



The Takeaway

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Shell Games

Chinese Reverse Merger Fraud



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Reverse mergers offer a quick and reliable way to gain access to the American capital markets. The ease of a reverse merger, however, also provides a loophole for nefarious actors to defraud investors. Despite Chinese companies systemically utilizing reverse mergers to defraud American capital markets of \$34 billion between 2007 and 2010,¹ regulation has yet to properly address the issue.

Regulation changes to protect against fraudulent companies listing on American stock exchanges still lack quality control measures and differ by market. Without creating a strong set of regulations at a congressional level, protecting American public exchanges—the NASDAQ and the New York Stock Exchange (NYSE)—from fraudulent actors will be impossible.

WHAT IS A REVERSE MERGER?

Reverse mergers are an attractive option for private corporations to go “public” by acquiring a majority of shares of a pub-

WHAT’S THE TAKEAWAY?

Reverse mergers offer a quick method for companies to go public.

Between 2007 and 2010, Chinese companies used reverse mergers to defraud investors of \$34 billion.

Regulation changes since have yet to close major loopholes relating to reverse mergers.

The United States Congress must enact policy to unify market regulations.

lic, often defunct, shell company that is then combined with the private firm to form a single entity.

In simple terms, a private company buys a public shell company in order to gain the shell company's listing on a major stock exchange. Some shell companies are created with the sole purpose of seeking a reverse merger. Consequently, the two firms exchange shares, dumping that of the shell company, and become one firm which is then listed on the stock exchange.

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By pursuing a reverse merger, private companies bypass the regulatory labyrinth associated with an initial public offering (IPO). Therefore, they tend to be more cost-efficient and less time-consuming, taking anywhere from a few weeks to four months in some cases to complete. Also, reverse mergers present private companies with more alternatives for financing in the future and provide greater liquidity.

Reverse mergers, however, present a variety of risks for investors. If not properly audited by credible firms, hidden liabilities may increase the chance of fraud. A well-respected,

transparent shell company is imperative for an effective reverse merger so the company can build the value of its stock.

Completing a reverse merger provides an easy route for international companies to get listed on an American exchange. Lax regulations, however, make it easy for companies to defraud investors through the reverse merger process. For example, limited access to records and lenient auditing guidelines provide an easy route for companies to masquerade behind fraudulent disclosures when completing the reverse merger process.

CHINA'S SYSTEMIC USE OF REVERSE MERGERS

Chinese companies view a reverse merger as preferable to initial public offerings (IPOs) since they offer a more viable route to the American capital market.² This is because Chinese companies typically encounter difficulties when pursuing an IPO.

Chinese companies tend to fare well after finalizing a reverse merger since they tend to "be better capitalized, have more positive operating cash flows, and are more likely to be categorized as a growth or mature stage firm," and have lower leverage than their American counterparts before starting the reverse merger process.³ Therefore, a majority tend to move up in their exchange tier or are highly profitable.

Despite such promising prospects, not all Chinese companies are what they seem when pursuing a reverse merger. In 2010, Muddy Waters, an investment research firm, released a report accusing Orient Paper of

overstating its revenue by 40%, overvaluing its assets, and overstating its gross profit margin.⁴ Two years later, Orient Paper agreed to a \$2 million settlement in damages for defrauding American investors.

The story of Orient Paper is far from being a singular incident. In the two years after the Orient Paper case, the Securities and Exchange Commission (SEC) initiated fraud investigations and halted the public trading of shares associated with 41 Chinese companies who listed on an American stock exchange via reverse merger. By 2011, at least 33 class action lawsuits against Chinese reverse mergers were filed.⁵ Several Chinese companies effectively used reverse mergers to defraud investors of close to \$34 billion by systematically misreporting their financial assets on official SEC filings.

HAS POLICY CHANGED?

In 2010, the SEC launched an initiative to pinpoint certain companies with foreign operations, including reverse mergers that resulted in the halting of trade for more than 35 companies with foreign operations.⁶ Also, the SEC warned investors of the risks of dealing with reverse mergers by enacting new regulations, including increased filing requirements, maintenance of share price, and a seasoning period.⁷ Reverse mergers, however, are typically excluded from these rules if they meet certain requirements, raising concern about the effectiveness of these rules.

