Ghouls and Godsend?

A Critique of “Reverse Merger” Policy†

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† The “reverse merger” discussed in this paper involves transactions of private companies with public shells addressed by the final rules issued by the Securities and Exchange Commission (SEC) in Release No. 33-8587. For clarification, the term “reverse merger” does not refer to the health law concept describing the occurrence of “a subsequent non-related and non-compensable injury . . . superimposed upon a compensable condition, thereby producing disabilities greater than would be suffered as a result of each injury by itself.” Dep’t of Pub. Health, Div. of Risk Mgmt v. Wilcox, 458 So. 2d 1207, 1210 (Fla. Dist. Ct. App. 1984).

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I. INTRODUCTION

This Article is about two stories and how they overlap. First, meet the haunted corporate graveyard, where the ghoulish specters of once thriving companies roam, looking to ensnare and devour the wary private-company passerby whilst spreading fear and fraud to the unsuspecting, well-intentioned masses. Into this nightmarish scene rides a vigilant constable, artfully wielding his mystical sword as he meticulously slays the outmatched, diabolical spirits fleeing his righteous presence.

Now, enter the second tale, where you encounter hundreds of thirsty, private-company souls, shriveled and groaning in dejected angst, forced to share but a single, slowly dripping spigot as they desperately long for public market liquidity. Along saunters a nobleman-regulator, wryly smirking askance with his hands buried in his velvet-lined trousers, indifferent to the wails of the wretched pariahs begging in his path. And with the steely indifference of a jungle poacher, he reaches to forever bar the trickle from the pipe.

Both parables describe the Security and Exchange Commission’s recent approach to regulating the market in reverse mergers. The first embodies the SEC’s perspective that reverse mergers and penny stock market activities generally are rife with illicit opportunistm and fraudulent conduct—the way to solve these ills is through additional SEC regulation. Figuratively, promoters of reverse mergers are ghouls, and the SEC is a godsend for beefing up regulation. The second story presents the view of small-cap companies looking to reverse mergers as a way to access the public markets for legitimate growth purposes—here, SEC intervention is unnecessary, unwanted, and detrimental.

We currently lack an objective basis to determine which parable rings true because surprisingly little is known about the economic implications of reverse mergers, as no major study has been published to date, leaving both sides with little in their arsenal for informed debate. This Article, while unfortunately not containing any new empirical research, attempts to frame the debate by first explaining the mechanics of the transaction along with the benefits and risks that flow to interested parties (Part II), and then to outline potential policy responses (Part III). Thereafter, I summarize the current U.S. policies (Part IV), followed by several of my recommendations to move beyond the apparent pseudointellectual deadlock (Part V).
II. TRANSACTION ANALYSIS

A. Reverse Merger Description

A reverse merger, like an initial public offering, is a transaction whereby a private company may become a public corporation with full access to the public capital markets. Prior to such a transaction, two separate entities exist: a private entity that desires to be public and a public company that usually has no ongoing operations or assets other than cash and cash equivalents. The public entity, referred to as a “public shell,” “shell company,” or “shell corporation,”1 frequently is a company that has liquidated its assets in bankruptcy proceedings and is left with nothing of value other than a public market for its securities.2

In effect, the public shell is sold to the private concern,3 and the private entity gains access to the public markets through a rather consistent process. Initially, ownership of the public shell is heavily concentrated in a single party,4 which often promotes the deal to the private entity. The equity holders in the private entity then purchase a majority stake in the shell from the shell owners, after which the private entity is merged into the public shell. Upon closing the deal, shareholders in the shell hold equity interests in the combined entity (the value of which is driven by the value of the private entity that merged into the public shell) and have access to the public stock markets, enabling them sell their shares. See the diagram below.

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2. Given that public shells have little or no assets or operations, they generally do not meet the listing standards of the stock exchanges or Nasdaq. Instead, the securities of shell companies trade on the OTC/Pink Sheets markets. See infra Part IV. A.6.f.

3. Public shells are sold on average in the range of $100,000 to $500,000 combined with an equity stake between three and eight percent in the post-transaction. See infra note 40.

4. The majority shareholder in the shell usually owns at least 95% of the outstanding shares of the shell. See, e.g., infra note 40.
A Critique of “Reverse Merger” Policy

Reverse Merger Transaction

Private SHs

shares

Private Entity

merges

Public Shell

cash pm

other public SHs

Promoter

Reverse Merger Outcome

Formerly Private SHs

Promoter

other public SHs

Combined Public Corporation
A similar but less common transaction used for accomplishing the same ends as the reverse merger is called a "backdoor registration."\textsuperscript{5} In this transaction, the public shell merges into the private entity, and the shareholders of the private entity remain the primary shareholders in the combined entity. See below.

\textbf{Backdoor Registration Transaction}

\begin{center}
\begin{tikzpicture}
  \node [circle, draw] (Private SHs) {Private SHs} ;
  \node [circle, above right of=Private Entity] (Promoter) {Promoter} ;
  \node [circle, below of=Promoter] (Public Shell) {Public Shell} ;
  \node [circle, below left of=Private Entity] (Private Entity) {Private Entity} ;

  \path [->] (Private SHs) edge node [above] {\textit{cash pmi}} (Promoter);
  \path [->] (Private Entity) edge node [right] {\textit{merges}} (Public Shell);
  \path [->] (Promoter) edge node [above] {other public SHs} (Private Entity);
\end{tikzpicture}
\end{center}

\textbf{Backdoor Registration Outcome}

\begin{center}
\begin{tikzpicture}
  \node [circle, draw] (Combined Public Corporation) {Combined Public Corporation} ;
  \node [circle, above of=Combined Public Corporation] (Formerly Private SHs) {Formerly Private SHs} ;

  \path [->] (Combined Public Corporation) edge (Formerly Private SHs);
\end{tikpicture}
\end{center}

A Critique of "Reverse Merger" Policy

Unlike an initial public offering, reverse mergers and backdoor registrations do not involve the issuance of new securities by an underwriter to the public or the registration of a sale of securities to the public. Rather, in the case of a reverse merger, the securities are already in the hands of the public (primarily the promoter) and are transferred to the owners of the private entity. Essentially, private ownership interests are merely swapped for public securities instead of being sold subject to a registered transaction whereby they become public securities. In the case of a backdoor registration, the private company is the surviving entity, but after the transaction, it succeeds to the reporting obligations of the pre-transaction shell.\(^6\)

B. Transaction Data

Unfortunately, no known database service tracks reverse mergers,\(^8\) leaving policy debates between regulators and practitioners largely overshadowed by uncertainty as to the merits of the transaction. Currently, comprehensive data on reverse merger transactions could only be obtained by conducting painstaking, needle-in-haystack searches through news databases\(^9\) in an attempt to compile an ample transaction log; such efforts would most likely result in a piecemeal list, however, since no single periodical reports each transaction, and no existing reports provide a consistent set of information for each transaction. Accordingly, salient information regarding reverse merger trends is not known, namely, information on frequency, deal size, deal consideration, operating industry, types of advisors,\(^10\) states of incorporation, post-transaction stock performance, stock trading patterns, incidence of subsequent bankruptcy, incidence of insider trading, incidence of securities fraud, incidence of securities class action law suits, age of private company, event causing public

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6. For simplicity purposes, the term "reverse merger" is used throughout this Article to refer to both reverse mergers and backdoor registrations.
7. See infra Part IV.A.4.
8. Thomson Financial’s SDC Platinum software contains a database entitled Domestic Mergers, 1979–Present, which tracks a type of transaction it labels a “reverse takeover.” While this term is often used to refer to reverse mergers, the transactions in the database are irrelevant for the purposes of this Article, as they seem not to involve public shells. In addition, certain reverse merger transactions reported by PR Newswire are not contained in SDC’s database.
9. Searches for terms such as “reverse merger” in the news database service offered by LexisNexis generate mountains of unrelated information in addition to relevant transactions. Many relevant transactions are skipped, however, since companies and news sources often describe the deal without using a key term such as “reverse merger.” Based on my early attempts to compile a transaction log, I would estimate that each year’s worth of data would require a minimum of approximately 300 to 500 hours, imposing an exorbitant information cost on eager researchers and market participants.
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company to become a shell, average number of employees, and executive compensation form and amount.¹¹

One component of the rule amendments adopted by the SEC in 2005 (the "2005 SEC Rule Amendments")¹² aims at facilitating data-gathering efforts going forwards. As a result of the changes, issuers are now required to indicate on certain periodic filings whether they are shell companies by use of a check box.¹³ It remains to be seen whether issuers will understand the new requirements and whether shell companies will comply.¹⁴

C. Benefits and Risks of Reverse Mergers

Implicit in the analysis of the relative merits of these transactions with respect to any given private entity is a compound analysis of the advantages and disadvantages: first, whether to become a public reporting company or to remain private;¹⁵ and second, whether to select the reverse merger as opposed to traditional methods of going public with an initial public offering. Both considerations give rise to differing benefits and costs to the management of the private entity, the private shareholders, and the shareholders of the combined, post-transaction corporation.

Only a one-step analysis is needed for parties that would have no involvement if a private entity pursued an initial public offering (IPO) instead of a reverse merger. Such parties are the shareholders of the pre-transaction public shell. These shareholders include both the "promoters" who hold the vast majority of shares as well as the "bystanders" who control only a tiny slice of the entity.¹⁶ Promoters and bystanders would not be implicated in an IPO, since the private company would issue shares directly to the public in such a transaction, rendering a shell unnecessary.

