SEC Approves Heightened Stock Exchange Listing Standards For Reverse Merger Companies

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On November 8, 2011, in response to proposals submitted to it by each of the New York Stock Exchange LLC ("NYSE"), NYSE Amex LLC ("NYSE Amex") and the NASDAQ Stock Market LLC ("Nasdaq", and collectively, the "Exchanges"), the Securities and Exchange Commission (the "Commission") approved heightened stock exchange listing standards for companies that have become publicly held as a result of a reverse merger.

The phrase "reverse merger" commonly describes a transaction in which a privately held company effectively "goes public" not through the traditional registered initial public offering process, but by simply merging with a publicly held shell company and continuing as the surviving entity. While the availability of this IPO alternative has allowed numerous companies to gain the increased access to the capital markets available only to publicly traded companies without the substantial capital outlay typically associated with an IPO, concerns have recently increased with regard to the visibility into and reliability of these companies' reported financial statements-- particularly those companies based primarily outside of the U.S. In its press release dated November 9, 2011, the Commission noted that it and the Exchanges have recently suspended or halted trading in more than 35 foreign-based public companies-- a number of which became public companies via reverse merger-- as a result of the lack of current and accurate financial information regarding those companies. Indeed, the Exchanges in their proposals pointed to widespread allegations of fraudulent accounting behavior by reverse merger companies, which allegations in turn have led to greater concerns that such companies' financials often cannot be relied upon by investors.

To combat the growing distrust of the reported financials of reverse merger companies, the Exchanges, beginning with Nasdaq in May 2011 and followed by NYSE and NYSE Amex in July, proposed a number of new listing rules relating primarily to (1) the amount of time a reverse merger company would be required to be listed, either over-the-counter in the U.S. or on a regulated foreign exchange, and thus make required filings (including audited financial statements) with the Commission, prior to applying for listing on one of the Exchanges, and (2) the length of time over which the reverse merger company would be required to maintain a minimum share price prior to applying for listing on one of the Exchanges. With regard to the former, the Exchanges reasoned that such a "seasoning" period would "provide greater assurance that the company's operations and financial reporting are reliable, and will also provide time for [the company's] independent auditor to detect any potential irregularities, as well as for the company to identify and implement enhancements to address any internal control weaknesses." Moreover, seasoning would provide time for additional regulatory and market scrutiny prior to the company being listed on one of the Exchanges. With regard to the prolonged minimum stock price requirement, the Exchanges pointed to instances in which some reverse merger companies had engaged in "quick manipulative schemes" in order to meet the minimum share price requirement for listing on one of the Exchanges, and reasoned that requiring the minimum price to be sustained over a meaningful period of time would effectively hinder such practices. Of note, each proposal provided certain exceptions to the heightened listing requirements relating to (x) whether the reverse merger occurred in connection with a firm commitment underwriting (citing the increased scrutiny of the parties' financials in connection with the due diligence process) and (y) whether the company had already filed with the Commission at least four annual reports, containing all required audited financial statements, since the closing of the reverse merger.

In response to the Exchanges' proposals, the Commission and the Exchanges received a number of comments opposing the heightened listing standards. Among the arguments put forth were: (1) that the new listing standards could have a "chilling effect" on companies interested in pursuing all available options for going public on one of the Exchanges, (2) that the reported financial statements of companies that go public in the U.S. via the traditional IPO process often suffer from the same deficiencies as companies that go public via reverse merger, (3) that the proposals would broadly hinder smaller companies' access to the capital markets, and (4) that the minimum stock price requirements are unfair, and that it is unrealistic to expect smaller companies to achieve such sustained stock prices on the over-the-counter market.

Rejecting these arguments, the Commission found the proposed heightened listing standards to be consistent with Section 6(b)(5) of the Securities Exchange Act of 1934, as amended, which requires that the rules of the national stock exchanges be designed to prevent fraudulent and manipulative acts and practices, and to generally protect investors and the public interest. The Commission observed that the one year seasoning requirement would ensure that a reverse merger company will have filed at least one full year of all required audited financial statements and all required Commission reports and disclosures prior to listing on an Exchange, thereby increasing the likelihood that all material information about the company will have been made public, and simultaneously demonstrating the company's ability to meet its filing and disclosure obligations. The Commission further concluded that the requirement that a reverse merger company maintain the specified minimum share price for "a sustained period," and in any event for at least 30 of the most recent 60 trading days prior to the date of the initial listing application, is "reasonably designed to address concerns that the potential for manipulation of the security to meet minimum price requirements is more pronounced for [reverse merger companies]," and that such a requirement would make it more difficult for companies to devise manipulative schemes to inflate their stock price for purposes of meeting the Exchanges' minimum share price requirements. Finally, the Commission approved the proposed exceptions to the heightened standards, explaining that it is "reasonable for the Exchanges to conclude that an issuer that (1) undergoes the due diligence and vetting required in connection with a sizeable underwritten public offering, or (2) has prepared and filed with the Commission four years of all required audited financial statements following the Reverse Merger, presents less risk and warrants the same treatment as issuers that were not formed through a Reverse Merger."

While it remains to be seen whether these heightened listing standards will altogether eliminate the fraudulent and manipulative practices alleged to have been committed by numerous reverse merger companies, one thing is clear: private companies hoping to avoid the IPO process by reverse merging into a public shell and immediately listing on one of the three Exchanges will need to reassess their game plans.

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