In November of 2011, the SEC approved “seasoning” regulations by NASDAQ and the NYSE that outlined stricter listing requirements for private companies. First, a compa-

ny must maintain a minimum closing price of at least \$4 prior to submitting a listing application and prior to approval. Second, companies must trade on American over-the-counter (OTC) markets for at least one year. Finally, companies must adhere to slightly stronger filing requirements that differ by exchange. These requirements are outlined in the table below. However, if a company wishing to trade on the market is worth \$40 million or more, it does not have to meet any of these requirements.

POLICY RECOMMENDATIONS

While new regulations enacted by the NASDAQ and NYSE make it easier for the SEC to catch and reprimand reverse mergers for fraud, they simply do not go far enough. Differences in filing requirements and overall lack of quality control still allow some fraudulent reverse mergers to list on American markets. From 2018 to 2019, the SEC settled multiple criminal lawsuits, resulting in over 30 criminal charges of wire fraud and conspiracy, for orchestrated schemes to fraudulently boost the stock of reverse merger companies to siphon millions of dollars from American capital markets.⁸

Table 1: New Seasoning Regulations in 2011

Requirement	NASDAQ	NYSE
\$4 closing price	30 of the last 60 trading days	30 of the last 60 trading days
Trade on OTC markets	1 year prior to listing	1 year prior to listing
Additional Financial Reporting	Two recent financial statements	Form 8-K including all audited statements

Source: Hinshaw & Culbertson LLP⁹

A better solution is for Congress to update the Sarbanes-Oxley Act of 2002 by introducing comprehensive quality control regulations on reverse mergers. New legislation must include a \$4 closing price minimum during the listing process and for at least one year after listing, removal of the \$40 million loophole, demonstrated ability to sustain growth for at least two years after listing, and standardization of filing requirements through all American exchange markets. Under this legislation, companies' financial statements must be approved by an American auditing agency prior to officially listing. By enacting the legislation outlined above, Congress can ensure quality control to protect American exchange markets from reverse merger fraud.

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Notes:

¹ Vlastelica, R. & Bases, D. (2011, May 12). Special report: Chinese stock scams are the latest U.S. import. Reuters Business News. <https://www.reuters.com/article/us-china-shortsellers/special-report-chinese-stock-scams-are-the-latest-u-s-import-idUSTRE74B4DW20110512>

² Nahoum, G. (2007). Small Cap Companies and the Diamond in the Rough Theory: Dispelling the IPO Myth and Following the Regulation A and Reverse Merger Examples. *Hofstra Law Review*, 35(4), 1865–1909.

³ Lee, C., Li, K., & Zhang, R. (2014). Shell games: Are Chinese reverse merger firms inherently toxic? Stanford Business School Working Paper No. 3063. <https://www.gsb.stanford.edu/faculty-research/working-papers/shell-games-are-chinese-reverse-merger-firms-inherently-toxic>

⁴ Block, C. & Regan, S. (2010, June 28). Muddy Waters Initiating Coverage on ONP – Strong Sell. Muddy Waters Research. http://d.muddywatersresearch.com/content/uploads/2010/06/ONP_Report_June2010.pdf

⁵ Jindra, J., Voetmann, T., & Walking, R.A. (2012). Reverse Mergers: The Chinese Experience. Menlo College Research Paper Series, working paper. <http://cdm15970.contentdm.oclc.org/utis/getfile/collection/p15970coll1/id/72/filename/73.pdf>

⁶ US Securities and Exchange Commission. (2011, November 9). SEC Approves New Rules to Toughen Listing Standards for Reverse Merger Companies. https://www.sec.gov/news/press/2011/2011-235.htm?mod=article_inline

⁷ Office of Investor Education and Advocacy. (2011, June). Reverse Mergers. Investor Bulletin, US Securities and Exchange Commission. <https://www.sec.gov/investor/alerts/reversemergers.pdf>

⁸ SEC Litigation Releases: #24175, <https://www.sec.gov/litigation/litreleases/2018/lr24175.htm>, #24583, <https://www.sec.gov/litigation/litreleases/2019/lr24583.htm>, and #24198, <https://www.sec.gov/litigation/litreleases/2018/lr24198.htm>

⁹ Data for Table 1 taken from Hinshaw & Culbertson LLP (2011, November 21). SEC, Nasdaq and NYSE Toughen oversight of Reverse Mergers. <https://www.hinshawlaw.com/newsroom/updates-163.html>

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