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"THE SHELL GAME": REVERSE MERGER COMPANIES AND THE REGULATORY EFFORTS TO CURB REVERSE MERGER FRAUDS

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INTRODUCTION

There comes a point in most companies' development when they must consider whether to go public or remain private. Ample reasons support either option. Staying private allows the company to keep its financial status and executive compensation confidential.[1] Remaining a private company also allows company owners to retain more control through flexible corporate governance structures—for example, the firm may choose to forgo independent directors, and need not solicit shareholder votes to effect major corporate changes.[2] Going public, on the other hand, allows company owners to cash in a portion of their equity without completely giving up control of the corporation, and offers the company access to public equity markets for raising capital in the future.[3]

The last factor—the ability to secure capital from the stock market—is perhaps the most important reason behind companies' decision to go public.[4] As a publicly listed corporation, the company may raise money directly by issuing additional shares to investors, thus bypassing the borrowing constraints of lending institutions. Company owners also welcome the opportunity to unload their share of the company's risk to risk-neutral investors on the stock market.[5] As a result of going public, the company's net worth can be increased, its debt de-

1. *US IPO Guide*, LATHAM & WATKINS, https://www.lw.com/thoughtleadership/lw-us-ipo-guide-2016 (last visited June 30, 2016).
2. *Id.*
3. *Id.*
4. Kyla Houge, *Reverse Mergers: A Legitimate Method for Companies to Go Public or an Easy Way to Commit Fraud?*, 36 J. NAT'L ASS'N ADMIN. L. JUD. 325, 330 (2016).
5. *Id.*

creased and its debt-to-equity ratio reduced.[6] The company's enhanced financial status will in turn increase its visibility and market competitiveness, which enhances the company's ability to raise funds continuously from the stock market.[7]

A predominant method for companies to gain these benefits is to pursue an initial public offering ("IPO").[8] An IPO, however, is often time-consuming and costly. One IPO checklist compiled by a law firm to guide a company through the process ranges over seventeen pages and contains 140 items, most of which would require days, if not months, to complete.[9] For example, under the Securities Act of 1933, an extensive registration statement must be filed with the Securities Exchange Commission ("SEC") to ensure that accurate information is provided to the market.[10] The registration statement must include the company's annual audited financial statement, along with other relevant financial information. It must also include a summary of the company's business, corporate governance structure, executive compensation and various risk factors.[11] Once the company files the requisite documents, SEC staff members perform an extensive review, which typically results in companies having to make multiple revisions to the filed documents.[12] An IPO also comes at a high cost. In anticipation of an IPO, the company not only needs to hire underwriters, attorneys, and accounting firms, but also must incur other costs to effect organizational changes, such as changing the composition of its board of directors.[13] The costs

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6. *Id.*

7. *Id.* at 329.

8. *Id.* at 331.

9. *US IPO Guide*, *supra* note 1.

10. Ashley N. Schawang, Comment, *Missing the Mark: An Examination of the Current Government Response to the Chinese Reverse Merger Dilemma*, 57 St. Louis U. L.J. 219, 226 (2012).

11. *See* Sec. & Exch. Comm'n, https://www.sec.gov/fast-answers/answersregis33htm.html (last visited Oct. 8, 2018).

12. Anna Pinedo & Alexandra Perry, Mayer Brown, IPO Prospectuses: Avoiding and Responding to Common SEC Comments 2, https://www.mayerbrown.com/files/Publication/194c97f0-a5d7-425d-8c0f-99822da3a52e/Presentation/PublicationAttachment/ea55eab7-3f87-4876-b368-5f0f756be975/IPO.pdf.

13. PwC, Considering an IPO?: The Costs of Going and Being Public May Surprise You 1 (2015), https://www.pwc.com/us/en/deals/publications/assets/pwc-cost-of-ipo.pdf (noting that being a public company sub-

directly attributable to an IPO average $3.7 million and the one-time organizational cost of going public is on average $1 million.[14]

Given the regulatory hurdles and prohibitive costs, many private companies are unable to pursue an IPO. These companies nevertheless desire access to capital markets, and often seek other ways to go public. One such way is a reverse merger. A reverse merger refers to a transaction where an existing public shell company acquires a private company.[15] Compared to a traditional IPO, a reverse merger is usually characterized by "shorter time process, lower costs, less commitment of management resources, less dilution to the [private company's] shareholders and an existing shareholder base."[16] A company only needs to file a Form 8-K with the SEC and does not have to go through the lengthy disclosure required for an IPO.[17] Legal and accounting fees also tend to be lower with a reverse merger.[18] Through a reverse merger, shareholders of the private company can continue to exert control over the new entity because there is no dilution of shares.[19] A reverse merger can take a few weeks to up to four months to complete, while an IPO takes approximately six to twelve months.[20] A reverse merger also allows the private company to determine the timing of the listing, which can be a crucial consideration for high-tech companies that need to protect the secrecy of their business information and are often operating in "volatile, frequently changing, and quickly evolving markets."[21]

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jects the company to a series of regulations that changes the corporate governance structure).

14. *Id.*

15. *Reverse Mergers*, INVESTOR.GOV, http://www.investor.gov/news-alerts/investor-bulletins/reverse-mergers (last visited Sept. 1, 2018).

16. *Reverse Mergers*, SICHENZIA ROSS FERENCE KESNER LLP, http://srfkllp.com/resources/reverse-mergers (last visited Jan. 13, 2017).

17. INVESTOR.GOV, *supra* note 15.

18. *Id.*; *see also* DAVID N. FELDMAN, REVERSE MERGERS: AND OTHER ALTERNATIVE TO TRADITIONAL IPOS 28 (2d ed. 2009) (noting that law firms generally charge a flat fee for reverse mergers).

19. *See* Erik P.M. Vermeulen, *High-Tech Companies and the Decision to "Go Public": Are Backdoor Listings (Still) an Alternative to "Front-door" Initial Public Offerings?*, 4 PENN. ST. J.L. & INT'L AFF. 421, 422 (2015).

20. Ken Clark, *Why Do a Reverse Merger Instead of an IPO?*, INVESTOPEDIA (Dec. 16, 2017), https://www.investopedia.com/ask/answers/08/reverse-merger-ipo.asp.

21. Vermeulen, *supra* note 19, at 425.

Stories of successful reverse mergers abound, involving household names like Berkshire Hathaway and Jamba Juice,[22] but concern for the reverse merger's potential as a tool for fraud has also been around since the transaction's inception. As early as 1969, the SEC opined that the reverse merger process was "in possible violation of the registration requirements of the [1933] Act and of the antifraud and anti-manipulative provisions of the [1933 Act] and the [1934 Act]."[23] This concern persists today, leading the SEC to reach the conclusion that "[m]any companies either fail or struggle to remain viable following a reverse merger" and warn investors about "instances of fraud and other abuses involving reverse merger companies."[24] To make matters more complicated, reverse mergers are frequently used by foreign companies (most notably, Chinese companies) to commit fraud. The foreign origin of these fraudulent actors makes it especially difficult for the SEC to enforce its regulations and discipline reverse merger transactions.[25]

This Note seeks to accomplish two goals. First, it will evaluate the performance of reverse merger companies and assess the utility of reverse mergers as a form of transaction. Second, it will consider reverse merger frauds, and propose several ways for regulators to combat fraudulent activities without hindering legitimate reverse merger transactions. Part I provides a general overview of how reverse mergers work, with a focus on the financing of reverse merger companies. Part II conducts a review of empirical literature about reverse merger companies' performance and argues that going public through a reverse merger does not necessarily have a negative impact on a company's subsequent performance. Based on this assessment, reverse merger regulations should allow legitimate transactions to proceed while at the same time detect and stop fraudulent activities. The remainder is devoted to searching for this balanced regulatory approach. Part III analyzes how frauds are committed through reverse mergers, and the SEC's regulatory responses. Part IV explores the reasons for Chinese companies' preference for reverse mergers and the difficulties en-

22. Houge, *supra* note 4, at 345–48.
23. *Id.* at 340 (internal quotation marks and citation omitted).
24. INVESTOR.GOV, *supra* note 15.
25. *See id.*

countered by the SEC in deterring reverse merger frauds perpetrated by Chinese companies. Part V proposes methods that regulate the reverse merger process without hindering its legitimate use.

