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By Kyla Houge *

I. INTRODUCTION

While the practice of trading stocks through stock markets has existed for centuries, the United States was the first nation to regulate this practice when it passed the Securities Act of 1933 (1933 Act) and the Securities Exchange Act of 1934 (1934 Act).[1] The primary objective of the 1933 Act was disclosure regarding the issue and sale of securities, while the 1934 Act created the U.S. Securities Exchange Commission (SEC) and vested it with "broad [regulatory] authority over . . . the securities industry."[2] Established during the era of the Great Depression, these regulations, "along with . . . the Investment Advisers and Investment Company Acts of 1940," were aimed at creating an efficient stock market and protecting the investing public.[3] Arguably, investor protection mechanisms and the efficiency of the U.S. Stock Market have led it to become and remain "the largest and most liquid [stock market] in the world."[4] In fact, as of August 2012, approximately 90 billion dollars in securities were

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[1] *Global Markets, National Regulation, and Cooperation: Hearing on U.S.-EU Financial Regulations Before the House Comm. on Financial Services*, 108th Cong. (2004) (statement of Ethiopis Tafara, Director, Office of International Affairs, U.S. Sec. & Exch. Comm.), https://www.sec.gov/news/testimony/ts051304et.htm. [hereinafter *Global Markets*].

[2] *The Laws That Govern the Securities Industry*, U.S. SEC. EXCH. COMM'N, http://www.sec.gov/about/laws.shtml#secexact1934 (last visited Oct. 17, 2015).

[3] *Global Markets*, *supra* note 1.

[4] *Id.*

traded daily on the New York Stock Exchange (NYSE), equating to a volume of 3.5 billion shares a day.[5]

The stock market has become a lucrative venture for companies and investors alike. Therefore, it should come as no surprise that companies desire to become publicly traded and experience the benefits gained from stock market participation. The danger arises, however, when fraudsters wish to take advantage of those same lucrative benefits of becoming publicly traded.

This article explores reverse mergers, a method commonly used by legitimate businesses and fraudsters alike. Part II provides a historical framework of publicly traded companies by detailing how they first began and exploring how they have evolved. Part III details several reasons a company may decide to go public. Part IV discusses, in detail, three common methods companies use when going public, called initial public offerings, Rule 144 placements, and direct public offerings, and the pros and cons of each method. Part V explores the origin of reverse mergers by explaining what a reverse merger is and exploring how reverse mergers work. Part VI discusses successful public companies that have emerged using reverse mergers. Part VII looks at how fraud is typically perpetuated through the reverse merger process. Part VIII provides specific recommendations on how to toughen the existing regulations. Part IX concludes by exploring the potential impacts of tougher regulations on reverse mergers.

II. Historical Background: The Beginnings Of Publicly Traded Companies

The world's first publicly traded company was formed several centuries before the existence of the first United States stock exchange and stock market regulations. The Dutch East India Company, formed in 1602 and globally known as Verenigde Oost-indische Capagnie (VOC), was the first company in the world to issue "negotiable shares" to the public.[6] The Dutch East India

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[5] Bob Pasani, *Trading Volume Better Than You Think*, CNBC (Aug. 24, 2012 at 12:44 PM EST), http://www.cnbc.com/id/48780316.

[6] Robert Wile, *The First Publicly Traded Company In History Used to Control All This Territory*, Bus. Insider (Mar. 20, 2014, 5:16 PM), http://www.businessinsider.com/dutch-east-india-company-holdings-2014-3.

Company was a multinational company created to protect the Dutch's trading interests within the Indian Ocean region.[7] The company issued shares to help raise capital, and initially, shareholders received a portion of their dividends in "spices and pepper grains."[8]

While the Dutch East Indian Company's success laid the foundation for the development of the world's oldest stock exchange, the Amsterdam exchange,[9] more than 100 years passed before the United States developed a stock exchange of its own. On May 17, 1792 "under a buttonwood tree on Wall Street," twenty-four brokers formally began the New York Stock Exchange (NYSE) by signing the Buttonwood Agreement.[10] In the agreement, the brokers pledged to only conduct business with each other and set minimum commission rates.[11] Their goal was to separate themselves from the auctioneers, whom the brokers felt possessed an unfair advantage, namely city recognition and the ability to sell twice daily.[12]

At its formation, the NYSE traded only five securities.[13] This grew into the hundreds by the end of the 1700s, as more companies became public in their effort to raise capital for project financing.[14] By 1825, over 380,000 shares were traded annually.[15] As time passed, even more companies became public, and the amount of

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[7] Ben Phelan, *Dutch East India Company: The World's First Multinational*, PBS (Jan. 7, 2013), http://www.pbs.org/wgbh/roadshow/fts/corpuschristi_201205A19.html.