Recognizing that the benefits and risks of reverse mergers impact various groups differently, I address each functional party individually below.

¹¹ At the outset of this research project, I intended to add this economic analysis so as to have a stronger foundation for the policy review and proposals contained herein. For a few examples of reverse mergers, see Luisa Kroll, Chinese Companies Take a Shortcut to U.S. Public Listings, FORBES, Apr. 26, 2004, at 43 (providing examples of five recent transactions).


¹³ See infra Part IV.A.6.f.

¹⁴ See infra note 139.

¹⁵ The thrust of this Article is to explain the reverse merger and analyze policy responses; extensive consideration of the merits of remaining private versus going public is available elsewhere. See, e.g., William K. Sjostrom, Jr., Going Public Through an Internet Direct Public Offering: A Sensible Alternative for Small Companies?, 53 FLA. L. REV. 529, 572-80 (2001).

¹⁶ I use this terminology to distinguish between shareholders which, during the pre-transaction period, are actively involved in acquiring control of the public shell for the purposes of soliciting private entities to engage in the transaction (the "promoters"), and those shareholders (the "bystanders") uninvolved in actively promoting and soliciting the transaction and whose investment is either (a) the remaining position in the shell as a result of a prior investment in the now defunct company or (b) a speculative position.
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1. Management of Private Entity

Managers of private entities, by virtue of their responsibility to continuously explore strategic alternatives for their business, are often solely, or at least significantly, accountable for the decision to pursue a transaction causing the entity to go public. Thus, they become a likely target for the persuasive efforts of parties having an interest in such a transaction. For large private companies with high revenues and a strong track record, investment bankers will court management with the hope of being selected to underwrite an IPO. Since the investment banks only hit payday upon completion of a transaction, they have a strong incentive to try to induce management to complete an IPO. Promoters of reverse mergers have essentially the same set of incentives as investment bankers. If managers elect to engage in a reverse merger, promoters are paid; if no reverse merger occurs, promoters are left without compensation.

Seeing as a transaction to take a company public will almost always be promoted by an outside party with a financial interest, and given that management is largely responsible for the decision to enter the transaction, one could expect that promoters will tend to emphasize the advantages the managers can anticipate upon completion of the transaction.

Regardless of the manner in which a private company goes public, managers will encounter certain advantages to the change in company status, most of which arise out of the managers' ownership of equity interests in the private entity (see Part). One benefit flowing specifically to managers in such transactions is the attendant prestige enjoyed by executives of public companies. This incentive is no surprise, as few private companies enjoy the spotlight continuously granted to public companies as a result of their ongoing analyst coverage, news stories, and SEC filings.

A second benefit to public officers is the relative simplicity of equity-based or stock-option compensation, given that the price of the underlying security is determined in public markets. These forms of compensation give officers the

17. To be appealing to an underwriter for an IPO transaction, private companies should have at least annual revenues of $20 million, profit of $1 million, and the potential to sustain a twenty percent plus growth rate for the next five to ten years. See GENERAL ACCOUNTING OFFICE, REPORT TO THE CHAIRMAN, COMMITTEE ON SMALL BUSINESS, U.S. SENATE, SMALL BUSINESS EFFORTS TO FACILITATE EQUITY CAPITAL FORMATION 21-22 (Sept. 2000) [hereinafter "GAO REPORT"].

18. The type of party promoting the transaction usually differs depending on the financial status and business plan of the private company. In general, reverse mergers are promoted successfully to relatively smaller companies with less of a proven record than those companies that are targeted by bulge bracket investment banks for an IPO. An interesting research topic would be to study the qualities differentiating private companies most suitable for each type of transaction.

19. Arguably, the positive reputational effect on the managers arises out of the general public's association of public company executives with immense wealth and a lavish lifestyles resulting from the enormous compensations received during the long-term application of their business skills.

20. See, e.g., Q&A: Small Business and the SEC: Should My Company "Go Public"?,
ability to share in the growth of the company value as they provide strategic guidance and operational oversight. Put simply, managers are more easily rewarded for their efforts.

Taking a company public is a complex process requiring sophisticated execution. Both during the transaction and thereafter, officers face additional time pressure, increasing regulation and a growing risk of shareholder suits from a broader range of stockholders. The time requirements imposed on management have historically differed between reverse mergers and IPOs. Prior to the 2005 SEC Rule Amendments, reverse mergers required less time prior to going public because the primary tasks only involved negotiating an agreement with a promoter and preparing a current report on Form 8-K to announce the event. More significant time was spent over the ensuing weeks, as the new entity was required to file audited financial statements within the following seventy-one-day window. The time requirements involved in an IPO, however, are front-loaded. Prior to issuing securities in an IPO, management is responsible for drafting a registration statement that includes audited financial statements through an extensive process often involving SEC review and will likely have traversed the country or even the world in a whirlwind road show. After the IPO (or seventy-one-day window, as was the case for reverse mergers), management, required to keep current in its periodic filings under the Exchange Act, faces the same time constraints as the officers of all public companies. The 2005 SEC Rule Amendments brought the timing of a reverse merger transaction more into line with that of a traditional IPO by eliminating the seventy-one-day window, requiring the company to file audited financials within four days of completion of the transaction.

While remaining private, companies face relatively few disclosure and governance rules; however, once management decides to go public, companies face considerable regulation impacting both the public company as well as the transaction itself. In recent years, public company regulation has expanded from requiring periodic disclosure and current reports under the Exchange Act to altering the structure and practices in the realm of corporate governance

http://www.sec.gov/info/smallbus/qasbsec.htm#eod3 (last visited Apr. 21, 2006).

21. In fairness, managers of private firms may also enter into arrangements whereby they may share in the increase of firm value through the same or similar financial instruments such as options, warrants or equity, but the firm valuation metrics prove to be much more complicated and uncertain than those of public companies.

22. See infra note 92.

23. See infra note 92.

24. Normally, outside legal counsel and accounting firms assist in this process. The Office of Management and Budget estimates that a Securities Act Form S-1 requires an average of 425 hours to complete, see OMB Approval No. 3235-0065, SEC Form S-1, and that a Securities Act Form SB-1 requires an average of 177 hours to complete, see OMB Approval No. 3235-0423.

25. See infra note 89.
through the Sarbanes-Oxley Act of 2002. As for the transactions themselves, recent changes have been made to the regulatory landscapes of reverse mergers and IPOs. In the absence of knowledgeable counsel, inexperienced managers run a huge risk of entangling themselves and their companies in the expansive federal securities regulatory web.

Finally, managers encounter the growing risk of shareholder lawsuits as the shares are traded into a broader set of hands. Attempting to comply with new regulations while being subject to additional scrutiny, managers must indeed walk circumspectly while at the helm of a new public company.

2. Shareholders of Private Entity

Shareholders of the private entity enjoy several key benefits upon completion of a going-public transaction. First, they receive detailed information regarding the company's business, properties, legal proceedings, executive compensation, related-party transactions, and results from operations. Specific risks are disclosed as well as historical financial statements, which shareholders can use to evaluate past company performance. In addition, mandatory disclosure can act to constrain managers from wasteful uses of corporate assets. While private companies could disclose the same information to their shareholders, often they do not do so unless contractually obligated, given the costs of producing the information as well as their fear of divulging information to competitors.

A second key benefit afforded to public shareholders is the aftermarket for their securities. This liquidity enables those holding shares to increase or decrease their investment with relative ease. As an example, venture capitalists may complete their participation by exiting altogether. Other parties, such as the typical investor, are able to purchase securities in industries they fancy, while they would not be able to do so if the companies were private.

Third, public shareholders may benefit from increased profitability due to
the relatively broader exposure of the company compared to its exposure when it was private. By being in the public spotlight, the company enjoys a certain amount of inherent advertising for its goods and services.

Private shareholders face certain pre- and post-transaction costs in taking a private company public. Reverse mergers and IPOs are both dilutive, meaning that each pre-transaction interest or share will be a smaller piece of the post-transaction pie (regardless of whether the pie grows). In reverse mergers, the promoter may retain 2% to 8% of the equity, and a portion of the equity also remains in the hands of bystanders; the larger the portions that go to promoters and bystanders, the smaller the amount of equity that will be held by the pre-transaction private shareholders. In IPOs, the issuance of new shares to the public makes IPOs fundamentally dilutive. Since prior shareholders do not receive pro-rata portions of the new equity, their positions are diluted accordingly.

Shareholders should consider the relative costs and benefits that flow to them in IPOs vis-à-vis reverse mergers. Either transaction will result in increased information disclosure, more liquidity, and dilution. Reverse mergers are touted as being less expensive and involving less time. Although generally ignored by promoters, the costs in reverse mergers exceed the actual outlays to purchase the public shell and to hire advisors to the transaction, as a portion of the equity stays on the table for the promoters and bystanders. In order to fairly weigh the net benefits to shareholders of pursuing a reverse merger versus an IPO, one would have to compare, for both transaction types, the relative value of the pre-transaction equity to the post-transaction equity held by pre-transaction shareholders.