I.
REVERSE MERGERS AND HOW THEY WORK

Reverse mergers have many forms, but all share the common theme of a private company merging with a public company, wherein the shareholders of the private company obtain a controlling interest in the public company.[26] Legally, the public shell company is the entity that survives the reverse merger, but the composition of its shareholders changes completely. The shareholders of the private company generally hold 90% to 99% of the shares of the new public company, while the shareholders of the shell company retain only 1% to 10% of the new company's shares.[27] The private company's management team generally takes over the board of directors and the management of the new company. As the shell company usually has few assets and operations of its own, the surviving public company's business operations and assets are "primarily, if not solely" those of the private company.[28]

Most reverse mergers are accomplished through a reverse triangular merger instead of a direct merger. In a reverse triangular merger, the public shell company creates a wholly-owned subsidiary. The shareholders of the private company exchange their shares for shares of the public company and the private company subsequently merges with the wholly-owned subsidiary instead of the public shell company.[29] After the reverse triangular merger, the wholly-owned subsidiary is dissolved and the private company as the surviving entity becomes a wholly-owned subsidiary of the public company.[30] Compared with a direct merger, a reverse triangular merger does not require the public company to obtain approval from its shareholders—the sole shareholder of the subsidiary is the

26. SICHENZIA ROSS FERENCE KESNER, *supra* note 16. *See also* INVESTOR.GOV, *supra* note 15.
27. SICHENZIA ROSS FERENCE KESNER, *supra* note 16.
28. INVESTOR.GOV, *supra* note 15.
29. Vermeulen, *supra* note 19, at 427.
30. *Id.* at 428.

public company and shareholder approval can thus be secured simply through a board resolution, which saves both time and money for the public company.[31]

To make the transaction even simpler, companies can pursue a share exchange or share acquisition, during which the public company acquires the private company as a wholly-owned subsidiary "through the issuance of the [public company's] shares, cash or a combination of both."[32] It avoids the need to make filings associated with the creation of the public company's subsidiary or filings of merger documents. The only possible drawback is that the share exchange agreement requires the consent of all the shareholders of the private company.[33]

A. *A Vibrant Shell Marketplace*

The popularity of reverse mergers is highly dependent on a vibrant shell marketplace "populated by some promoters who are repeat players and raise capital from specialized shell investors who demand (and receive) significant returns in the face of high risk."[34] In 2009, there were over 1,400 reporting shell companies in existence.[35] The SEC defines a shell company as one with "no or nominal operations, with no or nominal assets or assets consisting solely of cash and cash equivalents."[36] These shell companies are traded on the Over-the-Counter Bulletin Board ("OTCBB") or the "Pink Sheets" System. Most of the shares traded in the over-the-counter markets are "penny stock" shares, making the issuing companies perfect targets for reverse mergers.[37]

Most shell companies exist solely for the purpose of serving as the vehicle for reverse mergers, and there is a sense of urgency for them to fulfill their destiny. A study of 585 trading shell firms over 2006 to 2008 found that the stock price of

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31. SICHENZIA ROSS FERENCE KESNER, *supra* note 16.
32. *Id.*
33. FELDMAN, *supra* note 18, at 44.
34. Robert B. Thompson & Donald C. Langevoort, *Redrawing the Public-Private Boundaries in Entrepreneurial Capital Raising,* 98 CORNELL L. REV. 1573, 1590 (2013).
35. Ioannis V. Floros & Travis R.A. Sapp, *Shell Games: On the Value of Shell Companies*, 17 J. CORP. FIN. 850, 851 (2011).
36. *Id.* at 850.
37. Vermeulen, *supra* note 19, at 427.

most shell firms decreases rapidly over time, with the share price's half-life of 172 trading days.[38] Investors in shell companies do not profit from the trading of shell firm shares—only from the expectation that the shell companies may soon consummate a reverse merger. However, over the sample period, only 50% of the shell companies managed to pull off a reverse merger, and twenty-nine of the 287 shell firms that could not find a suitor for reverse merger found their share prices decline to zero at the end of the sample period.[39] The risk of investing in shell companies is increased by the fact that the market cannot readily tell which shell firms will be successful in consummating a reverse merger.[40] Founders and shareholders of shell companies therefore have every incentive to aggressively push their shell companies for reverse mergers. As a consequence, shareholders of public shell companies might not conduct enough due diligence about to-be-acquired private companies in their haste to complete the reverse merger and cash out. A more dreadful scenario exists where promoters of shell companies collude with fraudsters and become part of the scheme to trick ordinary investors in the market through reverse mergers.

Despite the significant risk of investing in shell companies, if a shell firm can succeed in completing a reverse merger, its shareholders can realize a significant profit. The lucrative nature of the shell marketplace earns some staunch proponents for itself and leads to considerable political pressure on the SEC to refrain from aggressively restricting investment in shell companies. While it is feasible to regulate reverse mergers by regulating shell companies, the SEC has not opted for this route. The restriction the SEC imposes on the creation and going public of shell companies is a duty of self-declaration: all companies reporting to the SEC must indicate whether they declare themselves a shell company through a check box on the cover of their Forms 10-K.[41] Without this

38. Floros & Sapp, *supra* note 35, at 851.

39. *Id.* at 857.

40. *Id.* at 858.

41. *See* Use of Form S-8, Form 8-K, and Form 20-F by Shell Companies, Securities Act and Exchange Act Release Nos. 33-8587 and 34-52038; International Series Release No. 1293; File No. S7-19-04 (Aug. 22, 2005, except Item 5.06 of Exchange Act Form 8-K, which is Nov. 7, 2005) (Final Rule).

potentially powerful regulatory weapon, the SEC must concentrate its regulatory efforts directly on reverse mergers.

B. *Financing Reverse Merger Companies*

Financing is crucial for reverse merger companies because a reverse merger transaction alone does not infuse any money into the company—it only endows a previously private company with a new status as a publicly traded company. Additional transactions, such as debt financing, factoring arrangements, or private placements, must be conducted simultaneously with the reverse merger to give the new public company the funds it needs. Financing is therefore an important consideration for reverse merger companies.

Compared with private companies, it is easier for reverse merger companies to attract investors because investors can generally resell their shares within a few months of the consummation of the reverse merger.[42] In a private placement, if the issuer is subject to the Securities Act reporting requirements, investors can only sell their stocks after a six-month holding period. If the issuer is not subject to those reporting requirements, investors must hold their stocks for a year before resale.[43] However, given that most reverse merger companies are relatively small in size and uncertain in financial prospect, even a few months of illiquidity may pose serious threats to investors. In order to assuage this concern, reverse merger companies increasingly turn to private investment in public equity ("PIPE") for financing, which can significantly shorten the period of illiquidity for investors.[44] PIPE financing consists of two steps: private placement and registration. When the reverse merger company engages in a private placement with investors, the two sides sign a registration rights agreement, stipulating that the reverse merger company will file a registration statement with the SEC, which, once declared effective, immediately allows investors to sell their shares on the public market.[45] PIPE financing therefore seems like a win-win strategy for reverse merger companies and investors: it pro-

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42. FELDMAN, *supra* note 18, at 75.
43. 17 C.F.R. § 230.144(d).
44. FELDMAN, *supra* note 18, at 75–76 (noting that the holding period can be reduced to as few as three months).
45. Thompson & Langevoort, *supra* note 34, at 1599.

vides reverse merger companies with quick access to cash, and reduces investor risk by guaranteeing a shorter holding period. An additional benefit of PIPE financing is that most PIPE financing investors are sophisticated institutional investors. Their willingness to invest in a reverse merger company sends a positive signal to the market and may enhance the future money-raising capability of the reverse merger company.[46]

Despite its advantages, PIPE financing is still limited in its ability to raise money. While an IPO can typically raise $20 million to $300 million,[47] PIPE financing raises far less than this amount.[48] Because reverse merger companies are generally strapped for cash, investors can get a sizable discount from the market price during the private placement negotiation.[49] In addition to this discount, private placements for PIPE financing are usually conducted with the assistance of a placement agent, who charges a high fee for the service.[50] A study of 1063 PIPE offerings by U.S. public companies from January 2002 through July 2005 found the mean agent fee at 6.8% of gross proceeds and the mean discount at 31.5%.[51] The financing of reverse merger companies therefore comes at a high cost, which must be considered in valuing reverse merger transactions.