[8] Jeroen Molenar, *Antique Share, Worth as Much as $764,000, Found by Student*, BLOOMBERG (Sept. 10, 2010, 9:58 AM PDT), http://www.bloomberg.com/news/articles/2010-09-10/antique-share-worth-as-much-as-764-000-found-by-dutch-history-student.

[9] *Id.*

[10] Brian Murphy, *The Rise of an American Institution: The Stock Market*, THE GILDER LEHRMAN INSTITUTE OF AMERICAN HISTORY, https://www.gilderlehrman.org/history-by-era/economics/essays/rise-american-institution-stock-market (last visited Oct. 18, 2015).

[11] *Id.*

[12] *Id.*

[13] *Id.*

[14] *Id.*

[15] Murphy, *supra* note 10.

shares exchanged continued to increase. As of 2010, the daily number of shares traded exceeded three billion.[16]

III. Why Companies Want To Become Public

> The conventional wisdom is that going public is simply a stage in the growth process of a company. Although there is some truth in it, this "theory" alone cannot explain the observed pattern of listings. Even in developed capital markets, . . . some large companies–such as United Parcel Service or Bechtel–are not public. In other [financial systems], publicly traded companies are the exceptions rather than the rule, and quite a few private companies are much larger than the average publicly traded company. These cross-sectional and cross-country differences indicate that going public is not a stage that all companies eventually reach, but it is a choice. [17]

Despite popular belief, a company's decision to go public is not based on its size or length of time in business. A company may decide to go public for a variety of other reasons: to raise capital, spread ownership risk, reduce the cost of capital, obtain financing, and/or reduce debt are among the most common reasons.[18] A company may also go public in a desire to increase its visibility and become more competitive within the general marketplace.[19]

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[16] *Id.*

[17] Marco Pagano, Fabio Panetta & Luigi Zingales, *Why Do Companies Go Public? An Empirical Analysis* 27-28 (Nat'l Bureau of Econ. Research, Working Paper No. 5367,1998).

[18] Business Dictionary, *Why Does a Company Decide to Go Public*, BusinessDictionary.Com, http://www.businessdictionary.com/article/780/why-does-a-company-decide-to-go-public/ (last visited Feb. 2, 2016).

[19] Kendra Decker, *Is Going Public The Right Answer For Your Company?*, Grant Thornton LLP (2015), https://www.grantthornton.com/~/media/content-page-files/technology/pdfs/2014/141211-PP-Going-Public-Chap1-141218-FIN.ashx.

Privately held companies may find it difficult to access loans from lending institutions.[20] By becoming public, companies are able to get capital from an alternative source, the stock market.[21] This allows companies "to overcome the borrowing constraints that [sometimes] keep production at . . .sub-optimal level[s] . . . [while] giv[ing] . . . [company owners] the chance to unload part of the . . . [ownership risk] to risk-neutral investors."[22] As a result, the company is able to potentially increase its net worth and/or decrease its debt, thus reducing its debt-to-equity ratio.[23] Additionally, by becoming public, the company can satisfy their "external funding needs" without having to encounter "high interest rates or . . . credit rationing" that a bank may offer.[24]

Should a company decide to use a bank as a method of funding their external needs, becoming publicly traded first can serve as an advantage. Publicly traded companies must provide information about its financials to the general investing public, enabling outside financial institutions to assess the company's credit worthiness and creates competition among lending banks.[25] The publicly traded company benefits because this "ensures a lower cost of capital [and/or] a larger supply of external finance [options]."[26]

A company may also seek to go public to raise its overall profile.[27] By becoming public, a company may be able to "heighten its name and [increase] brand recognition."[28] Analysts may also begin reporting on the company's performance and comparing its

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[20] Pagano et al., *supra* note 17, at 7.

[21] *Id.*

[22] Gian Luca Clementi, *IPOs and The Growth of Firms* 2 (Apr. 3, 2002), http://pages.stern.nyu.edu/~gclement/Papers/ipo.pdf.

[23] Decker, *supra* note 19. *See also* Sheyna Steiner, *Debt-to-equity ratio: What it means to investors and how to calculate it,* BANKRATE.COM (Feb. 3, 2016), http://www.bankrate.com/finance/investing/debt-to-equity-ratio-how-to-calculate.aspx (defining debt-to-equity ratio as "[t]he relationship between the total debt and total equity," which is calculated dividing a company's total liabilities by its shareholders' equity.).

[24] Pagano et al., *supra* note 17, at 7.

[25] *Id.*

[26] *Id.*

[27] Decker, *supra* note 19.