The fact that reverse mergers take less time may be misleading to shareholders. While the transaction itself may happen according to a faster timeline (a few days instead of several months), much of the work associated with “becoming public” occurs after the deal closes. In the case of a reverse

33. See infra note 40.
34. Usually between two and five percent of the equity in the shell remains in the hands of bystanders. Note that the bystanders do not swap or trade their securities in the transaction. Their holdings are unaffected by reverse mergers.
36. Unfortunately, this computation would be all but impossible to perform given that the methods for measuring enterprise value for a private company (discounted cash flows or DCF) is generally different than for public companies (market capitalization or comparative analysis). Using the most common valuation methodology for public companies, market capitalization, one would capture the additional value attributed to being a public company. Of course, since the comparison described in the body text above is ultimately between two methods of going public, ostensibly the value increase arising from “going public” would be enjoyed by both companies, allowing for a cross comparison. However, unless one were able to control for industry and size, it would be difficult to use DCF methodology given that underlying assumptions would differ (rate of growth, etc.).
merger, an unsophisticated management team may not fully grasp the significance of the obligations that arise from becoming a public company. If officers underestimate the daunting nature of preparing the company to meet its reporting obligations, the post-transaction company could easily devolve into an emergency situation so as not to violate federal law.

In a final analysis, shareholders will also have to consider the signaling effect of pursuing either transaction. The tenor of the SEC’s recent rules seems mistrustful of reverse mergers, and less mainstream research and information exists on their effects. IPOs, on the other hand, are a well-documented and celebrated practice as old as our security markets themselves. Indeed, an IPO is traditionally seen as a young company’s coming of age.

3. Shareholders of Public Shell

As discussed in the introductory portion of this section, shareholders of the public shell entity may be categorized as promoters and bystanders. Promoters, who have the strongest incentives to engage in reverse mergers, often control a stable of shell companies reserved for that purpose. Bystanders, on the other hand, most likely have never closed out a position in an operating public company that is wrapping up its affairs—sending the company’s common stock to a virtual zero price.

Promoters receive two legitimate benefits from reverse mergers, both financial in nature. Normally these shareholders, who own nearly all of the pre-transaction shares of the public shell entity, receive cash fees for their financial advisory services related to the transaction as well as a small slice of the equity in the post-transaction combined entity.

Bystanders, holding the same small amount of common stock in the public shell both before and after the transaction, receive an economic benefit only

37. The Commission states that the new rules “represent [its] latest effort in its ongoing campaign against fraud and abuse in the market for highly speculative securities, especially securities that trade at low share prices.” 2004 SEC Proposal, supra note 5, at 21,650.

38. See supra note 16.


40. See, e.g., In re Cybergate, Inc., Administrative Proceeding File No. 3-11512, SEC Administrative Proceeding File No. 3-11513, Exchange Act Release No. 49823, 2004 SEC LEXIS 1152 (June 8, 2004). In Cybergate, the SEC initiated public administrative proceedings against thirty-one companies to determine whether the registration of their securities should be revoked or suspended for failure to file required periodic reports. The Division of Enforcement described the business of Richard Surber, who registered or was substantially involved with each of the thirty-one companies, as taking companies public via reverse mergers in exchange for compensation of “cash fees in the range of $100,000 to $350,000 and two or three percent in stock ownership for each reverse merger deal it puts together.” 2004 SEC LEXIS 1152, at *15; see also SEC v. Surgilight, Inc., 2002 U.S. Dist. LEXIS 22853, at *2 (M.D. Fla. Oct. 15, 2002) (indicating that a promoter, who was subsequently charged with securities fraud related to a pump-and-dump scheme, received 8.7% stock ownership and a cash fee of $100,000 for the transaction); Ellen L. Rosen, An Often Risky Route for Going Public, N.Y. TIMES, Apr. 29, 2004, at C7 (claiming that reputable deals cost private companies around $500,000).
through their _equity_ position. Since they have no out-of-pocket costs related to
the deal (indeed they are unlikely to even know of the deal in advance), they
only experience the upside of the increase in value of their equity after the shell
acquires assets and operations through the reverse merger.

4. _Shareholders of Combined Corporation_

Those holding stock in the post-transaction entity benefit from the
opportunity for enhanced profitability arising from the attraction and retention
of qualified management as well as from the increased ability to realize
synergies with competitors through acquisitions. As mentioned earlier, a public
market for the securities of a company facilitates the design and
implementation of executive compensation plans that align managerial
incentives with the profit motive of shareholders. Incentive alignment may
increase profitability in two ways. First, existing managers can boost efforts to
increase the efficiency of ongoing operations while considering auspicious new
opportunities. Second, such executive compensation plans may well serve to
attract higher-quality management than could be procured through cash
payments in the form of salary, which may be subject to capital budgeting
constraints.

A public market for securities empowers the use of stock as acquisition
currency. Since opportunities for increased profitability may exist by pursuing
a business combination transaction, and given that a relatively small public
company may not have the amount of purchase consideration available in cash
or through debt financing, utilizing the firm’s shares as merger or acquisition
currency may be key to delivering additional value to shareholders.

A major potential risk to shareholders of the combined company is the
negative pricing pressure on the security due to any stigma investors may
associate with a reverse merger transaction. Whether this risk hurts investors
is an empirical question. The answer to this question, though unanswered in
this Article, would shed important light on entire the policy debate regarding
the deals. If such a stigma exists, the securities of companies that have
undergone a reverse merger will trade at a discount to their peers. Additionally,

41. Non-controlling shareholders who are not involved in managing the shell should not know of
the transaction in advance unless the information is made public pursuant to the disclosure rules in
Regulation FD.

42. See, e.g., Iman Anabtawi, _Secret Compensation_, 82 N.C. L. REV. 835, 836-37 (2004); Marcel
Kahan & Edward B. Rock, _How I Learned to Stop Worrying and Love the Pill: Adaptive Responses to
of the Firm: Managerial Behavior, Agency Costs and Ownership Structure_, 3 J. FIN. ECON. 305, 323
(1976) (advancing incentive compensation systems as a means to align managerial interests with those
of outside equity holders).

43. See, e.g., Surgilight, 2002 U.S. Dist. LEXIS 22853 (charges brought against a promoter for
being involved in a pump and dump scheme).

44. See _supra_ Part II.B (discussing the difficulty of obtaining data for analysis).
executives of such companies will likely be able to command higher compensation than their peers so as to overcome the negative signal of being associated with tainted businesses.

5. Markets

Securities markets have many functions, but at a very basic level, they offer businesses access to capital and offer investors the opportunity for returns. Both of these functions are implicated as a result of reverse mergers. While a private company issues no new shares through such a transaction (the number of shares of the public shell outstanding is the same both before and after the transaction), it may be able to tap into new capital during or after the reverse merger. At the time of the deal, promoters may provide additional financing to the new entity by contributing more cash into the shell in exchange for a higher percentage of equity in the post-transaction public company. Moreover, after the transaction, the public company will likely face increasing opportunities for equity financing as its exposure to potential investors grows.

Perhaps the strongest justification for the continued availability of the reverse merger is that it enables wide access to investments in embryonic companies with high growth potential—access normally only granted to venture capitalists and other elites of the financing world. Due to the economics of IPOs, early stage companies are not generally courted by underwriters and brought to market through the traditional process. Investment bankers pursue companies with established operations and proven revenues to take public. Smaller businesses simply do not make it over the IPO hurdle. Given the strong association between risk and return, if non-elites are unable to invest in riskier startups, they will not receive the higher returns on average that the elites may enjoy. Of course, whether the post-reverse merger startups actually provide returns commensurate with their risk is an empirical question that should be addressed through an extensive econometric study.

Reverse mergers, if associated with any form of securities fraud including insider trading and pump-and-dump schemes, may undermine the health of financial markets by causing a decrease in investor confidence. The SEC assumes a correlation between the transaction and fraudulent behavior without providing any substantive basis for its conclusion. Whether such a correlation

45. While underwriters claim eligibility criteria are necessary to ensure strong market demand for securities, which in turn leads to a payday on the underwriters spread, they also factor in the potentially detrimental reputational impact of underwriting a failed best-efforts offering.
46. See GAO REPORT, supra note 17, at 21-22.
47. Rather comically, the 2004 SEC Proposal, supra note 5, cites no actual cases of fraudulent activity; in the one apparent footnote in the proposal where they had intended to do so, the text reads "footnote for examples of shell companies filing multiple Form S-8 registration statements to distribute shares into the public marketplace." Id. at 21,654 n.48.
exists is also an empirical question that could be measured by tracking rates of fraud (number of administrative proceedings, indictments, settlements, convictions, etc.) for post-reverse merger startups relative to peers. Indeed, reverse mergers are somewhat unique in that they can be predicted to cause huge percentage-wise increases in the stock price of a public company upon the release of news that the company transformed from a shell with no significant assets or operations to an operating company by acquiring a private business; even if its stock price rose from virtually zero to only a few cents, the gain could be several hundred or thousand percent. Without investor savvy and adequate enforcement, the combination of potentially huge gains and relatively unsophisticated players is a recipe for market abuse.

III. POTENTIAL POLICY RESPONSES

A comprehensive, balanced consideration of appropriate regulatory approaches to reverse mergers must take into account the interests of private business in accessing capital and in minimizing compliance costs as well as the interests of the investor in diverse investment opportunities, information regarding such opportunities, and protection from fraudulent behavior. The satisfaction of each of these interests relies on the existence of healthy, accessible markets for a broad variety of securities. The analysis below deliberates the following five categories of theoretical policy responses: regulation of access to the public securities markets, transaction disclosure requirements, transaction review approaches, monitoring tactics, and punishment. A detailed review of the U.S. policy responses follows thereafter in Part IV.