II.
THE PERFORMANCE OF REVERSE MERGER COMPANIES

Reverse mergers as a form of transaction have gained increasing popularity in recent years. There were only three reverse mergers in 1990; in 2008, that number reached 236.[52] Data provider PrivateRaise recorded 257 reverse mergers in 2010.[53] This trend is partly the result of domestic companies'

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46. *Id.* at 1600.
47. FELDMAN, *supra* note 18, at 75.
48. Masako Darrough, Rong Huang & Sha Zhao, The Spillover Effect of Fraud Allegations against Chinese Reverse Mergers 9 (Jan. 5, 2015) (unpublished manuscript), https://ssrn.com/abstract=2545685 or http://dx.doi.org/10.2139/ssrn.2545685.
49. Thompson & Langevoort, *supra* note 34, at 1599–1600.
50. Na Dai & Hsuan-Chi Chen, *Seasoned Equity Selling Mechanisms: Costs and Innovations*, 11 J. PRIV. EQUITY 16, 23 (2008).
51. *Id.*
52. Floros & Sapp, *supra* note 35, at 851.
53. Vermeulen, *supra* note 19, at 437.

use of reverse mergers to bypass the various requirements of an IPO. More specifically, this increase reflects a trend among high-tech companies of going public through reverse mergers. During the first half of 2014, at least sixty-nine companies pursued a reverse merger, and most of them were healthcare and biotech companies.[54] Twenty-eight companies were able to raise a total of $85.6 million in private placements, demonstrating their earning potential.[55]

Another important reason behind this trend is the large number of Chinese companies seeking to gain access to the U.S. stock market through reverse mergers. During the period from January 1, 2007 to March 31, 2010, there were 159 companies from the China region that accessed U.S. capital markets through a reverse merger transaction.[56] Only fifty-six Chinese companies completed IPOs during the same period.[57] This influx of Chinese companies has created serious concern over Chinese reverse merger fraud, and has called into question the integrity of all reverse merger companies, domestic or foreign.[58]

In addition to the concern over reverse merger fraud, the performance of reverse merger companies has been continuously under scrutiny even when more and more companies are choosing to go public through reverse mergers. Media coverage of poorly-performing reverse merger companies and the SEC's warning in 2011 about reverse merger fraud gives the public an impression that reverse merger transactions are inherently toxic, but empirical research reveals a different story. Before reverse mergers were heavily utilized, reverse merger companies indeed performed poorly. A study of 121 reverse merger companies during the period between 1987 and 2001 found little improvement in operations or profitability after

54. *Id.*
55. *Id.* at 437–38.
56. PUB. CO. ACCOUNTING OVERSIGHT BD., RESEARCH NOTE NO. 2011-P1, ACTIVITY SUMMARY AND AUDIT IMPLICATIONS FOR REVERSE MERGERS INVOLVING COMPANIES FROM THE CHINA REGION: JANUARY 1, 2007 THROUGH MARCH 31, 2010 (2011) [hereinafter PCAOB ACTIVITY SUMMARY].
57. *Id.*
58. *See* Darrough, Huang & Zhao, *supra* note 48.

the reverse merger.[59] While the shell companies' shareholders received significant wealth gains upon the completion of these reverse mergers, over half of the sample firms did not survive the first two years after the reverse merger.[60] The performance of reverse merger companies changed drastically when more companies began to use this form of transaction. One 2014 study looked at 424 companies that went through a reverse merger between 2001 and 2010.[61] This new study employed an algorithm that compares each reverse merger company with a matched control firm similar in exchange, industry, date, and size.[62] By comparing the performance of the reverse merger company and the control firm, the study reached the conclusion that reverse merger companies are not inherently more problematic than other comparable publicly traded companies in terms of operation and financial health.[63] In fact, reverse merger companies are more likely to move up in exchange tier than the control firms and less likely to move down—they were even outperforming their counterparts during the ten-year period studied.[64]

Consistent with previous literature concerning reverse mergers, the 2014 study dispels the misunderstanding that firms pursuing reverse mergers are inherently problematic. Comparing U.S. and Chinese reverse merger companies, the study further found that the good performance of reverse merger companies was driven in large part by Chinese reverse merger companies.[65] These companies were generally larger and more mature when they started the reverse merger pro-

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59. Kimberly C. Gleason, Leonard Rosenthal & Roy A. Wiggins, III, *Backing into Being Public: An Exploratory Analysis of Reverse Takeovers*, 12 J. CORP. FIN. 54, 77 (2005).

60. *Id.*

61. Charles M.C. Lee, Kevin K. Li & Ran Zhang, *Shell Games: Are Chinese Reverse Merger Firms Inherently Toxic?* 13 (Stanford Graduate Sch. of Bus., Working Paper No. 3063, 2014), https://www.gsb.stanford.edu/faculty-research/working-papers/shell-games-are-chinese-reverse-merger-firms-inherently-toxic.

62. *Id.* at 4–5.

63. *Id.* at 5.

64. *Id.* at 32 (finding that 31.3% of reverse merger firms moved up in exchange tier while only 19.6% control firms did; 25.3% reverse merger firms moved down in exchange tiers compared with 30.1% control firms that moved down).

65. *Id.*

cess. In subsequent years, they also performed much better compared with U.S. reverse merger firms.[66] Compared to U.S. reverse merger firms, about 35% more Chinese reverse merger companies moved up in exchange tier[67] or became acquired. In terms of other measures of performance, such as "profitability, cash flows, likelihood of receiving a qualified audited opinion, survival rate, and changes in market liquidity," Chinese reverse merger companies also outperformed U.S. reverse merger companies.[68] This conclusion holds even if the sample were to include forty-two Chinese reverse merger companies that were accused of financial misconduct.[69]

The result of the study by no means suggests that the current regulations of reverse mergers are sufficient. Despite these reverse merger companies' performance, reverse merger fraud, especially those perpetrated by Chinese companies, still destabilizes the market and damages the credibility of other reverse merger firms and publicly traded Chinese companies in general. Legitimate Chinese reverse merger companies suffer the most from this spillover effect. Before the outbreak of Chinese reverse merger scandals, the spillover effect was relatively minor. After the SEC's investor bulletin and rule amendments in 2011, investors started to react negatively to incidents of Chinese reverse merger frauds.[70] Short sellers also began to

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66. *Id.* (noting that Chinese reverse merger companies tend to be "larger, less levered, more profitable, less likely to have a qualified audit opinion, and more likely to be at the Growth or Mature stage of the business life cycle").

67. Moving from trading on the OTCBB to trading on national stock exchanges — such as New York Stock Exchange or Nasdaq — would be considered as "moving up the exchange tier" because companies must meet national stock exchanges' listing requirements to be traded there. National stock exchanges may establish listing requirements for "price per share, total value, corporate profits, daily or monthly trading volume, revenues and SEC reporting requirements," and the ability of firms to meet these requirements is generally perceived as a sign of their financial strength. Similarly, as OTCBB has more stringent listing requirements than the "Pink Sheets" system, moving from trading on the "Pink Sheets" to trading on OTCBB would be considered as "moving up" as well. *See id.* at 21 n.39. *See also* Ken Clark, *Move from an OTC to a Major Exchange*, INVESTOPEDIA (Jan. 5, 2018), https://www.investopedia.com/ask/answers/08/otc-nyse-nasdaq.asp.

68. Lee, Li & Zhang, *supra* note 61, at 32.

69. *Id.* at 33.

70. Darrough, Huang & Zhao, *supra* note 48, at 32–33. For SEC 2011 Rule Amendments, see discussion *infra* Section III.C.

target Chinese companies whenever there was a report of a reverse merger fraud. It is worth noting that non-fraudulent Chinese companies, regardless of how they became public in the United States—whether through a reverse merger or a traditional IPO, suffered from the spillover effect as well, while U.S. reverse merger companies were spared.[71] The negative reaction of U.S. investors and the exploitation by short sellers have even forced legitimate Chinese companies to go private and withdraw from the U.S. stock market.[72] Many of these companies, however, are actually in good financial condition and likely will turn out to be good investment options for U.S. investors.[73] The negative market reaction to Chinese reverse merger fraud therefore both damages the interests of other legitimate Chinese companies and deprives U.S. investors of profitable investment opportunities.

The mechanism of reverse mergers and the empirical findings show that there is nothing inherently wrong with reverse mergers as a form of transaction. There is a vibrant shell marketplace and a mature system of shell company trading, thereby providing a solid infrastructure for reverse merger transactions. While they cannot raise as much money as a traditional IPO, reverse mergers nevertheless cater to the needs of smaller companies with limited means of raising capital. The comparison between reverse merger companies and their counterparts who went public through other ways, moreover, demonstrates that investment in reverse merger companies can be profitable for investors and reverse merger companies are not destined to fail—they might turn out to do very well. Given the value of reverse merger transaction for investors and for companies, legitimate reverse mergers must continue to be allowed.

Reverse merger fraud, however, has proven especially damaging for legitimate Chinese reverse merger companies. Despite positive U.S. performance, Chinese reverse merger

71. Darrough, Huang & Zhao, *supra* note 48, at 32–33.

72. *Id.* at 33 ("51 Chinese companies went or are planning to go private from April 2010 to 2012, some of which planned to relist in Hong Kong or the A-share market in mainland China. This trend is likely to continue. China Development Bank . . . is providing more than $1 billion to support smaller Chinese companies to go private or leave the U.S. stock market.").

