Reversing the Tide: A Targeted Approach to the Regulation of Chinese Reverse Mergers in the United States

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I. INTRODUCTION

With the unprecedented growth of the Chinese economy, an increasing number of Chinese companies have sought to access the American capital markets. In recent years, many Chinese companies have done so by employing transactions known as reverse mergers. The term Chinese Reverse Merger (CRM), as used in this Note, involves a privately held Chinese operating company utilizing a suitable shell company, or kegongsi, as a vehicle for trading its shares in the United States. These transactions have garnered a significant amount of public scrutiny due to numerous instances of fraud, accounting deficiencies, and other nefarious activities.2


While reverse mergers have become an increasingly popular means of becoming publicly traded in the United States over the last couple of decades, the trend is particularly marked among Chinese companies. Indeed, from January 2007 to March 2010, the number of reverse merger transactions in the United States involving Chinese companies was significantly greater than the number of initial public offerings (IPOs) completed by companies from China. Not only do CRMs seem to be the preferred mode for Chinese companies to become publicly traded in the United States, but also they comprise a substantial proportion of the overall number of reverse mergers. From January 2007 to March 2010, there have been 159 CRMs in the United States, representing 26% of the total number of reverse mergers during that period. The aggregate market capitalization of CRM companies is another way of illustrating the significant impact these companies have had on the American securities markets. According to the Public Company Accounting Oversight Board (PCAOB), the total market capitalization for 135 CRM companies was $12.8 billion as of March 2010. Although Chinese companies also comprise a large proportion of the total number of IPOs in the United States, the frequency of CRM transactions and significant total market capitalization of CRM companies make CRMs too substantial to ignore.

To be sure, there are reasons to be cautious about Chinese companies becoming publicly traded in the United States through reverse mergers, and to a certain extent, the recent fears expressed by commentators, scholars, and regulators are warranted. Fraudulent practices among Chinese companies have the potential to undermine the integrity of U.S. capital markets, thereby harming investors and challenging the efforts of American regulators. Securities regulations in the United States should therefore take...
into account the potential hazards to investors involved in CRM transactions. However, U.S. regulators must also be wary of enacting regulations that overly burden or impede foreign companies that seek to enter American financial markets.

This Note maintains that the current regulatory trend aimed at reverse mergers, and CRMs in particular, is not the ideal approach to curb fraud among CRM companies. CRMs are not inherently problematic, and regulations that unduly burden reverse merger transactions in the United States may have a chilling effect on American capital markets. More efficient laws would involve a continued push towards cooperation with Chinese authorities. This collaboration should allow the PCAOB to play a more prominent role in inspecting Chinese audits and provide the U.S. Securities and Exchange Commission (SEC) with the ability to require the disclosure of filings with Chinese regulators. These measures would target the primary means by which CRM companies engage in fraud—namely, misrepresenting their financial health and taking advantage of the lack of cooperation between China and the United States to provide Chinese and U.S. regulators with drastically different filings.

Part II of this Note begins with a background of what reverse mergers are and how they work, since a basic understanding of reverse mergers is necessary to place the CRM phenomenon into context. Part II also provides an overview of some of the benefits and potential risks associated with these transactions. Part III discusses the trend in CRM activity and analyzes why Chinese companies seek to access American capital markets using reverse merger transactions. Part IV follows with a discussion of the controversy stemming from this trend in CRM activity, and reviews how numerous instances of fraud and accounting deficiencies have resulted in widespread suspicion of CRMs. Part V proceeds with an analysis of how American regulators tackle misconduct among CRM companies in the United States. It also provides an overview of the current regulatory framework, as well as recent responses to concerns about CRMs such as more stringent listing criteria. Part VI outlines both sides of the debate over reverse merger regulation by presenting the dangers of over-regulation as well as the costs of under-regulation. These costs and benefits form the basis for an understanding of why targeted, efficient regulation is the ideal approach. Part VII provides specific prescriptions for a more targeted approach to regulating CRM transactions. It argues that the United States must engage more with Chinese authorities to enable U.S. regulators to undertake audit inspections and strengthen the PCAOB’s ability to access Chinese corporate filings. In addition, the SEC should require Chinese corporations to include filings with Chinese regulators in their SEC disclosures. This targeted approach will provide sufficient protection for investors while avoiding undue chilling effects on the market.

II. OVERVIEW OF REVERSE MERGERS

In order to fully understand the impact of CRMs and the appropriate regulatory treatment of these transactions, it is critical to gain a basic understanding of what reverse mergers are and how they operate. One must also appreciate the various reasons why companies choose to engage
in reverse mergers as a means of accessing capital markets, including the associated risks and benefits.

A. What is a Reverse Merger?

A reverse merger is a method of going public in which a private company arranges for its stock to be publicly traded following a merger with a publicly held “shell” company, rather than hire an investment bank to serve as an underwriter to market and distribute shares in an IPO. After the private operating company finds a suitable shell company, it merges into it and the shell company issues the operating company shareholders a majority stake in the shell company. After the merger is completed, the shell company holds the assets and liabilities of the operating company and is controlled by the former shareholders of the operating company. The shell company then replaces its directors and officers with those of the operating company, changes its name to that of the operating company, and leaves its shares to be publicly traded on whichever market they were trading on before the merger. Thus, unlike an IPO, a reverse merger does not involve the issuance of new securities to the public or the registration of a sale of securities to the public. Instead, the public shell company transfers shares to the private entity. The transaction is essentially a trade where the merging company swaps its private ownership interests for the shell’s public securities. Ultimately, the new owners of the acquired shell company can sell the newly issued shares over time, thereby increasing the number of outstanding public shares (also known as the public “float”).

1. The Basics of Shell Companies

A public shell company is a company that has securities registered under the Securities Exchange Act of 1934 (Exchange Act) but, pursuant to Exchange Act Rule 12b-2, has no operations or nominal operations, and either (1) no or nominal assets, (2) assets consisting solely of cash and cash equivalents, or (3) assets consisting of any amount of cash and cash equivalents.

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10 Id.; see also Feldman, supra note 3, at 35 (observing that the private operating company’s shareholders “generally receive between 65% and 95% of the public shell’s stock”); Aden R. Pavkov, Ghouls and Godsends? A Critique of “Reverse Merger” Policy, 3 BERKELEY BUS. L.J. 475, 478 (2006).
11 See Sjostrom, supra note 9, at 743.
12 Id.
13 Pavkov, supra note 10, at 481.
14 Id. at 478; see also Sjostrom, supra note 9, at 743; Feldman, supra note 3, at 35.
15 Pavkov, supra note 10, at 481.
16 Id. at 478. The term “public float” refers to the number of outstanding shares in the hands of public investors, as opposed to company insiders. See, e.g., Regina F. Burch, Financial Regulatory Reform Post-Financial Crisis: Unintended Consequences for Small Business, 115 PENN ST. L. REV. 409, 412 n.10 (2010) (defining “public float” as “the aggregate market value of the issuer’s outstanding voting and non-voting common equity held by non-affiliates”).
17 Unlike the Securities Act of 1933, the Exchange Act primarily regulates securities traded in the secondary market and requires that a company register with the SEC under certain conditions.
equivalents and nominal other assets. There are two reasons why a public shell company exists in the first place. Either it was a publicly held operating company that for some reason ceased operations and liquidated its assets, or, alternatively, it was never an operating company and was instead formed by another entity for the express purpose of creating a public shell to affect a transaction.

A shell company’s stock may or may not trade publicly, but in instances where the shell was a former operating company, its stock is already publicly traded since it registered its stock through the IPO process before ceasing operations. Although the shell might have previously been listed on national exchanges such as NASDAQ, it is unable to meet the exchange’s listing requirements since it no longer has any meaningful business operations. Thus, although the shell company’s stock remains publicly traded (albeit infrequently), its shares are typically traded on the over-the-counter (OTC) Bulletin Board or Pink Sheets, a centralized electronic quotation service for over-the-counter stocks available on the Internet. Since the surviving entity may not be able to accomplish its goals while remaining on the OTC market or the Pink Sheets, it may undertake steps to return the company to a national exchange.

