Published on *The National Law Review* https://natlawreview.com

SEC Approves More Rigorous Listing Requirements of the Major U.S. Stock Exchanges for Reverse Merger Companies

Article By:

Corporate Practice Group

The **Securities and Exchange Commission** has approved amendments to the listing rules of The **NASDAQ Stock Market LLC, New York Stock Exchange LLC and NYSE Amex LLC** which impose new requirements on operating companies going public by completing reverse mergers with SEC-reporting shell companies, including reverse mergers with unlisted **special purpose acquisition companies (SPACs).**

On November 8, 2011, the Securities and Exchange Commission (SEC) approved amendments to the listing rules of The NASDAQ Stock Market LLC (NASDAQ), New York Stock Exchange LLC NYSE) and NYSE Amex LLC(NYSE Amex) (collectively, the Exchanges) which impose new requirements on operating companies going public by completing reverse mergers with SEC-reporting shell companies (reverse merger companies).

The new rules define a **"reverse merger"** as any transaction whereby an operating company becomes a reporting company under the **Securities Exchange Act of 1934 (Exchange Act)** by combining, either directly or indirectly, with a shell company which is an Exchange Act reporting company, whether through a reverse merger, exchange offer or otherwise. In determining whether a company is a "shell company," the Exchange will look to a number of factors, including but not limited to: whether the company is considered a "shell company" as defined in Rule 12b-2 under the Exchange Act; what percentage of the company's assets are active versus passive; whether the company generates revenues, and if so, whether the revenues are passively or actively generated; whether the company's expenses are reasonably related to the revenues being generated; how many employees support the company's revenue-generating business operations; how long the company has been without material business operations; and whether the company has publicly announced a plan to begin operating activities or generate revenues, including through a near-term acquisition or transaction.

The SEC approved the rule changes on an accelerated basis and solicited comments on the already-adopted rules.

Background

The amendments were proposed by the Exchanges earlier this year in response to significant

investor protection and regulatory concerns which arose in connection with reverse merger companies, many of which operate primarily outside the United States. In particular, reverse mergers involving Chinese companies have come under scrutiny by the SEC and the **Public Company Accounting Oversight Board (PCAOB)**. In their proposals, the Exchanges referred to widespread allegations of fraudulent behavior by reverse merger companies leading to concerns that their financial statements could not be relied upon, as well as situations where promoters and others allegedly manipulated the stock prices of reverse merger companies higher to help meet initial listing bid price requirements and where companies gifted stock to artificially satisfy public holder listing requirements. In March, the PCAOB issued a research note on audit implications for reverse mergers involving companies from the China region, and in June, the SEC issued an investor bulletin warning investors about companies that engage in reverse mergers. The new listing requirements are in addition to all of the Exchanges' other initial listing requirements. We summarize below the new rules and discuss certain ambiguities regarding the meaning and scope of some of the provisions.

The New Requirements

Under the new rules, a reverse merger company will be eligible to list on an Exchange if it has:

1. concluded a "seasoning period" by trading for at least one year in the U.S. over-the-counter market or on another regulated U.S. or foreign exchange following:

   (A) in the case of NASDAQ, the filing with the SEC or other regulatory authority of all required information about the transaction, including audited financial statements (We note that the NASDAQ rule, in contrast to the NYSE and NYSE Amex rules, states that the audited financial statements must be "for the combined entity." The Form 8-K filed within four business days following the reverse merger containing all of the information and financial statements required by the applicable items of Form 8-K, including Item 2.01(f) (commonly referred to as a "Super 8-K") would not contain audited financial statements for the combined entity, but only for the operating company, with unaudited pro forma financial statements for the combined entity. The staff of NASDAQ has orally informed us that this variation was not intentional, and the financial statements required under Item 2.01(f) would be sufficient.); or

   (B) in the case of the NYSE and the NYSE Amex, the consummation of the reverse merger and (i) in the case of a domestic issuer, has filed with the SEC a "Super 8-K" or (ii) in the case of a foreign private issuer, has filed all of the information described in (i) above on Form 20-F;

2. maintained a closing stock price of $4 (or, in the case of the NYSE Amex, either $3 or $2, depending on the applicable listing standard) per share or higher for a sustained period of time, but in no event for less than 30 of the most recent 60 trading days prior to the filing of the initial listing application and prior to listing; and

3. timely filed all required periodic financial reports with the SEC or other regulatory authority (*e.g.*, Forms 10-Q, 10-K or 20-F), including at least one annual report containing audited financial statements for a full fiscal year commencing after filing the information described

above.

In their proposals for the new rules, the Exchanges stated that the additional listing requirements are designed to assure that a reverse merger company will have produced financial and other information in connection with its required SEC filings during the "seasoning" period and that it will have filed with the SEC at least one full year of audited financial statements before it is eligible to list on an Exchange. The Exchanges believe that these requirements should provide greater assurance that a reverse merger company's operations and reported financial results are reliable, and will also provide time for its independent auditor to detect any potential irregularities, as well as for the reverse merger company to identify and implement enhancements to address any internal control weaknesses. The Exchanges also stated that the "seasoning" period will also provide time for regulatory and market scrutiny of the reverse merger company, and for any concerns that will preclude listing eligibility to be identified. The Exchanges believe that the new minimum stock price requirements should address concerns that some may attempt to meet the Exchanges' respective minimum price tests required for Exchange listing through quick manipulative schemes in the stocks of reverse merger companies by requiring the minimum price to be sustained for a meaningful period of time.