73. *Id.* at 34 ("Since the remaining pool is likely to consist with weaker firms, the principle of the lemons market might apply here.").

companies must contend with negative investor attitudes due to the misconduct of a few fraudsters. The difficulty therefore lies in achieving a delicate balance in regulatory approach—allowing legitimate reverse mergers to proceed while preventing fraud and restoring investors' confidence in legitimate reverse merger companies. The ensuing sections will delve into the problem of reverse merger frauds and propose ways for reverse merger regulations to proceed.

III.
The History of Reverse Merger Fraud and the SEC's Regulatory Responses

Fraud has plagued the reverse merger transaction since its inception, but only in recent years have reverse mergers become an important area for U.S. securities regulation. In the early 2000s, there was a series of incidents in which Chinese companies went public in the United States through reverse mergers and subsequently raised a shockingly large amount of cash by misrepresenting their financial status. These scandals prompted the SEC to tighten its regulations of reverse mergers in response. The battle between the regulators and the fraudulent companies started as early as the 1970s, and is still waging on today.

A. *Rule 419 and the Regulation of "Blank Check Company"*

In the early 1970s and 1980s, a common reverse merger scheme involved fraudulent actors setting up new shell companies and then leaking speculative information about an upcoming reverse merger to the market to pump up the stock price. The promoters of shell companies would then sell their shares and make sizable profits.[74] In 1992, the SEC adopted Securities Act Rule 419 and Securities Exchange Act Rule 15g-8 in response to this scheme. Rule 419 introduced the concept of a "blank check company," defined 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 entities or person, and is issuing penny stock."[75] Rule 419 requires that

74. Vermeulen, *supra* note 19, at 429.
75. 17 C.F.R. § 230.419(a)(2) (1992) (emphasis added).

all the money raised during the IPO be placed in an escrow account accessible only after the shareholders approve the acquisition of an operating business or after eighteen months.[76] Adopted in conjunction with Rule 419, Rule 15g-8 further prohibits trading of the securities that are held in the escrow account.[77]

While Rule 419 and Rule 15g-8 make no mention of reverse mergers, they did effectively prevent the commission of fraud through public shells. A fatal flaw of Rule 419, however, lies in its definition of "blank check company." By restricting its scope to companies at their "development stage," Rule 419 does not reach those companies that have little or no assets or operation because they have gone through bankruptcy or asset sale.[78] Rule 419 therefore leaves enough leeway for opportunistic promoters of public shells to continue devising new ways to exploit the market.

B. *2005 SEC Rule Amendments*

In response to the increasing popularity of reverse mergers, in 2004, the SEC revisited the issue of reverse mergers and proposed a rule change, the main ideas of which were substantially embodied in subsequent rule amendments in 2005. In addition to offering a clear definition of "shell company" and requiring shell companies to declare their status in Form 10-K,[79] the rule amendments require shell companies to file a Form 8-K within four days of the closing of a transaction that changes its status as a shell company. The financial information required by Form 8-K is identical to the information currently required in a registration statement. These rule amendments, therefore, allow investors timely access to the same information that would be available in an IPO. They also close the loopholes of Rule 419 by adopting a broad definition of shell companies, thereby bringing more transactions under the regulation of the 2005 rule amendments.

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76. *Id.* § 230.419(e).
77. *Id.* § 240.15g-8.
78. *See* Aden R. Pavkov, *Ghouls and Godsends — A Critique of Reverse Merger Policy*, 3 Berkeley Bus. L.J. 475, 498; Houge, *supra* note 4, at 342.
79. *See* discussion *supra* Section I.A.

C. *2011 SEC Rule Amendments*

Although the 2005 rule amendments imposed more stringent regulations on reverse mergers, they ultimately failed to stop a series of Chinese reverse merger frauds. Most of these frauds were committed through pump-and-dump schemes. Under this scheme, corporate insiders or fraudsters who hold shares of the corporation first make misleading statements to boost the price of the stock. After their misinformation creates a buying frenzy for their stock in the market, they dump their shares and make sizable profits.[80] Reverse merger happens to be a common first step to perpetrating pump-and-dump schemes.[81] Reverse mergers offer fraudsters a shortcut to the stock market without much regulatory oversight from the SEC, thus serving as a convenient tool to carry out the pump-and-dump scheme. To prevent the use of reverse mergers in this way, it was imperative for the SEC to adopt new regulations.

In 2011, the New York Stock Exchange ("NYSE"), NYSE Amex, and NASDAQ, facing a large number of reverse merger related frauds, proposed rule changes to the SEC, demanding additional listing requirements for companies that become public through reverse mergers.[82] Over the objection that the proposed rule changes "would harm capital formation and hinder small companies' access to the capital markets,"[83] the SEC granted rule amendments according to the NYSE proposals. The new rules imposed considerably more rigorous listing requirements for reverse merger companies. Two significant components of the new rules are a yearlong "seasoning period" before listing on an exchange and a minimum trading price of four dollars before the company's submission of a listing application. The one year "seasoning period" requires companies to file at least one year of audited financial state-

80. Houge, *supra* note 4, at 349.

81. William P. Barrett, *How to Spot a Pump and Dump*, FORBES (Apr. 7, 2010), https://www.forbes.com/forbes/2010/0426/investing-pink-sheets-fraud-stock-scam-madoff-spot-pump-dump.html#51787ebe615e ("There is nothing inherently wrong with a reverse merger . . . . However, this variety of reorganization happens to be a common first step in penny stock scams.").

82. Order Approving NYSE Proposed Rule Changes Adopting Additional Listing Requirements for Reverse Merger Companies, 76 Fed. Reg. 70,795 (U.S. Sec. & Exch. Comm'n Nov. 8, 2011).

83. *Id.* at 70,796.

ments with the SEC after the merger.[84] During that time, reverse merger companies' shares must be traded in the U.S. over-the-counter market, on another national securities exchange, or on a regulated foreign exchange.[85] Another requirement is that a reverse merger company must "maintain a closing stock price of $4 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.[86]

These new requirements are designed to combat accounting fraud through reverse mergers. The "seasoning period" requirement ensures that material information about the issuer has been filed with the SEC before it goes public on the NYSE, thereby establishing "a demonstrated track record of meeting its Commission filing and disclosure obligations."[87] As a result of this "seasoning period," by the time reverse merger companies become publicly listed on the NYSE, investors have access to material financial information of these companies, and are able to make more informed decision given the improved transparency. The requirement that reverse merger companies maintain a minimum stock price for a sustained period of time addresses the concern that it is relatively easy for reverse merger companies to manipulate stock price to meet minimum price requirements of the securities exchanges. By requiring these companies to maintain the minimum price for a meaningful period of time, the rules reduce the possibility of manipulation, and ensure that the price of the securities issued by reverse merger companies accurately reflects the firm's condition. In theory, these requirements appeared promising for their capacity to curb reverse merger frauds.

As applied, the 2011 rule amendments fell short of their purpose. On the one hand, Chinese reverse merger companies continue to perpetrate fraud in the United States, carrying out the same scheme in over-the-counter markets or secur-

84. *Id.* at 70,795, 70,797.

85. *Id.* at 70,798 ("[T]hese additional listing requirements will assure that a Reverse Merger company has produced and filed with the Commission at least one full year of all required audited financial statements following the Reverse Merger transaction *before it is eligible to list on NYSE.*").

86. *Id.* at 70,797.

87. *Id.* at 70,798.

ities exchanges with less stringent regulations.[88] On the other hand, the new rules dampened the market's enthusiasm for reverse mergers and pushed legitimate companies to seek other more expensive and time-consuming ways to go public. The number of reverse mergers decreased from 257 in 2010 to 124 in 2013.[89] More importantly, the rules created additional roadblocks delaying legitimate, high-potential companies' access to the stock market. For certain companies, the benefit of stock market access outweighs the cost of complying with additional listing requirements, but the "seasoning period" and the minimum stock price make it more cumbersome for these companies to go public and delay their growth. Those companies' preference for reverse mergers must be taken into consideration by the SEC in promulgating future plans to regulate reverse mergers.

IV. CHINESE REVERSE MERGER COMPANIES

Reverse mergers by Chinese companies first emerged in the early 2000s, and became widespread around 2010.[90] This phenomenon brought exciting opportunities to U.S. investors, yet at the same time opened the door for Chinese companies to carry out reverse merger fraud in the United States. This section will focus on the host of factors that motivate Chinese companies to pursue reverse mergers, as well as the difficulties faced by U.S. agencies in their attempt to regulate Chinese reverse mergers.