2. Reverse Merger Structures and Factors Affecting Valuation

Generally, a direct merger between a private Chinese company and a public shell requires shareholder approval by the shareholders of both companies. Obtaining shareholder approval, however, implicates transaction costs in the form of the preparation and delivery of proxy statements as well as SEC review. In order to sidestep the costs associated with obtaining shareholder approval for direct mergers, a Chinese company will often structure its reverse merger as a reverse

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19 Sjostrom, supra note 9, at 744. Technically, shell companies formed for the express purpose of engaging in a merger are referred to as “blank check companies,” while shells resulting from a liquidated operating public company are called “public shells.” However, under industry standards both public shells and blank check companies are referred to as shells or public shells. Feldman, supra note 3, at 35.
20 See Sjostrom, supra note 9, at 744.
21 Id.; see also Pavkov, supra note 10, at 511. Shells that trade on the Pink Sheets are deemed less valuable than those that trade on the OTC Bulletin Board. See Types of Public Shells, PUBLICSHELL.COM, http://www.publicshell.com/shells.html (last visited Jan. 15, 2013) (noting that shells trading on the Pink Sheets range in price from $150,000 to $250,000, while shells trading on the OTC Bulletin Board sell for between $350,000 to over $600,000); Feldman, supra note 3, at 35 (“Shells that trade on the Over the Counter (“OTC”) Bulletin Board are more valuable than those trading on the Pink Sheets.”).
22 If the company was public only because it had a public offering, then the surviving entity files a Form 10 or Form 10-SB under the Exchange Act. See 15 U.S.C. § 78(12)(b) (2012); see also SIMON M. LORNE & JOY MARLENE BRYAN, ACQUISITIONS AND Mergers: NEGOTIATED AND CONTESTED TRANSACTIONS § 3:11.10 (Vol. 11 2013).
23 See Feldman, supra note 3, at 35.
triangular merger.26 In a reverse triangular merger, a public shell company forms a new, wholly-owned subsidiary that merges into the private operating company.27 Shares of the private company are then converted into shares of the public shell company.28 As a result, the private company becomes a wholly-owned subsidiary of the shell company, and the shareholders of the formerly private Chinese company now own a majority of the outstanding shares of the shell.29

Structuring a transaction as a reverse triangular merger may get around the requirement of obtaining shareholder approval from the shell company’s shareholders because the shell company is the sole shareholder of the subsidiary, and its vote is therefore the only vote needed.30 However, companies must also comply with the regulations of the exchanges on which they are listed, which may have more stringent shareholder voting requirements than the applicable state code. Indeed, many national stock exchanges require shareholder approval for an issuance of shares constituting more than twenty percent of the issuer’s outstanding shares.31 In addition to the potential to sidestep cumbersome voting requirements, an added benefit of a reverse triangular merger is the reduction in transaction costs associated with housekeeping matters after the merger. Since the private company survives the transaction, it does not have to change bank accounts, real estate titles, employee identification numbers, or make other similar arrangements.

Thus, a Chinese company seeking to undertake a reverse merger in the United States must make the strategic choice of determining the most

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26 See Sjostrom, supra note 9, at 746; Feldman, supra note 3, at 35–36.
28 See Sjostrom, supra note 9, at 746. When a private Chinese operating company receives shares in the shell company, the shell must comply with the applicable securities laws. The shell company’s issuance of shares to the Chinese entity is considered an offer and sale of securities and therefore must comply with the Securities Act of 1933. See Securities Exchange Act of 1933, 48 Stat. 74 (codified at 15 U.S.C. § 77a et seq. (2012)) (regulations at 17 C.F.R. § 230.145 (2013)) (“[A]n offer, offer to sell, offer for sale, or sale occurs when there is submitted to security holders a plan or agreement pursuant to which such holders are required to elect, on the basis of what is in substance a new investment decision, whether to accept a new or different security in exchange for their existing security.”). However, the shell company may rely on the exemption from registration provided in Rule 506 of Regulation D under the Securities Act. This merely requires the shell company to circulate a private placement memorandum to the Chinese company and file a Form D with the SEC. 17 C.F.R. § 230.506(b) (2013); Form D, U.S. SEC. & EXCH. COMM’N, available at http://www.sec.gov/about/forms/formd.pdf. In fact, if all of the shareholders of the Chinese company are “accredited investors,” the shell company need not even prepare the private placement memorandum. 17 C.F.R. § 230.502(b)(1) (2013) (“The issuer is not required to furnish the specified information to purchasers when it sells securities under § 230.504, or to any accredited investor.”).
29 See Feldman, supra note 3, at 36.
30 See Sjostrom, supra note 9, at 746; see also DEL. CODE ANN. tit. 8, § 251 (West 2011) (under Delaware corporate law, only shareholder approval from the shareholders of the constituent entities is required).
appropriate merger structure. Yet, the Chinese company must also make other tactical choices when choosing a shell. In particular, it must consider the various factors that tend to affect the valuation of the public shell’s stock that the Chinese company’s shareholders receive in consideration.

A Chinese company will consider at least four factors that typically affect this valuation. First, the “cleanliness” of the shell can have an impact on valuation, which depends primarily on how recently an operating business existed before it became a shell (assuming the Chinese company did not create the shell for the sole purpose of the merger). A second factor is the valuation of the private company merging into the shell, since “[a] start-up will retain less of the merged company than a sales-generating company with $1 million in earnings.” A third factor is the extent to which cash exists in the shell, since this inherently increases the shell’s value. Finally, the competence of the shell’s management will affect the valuation of its stock, since the value of the shell will be perceived as higher if those managing it are reputable.

Thus, in a CRM transaction, a Chinese company must strategically choose both the structure of the merger and the appropriate shell company.

B. Risks and Opportunities of Reverse Mergers Generally

In addition to the tactical decisions a Chinese company must make in undertaking a reverse merger, it also faces various risks and opportunities inherent in reverse merger transactions.

1. Risks of Reverse Mergers

One important risk that CRM companies face is associated with a lack of liquidity after the merger. Indeed, the shares of a private company that become publicly traded through a reverse merger might be more thinly traded compared to a company undertaking an IPO. This is because shares of the shell company are initially traded on the OTC Bulletin Board or Pink Sheets, where shares are more thinly traded as compared to those on national exchanges. Another risk that CRM companies encounter is that,
although reverse mergers are often pitched as a cheaper and more expedient alternative to IPOs, some evidence suggests that overall they may not be less costly. Moreover, comparing reverse mergers and IPOs is misleading.

Unlike an IPO, in which a privately held corporation hires an underwriter to manage the sale of newly issued stock to the public, the purpose of a reverse merger is not to raise capital, and the shares of the post-transaction operating company are thinly traded and relatively illiquid. Thus, a Chinese company seeking to access the public securities markets through a reverse merger may face higher transaction costs than it anticipated and difficulties with the liquidity of its shares.

Another concern associated with CRMs deals with the stigma associated with these transactions because of “signaling effects” that arise from the perception that lower quality companies undertake reverse mergers as opposed to IPOs. This distrust is particularly strong for CRMs. Since becoming publicly traded through a reverse merger signals to the market that a company may not be of sufficient quality to engage in an IPO, there may be apprehension about investing in that company, thus driving down its share price.

In contrast to an IPO, a reverse merger enables a company to become publicly traded without the support of an underwriter. A component of the negative “signaling effect” of a reverse merger is the absence of an underwriter to vouch for the quality of the company. The use of underwriters in an IPO sends a positive message to the market because the underwriter will not place its reputation at stake unless it has confidence in the company’s value and future performance. IPOs headed by reputable underwriters consistently command higher prices, higher net proceeds for the issuer, and overall better performance as compared to offerings underwritten by less reputable investment banks. Moreover, the risk of thinly traded).

39 See, e.g., Feldman, supra note 3, at 34 (noting that the reverse merger process is faster and cheaper than an IPO).
40 See generally Augusto Arellano-Ostoa & Sandro Brusco, Understanding Reverse Mergers: A First Approach 27 (Departamento de Economia de la Empresa, Universidad Carlos III de Madrid, Working Paper No. 02-17, 2002), available at http://docubib.uc3m.es/WORKINGPAPERS/WB/wb021711.pdf (finding evidence that the cost of a reverse merger that includes a seasoned equity offering is not cheaper than an IPO).
41 Sjostrom, supra note 9, at 748.
42 Id. at 748–49.
43 Id. at 749–50; see also Arellano-Ostoa & Brusco, supra note 40, at 17–18.
44 See infra Part IV.
45 See id. (discussing the “China discount” resulting from Chinese companies trading below their inherent value as a result of investor suspicions).
46 See Pavković, supra note 10, at 481; Sjostrom, supra note 9, at 750.
47 See Ronald J. Gilson & Reinier H. Kraakman, The Mechanisms of Market Efficiency, 70 VA. L. REV. 549, 620 (1984) (observing that an underwriter “represents to the market (to whom it, and not the issuer, sells the security) that it has evaluated the issuer’s product and good faith and that it is prepared to stake its reputation on the value of the innovation”).
48 Lily Hua Fang, Investment Bank Reputation and the Price and Quality of Underwriting Services, 60 J. Fin. 2729, 2729 (2005) (mentioning the “reputation capital” at stake for an underwriter).
49 Id. at 2730 (finding that reputable banks will seek to underwrite high quality issues and that quality underwriters obtain higher prices for issuers).
an issuer corresponds to the reputation of the underwriter.\textsuperscript{50} Since underwriters play a crucial role in the market’s confidence in a company’s financial health and future performance, a significant risk of reverse mergers is that they lack this important marker for investors to determine the company’s quality.\textsuperscript{51}

2. Benefits of Reverse Mergers

Despite the risks associated with reverse mergers, they typically benefit from lower costs and a reduced risk of withdrawal. A reverse merger is often completed at a fraction of the cost of an IPO, generally less than a million dollars, whereas an IPO ranges from millions to tens of millions of dollars.\textsuperscript{52} Although some scholars are skeptical that reverse mergers are really cheaper than IPOs in the long run,\textsuperscript{53} the relatively low cost of undertaking reverse mergers is a major benefit for companies seeking to create an active public market for their securities. Besides enabling companies to go public without an underwriter’s stamp of approval, the low cost of a reverse merger is likely a primary benefit to Chinese companies engaging in these transactions.

