Regulatory Review

New Rules Help Legitimize Reverse Merger Market

From new laws governing shell companies to legal speed bumps that specified purpose acquisition companies learned to maneuver, 2005 was a year of important changes to the way the reverse merger market operates. In particular, a number of regulatory changes made significant strides in reducing fraud and further legitimizing the reverse merger market. The changes have raised the quality of players and broadened the pool of investors.

One of the key developments in 2005 was the passage in late June of SEC rules governing shell companies. Long tainted by pump-and-dump schemes, shell companies were provided a new set of guidelines that transform both the nature and the timing of information they must make available. The changes were welcomed by reverse merger market specialists, who said that the improved governance was overdue.

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Shell companies had historically escaped scrutiny by providing limited financial information about an acquired company. Investors often were left without critical information regarding management, shareholders, and operations. Shell companies were only required to report a significant acquisition on Form 8-K with a brief description of assets; complete financial statements were not due until 71 days later. That all changed with the new shell rule. Since going into effect in August, the new rules require shell companies to provide information similar to what is available in an IPO prospectus.

A company that ceases being a shell company must furnish information comparable to what is required in a Form 10 filing within four business days. Investors are now able to review complete audited financial information, along with detailed descriptions of the business, shareholder information, competition, legal proceedings, and risk factors, among other information.

"These rules make a lot of sense. Before the change, the rules that were in effect were set up for acquisitions other than for shell companies. They weren't meant for reverse mergers so people were taking advantage of them," explained Louis Bevilacqua, partner at Thelen Reid & Priest. "Now, everybody understands what is going into the shell and the information is available to them immediately."

With the new shell rules the SEC formulated a new definition for what constitutes a shell company. A shell company is a company, other than an asset-backed issuer, with no 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 and nominal other assets.

The SEC has added a box on the cover sheets of Form 10-Q, Form 10-QSB, Form 10-K, Form 10-KSB, and Form 20-F that issuers must check to identify if they are shell companies. This feature means that shell companies can now be easily tracked, significantly enhancing the transparency of the market.

The SEC also eliminated the use of Form S-8 for shell companies. The policy makers noted that the form, which is meant to be used by public companies to register securities for sale in connection with employee benefit plans, was being abused. Shell companies were using the form to bypass registration requirements to raise capital and distribute securities. The 2005 rules stipulate that Form S-8 can only be used 60 days after a shell company becomes an operating company. This window gives investors the opportunity to absorb the information made available in the Form 8-K or other filing.

Public commentary during the review period of the suggested rules did lead the SEC to accommodate a few exceptions to the Form S-8 change. Certain shell companies that were created for the purposes of changing corporate domicile are permitted to use Form S-8 immediately after they cease being a shell company and file Form 10 details. The SEC also allows business combination-related shell companies to bypass the 60-day delay. They may use Form S-8 immediately after they cease being a shell and file Form 10 information.

The SEC also outlined in its rulemaking that the new shell company rules extend to cover foreign shell companies.

"These rules are drawing a better quality of investors willing to do PIPEs along with a reverse merger," said

Bevilacqua. "The SEC's rules have legitimized the reverse merger market."

SPACs

The market for SPACs emerged as one of the most robust arenas of new issue activity in 2005. Twenty-eight SPAC transactions were completed during the year with a queue of another 41 SPACs hoping to raise about $2.7 billion. Of all completed deals since 2003, only four have had acquisitions approved, with another seven waiting for approval.

Not wanting to miss out on one of the few windows of new issue activity, a wide variety of personalities have thrown their hat into the SPAC game. From Apple Computer executives to Richard Clarke, a former Clinton and Bush administration official, a number of high-profile names are working to attract investor dollars. Meanwhile, bulge-bracket firms Citigroup and Deutsche Bank have jumped into doing SPACs, further adding credibility to the structure.

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The tremendous surge in activity in 2005 did not come without some regulatory wrangling. In the early part of the year, the SEC slowed the review process of SPACs after one SPAC – International Shipping Enterprises – announced less than two months after coming public its intention to merge with Navios Maritime Holdings. This drew the SEC's attention.

Officials were concerned that International Shipping execs had been in contact with their target before going public. The SEC went back to all SPACs in filing and requested that they affirm that they had no contact with potential targets. As a result, many SPACs added a standard paragraph that specifically states that the issuer and its agents have not have any specific business combination under consideration nor have they been in contact with any prospective acquisition partner.

Another glitch that SPACs faced midyear was the shutdown of listings on the American Stock Exchange. While SPACs have historically only had access to the OTC Bulletin Board, a number of SPACs sought to list on the AMEX to further legitimize the structure and broaden the pool of interest. A few were able to list successfully on the AMEX before the door closed. After several months with little word from AMEX, the exchange began to warm again to the structure. Several SPACs began 2006 in the queue for listing.

"Listings on AMEX were on, then off, then back on again. There was nothing formal," said Mitchell Littman, a founding partner at Littman Krooks. He noted that there are some informal parameters for seeking an AMEX listing, including deal size (more than $60 million) and the underwriter's regulatory history. "Deals are evaluated on a case by case basis," he said.

Another speed bump that SPACs faced last year surfaced when the SEC turned its attention to the management warrant purchase agreements that had become standard in SPAC offerings. The sweetener had been added to SPACs to demonstrate management commitment to a transaction. Last summer, the SEC began to question whether the warrant agreements are in violation of Regulation M, which covers the manipulation of a trading market during an offering.

Bankers immediately reworked filed transactions with the feature and many took it out of deals being structured. A no-action request was filed with the SEC by Kenneth Koch with Mintz, Levin, Cohn, Ferris, Glovsky and Popeo on behalf of Key Hospitality Acquisition Corp. (KHPA.OB). The letter notes that the warrant purchase agreement should not be seen in violation of Regulation M because the warrant purchase terms are fully and publicly disclosed, the warrant purchases will be made pursuant to pre-established agreements and none of the warrants will be sold or transferred until the completion of a business combination.

The Division of Market Regulation responded in October that it would not recommend enforcement action if no warrant bids or purchases occur until 60 calendar days after the end of the restricted period for the unit distribution. In addition, the Division said the company must provide, upon request, a daily time-sequenced schedule of all warrant purchases made on a transaction-by-transaction basis. Also, if requested, the company must be available in person or by telephone if the Division had questions regarding the warrant purchases.

"The SEC set forth clear-cut parameters regarding the use of warrant purchase agreements," said Littman. "It was the right result."

SAFE Flip-Flops

One of the hottest areas of reverse merger and SPAC activity has been deals focused on the Chinese market. The economic promise of the Chinese market fueled a number of reverse mergers with Chinese private companies, as well as the formation of several Chinese-focused SPACs.

However, two rules put out by China's State Administration of Foreign Exchange (SAFE) in early 2005 put into question the future of offshore equity financing by Chinese companies via special purpose vehicles. Circulars 11 and 29 required that Chinese companies obtain SAFE approval for any Chinese resident to directly or indirectly establish or obtain control of a foreign company. SAFE's approval was also necessary for any Chinese resident to exchange domestic assets or equity interest for stock or assets of a foreign company. The problem was that little guidance was given as to what was required for approval.

SAFE essentially gave its nod of approval to Chinese companies seeking offshore financing.

In late October, SAFE did an about-face that reverse merger market participants were hoping for. SAFE issued Circular 75 which stipulated that Chinese companies must complete a registration process with the regulatory body before establishing an offshore holding company and before completing an offshore financing, however prior approval is not needed. SAFE essentially gave its nod of approval to Chinese companies seeking offshore financing. *-EK*