A. *An Obsession with Going Public*

As discussed earlier, going public can expand a company's access to capital and boost its financial strength. If successful, it also usually comes with large payout to company owners. It is therefore not difficult to understand why taking

88. *See, e.g.*, *In re* Advanced Battery Techs., Inc. Sec. Litig., No. 11 Civ. 2279, 2012 WL 3758085 (S.D.N.Y. Aug. 29, 2012); SEC v. Sierra Brokerage Servs., 712 F.3d 321 (6th Cir. 2013); SEC v. China Ne. Petroleum Holdings Ltd., 27 F.Supp.3d 379 (S.D.N.Y. 2014).

89. Vermeulen, *supra* note 19, at 437.

90. FELDMAN, *supra* note 18, at 61–62 (noting that the Chinese government used to be very concerned about foreign entities acquiring ownership interest in Chinese companies, but this attitude changed drastically in 2003, which precipitated the Chinese reverse merger trend).

their companies public becomes the ultimate goal for many Chinese company owners.[91] The obsession with going public leads Chinese companies to explore a variety of methods to access the U.S. securities market, and reverse mergers have so far been most favored. The reasons for the popularity of reverse mergers with Chinese companies are twofold: first, stringent rules for listing in domestic stock exchanges push Chinese companies to look overseas; second, many private Chinese companies' ineffective corporate governance structure and imperfect auditing foreclose the route of a traditional IPO in the United States, leaving a reverse merger as the only option.

State-run stock exchanges in China usually have strict requirements for companies to go public. To go public in China, companies must be incorporated in the Chinese Mainland (which disqualifies a large amount of high-potential tech companies incorporated overseas to evade domestic regulations) and have operated for no less than three years. The company also must have a three-year track record of profitability, and the cumulative pre-tax profit must be no less than 30 million Chinese Yuan (more than 4 million U.S. Dollars). The company's cumulative net cash flow from operation must be no less than 50 million Chinese Yuan (more than 7 million U.S. Dollars) over the last three financial years.[92] These hardline rules are not the only things driving domestic companies away; there are also implicit "soft rules" that become hurdles on domestic companies' path to the stock market. Most large banks in China are state-owned and favor large, state-owned enterprises.[93] A company is also more likely to get approval for an IPO if it is in a "favored industry" and has a good relationship

91. Peter Furhman, *Ethics and Investment Banking — How Disreputable Advisors, Bankers and Lawyers Damaged Chinese SMEs Through OTCBB Listings, Reverse Mergers*, CHINA FIRST CAP. PRESS (May 20, 2009), http://www.chinafirstcapital.com/blog/2009/05/20/ethics-and-investment-banking-%E2%80%93-how-disreputable-advisors-bankers-and-lawyers-damaged-chinese-smes-through-otcbb-listings-reverse-mergers/.

92. DELOITTE, GOING PUBLIC, https://www2.deloitte.com/content/dam/Deloitte/cn/Documents/audit/deloitte-cn-audit-goingpublic2016-en-zh-161206.pdf (last visited Sept. 1, 2018).

93. Linda Ji & Hunter Qiu, *Weighing Reverse Mergers for Private Chinese Cos.*, LAW 360 (June 25, 2012), https://www.law360.com/articles/352462/weighing-reverse-mergers-for-private-chinese-cos.

with the Chinese government.[94] Given the stringent regulations and the often unpredictable outcome of applying to go public in China, there is little wonder why many Chinese corporations are more willing to go public in the United States.

Once Chinese companies decide to go public in the United States, some may not be able to pursue an IPO because of concerns about "integrity of management, accounting irregularities and exaggerated future prospects."[95] These companies are usually legal domiciliaries in offshore havens such as the Cayman Islands or the British Virgin Islands because they need to circumvent China's regulations of certain "sensitive" industries such as internet services, and probably should not be allowed to go public in the United States in the first place.[96] The reverse merger process is an alluring alternative to these companies as it offers an opportunity to avoid the due diligence of a traditional IPO. More importantly, corporate governance and securities regulations are still nascent in China—investment in certain Chinese companies is therefore inherently riskier. Unlike the United States, China came to realize the importance of securities regulation only in the 1990s. The Chinese equivalent to the SEC, the China Securities Regulatory Commission ("CSRC"), was formed in 1992, and China's Securities Law became effective in 1999. At least in the field of securities regulation, China still has a lot of catching up to do. Most companies in China, especially smaller enterprises, are not sophisticated players in the market—they often dispense with business formalities, have primitive corporate governance structures, and conduct businesses based on instincts without much due diligence. These companies, because of their corporate governance structure and business conduct, can pose serious risks to U.S. investors.

B. *The Benefits of Cross-Listing*

Chinese companies also conduct reverse mergers in the United States to take advantage of the potential benefits of cross-listing. Cross-listing refers to the practice of companies listing their shares on multiple stock exchanges simultane-

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94. *Id.*

95. Qingxiu Bu, *The Chinese Reverse Merger Companies (RMCs) Reassessed: Promising but Challenging*, 12 J. INT'L BUS. & L. 17, 19 (2013).

96. *Id.*

ously. Some foreign companies go public in the United States even though they are already listed on domestic stock exchanges in their home countries. Several theories have been advanced regarding the financial motivations behind this kind of cross-listing. From the investor's perspective, cross-listing allows investors to diversify their investment internationally, so that they are only exposed to global systematic risk.[97] Cross-listing also overcomes informational and regulatory barriers and allows investors access to foreign stocks at a lower transaction cost.[98] From the point of view of cross-listed companies, cross-listing promises increased stock liquidity and an enlarged shareholder base.[99] One benefit of cross-listing is especially relevant for reverse merger companies: being listed in a foreign market can increase the company's visibility and creditability in its domestic market. The "bonding hypothesis" proposed by Jack Coffee states that when a company chooses to cross-list in a jurisdiction with more stringent disclosure requirements such as the United States, the company voluntarily submits itself to a more rigorous set of regulations, thereby boosting both domestic and foreign investors' confidence in the company.[100]

The bonding hypothesis has been used to explain Chinese companies' decision to cross-list in China and in the United States, but in practice, "bonding" seems more of a signal that Chinese companies want to send to investors rather than something they want to undertake. Even without the status of being public in the United States, Chinese companies can choose to conform to higher disclosure standards voluntarily if they are truly committed to transparency.[101] Chinese cross-listed companies, however, do not believe that they are really subject to U.S. regulations and even openly declare the ineffectiveness of U.S. legal actions against them in their pro-

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97. Amir N. Licht, *Legal Plug-Ins: Cultural Distance, Cross-Listing, and Corporate Governance Reform*, 22 BERKELEY J. INT'L L. 195 (2004).

98. *Id.* at 201.

99. *Id.* at 201–02.

100. *Id.* at 203.

101. Donald C. Clarke, *The Bonding Effect in Cross-Listed Chinese Companies: Is it Real?* (George Washington Univ. Law Sch. Pub. Law, Working Paper No. 2015-55, 2015), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2710717.

spectus statements.[102] This distorted use of the bonding hypothesis shows the additional incentives some Chinese companies have to become public in the United States through reverse mergers. Because of the relaxed disclosure requirements for reverse merger transactions and deficient regulations of foreign auditing, such companies may use altered financial statements to gain access to the U.S. capital markets and raise money from U.S. investors. Domestically, they may claim the status of a publicly traded firm in the United States, thereby improving such companies' credibility in the eyes of domestic investors. Because of the informational barrier created by distance, language and culture, such companies' poor performance in the U.S. stock market or even legal actions against them in the United States often do not reach domestic investors. Even when such companies' stocks have nearly no value on U.S. stock exchanges, they may project an image of financial health and credibility to domestic investors.

China Changjiang Mining & New Energy Co. ("CHJI") is an example of how Chinese reverse merger companies make use of the bonding hypothesis to lure in domestic investors. It was one of six problematic Chinese reverse merger companies mentioned by the SEC 2011 investor bulletin. The SEC suspended trading in CHJI's stock in April 2011 because of concerns over the completeness and accuracy of information contained in the company's filings. Investigations into the company concluded in May 2013, after the company made satisfactory filings with the SEC. The stock of the company is now trading at the price of four cents per share on OTCBB. The company could not have received much in terms of pecuniary gains by going public, but it still proudly claims itself as a

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102. The F-1 statements of cross-listed Chinese firms contain similar statements such as:

> Substantially all of our operations are conducted in China, and substantially all of our assets are located in China. A majority of our directors and executive officers are nationals or residents of jurisdictions other than the United States and a substantial portion of their assets are located outside the United States. As a result, it may be difficult for a shareholder to effect service of process within the United States upon these persons, or to enforce against us or them judgments obtained in United States courts, including judgments predicated upon the civil liability provisions of the securities laws of the United States or any state in the United States.