Another potential benefit of reverse mergers is that there is a reduced risk of withdrawal. An IPO is market-sensitive, and the issuer traditionally aims to “time” the market so that the offering is undertaken when market interest is at its peak. However, if market conditions deteriorate, the underwriter may decide to cancel the offering at the last minute or substantially lower the offering price.\textsuperscript{54} Conversely, reverse mergers are not sensitive to market conditions in the same way as IPOs, and therefore investors in reverse mergers will not need to cancel the transaction due to conditions in the market.\textsuperscript{55} Similar to the benefit associated with reduced cost, the benefits of reducing the risk of withdrawal is especially salient for Chinese companies that may be less knowledgeable about American market conditions and thus more susceptible to mistiming market fluctuations. Chinese companies engaging in reverse mergers need not be

\textsuperscript{50} See generally Glenn A. Wolfe et al., An Analysis of the Underwriter Selection Process for Initial Public Offerings, 17 J. FIN. RES. 77 (1994).

\textsuperscript{51} It is worth noting that despite the negative signaling effects of reverse mergers, some well-known and successful companies, such as Berkshire Hathaway, have gone public using reverse mergers. See David N. Feldman, Comments on Seasoning of Reverse Merger Companies Before Uplisting to National Securities Exchanges, 2 HARV. BUS. L. REV. 140, 140 (2012), available at http://www.hblr.org/2012/03/reverse-merger-seasoning/.

\textsuperscript{52} See Feldman, supra note 3, at 39; see also Sjostrom, supra note 9, at 750 (“Completing a $50 million IPO will roughly run a company 18% of the offering proceeds, including underwriter discounts, under pricing, and legal, accounting, filing, listing, printing, and registrar fees, or $9 million.”). Conversely, “[a] reverse merger generally costs between $100,000 and $400,000 to complete.” Rusty Cawley, Going Public: ‘Reverse Merger’ Offers Alternative to the Traditional IPO, DALLAS BUS. J. (May 14, 2000), http://www.bizjournals.com/dallas/stories/20000515/focus1.html?page=all.

\textsuperscript{53} See Arellano-Ostoa & Brusco, supra note 40, at 26 (the cost of a reverse merger “is essentially the same as the cost of an IPO”); see also Sjostrom, supra note 9, at 750–51 (when including “the value of the equity stake retained by the shell promoter and its affiliates,” the cost of a reverse merger is millions of dollars).

\textsuperscript{54} See Feldman, supra note 3, at 39.

\textsuperscript{55} See id.
concerned about timing their transactions in a foreign market, however.

Whether a reverse merger is appropriate is a company and situation-specific determination that requires the balancing of risks of illiquidity and negative “signaling effects” against the benefits of lower cost, expediency, and lower sensitivity to market conditions. The multitude of CRM transactions in recent years indicates that Chinese companies have determined that the benefits of engaging in a reverse merger outweigh the costs. However, the controversy stemming from CRMs is partly attributable to the relative pervasiveness of these transactions. Therefore, an understanding of the incentives for Chinese companies to engage in CRMs is necessary to analyze the appropriate regulatory response.

III. THE TREND IN REVERSE MERGERS INVOLVING CHINESE COMPANIES

Chinese companies engage in reverse mergers with U.S. public shell companies for a number of reasons. One incentive for Chinese companies to go public in the United States is “the new tougher, proposed Chinese rules for initial public offerings in China.”

Under these rules, the China Securities Regulatory Commission (CSRC) compels Chinese issuers engaged in an IPO to have a minimum aggregate three-year profit of RMB 30 million (approximately $4.82 million) and a minimum three-year revenue of RMB 300 million (approximately $48.22 million). In contrast, U.S. securities laws have no profit or revenue requirements, and this has historically made going public in the United States through reverse mergers an attractive option for many Chinese companies.

A second, related reason why Chinese companies engage in reverse mergers in the United States is that Chinese tax law has traditionally incentivized Chinese companies to seek out holding companies in the United States. Before January 2008, foreign invested enterprises in China enjoyed preferential tax treatment under Chinese law. During this period, Chinese companies commonly formed foreign invested enterprises when participating in share exchanges with a foreign intermediate holding company—a company that undertakes a share exchange or reverse merger with an American public company. Thus, the public holding company structure took advantage of the old Chinese tax law that gave preferential treatment to foreign entities in order to encourage investments in the country. Although this incentive is arguably no longer meaningful due to changes in the Chinese tax law in 2008, it was historically an important

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56 LORNE & BRYAN, supra note 23, § 8.1.
57 Id.
58 Id.
59 See id. § 3:11.10.
60 Id.
61 Id.
62 Id.
63 China’s newer treatment of foreign invested enterprises came into effect on January 1, 2008 under the Enterprise Income Tax Law. The Law generally taxes domestic and foreign invested enterprises at the same rate. See Zhonghua Renmin Gongheguo Qiye Suode Shui (中华人民共和国企业所得税法) [Enterprise Income Tax Law of the People’s Republic of China]
factor motivating CRMs.

A third reason that Chinese companies are interested in reverse mergers with U.S. shell companies is that these transactions allow Chinese firms to engage in private investment in public equity (PIPE) offerings following a reverse merger. PIPEs are a type of financing transaction in which a public company sells a small number of sophisticated investors common stock or securities convertible into common stock for cash by relying on an exemption from the SEC registration requirements. Subsequently, the company registers with the SEC the secondary distribution of the common stock issued in the private placements or the conversion of the convertible securities. The potential for obtaining PIPE financing serves as an important incentive for private companies (including those from China) to undertake reverse mergers. One reason PIPE financing is an incentive is that PIPEs, which are not available to private companies, are a vital source of financing for small companies that often have few other financing alternatives.

Finally, Chinese companies are eager to go public in the United States because “the United States is one of the largest, most established, and stable markets for public companies.” Indeed, the United States offers an environment in which Chinese firms can raise a large amount of capital, where the financial regulatory system is consistent, and merger candidates are plentiful compared to most other countries. While the advantages of accessing the U.S. capital markets are generally applicable to all foreign companies, China’s unprecedented economic growth and subsequent outpouring of capital and investment abroad has rendered the benefits of going public in the United States particularly pertinent for Chinese companies. However, the influx of Chinese firms into the United States through reverse mergers has caused substantial controversy due to

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64 LORNE & BRYAN, supra note 23; see also Sjostrom, supra note 9, at 752–53; Feldman, supra note 3, at 43.
65 See Sjostrom, supra note 9, at 752.
66 It is worth noting that becoming publicly traded does not guarantee a company’s ability to obtain financing through PIPE investments. The depth and liquidity of the market will likely have an impact on buyers’ appetites for such investments, since PIPEs do not present much value for buyers if there is not a liquid market to sell into. This is likely the case even though the majority of PIPE investments come from investors such as hedge funds with a higher threshold for risk. See, e.g., David J. Brophy et al., Hedge Funds as Investors of Last Resort?, 22 REV. FIN. STUD. 541, 544 (2006) (“[H]edge fund investors and hedge funds account for the vast majority of funding for structured PIPEs.”).
67 It is noted by William K. Sjostrom, Jr., PIPEs, 2 ENTREPRENEURIAL BUS. L.J. 381, 386 (2007) (noting that small public companies "generally pursue PIPEs not because they offer advantages over other financing alternatives but because the companies have no other financing alternatives"); see also Susan Chaplinsky & David Haushalter, Financing Under Extreme Risk: Contract Terms and Returns to Private Investments in Public Equity, 23 REV. FIN. STUD. 2789, 2790 (2010) (“By almost any standard, PIPE issuers are poorly performing firms,” and therefore PIPE issuers are left with “a smaller universe of financing options than companies able to access public debt or equity as a means of fund raising.”).
68 See LORNE & BRYAN, supra note 23.
69 See id.
instances of fraudulent conduct, lack of cooperation with regulators, and the general perception that such companies are of low quality.