A. Public Market Access

Regulatory bodies charged with the oversight of the securities markets could impose guidelines on market participants, restricting access to those in compliance so as to maximize the availability of capital and trading opportunities for legitimate purposes while minimizing risk of abuse.48

1. Company Qualification

Some companies may be truly unfit for public markets—their securities fail to offer investors enough value compared to alternative investment opportunities to outweigh the risks associated with ownership. Maintaining this view, a regulatory body could enforce company financial requirements and management clean-record or competency requirements. Financial requirements

48. Many such rules already exist in the United States. Broker-dealers must register with the SEC and securities professionals must register with the NASD.
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could be similar in construction to the listing requirements promulgated by exchanges, which establish minimum asset, income, trading volume, and market capitalization amounts, but could serve as absolute bars for certain companies to the entire public securities market instead of only a specific exchange or electronic communication network (ECN).

Management requirements, as part of the larger company qualification process, could include a clean-record rule in their most palatable form, essentially requiring public companies to employ only non-bad guys in executive officer positions. Further, management qualification approach could require executive officers to affirmatively demonstrate competency to pilot public companies. Such competency could be established through standardized tests administered by an appropriate agency, through appropriate academic degrees, by admission to certain qualified industry organizations, or by sufficient past experience. Although implementation of competency standards would involve a massive effort, they could eliminate companies with officers unable to control the complex effort of business management and regulatory compliance.

In deliberation of policies regarding company qualification, policymakers must take into account the significant related costs. If the vast resources contributed towards policy implementation exceed the current harms in the market that the policy seeks to ameliorate, such ideas should be abandoned in favor of less regulation.

2. Investor Qualification

In its nature somewhat paternalistic, regulation could be directed towards the investors, classifying them into baskets of investing sophistication (as determined by knowledge, wealth, or experience) and then permitting investments only in securities of appropriate complexity and risk. While this type of "sophistication" regulation has existed for some time, it has not been applied so as to categorize the common stock of certain public companies into different sophistication levels than shares of other public companies. Public common stock classification into sophistication baskets would present serious administrative difficulties arising from the difficulty in assessing the classification of the security at the time of a potential transaction and

49. See infra Part IV.A.6.f.
50. Despite seeming to be a grandiose undertaking, only approximately 60,000 executive officers would need educational oversight (assuming 12,000 public companies with five executive officers on average) compared to the 657,800 registered securities representatives the NASD currently oversees. See NASD website, http://www.nasd.com (last visited Mar. 31, 2006).
51. Consider, for example, the "accredited investor" concept in Regulation D.
52. See infra Part III.C (describing merit-review for an analogous discussion of security classification by government).
53. One class of securities may pass through different levels of classification as its asset levels,
subsequently ensuring that both the buyer and the seller are qualified to close the sale.

Investor sophistication regulation ostensibly would not directly address reverse mergers (although it could be designed to do so); rather, unsophisticated investors could be prohibited from investing in companies that do not meet company qualification standards similar to those outlined above—effectively barring their investment in shells or unproven post-transaction startups. Sophistication regulation could also correspond to disclosure levels, which would prohibit less sophisticated investors from buying stock in post-transaction companies that lack extensive disclosure.

A market system of classified public common stock smacks of unfair paternalism against less affluent or uneducated investors. This fundamental issue of fairness arises in comparing the way government would permit or deny the opportunity to invest in high-risk securities for relatively sophisticated and unsophisticated parties. The implications of any divergent treatment are exacerbated by the generally accepted view that free markets reward higher risk on average with higher returns. One could argue that the government ought not to interfere with a private individual’s rational decision-making process. If an investor desires to invest without receiving adequate disclosure and while risking huge percentages of her net worth, she could claim that the government should not obstruct her. Clearly, the individual’s freedom to determine the destiny of her property is at tension with the governmental or societal interest in protecting individuals (or, certain individuals) from the results of their own poor decisions.

3. Advisor/Promoter Qualification

Access to the public capital markets could be further regulated. Placing qualification requirements on parties acting as financial advisors to reverse merger transactions would ensure that they have the necessary knowledge and skills needed for their clients’ compliance with the federal securities laws. Advisor qualification could also serve to prevent fraud by informing parties at the heart of the transaction of the negative consequences of misbehavior. As the relative competence of transaction parties rose, so would the credibility of the companies resulting from such deals.

B. Transaction Disclosure (Registration)

Mandatory transaction disclosure by public companies has its roots in the Exchange Act, dating from the first half of the last century. Since that time debate has echoed through the halls of academia and government as to whether
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and the extent to which disclosure should be required. Several potential policy responses present themselves. At the far end of the spectrum is the position that no-disclosure requirements ought to be mandated. Public companies should be able to do a careful analysis of the costs and benefits of the release of information, taking into account its usefulness to investors, the cost of preparation, and the disadvantage of revealing strategies and operational results to competitors. Applying this position to reverse mergers, public companies would be able to determine what, if any, information they would like to reveal to investors.

At the other end of the disclosure policy spectrum is the view that public companies should disclose, periodically and upon certain events occurring in their business, extensive information—including standardized financial statements detailing performance and management statements regarding current strategies and expectations. Generally, this full and fair disclosure view is the philosophical position underlying the regulatory structure of U.S. markets. In the context of reverse mergers, full and fair disclosure would require issuers to announce the details of the transaction at the time of its occurrence followed by periodic reports detailing the performance of the post-transaction company over time.

Somewhere between the position of no disclosure and full and fair disclosure would be a system requiring some basic information regarding transactions and issuer performance without necessarily meeting the stringent audit requirements and standardization. This intermediate disclosure regime would cause companies to notify the markets of reverse merger transactions without requiring the costly dissemination of preparing audited financials and complex reports.

An interesting variation to the uniform disclosure systems described above is a regime permitting companies to elect which system to report under. This issuer choice disclosure variation could be wed to an investor sophistication policy such that only wealthy, knowledgeable investors could invest in low- or

56. Id.
57. One could claim that the true end of the spectrum would be full disclosure of all private business information. This position is implausible in that it fails to address information costs and competitive disadvantages. For an extensive discussion of mandatory disclosure, see Roberta Romano, Empowering Investors: A Market Approach to Securities Regulation, 107 YALE L.J. 2359, 2373-80 (1998).
58. See infra Part IV.
59. For a discussion of a proposal to permit issuers to elect levels of disclosure, see Alan Palmiter, Toward Disclosure Choice in Securities Offerings, 1999 COLUM. BUS. L. REV. 1 (1999).
no-disclosure companies while all investors could invest in full and fair disclosure companies.  

C. Transaction Filings Review

An important yet easily overlooked component to effective disclosure regimes is the review method used by regulators charged with ensuring legal compliance of company filings. The debate is generally framed by contrasting disclosure-based review, in which agency employees review filings to ensure adequate disclosure to investors without passing judgment on the relative virtues of the investment opportunity, with merit-based review, which would involve some type of governmental determination as to the suitability of the investment.  

In the United States, the predominant governmental policy has been to engage only in disclosure-based review. This position stems from a view that the markets, guided by rational, informed investors, are most efficient and effective for their purposes when they are free from any type of government tampering.

Merit-based review, while not necessarily entirely anti-market, could be conducted by assigning some type of grading scale to investment opportunities or transactions based on their perceived "quality." For example, blue-chip income stocks could be Grade A, while groups of securities that historically have been dogged by underperformance relative to their risk could be Grade F. Regulators could then restrict securities by denying registration of and public trading in securities below a certain grade or by permitting only certain qualified investors to transact in securities of lower grades. As a further example, if reverse mergers were found to be highly successful in one industry but not in a second, companies pursuing these transactions could receive a high grade in the one case, but not in the second.

The method of selecting filings for review is an extremely important process for enforcement purposes, regardless of whether operating under a disclosure- or merit-based review system. At one extreme, regulators could only review filings that were subsequently challenged by investors; at the other, agency employees could read through every line of every filing to ensure compliance. Balancing the interest of compliance enforcement with limitations on governmental resources, regulators may use sampling techniques to select...
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only a few mainstream transactions by seasoned issuers while selecting most transactions falling in novel or suspicious categories. If regulators have found a high correlation between fraudulent disclosure and reverse mergers, they could develop a sampling method that increases the frequency of review of these transactions.

D. Monitoring

One can imagine the concept of regulatory monitoring as an ongoing audit of certain types of suspicious companies. Agencies charged with monitoring responsibilities could identify high-risk companies (based on asset levels, lack of operations, types of transactions, identity of management) and then review both trading patterns in search of fraudulent behavior and public filings for disclosure noncompliance. If indeed reverse mergers are found to be associated with illegal or fraudulent activity, the organization could engage in ongoing monitoring of promoters of the transaction.

The primary benefit of a monitoring regime is that it permits private actors to behave freely instead of imposing authoritarian restrictions. Nevertheless, monitoring costs may rise dramatically alongside enlargements of the pool of high-risk companies and individuals as well as increased complexity of the monitoring analysis.

