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Alerts

SEC, Nasdaq and NYSE Toughen Oversight of Reverse Mergers

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Hinshaw Alert

On November 9, 2011, the U.S. Securities and Exchange Commission (SEC) approved rules proposed by The NASDAQ Stock Market LLC (Nasdaq) and the New York Stock Exchange LLC (NYSE) that will impose more stringent listing requirements on companies that become public through a reverse merger. These new rules are discussed below.

What Is a Reverse Merger?

Many private companies seek to access U.S. capital markets by acquiring control of existing public companies. These transactions are commonly referred to as "reverse mergers." In a reverse merger, an existing public "shell company," which is a public reporting company with few or no operations, is in effect acquired by a private operating company. The shareholders of the private operating company exchange their shares for most of the shares of the public company, thereby gaining a controlling interest in the public shell company. The private operating company replaces the board of directors and management of the public shell company. The post-merger surviving public company's assets and business operations are primarily, if not solely, those of the former private operating company.

SEC
The SEC has expressed concern about reverse mergers. It recently issued an Investor Bulletin on June 9, 2001, warning investors about the risks involved in investing in such entities, especially those involving foreign private operating companies. Risks associated with such entities include their not being able to comply with the SEC's filing and internal control requirements and a lack of history of complying with SEC regulations and public company accounting rules.

In the last year, the SEC has suspended trading in a number of reverse merger entities and revoked the registration of a number of these companies. The revocations occurred due to a failure of the entities to make required filings with the SEC.

Significant concerns have also arisen relating to accounting fraud allegations with respect to a number of companies following reverse mergers. The SEC recently brought an enforcement proceeding against an audit firm relating to its

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work for companies surviving a reverse merger.

Nasdaq
Under the proposal made by Nasdaq and approved by the SEC, Nasdaq would treat as a reverse merger any transaction whereby an operating company becomes a Securities Exchange Act of 1934 (Exchange Act)-reporting company by combining (directly or indirectly) with a shell company which is an Exchange Act reporting company, whether through a reverse merger, exchange offer or otherwise.

A reverse merger would not include:

- the acquisition of an operating company by a listed company satisfying the requirements of Nasdaq rules relating to companies whose business plan is to complete one or more acquisitions (see IM-5101-2); or
- a business combination described in Nasdaq Rule 5110(a) wherein a listed company combines with a non-Nasdaq entity, resulting in a change of control of the listed company and potentially allowing the non-Nasdaq entity to obtain a Nasdaq listing, sometimes called a “back-door listing”.

When determining whether a company is a “shell company,” Nasdaq will look at a number of factors, including:

- whether the company was considered a “shell company” as defined in Rule 12b-2 under the Exchange Act;
- what percentage of the company’s assets were active versus passive;
- whether the company generated revenues, and if so, whether the revenues were passively or actively generated;
- whether the company’s expenses were reasonably related to the revenues being generated;
- how many employees worked in the company’s revenue-generating business operations;
- how long the company had been without material business operations; and
- whether the company had publicly announced a plan to begin operating activities or generate revenues, including through a near-term acquisition or transaction.

Nasdaq has adopted certain “seasoning” requirements in connection with the listing of reverse merger companies which are set out in Nasdaq Rule 5110(c):

- A reverse merger company will be prohibited from applying to list on Nasdaq until the combined entity has traded in the U.S. over-the-counter market, on another national securities exchange, or on a regulated foreign exchange for at least one year following the filing of all required information about the reverse merger transaction with the SEC or other regulatory authority, including audited financial statements for the combined entity;
- The reverse merger company will have to maintain a $4 closing price for a sustained period of time but not less than 30 of the most recent 60 trading days immediately prior to submitting the listing application and as well as at least 30 of the most recent 60 trading days prior to the approval of the listing; and
- The reverse merger company will have to have timely filed (at the time of the listing approval) all required periodic financial reports with the SEC if it is a domestic issuer approval of the listing (or comparable information if it is a foreign private issuer for the prior year), including at least one annual report, which annual report must contain audited financial statements for a full fiscal year commencing after the filing of the information described above in the first bullet point.

A company surviving a reverse merger will not be subject to the requirements discussed above in Nasdaq Rule 5110(c) if, in connection with its listing, it completes a firm commitment underwritten public offering (as defined in the Nasdaq rules) where the gross proceeds to the company will be at least $40 million.