IV. CONTROVERSY OVER REVERSE MERGERS INVOLVING CHINESE COMPANIES

Much of the attention given to CRMs in recent years has been negative. Indeed, the influx of Chinese companies into the United States has been met with a high degree of skepticism and scrutiny. These suspicions stem from a wide range of misdeeds that CRM companies have committed, including failing to file the required periodic reports with the SEC, committing significant accounting frauds, reporting inflated revenues, and inventing non-existent customers and assets. In response to this worrisome range of misconduct, regulators have responded accordingly, through actions such as the SEC’s approval in 2011 of tougher listing standards for reverse merger companies.

Since much of the suspicion of CRMs relates to questionable accounting practices, in March of 2011 the PCAOB released an influential report on the activity of CRM companies and the subsequent audit implications. In its report, the PCAOB observed potential audit quality concerns for U.S. accounting firms auditing companies with substantially all of their operations in another country. One major concern was that “it appeared that U.S. firms provided audit services by having most or all of the audit performed by another firm or by assistants engaged from outside

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73 See generally OFFICE OF RESEARCH & ANALYSIS, PUB. CO. ACCOUNTING OVERSIGHT Bd., supra note 1.

74 Id. at 7.
the firm without complying with PCAOB standards applicable to using the work and reports of another auditor or supervising assistants.”

The PCAOB report also observed that accounting firms sometimes engaged assistants from outside the firm to perform auditing work on companies with substantially all of their operations outside the United States. This is troubling because where an accounting firm hires outside consultants to perform auditing work, the outside consultants’ work is insufficient for the accounting firm “to assert that the audit provided a reasonable basis for the firm’s opinion on the financial statements.”

Although the PCAOB report represents one of the more comprehensive testimonies on the accounting deficiencies of CRM companies, the recognition of these questionable accounting practices is relatively widespread. In a statement made before the Council of Institutional Investors in April 2011 regarding foreign companies going public in the United States through reverse mergers, SEC Commissioner Luis Aguilar asserted that “a growing number of them are proving to have significant accounting deficiencies or being vessels of outright fraud.” Aguilar added that “[w]hile it is Chinese companies that have grabbed recent headlines, the problems coming to the forefront would not necessarily be limited to companies based in China.”

While regulatory bodies have taken notice of CRMs, these transactions have also garnered a great deal of attention in the media. According to a June 2011 Wall Street Journal report, from February 2011 to early June 2011, forty Chinese companies have either acknowledged accounting deficiencies or seen the SEC or U.S. exchanges halt trading of their stocks because of accounting concerns. Private parties have also sought to expose instances of fraud and other deceptive practices by CRM companies. One example is Muddy Waters Research, an online service launched in June 2010 to expose fraud and misstatements by small Chinese companies trading in the United States. In a June 2010 report, its research exposed the alleged deceptive practices of Orient Paper, which purportedly overstated its 2009 revenue by a factor of forty and overvalued its assets by at least tenfold. In a report published in November 2010, Muddy Waters Research alleged that RINO International, an environmental equipment manufacturer, overstated its revenue, engaged in serious accounting misstatements, and allowed its management to drain cash from

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75 Id.
76 Id. at 8.
77 Id.
79 Id.
80 See supra notes 2 and 70 for examples of media reports.
82 See DeFotis, supra note 2, at 36.
the company for personal use. RINO’s shares were subsequently delisted.

Fraudulent practices by Chinese companies are not limited to the U.S. market. For example, shares of Chinese corporations traded in Korea have aroused similar concerns. One illustrative case involved China Ocean Resources, a Chinese deep sea fishing company listed on the Seoul bourse. The company saw its stock price drop dramatically following allegations that it overstated the size of its fishing fleet in public disclosures. In another instance in Korea on March 22, 2011, trading in the shares of polyester yarn manufacturer China Gaoxian Fibre Fabric Holdings froze after its auditor was unable to verify the bank balances of one of the company’s affiliates. China Gaoxian Fibre’s trading halt in Korea came a day after its shares stopped trading on the Singapore Exchange, showing how suspicions in one market can affect trading in another. Allegations of deceptive practices by firms such as China Ocean Resources and China Gaoxian Fibre have caused investors to become wary of investing in these companies. As a result, Chinese companies often trade below their inherent value, creating a “China discount.”

There is little doubt that a dark cloud looms over Chinese companies trading in foreign countries, largely resulting from widespread accounting fraud and deficiencies in financial reporting practices. In the United States, suspicions regarding CRMs have elicited a response from regulatory bodies seeking to mitigate the risks that reverse mergers pose to shareholders and the overall market. Regulators have responded by developing a framework to address the distrust of reverse mergers.

V. CURRENT REGULATORY FRAMEWORK AND RESPONSE TO CONCERNS OVER CHINESE REVERSE MERGERS

A number of regulations apply to Chinese companies engaging in reverse mergers, and in response to the concerns outlined above, U.S. regulators and stock exchanges have adopted tougher standards for Chinese companies to trade in the United States. In the wake of the 2008 financial crisis, the heightened regulatory environment has seen the adoption of legislation affecting CRMs. Thus, it is useful to first examine the regulations that existed before the financial crisis and then discuss more recent legislation that falls within the post-recession wave of regulatory scrutiny.

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85 See DeFotis, supra note 2, at 36.
87 Id.
88 Id.
90 The regulation of the securities industry has been significantly impacted by recent legislation.
A. Pre-2008 Regulatory Framework

Under the regulatory framework that existed for many years, a number of SEC regulations applied to CRM companies. Rule 419 of the Securities Act represents one of the earlier regulatory responses to abuses that occurred in reverse mergers.\(^1\) Transactions involving entities known as “blank check companies” were frequently used in the 1980s by boiler rooms for “pump-and-dump” schemes\(^2\) and other fraudulent activities.\(^3\) In 1992, the SEC, under the direction of Congress, responded to the unscrupulous activities associated with the use of blank check companies by adopting Rule 419.\(^4\) Specifically, the SEC adopted Rule 419 to address four primary concerns associated with blank check companies: “promoters milking the shells for cash, abusive trading practices, the fact that no time limit existed to find a reverse merger candidate, and the fact that investors were not generally given an opportunity to review or vote on a proposed merger.”\(^5\)

Rule 419 has three major components relevant to reverse mergers. First, a blank check company going public through an IPO must place all money raised in the offering (less up to 10% for various expenses and the underwriting commissions) as well as the shares issued in the offering in an escrow account until the merger is executed.\(^6\) This requirement ensures that no dishonest parties convert the funds raised in the IPO and that no trading occurs.\(^7\) Second, the blank check company must complete a merger within eighteen months after the IPO; otherwise the company must...
return all remaining funds to the investors. Finally, if investors are unsatisfied with the proposed merger, they may “opt out” and have their money returned.

This third stipulation also requires the blank check company to obtain SEC approval for a document similar to a prospectus that provides detailed information about the company that will merge into the blank check company. Thus, Rule 419 requires enhanced disclosure to potential investors.

In response to the apparent unattractiveness of Rule 419 compliance, an entity known as a special purpose acquisition company (SPAC) emerged. Generally, a “SPAC is a shell company taken public through an IPO with the intent of acquiring an unidentified operating business within eighteen to twenty-four months.” Although SPACs are essentially blank check companies, they are not technically subject to the requirements of Rule 419. Nevertheless, companies employing SPACs in reverse merger transactions often voluntarily comply with many of the provisions of Rule 419 to attract investors.

Although Chinese companies may choose to comply with many aspects of Rule 419, SPACs are an attractive option because, unlike shares of Rule 419 shells, the shares of a SPAC are permitted to trade, “earning money for the promoters and affiliated investment banks for commissions, and allowing investors to trade out of the stock . . . even before a merger is completed.” Thus, SPACs have become popular vehicles in reverse mergers because they allow the promoters to avoid some of the stringent prescriptions of Rule 419, and they are still relatively safe for investors who can opt out if they are unhappy with the proposed merger.