Id. at 6–7.

publicly listed company in the United States on its website and is not in the slightest bit abashed about going public through a reverse merger—this fact is mentioned explicitly in the company's introduction.[103] Interestingly, none of this information is displayed on the English version of the company's website.[104] As shown by this example, going public in the U.S. is about more than just the money; it is also a show of strength aimed at boosting the company's status in its domestic market.

Not all cross-listed companies commit securities fraud; some are willing to jump through all the hoops of the reverse merger process just to claim the title of a publicly traded company in the United States. Some of them, however, might refuse to comply with regulations of public companies and might make falsified or inadequate filings with the SEC to remain public. These companies are unconcerned about their U.S. reputation because their main focus is on attracting domestic investors. It is thus foreseeable that they might flagrantly disregard the rules and regulations of the U.S. securities market, so long as they can keep their public status. This subset of companies thus requires special attention in the promulgation of new regulations.

C. *The Difficulty of Regulating Chinese Reverse Merger Companies*

While U.S. companies have committed reverse merger fraud, Chinese companies are primarily responsible. The pump-and-dump fraud scheme exploded around 2010. More than fifty U.S. listed Chinese companies were either delisted or halted from trading based on claims of fraud or other violations of U.S. securities laws in 2011 and 2012.[105] Class action lawsuits against Chinese companies accounted for nearly 10% of all securities class actions from 2010 to 2012, and there were thirty-one such class action lawsuits in 2012; prior to 2010, such lawsuits were non-existent.[106]

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103. CHINA CHANGJIANG MINING & NEW ENERGY CO., http://www.sxcjny.cn/CN/about.asp?id=2 (last visited Jan. 15, 2017).

104. CHINA CHANGJIANG MINING & NEW ENERGY CO., http://www.sxcjny.cn/EN/index.asp (last visited Sept. 28, 2018).

105. Francine Mckenna, *After China Fraud Boom, Nasdaq Steps up Scrutiny of Shady Listings*, MARKETWATCH (last visited June 20, 2016), http://www.marketwatch.com/story/after-china-fraud-boom-nasdaq-steps-up-scrutiny-of-shady-listings-2016-06-20.

106. *Id.*

As previously discussed, the current regulatory regime has failed to effectively prevent Chinese reverse merger frauds. Instead of choosing the NYSE or NASDAQ, which possess more stringent listing requirements for reverse merger companies, those who seek to perpetrate frauds now turn to less demanding securities exchanges. The discrepancy in accounting standards and the inability of U.S. authorities to supervise foreign auditing lead to substandard accounting practices and allow misleading and inaccurate financial statements to beguile investors. Jurisdictional limitations render shareholder class actions and SEC enforcement actions ineffective: those who commit reverse merger fraud in the United States often walk away with their ill-gotten profits, and the authorities are left with no means of recovery.

Because of the special regulatory difficulties posed by Chinese reverse merger frauds, future reverse merger regulations should adopt a more targeted approach. While they do not have to apply different standards to reverse merger companies based on the private companies' place of incorporation, regulators should focus on fixing the deficiencies of the current regulatory scheme that allows fraud to occur.

1. *Shell Promoters*

Going public in the United States can be complicated for Chinese companies: language barriers, geographical distance, time differences, and drastically different regulatory schemes all make the road to U.S. capital markets tortuous. This, combined with shell company owners' pressure to conduct a reverse merger for their shells, gives rise to the profession of shell company promoters. Various players during the reverse merger process may play the role of the promoter—they can be lawyers, bankers, auditors or just consultants who facilitate Chinese companies' access to the U.S. stock market. Touting the reverse merger process as only costing a fraction of that for an IPO—generally $100,000 to $400,000, the promoters often forget to mention a crucial caveat: the owners of the shell companies generally retain 10% to 20% of the shares of the post-merger company. As a result, the private company not only needs to pay the fees for the promoters, but also "pays" 10% to 20% of the shares in the now public company to the original

shell owners.[107] The promoters may also conveniently forget to explain to Chinese company owners that the reverse merger process is not a capital raising transaction by itself. Once the companies are publicly listed on OTCBB or NASDAQ, the promoters grab their money and disappear, leaving the private companies to shoulder the high cost of remaining public in the United States. Several hundred Chinese companies now listed on the OTCBB are "somewhere between 'on life support' and 'clinically dead,'" with almost no liquidity and shares trading at several cents.[108] For such companies, remaining public causes them more harm than good, and the decision to go public in the first place is probably a regrettable one.

Chinese companies that fall prey to shell promoters can seldom attract U.S. investment because it is relatively easy for investors to tell that these companies are not promising investment opportunities. It is the other form of Chinese reverse merger fraud that most harms U.S. investors—when the owners of the private companies collude with shell promoters to defraud American investors. When the companies become publicly listed, the promoters and the company insiders start to aggressively market the shares of their company. Once investors are lured in and the price of the shares driven up, the company insiders and the promoters dump their shares on the market, and bag a large amount of cash, leaving the investors with practically no recourse. The promoters and the corporate insiders are therefore equally culpable in committing fraud, but current enforcement actions seem to focus more on corporate insiders.

2. *Lack of Accounting Transparency*

Many scholars attribute the prevalence of Chinese reverse merger fraud to the subpar auditing practices of Chinese reverse merger companies. The Sarbanes–Oxley Act of 2002 created the Public Company Accounting Oversight Board ("PCAOB"), and requires publicly traded companies to use a PCAOB-registered auditor.[109] Such auditors are subject to the

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107. Peter Fuhrman, *Reverse Mergers — Knowledgeable Comment*, CHINA FIRST CAP. PRESS (July 13, 2010), http://www.chinafirstcapital.com/blog/2010/07/13/reverse-mergers-knowledgable-comment/.

108. Fuhrman, *supra* note 91.

109. 15 U.S.C. § 7211(a)–(c) (2002).

Board's oversight and must meet the standards for auditing, quality control, and ethics set by the Board.[110] Both American and foreign auditing firms can register with the PCAOB—about 900 foreign auditing firms have registered, among which fifty-three are located in China.[111] As Chinese reverse merger companies are publicly listed in the United States, they are subject to the Sarbanes–Oxley Act and must be audited by PCAOB-registered auditors. As of March 2010, U.S. auditing firms audited 74% of the Chinese reverse merger companies while Chinese registered auditing firms audited 24%.[112]

Several deficiencies exist within these firms' auditing practice. 94% of the auditing firms that audit reverse merger companies are small firms, which are subject to triennial instead of annual inspection by the PCAOB. As foreign auditing firms are forbidden to set up their own auditing offices in China, they are forced to operate through Chinese affiliates. These small firms, however, may lack the resources to hire affiliates in China or conduct adequate overseas audits. As a result, they may choose to outsource the audit to unreliable Chinese auditing firms. They then either base their reports on the work produced by local auditors, or they may simply sign off on the work without verifying the documents' accuracy.[113] In addition to outsourcing, the PCAOB identifies another way for a U.S. auditing firm to conduct an audit of a Chinese company: hiring consultants. The consultants are authorized by the U.S. firm to plan the audit, travel to China, and communicate with the issuer. A substantial portion of the audit report is completed by the consultants, while the employees of the U.S. firm are not involved throughout the auditing process—they simply sign off on the audits produced by outside consultants.[114]

The PCAOB is well aware of these problems in the audits of corporations that have substantial operations overseas, and accordingly developed two regulatory regimes to discipline the practice of outsourcing and consultant-hiring. One way is by treating the U.S. auditor as the "principal auditor," who is per-

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110. *Id.* § 7212(b)(3).