E. Punishment / Liability

While each of the potential policy responses outlined above could help to detect and prevent fraudulent activity, none serves to punish bad actors who have engaged in harmful conduct or to restore victims. Although punishment and liability are outside of the scope of this Article, it is important to mention some possible policies in passing. In simplest terms, punishment for fraudulent behavior could be directed towards those who actually committed wrongdoing, those who assisted primary parties in engaging in harm, and those who benefited from the mischievous deeds. How one defines "wrongdoing," "assistance," and "benefit" would have enormous implications to those engaged in and surrounding fraudulent activity. In the arena of reverse mergers, "wrongdoings" could be insider trading and pump-and-dump schemes. Of

65. Compare this idea with the concept of shareholder monitoring. See, e.g., Randall S. Thomas, Improving Shareholder Monitoring of Corporate Management by Expanding Statutory Access to Information, 38 ARIZ. L. REV. 331 (1996); John C. Coffee, Jr., Liquidity Versus Control: The Institutional Investor As Corporate Monitor, 91 COLUM. L. REV. 1277 (1991). Arguably, shareholder monitoring would be ineffective both in the pre-transaction shells, which are controlled by the promoter, as well as the post-transaction companies, since few institutional investors make investments in the penny stock markets.

66. The NASD monitors participants in the securities industry. See infra Part IV.B.2.

course, the legal system ought not to focus exclusively on perpetrators—inherent in fraudulent activity is the existence of victims. For any regulatory system to succeed in actually protecting investors, the teeth of liability should sink firmly into the spoils of the fraudulent, to the benefit of the victims.

IV. U.S. POLICY RESPONSES

First embodied in the Securities Act of 1933, the bedrock regulatory philosophy behind U.S. federal securities laws relies on the belief that the interests of capital formation and investor protection are most fairly and efficiently balanced in the public markets when companies provide investors full and fair disclosure.68 As discussed previously in this Article,69 such disclosure informs the decisions of investors, permitting the selection of investments with desired levels of risk and expected returns. The full and fair disclosure regime is supported by the dual statutory pillars70 of the Securities Act of 1933,71 which provides for a registration process whereby companies register the offering of securities to the public by providing comprehensive information about the securities and the company itself, and the Securities Exchange Act of 1934,72 which generally requires public companies to file ongoing periodic reports detailing results of operations.

The U.S. securities markets are regulated today by the Securities and Exchange Commission (SEC), which was created by Congress in 1934, as well as self-regulatory organizations (SROs) within the industry.73 In line with its purpose, the SEC, under the federal securities laws, has broad rule-making powers.74 Many of those powers are shared with or delegated to SROs such as the NASD75 and the national stock exchanges.76 In addition to rule-making power aimed at fraud prevention, the SEC and the SROs are equipped with investigative powers for detection as well as punitive powers for enforcement. The various existing and proposed rules affecting and directed towards reverse mergers are discussed below, with particular emphasis placed on the 2005 SEC Rule Amendments.

68. Prior to the Securities Act of 1933, securities were regulated at the state level in the United States, generally under a merit-review regime. See THOMAS LEE HAZEN, THE LAW OF SECURITIES REGULATION § 1.2(2) (4th ed. 2002).
69. See supra Part III.B.
70. Federal securities law arises strictly from statute—no federal common law exists. See HAZEN, supra note 68, at § 1.0(2).
73. See LOSS & SELIGMAN, supra note 61, at §§ 7-B-1, 7-C-1.
74. For a broader background discussion, see HAZEN, supra note 68, at §1.0(2).
75. The NASD, formerly the National Association of Securities Dealers, is the only national association registered under the Exchange Act. See infra Part IV.B.1.
76. See infra Part IV.B.1.
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A. Securities and Exchange Commission

1. Disclosure Mandate

Until quite recently, the SEC has not proposed or adopted regulation targeted to reverse mergers specifically. Instead, general rules for reporting companies, relating to disclosure of transactions consisting of a material event, have governed the release of information concerning reverse mergers. After disclosure of transaction-related information, including financial statements, post-transaction companies are subject to the same general disclosure rules as peer reporting companies. The only relevant variation in treatment by disclosure rules hangs on the size of the reporting company—transaction history is irrelevant.

2. Penny Stock Reform Act of 1990

Directed by the Securities Enforcement and Penny Stock Reform Act of 1990, the SEC implemented rules governing trading activity in the securities of companies with low market capitalization (and low stock prices) as a measure to combat fraudulent activity. These rules, while not intended to address the reverse merger transaction specifically, served the general purpose of requiring brokers and dealers in penny stocks to provide investors additional risk disclosure prior to trades, thereby protecting investors from blind-faith scams.

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77. The first public record of the SEC's awareness of reverse mergers is in a release expressing its concern about (i) the use of spin offs as a tool by companies with little or no activity to distribute shares of private companies in contravention, in the SEC's view, of the registration requirements of the Securities Act and (ii) reverse mergers used to circumvent the registration process. Of primary concern to the Commission was the potential for fraud and deceit. See SEC Release No. 33-4982, supra note 3.

78. Additionally, reverse mergers are impacted by regulation affecting the viability of pre-transaction shells. See infra Part IV.A.6.f.


3. Rule 419

In 1992, the SEC adopted Securities Act Rule 41982 to deter fraudulent activity connected to blank check offerings. In essence, this new regulation imposed an escrow requirement on any funds investors contributed to blank check companies in exchange for shares. The rule defines a “blank check company” as: “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 . . . is issuing penny stock.”83 As a result of the rule, blank check companies cannot access deposited funds until shareholders approve of the acquisition of an operating business.84 Moreover Exchange Act Rule 15g-8, adopted in conjunction with Rule 419, prohibits trading in blank check company securities during the escrow period. The apparent intent of these regulations is to prevent fraud in public shells before any merger type transaction occurs. Notably, the definition of “blank check company” would not necessarily include those public entities that post-bankruptcy or asset sale had little or no operations or assets since such companies would no longer be in the “development stage.”85

4. Interpretive Releases

The SEC has commented on reverse mergers occasionally in recent years. In 1999, the Division of Corporation Finance issued a letter clarifying accounting and reporting issues arising in the context of reverse mergers.86 The letter admitted that SEC rules then in existence did not directly address how reverse mergers impact the reporting requirements of shell companies post-transaction.87 Nevertheless, the staff spelled out that, in any case, the Exchange Act permits reporting companies no longer than a twelve-month lag in filing audited financials at any given point in time.88 Within fifteen days89 of the

83. Rule 419(a)(2).
84. Rule 419(b), (e).
86. Note that the letter refers to reverse mergers as “reverse acquisitions.” For discussion of accounting issues, see Frequently Requested Accounting and Financial Reporting Interpretations and Guidance, SEC Division of Corporation Finance Letter, at 17-19 (May 1, 1999) [hereinafter “SEC CF Guidance Letter”]. See also Dennis R. McNally & Raymond H. Hermanson, Accounting for Public Shell Reverse Mergers, 42 ORANGE COUNTY LAW. 18. Because the accounting issues are not important for the purposes of this paper, they are not covered here. For discussion of reporting issues, see SEC CF Guidance Letter, at 75-78.
87. SEC CF Guidance Letter, supra note 86, at 75.
88. Id.
89. The SEC CF Guidance Letter, supra note 86, states fifteen days, but this was recently changed to four days by new rules tightening the timing requirement for the disclosure of such events. See Additional Form 8-K Disclosure Requirements and Acceleration of Filing Date, Securities Act Release
reverse merger (the “Fifteen-Day Notice Window”), the issuer was supposed to file a report on Form 8-K containing notice of the transaction along with audited financial statements of the pre-transaction private company covering the three most recently completed fiscal years.\(^9\) Unaudited interim financial statements as well as pro forma financial data demonstrating the effects of the transaction were also to be included on Form 8-K.\(^1\) If the pre-transaction private entity’s financial statements were unavailable, the post-transaction reporting company had a sixty-day grace period\(^2\) from the date of the initial Form 8-K (the “Sixty-Day Grace Window”) during which it has to file the requisite financial information. Combining the Fifteen-Day Notice Window with the Sixty-Day Grace Window (or subsequently, the Four-Day Notice Window with the Seventy-One-Day Grace Period),\(^3\) issuers had a total of seventy-five days after a reverse merger to file audited financial statements. During that seventy-five day period, stockholders could have had little or no information from which to determine the value of their securities.\(^4\)

Less than a year later, the Office of Small Business in the Division of Corporation Finance at the SEC sent a no-action letter to the NASD in which it addressed the issue of whether parties to transactions like reverse mergers would be able to freely resell their shares of the post-transaction company while being exempt from the registration requirements of the Securities Act.\(^5\) The letter claimed that promoters of such transactions were “underwriters” of the shell company securities such that registration under the Securities Act was necessary in connection with resale;\(^6\) the letter did not directly address whether the pre-transaction shareholders of the private company would also be considered “underwriters” (and thereby subject to registration requirements). The SEC indicated that Rule 144, which permits the resale of restricted or

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\(^90\) SEC CF Guidance Letter, supra note 86, at 76. For private companies that would have been eligible to use S-B forms, only audited financials covering the previous two fiscal years are required. Id. U.S. and Canadian companies are eligible to use S-B forms when they have both revenues and a public float of under $25M. See infra note 170.

\(^91\) SEC CF Guidance Letter, supra note 86, at 76-77.

\(^92\) The SEC CF Guidance Letter indicates a 60-Day Grace Window. Id. However, along with the change to the 4-Day Notice Window mentioned above in note 89, the 60-Day Grace Window was expanded to 71 days. See Instruction (a)(4) to Item 9.01 of Form 8-K.

\(^93\) See supra notes 90 and 92.