In the last decade, the SEC has sought to further regulate entities engaged in reverse mergers. In 2005, the SEC adopted rules and rule amendments that prohibit shell companies from using Form S-8 under the Securities Act and update the requirements of Form 8-K under the Exchange Act as they apply to shell companies. The SEC explained its reasoning for limiting the ability of shell companies to use Form S-8 as follows:

Because shell companies do not operate businesses and, hence, rarely have employees, we see little legitimate basis for shell

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99 Feldman, supra note 3, at 37.
100 Id.
101 See Sjostrom, supra note 9, at 756–59; Feldman, supra note 3, at 37–38.
102 Sjostrom, supra note 9, at 756.
103 Id. at 758.
104 Id.
105 Feldman, supra note 3, at 38.
106 Id.; see also STEVEN DRESNER & E. KURT KIM, PIPES: A GUIDE TO PRIVATE INVESTMENTS IN PUBLIC EQUITY 249 (2010); DAVID N. FELDMAN, REVERSE Mergers: TAKING A COMPANY PUBLIC WITHOUT AN IPO 45 (1st ed. 2006).
107 Form S-8 is a short-form registration statement available to publicly traded companies that wish to offer their employees securities through benefit or incentive plans. See 17 C.F.R. § 239.16b (2013).
companies to use Form S-8. For this reason, and because of the history of abuse of Form S-8 by reporting shell companies, we are prohibiting shell companies from using Form S-8 until 60 days after they cease being shell companies and file required information.\(^\text{109}\)

However, the SEC “included limited exceptions to this prohibition for shell companies that are used in certain change of domicile or business combination transactions.”\(^\text{110}\)

While Form S-8 is limited to the narrow purpose of registering securities offered pursuant to employee benefit plans, it was still significantly abused by shell companies to raise capital.\(^\text{111}\) Companies misused Form S-8 by registering the sale of shares to “consultants” who in fact did not qualify for securities offerings under Form S-8.\(^\text{112}\) According to the SEC, such schemes “lead to unregistered resales of securities into the public market by these purported ‘employees’ or ‘consultants,” denying the protections of the Securities Act to the real public purchasers of the company’s securities.”\(^\text{113}\) Thus, the purpose of the 2005 amendments was to “protect investors in shell companies and to deter fraud and abuse in our public securities markets through the use of shell companies.”\(^\text{114}\)

The SEC explicitly asserted that the amendments pertaining to shell companies apply to reverse merger transactions.\(^\text{115}\) Besides prohibiting shell companies from using Form S-8, the SEC also adopted amendments addressing the use of Form 8-K to report reverse mergers. As of 2005, companies engaging in reverse mergers are obligated “to file current reports on Form 8-K to report both the entry into a material non-ordinary course agreement providing for the transaction and the completion of the transaction.”\(^\text{116}\) Shell companies engaging in reverse mergers are required to report under Item 1.01 of Form 8-K (Entry into a Material Definitive Agreement).\(^\text{117}\) Moreover, the surviving entity may report under either or both of Item 2.01 of Form 8-K (Completion of Acquisition or Disposition of Assets) and Item 5.01 of Form 8-K (Changes in Control of Registrant).\(^\text{118}\) Finally, audited financial statements and pro forma financial

\(^{109}\) Id. at 4.

\(^{110}\) Id.

\(^{111}\) Id. at 15.


\(^{114}\) Id. at 42.

\(^{115}\) Id. at 4.

\(^{116}\) Id. at 5.

\(^{117}\) Id.

\(^{118}\) Id.
information for transactions reportable under Item 2.01 would be required to be filed under Item 9.01 of Form 8-K (Financial Statements and Exhibits).  

B. Development of Tougher Listing Standards for Reverse Merger Companies

On November 8, 2011, a major development in the regulation of CRMs occurred when the SEC approved new rules to toughen listing standards for reverse merger companies. The SEC’s adoption of more stringent listing standards came in response to requests submitted by NASDAQ, the New York Stock Exchange (NYSE), and NYSE Amex in the summer of 2011.

In its proposal, NASDAQ addressed several regulatory concerns, such as accounting fraud allegations associated with reverse merger companies. NASDAQ noted that certain companies engaging in reverse mergers have been the subject of widespread allegations of fraud, resulting in fears that the financial statements of those companies cannot be relied upon. NASDAQ also observed situations in which promoters and others involved in reverse merger transactions “intended to manipulate prices of Reverse Merger companies’ securities higher to help meet Nasdaq’s initial listing bid price requirement, and where companies have gifted stock to artificially satisfy Nasdaq’s public holder listing requirement.”

Under the new rules, a reverse merger company is eligible to apply for an initial listing on the applicable exchange only if it meets certain “seasoning period,” filing, and minimum stock price requirements. The seasoning period requirement mandates that a reverse merger company trade for at least one year in the U.S. over-the-counter market, on another national exchange, or on a regulated foreign exchange following the reverse merger. The tougher filing standards also require the reverse merger company to timely file all required reports following the reverse merger transaction, including the filing of at least one annual report containing all required audited financial statements for a full fiscal year beginning after the date of the company’s initial SEC filing of the reverse

119 Id. at 5 (citing Securities Act Release No. 33-7646, supra note 112).
122 Id.
123 Id.
125 See Exchange Act Release No. 34-65708, supra note 72, at 7, 12 (approving the proposed one-year seasoning requirement). Although NASDAQ originally proposed a six-month seasoning period, it later amended its proposal, which was subsequently approved by the SEC, to lengthen the seasoning period to one year. Id. at 7; see also Exchange Act Release No. 34-65709, supra note 72, at 3, 14 (approving the proposed one-year seasoning requirement); Exchange Act Release No. 34-65710, supra note 72, at 3, 14 (approving the proposed one-year seasoning requirement).
Finally, the SEC adopted minimum stock price requirements relating to listings on NASDAQ and NYSE, requiring the reverse merger company to maintain a closing stock price of $4 for a “sustained period,” as well as for at least thirty of the most recent sixty trading days prior to the date of the initial listing application as well as the date of listing. In the case of NYSE Amex, the requirement involves maintaining both an absolute and an average minimum stock price “equal to the stock price requirement applicable to the initial listing standard under which the Reverse Merger company is qualifying to list.”

The impact of these tighter regulatory standards for reverse mergers may be particularly significant for Chinese companies. The rules requiring minimum stock prices in reverse mergers will affect many Chinese companies that fail to meet these pricing thresholds. Given the distrust of CRMs and the “China discount,” Chinese companies may find it especially difficult to meet these minimum price requirements. Moreover, the new regulations will have an outsized impact on Chinese companies overall because the volume of reverse mergers from China is far greater than that from any other country. Therefore, Chinese companies—more than those organized in any other country—will have to reform their practices to conform to the growing scrutiny and tougher regulations in the United States.

Chinese companies also face increased regulatory oversight because “China-based auditors now potentially face scrutiny from the SEC’s Enforcement Division for their audit work for U.S.-traded Chinese issuers.” In SEC v. Deloitte Touche Tohmatsu CPA Ltd., argued before the District Court for the District of Columbia, the SEC took the position


129 An analysis of the current stock prices of CRM companies listed on U.S. national exchanges is instructive in determining the potential impact of the new listing requirements on CRMs. A June 2011 table published by Bloomberg shows eighty-three CRM companies, sixty of which were still listed as of November 21, 2013. See Nikolaj Gammeltoft, Table of Chinese Reverse Mergers on U.S. Exchanges, BLOOMBERG (Jun. 24, 2011, 2:33 PM), http://www.bloomberg.com/news/2011-06-22/table-of-chinese-reverse-merger-companies-listed-on-u-s-stock-exchanges.html. Of these sixty CRM companies, thirty-four had stock prices below $2, amounting to approximately 57% of all CRM companies comprising the list. Id. While the current stock prices are not indicative of the prices at the time of listing, and the list published by Bloomberg may not be exhaustive, these numbers are instructive in demonstrating that the minimum price thresholds adopted in 2011 could have a significant impact on many Chinese companies seeking to list on U.S. national exchanges. Id.


that federal courts have jurisdiction over Chinese auditors because the audit reports could be filed with the SEC and investors would rely upon such filings. On January 4, 2012, the court ruled in favor of the SEC, granting it jurisdiction to require Deloitte Touche Tohmatsu to turn over documents related to the SEC investigation into alleged fraud by the accounting firm’s client, Longtop Financial Technologies Limited. This case represents a significant jurisdictional victory for the SEC in its enforcement efforts within the CRM context.

The SEC has continued to press accounting firms to divulge documents connected to SEC fraud investigations. On May 9, 2012, the SEC announced it was investigating another client of Deloitte’s Shanghai affiliate, and filed an administrative proceeding seeking to force Deloitte to provide the SEC with audit work papers for the client. In December of the same year, the SEC brought administrative proceedings against the four largest U.S. accounting firms for refusing to turn over materials prepared in connection with audit work for clients under SEC fraud investigations.

Despite increased scrutiny and recent expansion in the jurisdictional reach of U.S. courts, there are limits on the ability of regulators to enforce U.S. securities laws against these companies. Moreover, the SEC as well as private plaintiffs may have difficulty enforcing remedies, thereby lowering the amount that investors can recover. As Commissioner Aguilar noted, “[t]he consequences of the growing problems in this area has real significance, because it has been reported that billions of U.S. savings and investment dollars have been entrusted with these companies.”