A reverse merger company will no longer be subject to the requirements of Nasdaq Rule 5110(c) once it has satisfied the one-year trading requirement discussed above and has filed at least four annual reports with the SEC or other regulatory authority containing all required audited financial statements for a full fiscal year commencing after filing the information described in the first bullet point set forth above.

In addition, any reverse merger company must also meet all other applicable Nasdaq listing requirements for initial listing, including the minimum price requirement and the requirement contained in Rule 5210(e) that the company not be delinquent in its filing obligation with the SEC or other regulatory authority.

NYSE

The SEC also approved rule changes proposed by the NYSE that impose additional listing requirements for a company that has become public through a reverse merger.

The NYSE would treat as a reverse merger any transaction whereby an operating company becomes an Exchange Act-reporting company by combining (directly or indirectly) with a shell company which is an Exchange Act-reporting company, whether through a reverse merger, exchange offer or otherwise.

A reverse merger would not include the acquisition of an operating company by an NYSE-listed company which qualified for initial listing under Section 102.06 of the NYSE Listed Company Manual (Manual).

In determining whether a company is a "shell company", the NYSE will consider, among other factors:

- whether the company was considered a "shell company" as defined in Rule 12b-2 under the Act;
- what percentage of the company's assets were active versus passive;
- whether the company generated revenues, and if so, whether the revenues were passively or actively generated;
- whether the company's expenses were reasonably related to the revenues being generated;
- how many employees worked in the company's revenue-generating business operations;
- how long the company had been without material business operations; and
- whether the company had publicly announced a plan to begin operating activities or generate revenues, including through a near-term acquisition or transaction.

The company surviving the reverse merger would not be eligible for listing on the NYSE unless the combined entity had, immediately preceding the filing of the initial listing application, complied with the following requirements of Section 102.01F of the Manual:

- traded for at least one year in the U.S. over-the-counter market, on another national securities exchange, or on a regulated foreign exchange following the consummation of the reverse merger and (1) in the case of a domestic issuer, has filed with the SEC a Form 8-K including all of the information required by Item 2.01(f) of Form 8-K, including all required audited financial statements; or (2) in the case of a foreign private issuer, has filed the information described in (1) above on Form 20-F;
- maintained a $4 closing price for a sustained period of time but not less than 30 of the most recent 60 trading days immediately prior to submitting the listing application and as well as at least 30 of the most recent 60 trading days prior to the listing date; and
- timely filed with the SEC all required reports, since the consummation of the reverse merger, including the filing of at least one annual report containing audited financial statements for a full fiscal year commencing on a date after the date of filing with the SEC of the filing described in the first bullet point above.

The NYSE would have the discretion to impose more stringent requirements than those set forth above. Factors that would be considered include:

- an inactive trading market in the company's securities;
- the existence of a low number of publicly held shares that were not subject to transfer restrictions;
- if the reverse merger company had not had a registration statement or other filing subjected to a comprehensive review by the SEC; or
- if the company had disclosed that it had material weaknesses in its internal controls which had been identified by management and/or the company's independent auditor and had not yet implemented an appropriate corrective action plan.

A reverse merger company would not have to comply with the requirements of Section 102.01F of the Manual if it was listing on the NYSE in connection with an initial firm commitment underwritten public offering (as defined in Section 102.01B of the Manual). In such an offering, the proceeds to the company would have to be sufficient on a stand-alone basis to generate $40 million in aggregate market value of publicly held shares. Furthermore, the offering must be made subsequent to or concurrently with the reverse merger.

A reverse merger company will no longer be subject to the minimum price trading requirement of Section 102.01F of the Manual if it has satisfied the one year trading requirement of Section 102.01F and has filed at least four annual reports with the SEC or other regulatory authority containing all required audited financial statements for a full fiscal year commencing after filing the information required by Section 102.01F (described in the first bullet point under the discussion of Section 102.01F). Such a company would have to meet the stock price requirement of Section 102.01B of the Manual and not be delinquent in its filings with the SEC. Such a company would have to meet the stock price requirement of Section 102.01B and not be delinquent in its filings with the SEC.

In addition to meeting the criteria set forth above, a company that was formed by a reverse merger would be required to comply with one of the initial listing standards for operating companies set forth in Section 102.01C or 103.01B of the Manual and the applicable distribution, stock price and market value requirements of Sections 102.01A and 102.01B of the Manual (in the case of companies listing pursuant to Section 102.01) and Section 103.01A (in the case of companies listing pursuant to Section 103.01).

For further information, please contact Timothy M. Sullivan or your regular Hinshaw attorney.

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