\(^94\) This lack of information is one problem that the 2005 SEC Rule Amendments attempt to correct. See infra Part IV.A.6.d.


\(^96\) Id. at *3. This position is predicated on the view that when promoters trade in the company’s securities, especially if the promoters control or controlled a large portion of the shares outstanding, such transactions are not the ordinary market transactions between private investors that were intended to be exempt by Section 4(1) of the Securities Act. Accordingly, the SEC views these promoters to be statutory underwriters, especially since many promoters appear to “be in the business” of performing these transactions. Id. at *3-4.
control securities if certain conditions are met, would not be available for resale transactions by promoters since such sales appear to be aimed at distributing shares to the public without registration. This was a very significant declaration—it removed promoters’ incentives for the transaction by requiring full-blown registration of any sales. Although not addressed in the letter, it appeared that pre-transaction shareholders in the private company could sell their post-transaction shares as long as they complied with the requirements of Rule 144, including the holding period and trading volume provisions. As a final note, the letter warned that parties involved in the transaction must pay particularly close attention to Regulation M, which governs distributions of securities, when selling into an “illiquid market.”

On April 7, 2000, the Office of Small Business sent a no-action letter to the Director of Listing Qualifications at NASDAQ addressing backdoor registrations. Stating the SEC’s position, the letter claimed that private acquirers of public shells should not be deemed successor issuers to the public shell’s reporting obligations under Exchange Act Rule 12g-3(a) because the definition of “succession” under Exchange Act Rule 12b-2 demands a “direct acquisition of the assets comprising a going business,” and the public shell could not be deemed “a going business.” Despite making this academic point, the letter conceded to entrenched practice, permitting backdoor registration so long as successor companies filed, at a minimum, “complete audited and pro forma financial statements.”

Interestingly, one commentator declared the combination of these two letters to be “the death of the shell game.” Apparently that position proved to be overstated given the Commission’s continued regulatory attempts.

5. 1999 Form S-8 Proposal

In 1999, the SEC released a rule proposal that sought to curb a fraudulent scheme perpetrated by shell companies: the issuance of securities to “employees,” who were actually only advisers or consultants to the company on Form S-8. Although ultimately never adopted by the SEC, the rule would

97. Id.
101. Roberts Letter, supra note 100, at *2.
102. Id. This level of financial disclosure is equivalent to that required by Form 10 or Form 10-SB, which are used to register a class of securities under the Exchange Act. Id.
103. See Robert Paul Turner, The Death of the Shell Game, 10 Niev. Law. 6 (Jan. 2002).
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have prohibited the use of Form S-8 by shell companies, which merited consideration since securities registered on Form S-8 become effective immediately upon filing without SEC review. The argument against Form S-8 usage by shell companies was that they have no legitimate need for easy security registration since they have no underlying business in which the employees could share an economic interest. Not surprisingly, shell company promoters could argue that the economic business of the company was to acquire other operating companies. When the dust settled, the SEC ultimately abandoned the proposed rule without comment.


a. Overview

As part of its ongoing campaign against the perceived threat of fraudulent and manipulative activity arising from reverse mergers, the SEC proposed a rule change affecting the use of Form S-8 and Form 8-K by shell companies in 2004. In essence, the SEC first proposed to define “shell companies” as those with little to no operations and little to no assets other than cash and cash equivalents. Second, the Commission suggested the prohibition of the use of Form S-8 by shell companies, reviving the idea originally offered in 1999. Finally, the SEC proposed requiring shell companies to file additional information on Form 8-K upon completion of a transaction causing such entities no longer to be classified as shell companies. In 2005, the SEC adopted a set of rules substantially embodying the 2004 proposal, subject to a few modifications designed to limit the impact of the new rules on newly-formed shell companies created for the purpose of either changing domicile or effecting certain business combinations. In addition to the three concepts introduced in the 2004 proposal, the adopted rules require all issuers to indicate whether they are shell companies through a check box on the cover of their Forms 10-K (or, as applicable, Forms 10-KSB or Forms 20-F), and further require shell companies to report changes of control under an item on Form 8-K specifically reserved for such transactions.

105. Id.
106. This type of rationale is also commonly stated in the business descriptions of blank check companies in their public filings.
108. Id. at 21,656.
109. Id. at 21,653.
110. Id. at 21,654.
111. See 2005 SEC Rule Amendments, supra note 5.
112. Id.
b. Definition of "Shell Company"

By defining a shell company as one with little or no operations and little or no assets other than cash and cash equivalents, the Commission hoped to achieve more objectivity than was obtained in previous formulations of the concept. Nevertheless, the definition proposed in 2004 was both over- and under-inclusive, all the while remaining subject to ambiguity and opportunities for gaming. When the definition was finalized and adopted in 2005, the Commission narrowed its application to fix its overly broad scope as discussed in Part 0 below, but the SEC did not deal with other inherent problems in the definition.

The SEC asserted that the proposed rules were to prevent the use of shells "for fraudulent and manipulative purposes," and to do so, the Commission promoted "full disclosure." Why, then, are the rules limited to companies with little or no assets or operations? A company with ongoing operations or significant assets would also be able to engage in a pump-and-dump scheme by acquiring a private company and then promoting the combined entity prior to full disclosure.

Perhaps the characteristics of share ownership normally differ between companies with and those without assets and operations. For example, on average the companies with little or no assets and operations may have lower stock prices and more concentrated share ownership than companies with significant assets and operations. With a lower stock price, fraudulent promoters may perceive an opportunity for a greater percentage change in stock

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113. The text of the final definition is as follows:

*Shell company.* The term *shell company* means a registrant . . . 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.

*Id.* at 42,246.

114. 2004 SEC Proposal, *supra* note 5, at 21,661. The rule avoids more subjective definitions such as "blank check company," "development stage company," concern that "has indicated that its business plan or purpose is to merge with an unidentified company" and a concern with "no specific business plan or purpose," which appear in Rules 251, 419 and 504 promulgated under the 1933 Securities Act. See 15 U.S.C. § 77g(b)(3) (2006); 17 C.F.R. §§ 230.251(a)(3), 230.419(a)(2)(i), 230.504(a)(3) (2006). Such definitions come with the attendant difficulty of objectively determining whether a given company ought to be included. Moreover, companies retain leverage to impact their inclusion. In note 69 of the Proposed Rule, the Commission notes:

Because the definition of ‘blank check company’ requires that the company have ‘no specific business plan,’ many companies seek to circumvent Rule 419 promulgated under Section 7(b) by arguing that they have a specific business plan when they do not have a business plan that would attract investment by a reasonable investor seeking a reasonable balance of risk and return.

*See also* 2005 SEC Rule Amendments, *supra* note 5 (noting that post-bankruptcy shells are excluded).


116. *Id.*
price as a result of a pumping scheme. Additionally, when the stock price is initially lower, it is relatively cheaper for the promoter to acquire control of the shell prior to a reverse merger. With concentrated ownership comes board control, and it becomes easier to cause the public company to engage in a reverse transaction. But, what about the company with significant assets or operations that has concentrated equity ownership? Its shareholder-promoter could also benefit from a pump-and-dump scheme predicated upon a reverse merger.

The “no or nominal assets” standard regarding illiquid assets opens the Commission’s definition to serious ambiguity. Perhaps the standard measures the illiquid assets of the subject company versus those of its peers. If so, what peer grouping would be appropriate? Would it be all companies with securities registered under the Securities Act? Maybe it would be those companies with similar industry backgrounds, or perhaps the peer grouping should consist of companies with similar stock prices, or even possibly companies traded on the same exchanges or electronic networks. The reality is that most public shells have very few assets overall (otherwise they would be operating companies). But so do many of their typical peers trading in the Pink Sheets. The SEC may be casting a net wider than intended here, which could serve to inhibit legitimate transactions routinely conducted by small-cap companies.

Also suspect is the “no or nominal operations” standard in the shell company definition. Again, the criticism launched against the “no or nominal assets” standard applies. It is unclear whether the “no or nominal operations” standard is intended to be a relative standard, and if so, what the appropriate peer grouping should be. Perhaps more daunting is whether activities aimed at the sale of the shell would constitute “nominal operations” or whether they would exceed such a threshold. If they do exceed the threshold, then the purposes of the rule would be undermined in that it would not apply to the types of companies the SEC most suspects.