111. Schawang, *supra* note 10, at 232–33.

112. PCAOB ACTIVITY SUMMARY, *supra* note 56, at 1.

113. Bu, *supra* note 95, at 25.

114. Katherine T. Zuber, Note, *Breaking Down a Great Wall: Chinese Reverse Mergers and Regulatory Efforts to Increase Accounting Transparency*, 102 GEO. L.J. 1307, 1323 (2014).

mitted to use "the work and reports of other auditors who have audited the financial statements of one or more subsidiaries, divisions, branches, components, or investments included in the financial statements presented."[115] To qualify as a "principal auditor," the firm must ensure that its participation in the audit is "sufficient." Specifically, if the issuer is a corporation whose operation is substantially based outside of the United States, the PCAOB suggests that the principal auditing firm must play a significant role in the audit to achieve "sufficient" participation. In determining whether the U.S. auditor meets the standard for "sufficient participation," the auditor must consider factors such as "the materiality of the portion of the financial statements he has audited in comparison with the portion audited by other auditors, the extent of his knowledge of the overall financial statements, and the importance of the components he audited in relation to the enterprise as a whole."[116] If the U.S. auditor qualifies as the principal auditor, it then becomes the U.S. auditor's responsibility to ensure that the other auditors are familiar with and comply with U.S. accounting standards.[117] Another way to structure the auditing of foreign corporations is for the U.S. auditor to hire outside "assistants" to perform the audits. The assistants are generally local auditing firms. The U.S. firm is responsible for reviewing the work of its assistants in the same way that it would review the work of its employees.[118] The U.S. firm must also plan the audit and ensure the auditing process' compliance with the PCAOB standards.

While they do offer some guidelines to auditing firms about the optimal arrangements for auditing foreign companies, there remain practical difficulties for the PCAOB to effectively supervise these auditing firms. China is one of the few countries that does not allow the PCAOB to inspect audit firms' work related to U.S.-listed issuers whose operations are largely based overseas. While the PCAOB can inspect the audits performed by U.S. auditing firms, it lacks access to the work of Chinese auditing firms, which, as mentioned above,

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115. *Id.* at 1322.

116. *AU Section 543: Part of Audit Performed by Other Independent Auditors*, PUB. CO. ACCOUNTING OVERSIGHT BD., https://pcaobus.org/Standards/Auditing/Pages/AU543.aspx (last visited Oct. 8, 2018).

117. *Id.*

118. *Id.*

are frequently employed by U.S. auditors to audit Chinese corporations. Claiming that supervision of local auditing firms by the PCAOB would breach its sovereignty and violate the State Secrets Law, China has denied the PCAOB access to local firms' auditing information.[119] So far, the PCAOB's attempts to negotiate with Chinese authorities have not had much success. In 2012, the PCAOB and Chinese regulators reached tentative agreement on "observational visits" during which "PCAOB inspectors would observe the Chinese authorities conducting their own audit oversight activities and the Chinese could observe the PCAOB at work."[120] Even after engaging in this "trust-building exercise," the PCAOB still has not gained full access to the audits of Chinese companies.[121] While there have been some positive signals recently,[122] it is clear that China's reluctance to disclose information will continue to hinder the PCAOB's efforts to supervise the auditing of Chinese reverse merger firms. The lack of supervision, in turn, allows fraudulent accounting practices to persist.

3. *Ineffectiveness of Shareholder Class Actions and SEC Enforcement Actions*

The lack of transparency in accounting allows Chinese reverse merger companies to offer misleading financial statements and carry out fraud with ease. Even when their plots are discovered by investors or the SEC, because of the difficulty of bringing actions and enforcing judgments against Chinese reverse merger companies, the fraudsters often get away with their wrongdoing. Without any fear of punishment, Chinese

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119. Bu, *supra* note 95, at 31.

120. Lewis H. Ferguson, Pub. Co. Accounting Oversight Bd., Investor Protection through Audit Oversight, Address at the California State University 11th Annual SEC Financial Reporting Conference (Sept. 21, 2012).

121. The PCAOB and China were close to reaching an agreement in 2015, but it fell through because the Chinese have narrowed the terms of examination "so significantly that it wasn't worth proceeding." Dave Michaels, *U.S. Investors Have Another Reason to Fret Over China Firms*, BLOOMBERG (Nov. 3, 2015), https://www.bloomberg.com/news/articles/2015-11-03/u-s-investors-have-one-more-reason-to-fret-about-chinese-firms.

122. *See* Heather Jimaa, *PCAOB might finally have a look at USA listed Chinese companies' audits*, INT'L ACCT. BULL. (Aug. 9, 2016), http://www.internationalaccountingbulletin.com/news/pcaob-might-finally-have-a-look-at-usa-listed-chinese-companies-audits-4974837/.

reverse merger companies have nothing to lose by engaging in fraud.

While a number of shareholder class actions have been filed against Chinese reverse merger corporations since 2010, many hurdles stand in the plaintiff's way of winning. For instance, in the initial stage of litigation, plaintiffs may face difficulties locating and serving the defendant because of the geographical distance and language barrier between the two countries. Even if the plaintiff successfully serves the defendant, the plaintiff's suit may not survive a motion to dismiss because of the stringent pleading standard. The Private Securities Litigation Reform Act of 1995 ("PSLRA") and Federal Rules of Civil Procedure 9(b) require the plaintiff to plead with particularity "the facts and circumstances that constituted fraud in a particular case."[123] Chinese authorities' reluctance to facilitate information exchange, combined with the practical difficulty of carrying out investigations in a foreign country, makes it difficult for the plaintiff to gather sufficient information to meet the pleading standard. Assuming that the plaintiff manages to win a verdict against the defendant, it is very unlikely that they can recover damages because the assets of the reverse merger companies are in China and the judgment might not be enforceable there.[124] The PRC Civil Procedure Law imposes stringent requirements for the enforcement of foreign judgments, and such requirements had never been met until 2017 when a Wuhan court first decided to enforce the judgment of a U.S. court in China.[125] It remains to be seen whether the Wuhan ruling is an isolated incident or signals Chinese courts' willingness to enforce U.S. judgments. Given these hurdles, U.S. investors are left without one of their most powerful protection mechanisms, shareholder class actions, and U.S. investors are placed in a very disadvantageous position when defrauded by Chinese reverse merger companies.

Unfortunately, the SEC cannot help these defrauded U.S. investors. While it has the authority to deregister or delist companies that have committed fraud, the SEC's enforcement ac-

123. Zuber, *supra* note 114, at 1312.

124. *Id.* at 1313.

125. Suni Gong, *The Chinese Court's Enforcement of a U.S. Civil Judgment*, TRANSNATIONAL NOTES (Apr. 17, 2018), https://blogs.law.nyu.edu/transnational/2018/04/the-chinese-courts-enforcement-of-a-u-s-civil-judgement/.

tions frequently face the same difficulties as shareholder class actions. The Chinese government has been unwilling to cooperate with the SEC in its enforcement actions against Chinese issuers, and consequently, the SEC often lacks enough information to go after Chinese reverse merger companies, thereby leaving the investors even more vulnerable to the threat of fraud from Chinese reverse merger companies.[126]

V. RECOMMENDATIONS FOR REGULATING THE REVERSE MERGER PROCESS

Despite increasingly stringent regulations and heightened investor awareness, reverse merger fraud continues to happen in the United States, causing U.S. investors millions of dollars in losses. Previous SEC regulations focused on imposing increasingly stringent disclosure requirements on reverse merger transactions, but this approach, if continued, might hinder legitimate transactions and eliminate the very benefits of reverse mergers. Moreover, for reverse merger companies that are bent on improving their credibility with domestic investors, such regulations can hardly stop them from accessing the U.S. stock market. The ideal regulatory approach therefore must ensure protection for investors without decreasing the viability of reverse merger transactions for legitimate companies. The SEC can use its regulatory tools to improve investors' ability to distinguish good reverse merger companies from illegitimate ones, and to ensure adequate compensation to investors if fraud occurs. A more balanced regulatory approach would aim to preserve reverse mergers as an option for companies with limited means to go public, while at the same time prevent reverse merger frauds from damaging the interests of U.S. investors.

A. *Increasing Accounting Transparency*

As most reverse merger frauds are carried out by filing inaccurate and misleading financial statements, one focus of any reverse merger regulation should be on the auditing practices regarding foreign corporations publicly listed in the United States. The PCAOB should certainly continue its effort

126. Zuber, *supra* note 114, at 1315.

to promote cooperation with the Chinese regulators and try to gain access to the auditing documents of U.S.-listed Chinese companies for better supervision of such companies' auditing. This approach does have one critical drawback, though—it depends too much upon the Chinese government. If experience can be of any guidance, the Chinese have been very hesitant to open up local auditing procedures and documents to U.S. regulators. Therefore, the PCAOB must devise other ways of increasing accounting transparency while actively pursuing cooperation with the Chinese authorities.

One method to increase accounting transparency would be to require reverse merger companies to disclose in detail their auditing arrangements in their financial statements. Neither of the two permissible auditing arrangements between U.S. and local auditors mentioned in Section IV requires disclosure about the distribution of work between local and U.S. auditors. For auditing firms that can qualify as principal auditors, they are allowed to use the work of other auditors without making specific reference to local auditors in their reports; the PCAOB even counsels against such disclosure because stating in the report that part of the audit was made by another auditor "may cause a reader to misinterpret the degree of responsibility being assumed."[127] For auditors that hire local assistants, there similarly does not exist any requirements for them to disclose the use of local auditing firms.

