 2012, NASDAQ lowered its minimum stock price to $2 (two United States Dollars) or $3 (three United States Dollars), as the case was with NYSE Amex, so long as a reverse merger company complies with other criteria.113 The effect of the race to the bottom might beneficial for reverse merger companies in a way that the minimum prices will continue to go down, if the competition is kept up. However, when he competition went on which may result in very low minimum stock prices, the requirement will not be doing what it is supposed to be doing, which is warding off penny stock companies.

112 SEC Notice to NASDAQ, supra note 91. p.12.

We have established in the foregoing sections that there were mixed reception with the NYSE new listing requirements. Being substantially more regulated after the new listing rules, there will certainly be changes on the behavior of companies. The following is the possibilities which may occur in the regime of the new listing requirements of the Exchanges:114

1. Companies would still conduct reverse merger, but with no intention in listing themselves in any of the Exchanges. Younger and/or smaller companies would prefer to be listed in a stock exchange with relatively less stringent listing requirements.

2. Larger companies who still want to conduct reverse mergers may take advantage of the exception granted by the new listing requirements by conducting a fully-underwritten public offering.

3. Companies will use the mandatory seasoning period in the OTC markets as an opportunity to obtain some amount of public financing.

4. Companies will resort to a self-filing using a Form 10 or S-1 filing which may be concurrent with or follow a financing.

Parties objecting to the ideas of the new requirements enacted by the Exchanges in regulating reverse merger companies stated their fear about the impact of this new set of requirements to the growth of smaller companies. This is understandable, as reverse merger as an alternative to an IPO is most attractive to smaller companies, who has limited resources in conducting an IPO. The requirements imposed will certainly decrease the attractiveness of reverse merger, as it would become less simple than it was prior to the enactment of the new rule. Feldman, who commented on the proposals of the new Exchange Rules expressed that the new requirements will have “chilling effect of discouraging exciting growth companies from pursuing all

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available techniques to obtain the benefits of a public listed stock and greater access to capital.”

The fact is that additional requirements did not do much to the disclosure requirements, as it simply highlighted the disclosure requirements previously enacted by the Commission. There were no fresh disclosure requirements which can contribute to better transparency to investors after the enactment of 2005 SEC Rule. Admittedly, the seasoning period may provide time for analysis. However, as the regulation has only been enacted less than a year ago, there is no company which have completed the seasoning period. Moreover, it cannot be proven at this point, whether such seasoning period has served its purpose in enabling better analysis on a reverse merger company, thus, keeping the investors better informed.

**Conclusion**

All the regulatory efforts which have been undertaken by the Commission, which are Rule 419, the 2005 SEC Rule and the ratification of the Exchanges Rules, have their own qualities and drawbacks in providing investors with sufficient protection. Rule 419, for one thing set the initial stance of the Commission towards reverse merger, which is keeping it legitimate and safe for the sake of investors. Such rule provided the means for an investor to be informed when an acquisition occurred in a penny stock company. The 2005 SEC Rule, on the other hand provided a comprehensive requirement which has a good impact to the disclosure of information. The limitation on the use of SEC forms can be construed as the most advanced effort by the SEC in minimizing information asymmetry in reverse mergers. The Exchanges Rules, on the other hand presented itself with many possible drawbacks in the side of the companies, while doing very little in contributing for the reduction of information asymmetry.

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CHAPTER VI

Conclusion

The act of going public is very important in the life cycle of a firm. Although the traditional IPO is commonly chosen by companies in order to go public, reverse merger remains as an alternative method which can be undergone by companies. Although the amount of capital that is raised is not as big as that of an IPO, reverse merger offers several benefits, such as the ability to surpass initial disclosure requirements which quickens the process of going public, inexpensiveness and independency from both the IPO market and underwriters. However, the most significant drawback of a reverse merger transaction is the extent of information asymmetry which exists in reverse merger firms.

As for the scheme of the transaction itself, in essence, a reverse merger involves an acquisition of a private company by a public shell company, which may come in the form of a formerly operating company or an SPAC. Methods used in the process can either be a reverse triangular merger or a reverse takeover (simply a share exchange). Whichever method was chosen by the transaction promoter, the end result of the transaction is that the private company becomes a fully-owned subsidiary of the public shell company. Following the end of the reverse merger, to raise funds needed for the newly combined company, a financing phase started. Financing methods possible for this transaction are Seasoned Equity Offerings or PIPE Financing.

The whole idea of reverse merger is to enable an easier process to go public, without the formalities which is present in traditional IPOs. Information asymmetry becomes an unavoidable trait of reverse merger firms. As disclosure requirements, regulatory control and intermediary role is lacking in reverse mergers, information asymmetry is heightened. This matter leads to the frequent misevaluation of stock prices. Such disadvantages to investors earned a bad reputation for reverse mergers.

Such bad reputation which was acquired from the amount of information asymmetry and exemplified with some fraud cases of reverse merger firms in the United States called for regulatory actions by the SEC. First, there was Rule 419, which was enacted in 1992. Such
rule protected investors by requiring proceeds retained from the offering of blank check companies to be stored in an escrow account, setting an eighteen months time frame for the completion of a merger and allowing investors to rescind their investment should they disapprove of the merger. Thirteen years after the enactment of Rule 419, the SEC amended the usage of forms which are often misused by shell companies, which are forms S-8, 8-K and 20-F. Recently, the Commission issued an investor bulletin which warned investors to be cautious when investing in reverse merger companies. Subsequently, with SEC’s approval, three major stock exchanges, NYSE, NASDAQ and NYSE Amex issued listing requirements which are more stringent for reverse merger companies.

From the findings which were obtained by analyzing the aforementioned regulations, it can be concluded that each regulatory efforts by the Commission has their own effects in reducing information asymmetry and protecting investors. Rule 419 provided an instrument for investors to be informed in regards of a reverse merger conducted by blank check companies and the safekeeping of offering proceeds from the misuse by fraudulent promoters. This effort, while effective, on the other hand contributed to the recent practice of reverse mergers, as promoters managed to find ways to circumvent from Rule 419.

The rule changes of 2005, on the other hand, were found to have the most profound positive effect on the reduction of information asymmetry. By regulating the usage of disclosure forms, misuse of such forms can be avoided. Further, the formulation of the definition of shell companies under this new regulation prevented easy deviation from the rules, as the Commission refused to provide a concise definition of the term ‘nominal’, which is used in the definition of shell companies.

The rules which were enacted by the Stock Exchanges, on the other hand, did little for the reduction of information asymmetry, as it offered no new revolutionary disclosure requirement complementing the requirements of the SEC which can ensure investors a higher level of awareness as to what the reverse merger companies were up to. The means of investor protection which was taken by the Stock Exchanges, such as requiring a seasoning period and minimum stock price maintenance as an initial listing requirement for reverse merger companies. While critics to the new requirements stated their objections by
pointing out that the new listing requirements may harm capital access for smaller companies, it remained to be determined whether these new requirements really do protect investors, keeping in mind that the rule has just been recently enacted.
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