117. See 2004 SEC Proposal, supra note 5, at 21,656.
118. In the adopting release, the Commission indicates that it uses the term “nominal” out of a concern that quantitative thresholds might be too easily circumvented, and that it believes the term is not too vague or ambiguous. 2005 SEC Rule Amendments, supra note 5, at 42,236. While an imprecise definition may expand the SEC’s power to thwart circumvention on the margin, the ambiguity imposes costs on issuers as they attempt to sort out whether they fall within the domain of the definition. See infra note 139.
119. See infra Part IV.B.2.
120. See 2004 SEC Proposal, supra note 5, at 21,656.
121. The proposed rule is purportedly to prohibit individuals from promoting reverse mergers, which according to the SEC, are often transacted to fraudulent ends. See 2004 SEC Proposal, supra note 5, at 21,651. Accordingly, if a company’s operations consisted of promoting reverse mergers, and it thereby was exempted from the proposed rule, then the rule itself would be rendered ineffectual.
c. Definition of "Business Combination Shell Company"

The definition of "shell company" originally proposed in 2004 was overreaching in that it would have applied to shell companies engaged in routine transactions unrelated to reverse mergers. In the 2005 SEC Rule Amendments, the Commission dealt with this issue by creating an exempt classification for shell companies deemed to be a "business combination shell company," which includes those created for the purpose of either changing domicile or effecting certain business combinations. To fall within this exempt classification, a shell company must either be formed solely for changing domicile within the United States or be formed by a non-shell company solely in connection with a business combination with other non-shell companies. As a result of this exempt category, merger subsidiaries in a typical triangular merger would not be required to follow the filing requirements on Form 8-K applied to shell companies as discussed below.

d. Form 8-K

i. Acquisitions

With the objective of decreasing the opportunity for fraud and manipulation, the SEC's new rules require a shell company to file a detailed report on Form 8-K within four days of the closing of a transaction that causes it no longer to be a shell company. The financial information required to be filed on such Form 8-K is identical to the information currently mandated to be included on a registration statement on Form 10 or Form 10-SB, which are used to register securities under the Exchange Act. As a result of the new rule, shell companies do not need to file an additional Form 8-K; instead, the amount of information they must file on the initial Form 8-K increases. Notably, the adopted rules exempt "business combination shell companies" from having to include the level of information required by a Form 10 registration statement.

Most significant is how the changes to Form 8-K in the rules affect the timing of the filing of audited financial information for the private entity in the transaction. As stated above, the current regulatory scheme requires a Form 8-K to be filed within four days of the completion of the transaction. Prior to the adoption of the new rules, reporting companies were given the option of filing

122. See 2005 SEC Rule Amendments, supra note 5, at 42,236.
123. Id.
124. Id. at 42,239.
125. Id.
126. At the present, shell companies are required to disclose the transaction under either or both of Item 2.01 (Completion of Acquisition or Disposition of Assets) and Item 5.01 (Changes in Control of Registrant) of Form 8-K. See Instructions to Form 8-K, supra note 92.
127. See Items 2.01(f), 5.01(a)(8), on SEC Form 10.
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the audited financial information in the initial Form 8-K or at any time up to seventy-one days after the initial filing due date.\textsuperscript{128} Since the new rules mandate that audited financials must be filed with the initial Form 8-K (which must be filed within four days of the transaction), the significant impact of the rules is to close the seventy-one-day window that previously existed.

The SEC eliminated the seventy-one-day window for shell companies for two reasons. First, the Commission contended that during the window no public information existed concerning the operations and assets of the company's operating business.\textsuperscript{129} Essentially, the fear was that investors could trade the company's securities without having any substantive basis for determining their worth. It seems strange, however, that this argument was used to support the elimination of the window solely for shell companies. Any reporting company that would combine with a private entity and delay filing audited financials would place investors in a position where they would not have all material information regarding their investment, and yet the new rules do not address this situation.

Second, the SEC suggested that the rationale for initially allowing the seventy-one-day window for companies was to accommodate the inherent difficulty of combining the financial statements of two operating companies in addition to obtaining an audit in a short time period, a difficulty that would not be encountered in transactions with shell companies, which would ostensibly adopt the financials of the private target directly prior to the deal.\textsuperscript{130} This second rationale is more compelling given the ability shell companies to delay reverse merger transactions until audited financials are available.

In adopting a new regulation, it is important to carefully weigh the costs and benefits. Elimination of the seventy-one-day window for bona-fide shell companies might have been a prudent regulatory change if the rule applied exclusively to reporting companies with no illiquid assets or operations that acquired a single private company with audited financials. In such a case, the costs would be minimal, while the market would benefit from fuller and faster disclosure. However, when the shell company has illiquid assets or operations, or when the private company has unaudited financials, or if the shell acquires several private companies simultaneously, the costs of generating a combined set of audited financial statements becomes increasingly difficult and time consuming, undermining the SEC's second reason for excluding shell companies from the seventy-one-day window.

\textsuperscript{128} See Instructions to Form 8-K, \textit{supra} note 92.
\textsuperscript{129} 2004 SEC Proposal, \textit{supra} note 5, at 21,655.
\textsuperscript{130} \textit{Id.}
ii. Changes in Control

In the arena of backdoor registrations, the new rules codify, and thereby legitimize, the process previously permitted by the staff whereby the reporting obligations of the public entity succeed to the surviving company.\(^\text{131}\) The Commission achieves these ends by amending the definition of "succession" in Exchange Act Rule 12b-2 to include a shell company change in control,\(^\text{132}\) which would have the effect of imposing the reporting obligations of the public shell onto the combined entity resulting from a backdoor registration.\(^\text{133}\) Since the surviving entity would automatically assume Exchange Act reporting obligations on account of the hooks in Rules 12g-3 and 15d-5, it would not be required to file an Exchange Act registration statement, yet it would need to disclose the backdoor registration on Form 8-K.

e. Form S-8

In an attempt to remove the opportunity for abusive schemes, the new rules forbid the use of Form S-8 by shell companies. The prohibition continues for any former shell company until sixty calendar days after it files, upon completion of a transaction in which it ceases to be a shell company, information equivalent to that required by Form 10 or Form 10-SB in connection with the registration of a class of securities.\(^\text{134}\) The SEC holds the view that the sixty-day period will afford employees and the market the opportunity to absorb all relevant information in the company’s disclosures.\(^\text{135}\) Notably, an exception to the sixty-day waiting period applies to "business combination related shell companies," formed solely for changing domicile or entering transactions with non-shell companies.\(^\text{136}\) These entities may file registration statements on Form S-8 immediately after completion of such transactions.

The Form S-8 rule change is flawed. First, it depends on the notion that markets are slow to absorb information. Second, a common offering targeted by this rule change was already prohibited. Part of the SEC’s justification for the rule change was that some companies had been registering security sales improperly on Form S-8 in cases where employees, consultants, or advisors were compensated with the securities for work that does not qualify for the use

\(^{131}\) The previous process is described \textit{supra}, Part IV.A.4.


\(^{133}\) This transfer of reporting obligations would automatically occur for public shells with securities registered under either Section 12 or Section 15 of the Exchange Act.

\(^{134}\) See 2005 SEC Rule Amendments, \textit{supra} note 5, at 42,238. Such information may be filed on Form 8-K (as would be the case for the typical reverse merger), on Form 10 or 10-SB (registering a class of securities under the Exchange Act), or on Form S-4 (in a registration statement related to the transaction).

\(^{135}\) \textit{Id.}

\(^{136}\) \textit{Id.} at 42,247.
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of Form S-8. These types of registrations were already in violation of the securities laws.

f. Shell Company Check Box Disclosure

Ultimately, the most important component of the 2005 SEC Rule Amendments will be the new requirement obligating issuers to indicate whether they satisfy the "shell company" definition on the cover of their periodic reports through the use of a check box. Going forward, researchers and regulators will be able to compile data sets of shell companies that may be used to monitor their reporting behavior as well as to study the frequency and effects of reverse merger transactions. It should be noted that ambiguity in the SEC's definition of "shell company" creates new compliance costs as companies attempt to determine whether they properly fit into the category. At this early stage, some companies already are having difficulty applying the somewhat nebulous standard as they decide which box to check. The utility of the new check box disclosure will depend on the ability of issuers to comply with the requirement.

B. Self-Regulatory Organizations

Self-regulatory organizations (SROs) work in conjunction with and are subject to the SEC's authority. Composed of exchanges and the NASD, SROs assist in preserving the integrity of the securities markets; they protect investors by regulating their members to ensure proper standards of conduct. The exchanges have rules governing the behavior of their members and standards for the companies whose securities are listed on them. The NASD licenses security professionals and admits firms into the securities industry. Further, it regulates securities trading, oversees the education of securities professionals, and oversees the administration of examinations that test understanding of compliance rules. This section demonstrates that most SRO regulation related to reverse mergers impacts pre-transaction public shells as opposed to the transaction itself.

137. 2004 SEC Proposal, supra note 5, at 21,654; see also General Instruction A.1.(a)(1) to Form S-8 (prohibiting the use of securities registered on Form S-8 for compensating services rendered in connection with a capital-raising transaction).


139. Since the check box requirement was initiated in the latter half of 2005, we do not yet have a data set containing a full year's worth of annual reports. Initial filings in which companies have indicated that they are shell companies demonstrate confusion as to which companies are appropriately deemed shell companies. See, e.g., LCNB Corp., Annual Report (Form 10-K) (Mar. 6, 2006). LCNB, a bank holding company with over $539 million in assets as of year end 2006 and $27 million in income for the year, checked the box to indicate that it is a shell company.

140. For a broad overview discussion of exchange rules and organization, see LOSS & SELIGMAN, supra note 61, at 2701-14.

1. Exchanges

Currently there are eight national stock exchanges registered with the SEC under the Exchange Act. Each exchange retains rule-making authority subject to SEC approval and wields its power by setting listing standards issuers must meet before their securities may trade on the exchange. Exchanges generally also have delisting standards, which, if met by listed companies, will lead to removal of the securities from the exchange. Delisting is relevant in the context of reverse mergers when the public shell involved in the transaction is listed on an exchange. If a shell were listed and acquired a private entity, that entity would automatically become an exchange-listed company.