As the SEC encourages investors to do more research about issuers, the PCAOB's current approach seems to work against informed investor decisions. Requiring issuers to disclose their accounting arrangements can put investors on alert if most of the work is done by a foreign auditor, thereby prompting investors to investigate further and inquire about the issuer. Mandatory disclosure can also discipline auditing firms. If some auditing firms are discovered by investors to frequently outsource their work to foreign auditors without proper supervision and sufficient involvement, it is conceivable that such auditing firms' reputation will suffer. For fear of damage to their reputation, these auditing firms will be motivated to shoulder more responsibility in the auditing process by verifying the reports of the local auditors and ensuring the accuracy of the financial statements. A clear delineation of re-

127. *Id.* at 1322.

sponsibility in the issuer's financial disclosure thus can both provide more information to investors and effect change in auditing practice.

B. *Targeting Reverse Merger Promoters in Enforcement Actions*

As discussed in Section IV, many procedural hurdles exist in bringing shareholder class actions and SEC enforcement actions against Chinese reverse merger companies. This uncertainty increases the risk in bringing action against such companies; the difficulty of recovering damages, moreover, often makes pursuing actions against reverse merger companies pointless. To eliminate the procedural hurdles once again requires cooperation from the Chinese government, and necessarily implicates more than the securities regulation agencies of the two countries—the impact of allowing foreign investigations to proceed in China and recognizing foreign judgments will have repercussions in other areas that the Chinese government probably does not want. To ensure that shareholder class actions and SEC enforcement actions remain effective in protecting the general public's interest, there must be a change of strategy.

The procedural hurdles exist because the reverse merger companies are based in China, with their assets and documents out of the reach of investigators. There will not be any such hurdles if the actions target domestic entities. The shareholders and the SEC should therefore choose to bring actions against U.S. promoters who lure Chinese company owners into the reverse merger process, and serve as accomplices or masterminds in the frauds. Compared with reverse merger company owners, these promoters are generally based in the United States, making it easier to locate and serve them. Their documents are more easily accessible during the discovery process. With their assets largely on U.S. soil, the likelihood of recovering damages will be greater as well.

The success of several actions against U.S.-based promoters proves that this method is a viable way to punish promoters of fraudulent reverse mergers and to restore some loss to the investors.[128] Certainly not all of the promoters of reverse

128. *Id.* at 1315. *See also* Alexandra Stevenson, *Adviser on Chinese Reverse Mergers is Charged in a Securities Fraud Case*, DEALBOOK (Sept. 10, 2015), https://www.nytimes.com/2015/09/11/business/dealbook/adviser-on-chi-

merger companies are based in the U.S., and many Chinese nationals engage in peddling shell companies to local corporations, but considering the practical difficulty of prevailing in actions against Chinese entities, focusing shareholder actions and SEC enforcement efforts on U.S. promoters is definitely a more effective route.

C. *Educating Investors, and Maybe Even the Chinese Authorities*

Rule promulgations and legal actions are two of the most important tools to combat reverse merger fraud, but the SEC can also use certain "soft" tools to influence the reverse merger markets and prevent fraud.

Investor education is one such "soft" tool. The Investor Bulletin published by the SEC in 2011 alerted investors to the potential risks of fraud when investing in reverse merger companies. The SEC instructs investors to research and evaluate reverse merger companies' financial situation before making any investment decision.[129] This general instruction, however, is not likely to offer much guidance for unsophisticated investors. To truly empower investors, the SEC should offer more detailed instructions to spot high-risk factors from the companies' financial statements. Investors also need to be educated on how companies and shell promoters perpetrate reverse merger fraud, so that if they are confronted with the aggressive marketing of a company's shares, they will critically evaluate these materials. Moreover, investors should be made aware of the possibility that companies' financial statements might not be prepared by reputable U.S. auditing firms, but by their local affiliates or assistants, whose work probably does not receive enough scrutiny to ensure its accuracy. With sufficient education, investors will not fall easily into the trap of reverse merger fraud. If the fraud scheme loses its profitability, it might even die out on its own. Investor education can also improve investors' ability to tell legitimate Chinese reverse merger companies from the fraudulent ones. By signaling to investors that some Chinese reverse merger companies have

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nese-reverse-mergers-charged-with-fraud.html. Note, however, that there are cases where shell promoters have less assets than the actual company. In this scenario, going after shell promoters might not be an effective way to compensate shareholders, but it nevertheless might have a deterrence effect.

129. INVESTOR.GOV, *supra* note 15.

high growth potential and make good investment choices, the SEC can limit the spillover effect of Chinese reverse merger frauds and ensure that good Chinese companies are not discouraged by investor hostility, thereby offering more investment opportunities to U.S. investors.

A more ambitious use of such "soft" tools would be to communicate more with Chinese regulators and persuade China to cooperate with U.S. regulators in audit inspections and law enforcement. Reverse mergers are essentially regulated by U.S. laws, but because charges of fraud against Chinese companies damage the reputation of all Chinese companies, legitimate and illegitimate alike, China also has a stake in stopping Chinese companies from committing fraud in the United States. Even legitimate, large companies like Alibaba are being questioned by investors in the United States because of their governance structures and opaque accounting methods.[130] While it is not likely that China will start cooperating with U.S. regulators overnight, progress can be made in many areas that will benefit both sides.

CONCLUSION

There is nothing inherently problematic with reverse mergers as a form of transaction—used by legitimate companies, they offer quicker and cheaper access to much needed capital. While they cannot raise as much money as a traditional IPO, they suit the needs of those companies which for various reasons cannot pursue an IPO. Going public through a reverse merger also does not influence a company's subsequent performance. Currently, reverse merger companies are outperforming firms comparable in size, industry, and exchange that went public through an IPO. Chinese reverse merger companies, which have been plagued with fraud, have turned out to deliver strong financial and operational performance.

130. *See* James Covert, *"High-up" Alibaba Staffer Helping SEC Probe into Tech Giant*, N.Y. POST (Nov. 1, 2016), https://nypost.com/2016/11/01/high-up-alibaba-staffer-helping-sec-probe-into-tech-giant/. *See also SEC Probes Alibaba Accounting Methods, Shares Dive*, REUTERS (May 25, 2016, 9:23 AM), https://www.reuters.com/article/us-alibaba-accounts-sec-idUSKCN0YG1U0; Jim Collins, *Alibaba Accounting Practices Probe Illustrates Major Risk of Owning Chinese Stocks*, FORBES (May 26, 2016, 10:00 AM), https://www.forbes.com/sites/greatspeculations/2016/05/26/alibaba-accounting-practices-probe-illustrates-major-risk-of-owning-chinese-stocks/#25724f1d263c.

Tech start-ups are also showing a strong preference for reverse mergers, and these companies usually have high growth potential and often offer attractive investment opportunities.

Reverse merger transactions should therefore be allowed to proceed, not only because it is infeasible to completely ban the acquisition of a private company by a public company, but also because the cost of such a ban will very likely outweigh its benefit. This, however, does not mean that U.S. regulatory authorities should leave the current regulatory scheme unchanged. Chinese reverse merger fraud remains a serious concern despite several attempts by the SEC to regulate reverse mergers. Fraud not only hurts U.S. investors, but also damages the credibility of legitimate Chinese reverse merger companies, and leads to a hostile attitude towards publicly traded Chinese companies in general. The spillover effect, in the end, can deprive U.S. investors of valuable investment opportunities because legitimate Chinese companies might be reluctant to enter the U.S. stock market given the presumption against them based on nationality.

To protect U.S. investors and ensure meaningful access to foreign stocks on U.S. exchanges, U.S. authorities must fix the deficiencies of the current reverse merger regulatory scheme, while ensuring the viability of reverse merger transactions for legitimate companies. One potential way to proceed is to place more emphasis on investor protection—equipping investors with tools to guard against fraud and devising ways to make them whole should they fall victim to fraud. Increasing accounting transparency is also crucial given that most reverse merger fraud is committed through misleading or inaccurate auditing statements. Since shareholder class actions and SEC enforcement actions are often ineffective in deterring Chinese reverse merger fraud because of jurisdictional limitations, it might be useful to impose liability on shell company promoters who have assets within the United States that can be attached to compensate U.S. investors. Devoting more resources to investor education and seeking the Chinese government's cooperation may also complement formal regulations and reduce incidents of reverse merger frauds.