The new NYSE and NYSE Amex rules explicitly permit those Exchanges to exercise their discretion to impose additional or more stringent criteria if they believe it is warranted in the case of a particular reverse merger company. NASDAQ's new rules do not explicitly provide for this additional discretional authority, although NASDAQ generally has discretion as to the listing of companies on its markets.

Length of Pre-Listing Period

As noted above, each of the Exchanges requires that, in order to list, the reverse merger company must have filed audited financial statements covering a *full fiscal year* commencing *after* the filing of its "Super 8-K". As a result, reverse merger companies may be prohibited from listing on the Exchanges well beyond the one-year trading period described above. For example, if a calendar year-end reverse merger company files the required information on January 2, 2012, it would not be able to list until it files audited financial statements for 2013, which likely would be in March 2014. Such a company could in theory change its fiscal year to shorten this time frame, but this would be a costly and disruptive endeavor.

Reverse Mergers with SPACs

A special purpose acquisition company (SPAC) is a shell company which raises capital in an SEC-registered initial public offering (IPO), places substantially all of the IPO-proceeds in a trust account and then seeks to acquire an operating business or assets. At the time of its acquisition, the SPAC offers its public shareholders the opportunity to redeem their shares for a *pro rata* portion of the cash in the trust account (the "redemption offer") either in conjunction with a shareholder vote on the acquisition transaction or by way of a tender offer. Each of the Exchanges has special listing requirements for SPACs (See NYSE Listed Company Manual Section 102.06, NYSE Amex Company Guide Section 119, and NASDAQ IM-5101-2).

The new rules carve out of the definition of "reverse merger" the acquisition of an operating company

by a SPAC, but only if the SPAC already is listed. (We note that while the NYSE and NYSE Amex rules specify that the carve-out is limited to a listed SPAC "which qualified for initial listing" under their respective special SPAC listing requirements, the NASDAQ rules specify that the exemption is available for a listed SPAC "satisfying the requirements of" its special SPAC listing requirements. The staff of NASDAQ has orally advised us that, under NASDAQ's formulation, a SPAC listed on another Exchange which seeks to transfer its listing to NASDAQ at the time of its acquisition transaction could qualify for the carve-out as long as the SPAC would also have satisfied NASDAQ's SPAC listing requirements.)

As a result of the limited carve-out under the new rules, we expect that most new SPACs will apply for listing on an Exchange in connection with their IPOs in order to be able to be listed on an Exchange immediately following the consummation of their acquisition transactions. Based on oral guidance we received from the staffs of the NYSE and NASDAQ, current or future SPACs that trade in the over-the-counter market (such as on the OTC Bulletin Board) will be eligible to uplist to an Exchange, and avoid being subject to the new rules, except if the SPAC has announced, or is about to announce, its acquisition. The staffs believe that it would be a circumvention of the new rules to allow a SPAC that has announced, or is about to announce, an acquisition, to avoid the new requirements. Because the determination of whether a SPAC is about to announce an acquisition will be made by the applicable Exchange based on the particular facts and circumstances (and could be made with the benefit of hindsight), any SPAC not listed on an Exchange that wants to be listed on an Exchange immediately following the consummation of its acquisition transaction should file its listing application to uplist to an Exchange as soon as possible.

As a result of the new rules, we expect that few SPACs will conduct their redemption offers by way of a tender offer. Listing on an Exchange will subject a SPAC to all of the Exchange's listing rules, including the requirement to obtain shareholder approval prior to issuing shares which equal 20 percent or more of the common stock outstanding before the issuance. Because SPAC acquisition transactions typically involve an issuance of this magnitude, most listed SPACs will be required to hold shareholder votes on their acquisition transactions. Therefore, they will conduct their redemption offers in conjunction with the shareholder vote and not by way of a tender offer.

Exceptions to the Additional Listing Requirements

The new rules include two exceptions. First, a reverse merger company is exempt from all of the new rules if it is listing in connection with an initial firm commitment underwritten public offering generating gross proceeds of at least $40 million (or, in the case of the NYSE, where the proceeds satisfy certain aggregate market value of publicly-held shares requirements). Second, a reverse merger company will not be required to comply with the minimum price requirement described above if it has satisfied the one-year trading requirement described above, has filed at least four annual reports with the SEC or other regulatory authority containing all required audited financial statements for a full fiscal year commencing after filing the information described above and is not delinquent in its filing obligations with the SEC or other regulatory authority.

Other Transactions Not Covered by the New Rules

The new rules do not apply where the operating company already is a listed entity prior to its reverse merger. In addition, the new rules by their terms apply only to reverse mergers (and similar transactions) involving operating companies and shell companies, and therefore should not apply to acquisitions of assets by shell companies where no operating company is involved.

Finally, the NASDAQ rules, but not the NYSE or NYSE Amex rules, also carve out a business combination described in NASDAQ Rule 5110(a) (relating to a listed company that combines with a non-NASDAQ entity, resulting in a change of control of the company and potentially allowing the non-NASDAQ entity to obtain a NASDAQ listing, sometimes called a **“back-door listing”).**

National Law Review, Volume I, Number 333