The New York Stock Exchange (NYSE), the largest and most respected stock exchange in the United States, has the most stringent de-listing standards. The NYSE considers securities for removal based on the number of shareholders, the trading volume, the number of publicly held shares, the aggregate market value of shares outstanding, and the total global market capitalization. Moreover, companies subject to removal include companies significantly reducing operating assets or scope of operations and companies entering bankruptcy or liquidation. These rules effectively deter public shells from remaining on the NYSE. The regional exchanges, that is, non-NYSE exchanges, have similar but slightly less demanding standards. Nevertheless, because few companies actually seek listing with the regional exchanges, a review of their standards is somewhat useless in policy discussions.

2. NASD and the Over-the-Counter Markets

Securities that are not listed on an exchange trade in the over-the-counter (OTC) market. The OTC market differs from exchanges in that there is no central location or floor where securities are traded; instead, securities may be traded by dealers called marketmakers. The NASD, the only association

142. These are the New York Stock Exchange (NYSE), American Stock Exchange (AMEX), Pacific Exchange, Chicago Stock Exchange, Cincinnati Stock Exchange, Boston Stock Exchange, and the Chicago Board Options Exchange. LOSS & SELIGMAN, supra note 61, at 2525. To participate in security transactions, exchanges are required by Exchange Act Section 5 to be registered with the SEC under Sections 6 and 19(a). Id.
143. Id.
144. In 2002, over $10.7 trillion worth of securities were traded on the NYSE. The stock exchange with the second highest value of total trades was the Chicago Stock Exchange at $800 billion, or less than ten percent of the value of the NYSE trades. See SEC 2003 Annual Report.
145. NYSE Rule 499.20.
146. Id. at nos. 13 and 14.
147. LOSS & SELIGMAN, supra note 61, at 1825.
148. Id. at 1826.
149. Id. at 2605.
150. Id.
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registered with the SEC under the Exchange Act, is the SRO charged with the responsibility of regulating the OTC. The OTC consists of the Nasdaq Stock Market (also referred to as "Nasdaq" and including the Nasdaq National Market and the Nasdaq Capital Market), the OTC Bulletin Board Service (referred to as “OTCBB”), and the Pink Sheets.

The Nasdaq maintains listing standards for the companies whose securities are quoted on either the Nasdaq National Market (the “NNM”) or the Nasdaq Capital Market (the “NCM”). The NNM removes companies if they fail to meet one of two standards, while the NCM only maintains a single standard. See below.

151. Id.

152. The Nasdaq Stock Market (or Nasdaq) is:
an electronic securities market comprised of competing market makers whose trading is supported by a communications network linking them to quotation dissemination, trade reporting, and order execution systems. This market also provides specialized automation services for screen-based negotiations of transactions, on-line comparison of transactions, and a range of informational services tailored to the needs of the securities industry, investors and issuers. The Nasdaq Stock Market consists of two distinct market tiers: the “Nasdaq National Market” or “NNM,” and “The Nasdaq Capital Market.” The Nasdaq Stock Market is operated by The Nasdaq Stock Market, Inc., a wholly-owned subsidiary of the Association.

NASD Rule 4200(a)(29).

153. See id.
The important point to note from these continued listing requirements is that if a shell company is unable to maintain qualification, it will lose value for reverse merger purposes because the post-transaction entity will not have the added prestige associated with the Nasdaq imprimatur. Regardless, larger private companies engaging in reverse mergers could apply for a Nasdaq listing after the transaction.

The OTCBB, which is a securities quotation and trading service for broker-
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dealers, is also subject to the regulatory purview of the NASD.\textsuperscript{162} To be eligible for trades over the OTCBB, securities cannot be listed on Nasdaq or on a national securities exchange, and the issuer of the security must be registered and current in its filings under the Exchange Act, subject to a thirty- or sixty-day grace period.\textsuperscript{163} Accordingly, if public shells are delinquent in their current or periodic reports,\textsuperscript{164} shareholders will not be able to effect trades on the OTCBB.

The Pink Sheets, the wild west of stock markets, are the lowest tier for transacting in securities. Originally named after the color of the paper that securities prices were recorded on, the Pink Sheets have developed from their origins in 1904 as a paper-based, interdealer quotations system to a centralized electronic quotation service available on the Internet.\textsuperscript{165} The privately-owned market has little or no regulatory authority over issuers, marketmakers or investors.\textsuperscript{166} Instead, broker-dealers involved in trading are directly subject to SEC and NASD regulation.

While neither the SEC nor the NASD has a particular set of rules aimed at reverse mergers specifically, they do have regulation aimed at keeping companies current in their reporting and at making information available to investors. Such regulation effectively bars public shells from gathering dust for months or years and then springing back to life to launch a private entity into the public markets. Through Exchange Act Rule 15c2-11,\textsuperscript{167} the SEC can prohibit brokers and dealers from publishing a security quotation in any quotation medium (including the Pink Sheets) without reviewing certain information that they must keep in their records regarding the security and its issuer.\textsuperscript{168} The broker-dealer must have a reasonable basis for believing its

\begin{itemize}
  \item \textsuperscript{162} See NASD Rule 6500.
  \item \textsuperscript{163} See NASD Rule 6530(a).
  \item \textsuperscript{164} David Feldman, a securities lawyer specializing in reverse mergers, estimates that it costs up to $25,000 per year in accounting and legal fees to keep a shell current in its reporting. Bloomberg News, \textit{S.E.C. Acts on Corporate Shells}, \textit{N.Y. TIMES}, June 9, 2004, at C3.
  \item \textsuperscript{165} See Pink Sheets website, http://www.pinksheets.com/about/index.jsp (last visited Mar. 31, 2006).
  \item \textsuperscript{166} Id., at http://www.pinksheets.com/otcguide/investors_index.jsp (last visited Mar. 31, 2006).
  \item \textsuperscript{167} 17 C.F.R. § 240.15c2-11 (2006).
  \item \textsuperscript{168} Information requirements include a prospectus, offering circular, annual report together with any quarterly and current reports required under the Exchange Act, or the following information, which must be reasonably current:
    \begin{itemize}
      \item the exact name of the issuer and its predecessor (if any); the address of its principal executive offices; the state of incorporation, if it is a corporation; the exact title and class of the security; the par or stated value of the security; the number of shares or total amount of the securities outstanding as of the end of the issuer's most recent fiscal year; the name and address of the transfer agent; the nature of the issuer's business; the nature of products or services offered; the nature and extent of the issuer's facilities; the name of the chief executive officer and members of the board of directors; the issuer's most recent balance sheet and profit and loss and retained earnings statements; similar financial information for such part of the 2 preceding fiscal years as the issuer or its predecessor has been in existence; whether the broker or dealer or any associated person is affiliated, directly or indirectly with the issuer; whether the
    \end{itemize}
\end{itemize}
records are materially accurate and that the sources of information are reliable. The NASD bolsters Rule 15c2-11 by requiring any broker or dealer to submit the necessary information required by the SEC rule to the NASD prior to initiating or resuming quotations in the Pink Sheets. In combination, these regulations effectively bar trading in delinquent shell companies.

C. Summary of U.S. Policy

The U.S. regulatory landscape impacting reverse mergers consists of two essential components. First is the policy of full and fair disclosure, beginning with the shell company check box requirement and extending to the obligation to report descriptive and financial information about reverse mergers and the post-transaction combined company. At its crux, the recent SEC rule amendments were an attempt to enhance and clarify disclosures to investors. Second is the tiered cascade of performance and information requirements from the NYSE down to the Pink Sheets, preventing old shells from lying dormant before springing to fraudulent life.

V. RECOMMENDATIONS

Foremost, the U.S. approach to regulating reverse mergers appears to be unobtrusive (it does not prohibit such transactions) while generally protecting investors. The recent implementation of the shell company check box disclosure of shell company status should permit robust econometric studies of reverse mergers in the next few years. As noted from my calls for various forms of empirical research throughout this Article, the current level of actual data on these transactions is sparse. New empirical research will give us the tools to determine the extent to which legitimate companies use reverse mergers for proper ends and to analyze the impact of government regulation on the transactions and entities involved. It may very well turn out that further regulation threatens an important financing mechanism for private companies.

Viewing reverse mergers and their pesky means of accessing the public markets as symptomatic of a larger problem, I believe managers of relatively small private companies are not familiar with the regulations that are available to small companies. Private companies can register a securities offering of up

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Id. at § 240, 15c2-11(a)(1)-(3), (5).
169. See NASD Rule 6740.
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to $10 million on the simplified Securities Act Form SB-1 as long as they meet the definition of "small business issuer." In addition, the SEC should emphasize to private businesses the relative ease with which small businesses are able to navigate the applicable federal securities law. Unfortunately, advisors in the private sector have little incentive to assist companies with small-business IPOs because there is not much money on the table in these small deals for consulting or underwriting fees. In reverse mergers, however, the promoter has the financial incentive of selling his shares of the shell to the private company. Since the incentives to educate small businesses about IPOs do not exist in the private sector, the SEC should take on a more active role in promoting them to private managers.

VI. CONCLUSION

In the end, we see that aspects of both parables ring true. Sans the mystical sword of the dashing SEC regulator, significant incentives exist for promoters and private shareholders to use shells for ghoulish ends. Yet should regulators ignore the specific financing needs of private companies, they run the risk of drying up a portion of the small-cap market and all the innovation and business potential it engenders. For a happier ending to this story, thoughtful solutions, informed by a stronger economic understanding, must arise to balance the important interests of fraud prevention, access to capital, and investor choice.

170. See Rule 405. For an excellent discussion of the capital-raising options available to small business issuers, see Choi, supra note 79, at 31-35.