Despite these issues, those favoring greater regulatory oversight of

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132 Id.
136 See Aguilar, supra note 78.
137 See Wilczek, supra note 2, at 809; see also Paul R. Bessette et al., Securities Litigation in 2011 by the Numbers, and a Look Behind the Rise in Securities Cases Against U.S. Listed Chinese Companies, 59 ADVOC. (TEXAS) 40, 42 (2012) ("Private plaintiffs who bring actions against Chinese companies face significant hurdles, both typical of private securities actions and unique to actions against foreign defendants."). There is also evidence that the number of class action lawsuits against CRM companies has diminished substantially. In its 2012 summary of securities class action filings, Cornerstone Research reported that the wave of filings against CRM companies seen in late 2010 through 2011 has subsided. New CRM cases in 2012 declined significantly to 10, down from 31 filings in 2011. See CORNERSTONE RESEARCH, SECURITIES CLASS ACTION FILINGS, 2012 YEAR IN REVIEW 1 (2013), available at http://www.cornerstone.com/files/upload/Cornerstone_Research_Securities_Class_Action_Filings_2012_YIR.pdf. However, there have been some recent high-profile private cases against CRM companies, such as the recent award of $77.5 million by an arbitration panel in Hong Kong to Starr International Co., an investment firm run by former AIG Chief Executive Officer Maurice “Hank” Greenberg. See Joe Schneider & Dune Lawrence, China MediaExpress a Fraud, Hong Kong Arbitration Rules, BLOOMBERG (Jan. 15, 2013, 7:57 PM), http://www.bloomberg.com/news/2013-01-16/china-mediaexpress-a-fraud-hong-kong-arbitration-rules.html.
138 Aguilar, supra note 78.
CRM activity will be pleased by the SEC’s approval of tougher listing standards for reverse merger companies and the D.C. Circuit Court’s ruling in *Deloitte*. Moreover, regulators seem to be cognizant that the rise of China not only poses geopolitical worries for the United States, but also has real economic consequences as Chinese companies seek to enter U.S. capital markets. Yet, under a targeted approach to regulating CRMs, U.S. regulators must also be wary of being too heavy-handed and creating chilling effects in the market through over-regulation.

VI. THE COSTS AND BENEFITS OF OVER-REGULATION AND UNDER-REGULATION

When it comes to the regulation of reverse mergers, regulators seem to have adopted a “more is better” approach. Fraudulent activity among CRMs in particular has elicited a strong reaction from regulators who see the need for more forceful regulation. The goal should not be more regulation, but smarter regulation. While oversight of CRMs is undeniably important, over-regulation comes with significant costs, and U.S. regulators must keep these costs in mind when adopting new regulations. The discussion below outlines both sides of the CRM regulation debate—the dangers of under-regulation and the costs of over-regulation.

A. The Dangers of Under-Regulation and Reasons for Strong Regulatory Oversight

While there are many potential risks associated with under-regulating CRMs, these dangers may be grouped into two broad categories. The first is the perceived or real threat to the integrity of U.S. capital markets overall. Fraud and a lack of transparency among market participants can be detrimental to the proper functioning of a country’s financial markets. To the extent that fraudulent activities go unregulated and the operations of publicly traded firms are characterized by opacity and shadiness, investors will lose confidence in American financial markets. Not only will American investors run scared, but the perception of investors abroad can also impact the amount of capital inflows into the United States. Thus, a blow to investor confidence resulting from a failure to adequately regulate fraudulent activity among foreign market entrants could have a significant macroeconomic impact.

The second category of risk arising from a failure to adequately regulate CRMs is direct harm to individual investors. For example, in an ongoing case against RINO International Corp., a Chinese entity incorporated in Nevada, investors claim that RINO issued materially false

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140 See Jain et al., *supra* note 139.
or misleading information about its true financial condition, purportedly resulting in hundreds of millions of dollars in investor losses. To date, investors in CRM companies have lost billions. Thus, investors who place their trust in companies that engage in fraudulent activity may suffer significant monetary losses.

The regulation of CRMs is important in two fundamental ways. First, oversight, disclosure, and registration requirements attempt to ensure transparency so that investors can make informed decisions. Second, laws regulating CRMs provide investors and the market with ex post remedies. Investors may bring private actions against CRM companies, and the SEC may punish firms by revoking their registration and bringing enforcement actions. While in reality private recovery may be difficult, such ex post remedies send an important signal to CRM companies, investors, and the overall market.

B. The Risks of Over-regulation and Reasons to Favor a Free-Market Approach

At present, it is unclear whether the SEC and national securities exchanges have gone too far in their oversight of CRMs. The recently adopted tougher listing standards are too new to determine their long-term impact on CRM activity. Moreover, the tepid global economic environment is likely playing a role in the decrease in CRMs in recent years, further complicating any analysis of the impact of regulation on CRM activity. However, the SEC’s recent push for more stringent regulation of reverse merger companies should be cause for concern. Recent evidence suggests that stricter listing standards are not necessary since the risks associated with reverse mergers are not specific to reverse mergers, but instead are endemic to the markets in which reverse merger


143 See, e.g., The Laws That Govern the Securities Industry, Purpose of Registration, U.S. SEC & EXCH. COMM’N, http://www.sec.gov/about/laws.shtml (last visited Jan. 29, 2013) (stating that the purpose of registration requirements is to enable “investors, not the government, to make informed judgments about whether to purchase a company’s securities”).

144 See Wilczek, supra note 2, at 809; Besette et al., supra note 137.

145 See OFFICE OF RESEARCH & ANALYSIS, PUB. CO. ACCOUNTING OVERSIGHT BD., supra note 1, at 3 (indicating that the total number of reverse mergers in the United States dropped from 234 in 2007 to 141 in 2009).
firms operate. Although there is little doubt that some degree of regulation is necessary, the SEC will fail to solve these concerns by over-regulating CRMs. Indeed, over-regulating reverse mergers may substantially burden smaller firms that are unable to become publicly traded through an IPO, and therefore must access the American capital markets through a reverse merger. It would be misguided to see this cost as a necessary evil to maintain the integrity of U.S. markets and protect investors. Small businesses are a critical element in the American economy, creating the vast majority of employment in the United States and generating most of the net job growth over the last two decades. Regulations that would hamper the ability of small businesses to access capital would be detrimental. In fact, over-regulation could have a “chilling effect of discouraging exciting growth companies from pursuing all available techniques to obtain the benefits of a public listed stock and greater access to capital.”

Even where regulation is not overly burdensome, it may be an inferior method of responding to corporate fraud when compared to private market participants. To the extent markets are capable of responding to corporate frauds, there are benefits to permitting them to do so. First, market participants “are likely to be better informed and motivated than regulators.” Moreover, markets can respond with a variety of solutions and apply the most efficient approach. In contrast, regulators may not decide upon the most efficient means of curbing fraudulent behavior.

One approach that has proven effective has been the efforts of private actors to shine the spotlight on Chinese firms, such as the reports provided by Muddy Waters Research. The activities of short sellers and industry analysts have been instrumental in exposing fraud among CRM companies. By publicizing the allegedly improper behavior of certain

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146 See Lee et al., supra note 70, at 30 (“While [reverse merger] firms are speculative in nature and are prone to bankruptcy, these problems are endemic to the markets in which [reverse merger companies] reside, and are not issues specific to [reverse mergers]. Our results do not support the view that current [reverse merger] listing requirements are ‘too loose.’”).

147 See E-mail from James N. Baxter, Chairman & Gen. Counsel, N.Y. Global Grp. Inc., to Elizabeth M. Murphy, U.S. Sec. & Exch. Comm’n (Oct. 17, 2011), available at http://www.sec.gov/comments/sr-nasdaq-2011-073/nasdaq2011073-2.pdf (“In many circumstances, reverse merger is the only available process through which a small U.S. company can raise growth capital through obtaining a listing on a stock exchange.”).

148 See Frequently Asked Questions, U.S. SMALL BUS. ADMIN., http://www.sba.gov/sites/default/files/sbfaq.pdf (last visited Sept. 8, 2013) (finding that small businesses represent 99.7% of all employer firms and have generated 65% of all net new jobs in the 17 years leading up to the report).


151 Id.

152 Id. (“A political or regulatory approach will pick a particular solution that may not be the most efficient overall.”).

153 MUDDY WATERS, LLC, supra note 83 (issuing a report exposing fraudulent practices by Orient Paper); see also MUDDY WATERS, LLC, supra note 84 (issuing a report exposing deceptive practices by RINO International).
Chinese firms, these private market participants allow investors to digest the full range of publicly available information and react accordingly. Thus, investors may impose a “Chinese discount” or avoid investing in CRM companies altogether, which may provide stronger incentives to reform the behavior of CRM companies than any regulatory mechanism. If anything, the market may be overreacting to CRM frauds by punishing non-fraudulent CRM firms too severely.\textsuperscript{154} This bolsters the argument for tempering the regulation of CRMs.

Not only can a free market approach enable investors to react efficiently to fraudulent activity among CRM companies, but there is also evidence that Chinese companies are responding as well. In response to negative investor sentiment and a regulatory climate change, dozens of CRM companies have sought deals with private equity funds to go private.\textsuperscript{155} On the one hand, this trend may not represent a net positive for investors. For example, “[w]hen a company goes private, U.S. investors will lose an opportunity to participate in the future growth opportunity of the company.”\textsuperscript{156} On the other hand, this wave of going-private transactions signifies the market’s capacity for self-regulation. The market’s ability to efficiently tend to itself undermines the arguments of those who see government regulation as a panacea.

VII. PRESCRIPTIONS FOR SMARTER REGULATION: TARGETING THE UNDERLYING CAUSES OF FRAUD RATHER THAN CRM TRANSACTIONS

The above discussion suggests that neither a heavy-handed regulatory approach nor a purely free-market approach will be effective in regulating CRMs. Leaving regulation entirely to the market is impossible since market participants cannot make efficient decisions when Chinese companies withhold valuable information. However, over-regulation could stifle the American economy and discourage capital inflows. Indeed, the current trend towards more stringent regulation of reverse mergers may have a negative impact on U.S. capital markets by unduly burdening small foreign businesses. The SEC should therefore employ efficient, targeted regulations that enable investors to make informed decisions while reducing the risk of fraud among CRM companies. Smarter regulations would not target reverse merger companies that may commit fraud, but rather the underlying causes of fraud.

The adoption of tougher listing standards for reverse mergers was largely motivated by allegations of wrongdoings among Chinese firms.\textsuperscript{157} While it is true that CRM companies have engaged in fraudulent activity, a

\begin{footnotesize}
\begin{itemize}
\item[154] See Darrough et al., supra note 130, at 27.
\item[155] Id. at 34; see also McMahon, supra note 142; Ye Xie & Victoria Stilwell, Muddy Waters Retreats on Short Selling Chinese Stocks, BLOOMBERG (NOV. 27, 2012 10:12 PM), http://www.bloomberg.com/news/2012-11-27/block-gives-up-as-short-selling-declines-china-overnight.html.
\item[156] Darrough et al., supra note 130, at 34.
\item[157] Letter from David N. Feldman, supra note 149 (noting that in NASDAQ’s proposal for tougher listing standards, “virtually all” of the allegations of misconduct cited by NASDAQ involved Chinese firms).
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regulatory approach that targets CRM transactions is misguided. Aside from the obvious costs of alienating the flow of Chinese capital into the United States, singling out CRMs is inappropriate because evidence indicates that the high level of distrust of CRMs is unwarranted. Chinese companies engaging in reverse mergers actually tend to perform better than other reverse merger companies, including U.S. firms. After first becoming publicly traded, compared with their U.S. counterparts, CRM companies are more profitable, have a higher market capitalization, and maintain lower leverage. Moreover, evidence suggests that Chinese companies that became publicly traded through an IPO do not perform better than CRM firms. In addition, in 2011, U.S. stock exchanges delisted more Chinese IPO companies than those that became publicly traded through a reverse merger.

This evidence indicates that targeting CRMs is inappropriate because they are not inherently toxic transactions and are no less problematic than U.S. reverse mergers or Chinese IPOs. Even if one believes that Chinese firms account for a disproportionate amount of the fraud associated with reverse mergers, stringent regulations of reverse mergers generally are missing the mark. In fact, 74% of the reverse mergers between January 2007 and March 2010 were completed by non-Chinese companies, most of which were U.S. firms.

Regulations must not target CRMs, but rather the ultimate ability of CRM companies to engage in fraud. Any perception that fraud by Chinese companies occurs only among shady firms who access the capital markets through CRMs is incorrect. A number of Chinese companies facing fraud allegations became publicly traded through IPOs rather than reverse mergers, including Longtop Financial, which employed Goldman Sachs and Deutsche Bank as its IPO underwriters and Deloitte as its auditor. The risks of under-regulation to the economy and individual investors apply to any area where fraud occurs, and does not imply that CRMs in particular should be singled out. Even if one assumes that CRMs deserve a disproportionate share of the blame, the fact that fraud among CRM companies still occurs indicates that more regulation is likely not the answer.

The primary method by which CRM companies have engaged in fraud is through fraudulent misrepresentations about their health and financial performance. Rather than adopting regulations that make it more difficult for CRM transactions to occur at all, the SEC should undertake targeted

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158 See Darrough et al., supra note 130, at 24; see also Lee et al., supra note 70, at 20–22 (finding that CRM companies are healthier and perform better than U.S. reverse merger companies).

159 See Lee et al., supra note 70, at 6.

160 Id. at 25 (finding evidence that Chinese IPO companies experience more negative long-term stock returns than reverse merger companies).

161 Email from James N. Baxter, supra note 147, at 3 (“Contrary to popular belief, research data shows that in 2011, a higher percentage of China based IPO companies have been delisted by U.S. stock exchanges than those that have become public via reverse merger.”) (emphasis omitted).

162 See OFFICE OF RESEARCH & ANALYSIS, PUB. CO. ACCOUNTING OVERSIGHT BD., supra note 1, at 3.

measures to impede the ability of Chinese firms to hide the truth about their financial wellbeing. Regulators in the United States could employ more efficient regulations of CRMs in two primary ways. First, CRMs and other foreign reverse mergers should be subject to inspection by the PCAOB. Second, filings with Chinese regulators should be made available in SEC filings. Both of these prescriptions boil down to a push towards better cooperation between Chinese and U.S. regulators.

While greater harmony between U.S. and Chinese regulators may be easier said than done, the template for such cooperation has already been formed. In October 2012, the PCAOB and Chinese authorities reached an agreement allowing the PCAOB to examine the audits of U.S.-listed Chinese companies, although the agreement broke down shortly thereafter. A primary issue is that Chinese regulators view the disclosure of audit records to the PCAOB as revealing state secrets. However, unlike China’s large state-owned enterprises, CRM companies are by definition small, privately held companies. The Chinese government should therefore not be concerned about American inspection of these small firms. The PCAOB and Chinese regulators could obtain deeper cooperation if the negotiation is limited to the inspection of small-cap privately held companies—namely, the kinds of companies that engage in CRMs. The added benefit of this limited agreement would be to open the door to broader cooperation down the road. Once Chinese authorities realize that American audit inspections of U.S.-listed Chinese companies are not tantamount to espionage, China may be willing to engage in more substantial collaboration.

In fact, in recent months the PCAOB and Chinese authorities have made progress towards achieving a framework for deeper cooperation. In May 2013, the PCAOB, CSRC, and Ministry of Finance of China entered into a Memorandum of Understanding (MOU) setting forth an enforcement cooperation agreement. The MOU encourages "mutual assistance and the exchange of information for the purpose of enforcing and securing

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166 See, e.g., Frederic M. Stiner, Jr. & Susan A. Lynn, Auditing Issues with Chinese Reverse Merger Companies Traded in the United States, 2 INT’L J. ACCT. & FIN. REP. 76, 84 (2012), available at http://www.macrothink.org/journal/index.php/ijafr/article/download/21872202 ("Chinese companies can either comply with the demands of the PCAOB and the SEC, and face sanctions by the Chinese government for revealing state secrets to a foreign government, or the companies can refuse to comply with the demands of the American regulators.").

compliance with the respective Laws and Regulations of the jurisdictions of the [participating U.S. and Chinese parties].”  Although the agreement may represent an encouraging step towards more U.S.–China enforcement cooperation, it does not provide the PCAOB with the ability to inspect Chinese accounting firms and is plagued by loopholes.

A major weakness in the MOU is its limited scope and the PCAOB’s inability to conduct inspections of Chinese audits.  Without the power to inspect CRM companies listed in the United States, the MOU does little to curb accounting fraud in U.S. filings.  Not only does the MOU fail to provide the PCAOB with the capacity to undertake inspections, but it also contains significant loopholes that threaten to undermine its effectiveness.  Article III, Section (b) sets forth various exceptions that would allow the Chinese authorities to deny the PCAOB’s request for assistance.  Article III, Section (b)(iii) of the MOU is a particularly troubling exception to the agreement to provide mutual assistance and exchange information.  It states that “[a] request for assistance may be denied on an exceptional basis . . . on grounds of public interest or essential national interest.”  In the past, Chinese regulators have characterized the disclosure of audit records to the PCAOB as revealing state secrets.  Therefore the CSRC or Chinese Ministry of Finance may choose to deny the PCAOB’s request for assistance “on grounds of public interest or essential national interest.”

Given the willingness of Chinese regulators to invoke its national security to withhold information from the PCAOB, Chinese authorities may choose to liberally invoke the exceptions in Article III, Section (b), undermining the MOU’s purpose.  Without a stronger mechanism for the PCAOB to monitor the audits of U.S.-listed Chinese companies, the MOU is little more than a symbol of cooperation.

Aside from PCAOB inspections, the SEC should mandate disclosure of filings with Chinese regulators in order to ensure they are consistent with filings in the United States.  This requirement should apply to all

168 Id. at 1.
169 See Michael Rapoport & Dinny McMahon, U.S., China Set Pact on Auditor Access, WALL ST. J., May 24, 2013, http://online.wsj.com/article/SB100014241278873246659404578501841277852794.html (noting that the MOU does not “allow the PCAOB into China for inspections of Chinese firms that audit U.S.-traded companies, which the U.S. regulator has pushed for”); Michael Cohn, PCAOB Deal with China Seen as Just the First Step, ACCOUNTING TODAY (May 30, 2013), http://www.accountingtoday.com/debits_credits/PCAOB-Deal-China-First-Step-66905-1.html (“[T]he deal is limited to enforcement action cases and doesn’t give the PCAOB the ability to just request work papers willy-nilly, nor does it provide the ability to do inspections of firms in China that audit U.S.-listed companies . . . .”).
170 See U.S.–China MOU, supra note 167, at 2.  Article III, Section (b) in its entirety provides:

(b) A request for assistance may be denied on an exceptional basis by the Requested Party: (i) where the request would require the Requested Party to act in a manner that would violate domestic law; (ii) where the request is not made in accordance with the provisions of this MOU; (iii) on grounds of public interest or essential national interest; or (iv) where the information provided in the request is not sufficient or specific enough for the requested party to provide assistance, the requested party can deny the request or ask the requesting party to provide more information.

171 Id.
172 Stiner, Jr. & Lynn, supra note 166.
foreign reverse merger companies in order to avoid explicitly targeting China. As with the current debate over the PCAOB’s role in Chinese audits, the Chinese government may be reluctant to allow companies to divulge corporate filings for fear of revealing state secrets. In response, U.S. regulators might employ a similar line of reasoning as recommended above—namely, that the kinds of companies that engage in reverse mergers would not be revealing state secrets by publicly disclosing its Chinese filings.

Mandating the disclosure of filings with Chinese authorities is critical in effectively targeting fraud among CRM companies because the fraud often involves a discrepancy in the filings in China and those in the United States. Chinese companies have been found to report larger profits to the SEC than to Chinese authorities. For example, in the case filed against RINO International, plaintiffs allege that RINO reported $192.6 million in revenue to the SEC in 2009, while documents filed with China’s State Administration of Industry and Commerce indicate that RINO only generated $11 million in revenue during the same year.

Chinese companies are less likely to materially misrepresent their financial condition to Chinese authorities because they fear the consequences from the Chinese government. Indeed, “economic crimes” can be grounds for capital punishment in China. U.S. regulators can minimize the ability of Chinese companies to take advantage of the less draconian laws in the United States by mandating disclosure of filings with Chinese authorities.

VII. CONCLUSION

At a time when the United States is increasingly under pressure to remain competitive in the global marketplace, now more than ever it must signal to the world that it is committed to maintaining its reputation for fostering a free flow of capital in an environment of dynamic financial transactions. However, it is clear that keeping a watchful eye on CRMs in the United States is necessary to protect investors and the legitimacy of the American economy, which has long been recognized for its safe, transparent, and liquid capital markets.

A reverse merger as a financial transaction is not inherently dangerous. When issuing regulatory responses to CRMs, the United

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176 See, e.g., Ashley N. Schawang, Missing the Mark: An Examination of the Current Government Response to the Chinese Reverse Merger Dilemma, 57 ST. LOUIS U. L.J. 219, 250 (2012) (“Chinese corporations do not dare commit such fraud in their own country because they know the severity of the consequences.”).
178 See OFFICE OF RESEARCH & ANALYSIS, PUB. CO. ACCOUNTING OVERSIGHT BD., supra note 1; Cheng et al., supra note 71, at 1438.
States must not overlook the importance of the infusion of capital into U.S. markets and the maintenance of the U.S. economy as an environment categorized by exciting growth, innovation, and freedom. Indeed, there has been a tremendous influx of Chinese capital into the United States, which stands to benefit the country in many ways as long as the United States is careful not to stifle Chinese interests in entering American capital markets.

Since CRMs are not inherently toxic and provide benefits to the U.S. economy, U.S. regulators should target the root of fraud, rather than adopting regulations that burden all reverse merger companies. More efficient regulations would involve closer monitoring by the PCAOB and required disclosures of foreign filings to U.S. regulators. This necessitates cooperation with Chinese authorities. Collaboration with China is easier said than done, but it is also not unattainable. The concerns behind the Chinese government’s hesitation to disclose information about its companies are unwarranted, and negotiations should focus on these concerns in order to alleviate them. The United States should also emphasize that collaboration benefits China. Indeed, regulating CRMs in the United States “might be beneficial to them in the long run as a way to weed out the fraudulent and weak players and rebuild Chinese companies’ reputation in the [United States].” Thus, regulation may have positive implications for the future of Chinese companies, in both material and reputational respects.

Some may argue that to the extent CRMs pose a platform for accounting abuses and other fraudulent activities, rendering American markets inhospitable to Chinese investment is a laudable goal. There are important reasons why such an approach is dangerous. First, while there have been cases of fraud associated with CRMs, many CRM transactions are perfectly legitimate. Thus, adopting regulations that would target CRMs generally rather than punishing or deterring specific companies seeking to engage in nefarious activities would be both inefficient and unnecessary. This approach of using a sledgehammer to crack a nut is not ideal. Rendering American markets unwelcoming to CRM transactions is also problematic in that it may have broader implications for the market

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179 CHARLES W. FREEMAN III & WEN JIN YUAN, CTR. FOR STRATEGIC & INT’L STUDIES, CHINA’S INVESTMENT IN THE UNITED STATES—NATIONAL INITIATIVES, CORPORATE GOALS, AND PUBLIC OPINION STUDIES ASIA 1 (Nov. 2011), available at http://csis.org/files/publication/111107_Freeman_Briefing_China_Investment_in_US.pdf (“China has been using its massive dollar reserves to purchase U.S. Treasury bills and it is now the largest foreign holder of Treasury securities. By August 2011, China held US$1137 billion in Treasuries, while Japan, the second largest holder, only had US$936.6 billion. Moreover, China’s Outward Foreign Direct Investment (OFDI) to the [United States] has also soared in recent years. In both 2009 and 2010, the value of China’s direct investment assets in the United States increased by 130%. The total investment flow in 2010 was in the vicinity of US$5.3 billion, bringing accumulated Chinese direct investment in the [United States] to roughly US$11.6 billion since 2003.”).


181 Cheng et al., supra note 71, at 1438.
overall by producing chilling effects and deterring would-be foreign investors and entrepreneurs.

China’s economy will continue to grow at a significant rate, and its appetite for investment in the United States and access to American capital markets will likely remain strong. If anything, China’s power in the realm of global finance will only grow relative to that of the United States. While the pace of China’s growth may not be sustainable in the long run, especially as its middle class grows more robust, American regulators must recognize that the benefits of allowing CRMs to flourish in the United States—albeit under a watchful eye—far outweigh the costs of creating an investment atmosphere inhospitable to Chinese companies.

Targeted regulations address the fears associated with fraud among CRM companies, while at the same time enabling the free market to self-regulate. Requiring disclosure of foreign filings avoids the unfair targeting of China and CRM companies in particular, as it would apply to all foreign reverse merger companies. Moreover, unlike the listing standards for reverse merger companies adopted in 2011, greater PCAOB involvement and disclosure of foreign filings would be minimally burdensome. At the same time, these measures achieve the ultimate goal of U.S. securities laws—to protect investors by enabling them to make informed decisions.

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182 The International Monetary Fund has predicted that China’s growth in 2014 will be 7.3%. See INT’L MONETARY FUND, WORLD ECONOMIC OUTLOOK OCTOBER 2013, TRANSITIONS AND TENSIONS 2 (July 9, 2013), available at http://www.imf.org/external/pubs/ft/weo/2013/02/pdf/text.pdf.