[28] *Id.*

performance against other companies within the same "peer group" after going public.[29] Through this coverage, analysts will "highlight . . . strengths and recommend[] areas for improvement."[30] Analyst activities will also help raise the company's profile.[31] As a result of increased coverage and brand recognition, "potential customer[], investor[], and employee[]" interest in the company may increase.[32]

IV. Common Ways For A Company To Go Public & the Pros and Cons of Trading Publicly

A. Initial Public Offering

An initial public offering (IPO) is one of the more commonly known methods that companies use to go public. An IPO represents the first time that a company's shares are available for the public to purchase.[33] Prior to going public, little is known about the health of the company. As a result, federal securities laws require companies to register with the SEC or fall under a lawful registration exception.[34]

Because so much is disclosed about a company's financial health and overall strength, companies often make plans to position themselves for a successful IPO far in advance of filing the required SEC documents.[35] A company may change its corporate structure, which includes modifying its tax status and addressing other tax considerations prior to its IPO announcement.[36] The company's goal is to be structured in a way that will help them accomplish "future

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[29] *Id.*

[30] *Id.*

[31] *Id.*

[32] *Id.*

[33] Securities & Exchange Commission, Investor Bulletin: Investing In An IPO 1 SEC Pub No. 133, http://www.sec.gov/investor/alerts/ipo-investorbulletin.pdf [hereinafter SEC Investing In IPO].

[34] *Id.*

[35] Eric C. Sibbitt, K. Peter Ritter & Evan T. Pickering, *Capital structure and tax consideration for an IPO,* The Deal Pipeline (Sept. 13, 2011, 3:30 PM), http://www.thedeal.com/content/private-equity/capital-structure-and-tax-considerations-for-an-ipo.ph

[36] *Id.*

corporate goals" and be viewed as an attractive investment to future potential investors.[37]

In the case of an IPO, the process generally starts with the company filing either a Form S-1 or other registration documents.[38] After the forms are filed and the SEC staff "declar[es] the registration statement effective," a prospectus is made available for the company to use when soliciting potential investors.[39] "The prospectus . . . describ[es] the company, the IPO terms and other information that" may help a person make the decision of whether to invest in that company.[40]

While the process on its face sounds relatively simple and straightforward, the IPO process is actually very expensive and time consuming for companies who wish to go public. In 2002, the Sarbanes-Oxley Act (SOX) was implemented, which "mandated a number of reforms to enhance corporate responsibility, enhance financial disclosures and combat corporate and accounting fraud."[41] The SOX essentially made becoming public via the IPO process more difficult for companies because a company is required to be firmly established and is subjected to stricter regulatory requirements than in the past.[42] Once a company files the required documents with the SEC, the staff reviews the documents to make sure that the required disclosures meet the stricter standards set by SOX.[43] This often results in multiple revisions to the documents submitted to the SEC staff, which in turn results in prospectus revisions.[44]

In addition to the regulatory filing requirements, a company needs to hire an investment bank to help sell the actual shares of the

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[37] *Id.*

[38] SEC INVESTING IN IPO, *supra* note 33, at 1.

[39] *Id.*

[40] *Id.*

[41] *The Laws That Govern the Securities Industry,* U.S. SEC. & EXCH. COMM'N, http://www.sec.gov/about/laws.shtml#sox2002 (last visited Nov. 10, 2015).

[42] Elizabeth Wasserman, *How to Prepare a Company for an Initial Public Offering*, INC.COM (Feb. 10, 2010), http://www.inc.com/guides/preparing-for-initial-public-offering.html.

[43] *The Laws That Govern the* Securities *Industry*, *supra* note 41.

[44] *Id.*

company.[45] The hiring of the investment bank typically precedes the filing of the regulatory documents.[46] This is because the investment bank's underwriters typically help the company determine how many shares to sell, the initial offering price, and the "type of securities to be issued."[47] The company and underwriter also have negotiations surrounding how the shares will actually be sold.[48] Sometimes one underwriter will effectuate the sale of the IPO, and in other instances, several underwriters will share that function.[49] At its completion, the average company spends over $3 million dollars to become public via the IPO process.[50]

While the IPO process can be tedious and expensive, there are pros a company could experience from going public using this method. A company often goes public to raise capital.[51] The ability to raise capital through the securities market is a big benefit for many companies.[52] By going public through an IPO, a company's "access to capital markets to raise money through [stock] and bond offerings" is increased exponentially.[53] Additionally, the IPO process increases the company's visibility, which has a direct impact on brand recognition and overall consumer confidence.[54] Because the disclosure requirements are so stringent, going public using the IPO

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[45] *The Underwriting Process*, DESJARDINS ONLINE BROKERAGE, https://www.disnat.com/en/learning/trading-basics/initial-public-offerings-ipos/the-underwriting-process (last visited Nov. 15, 2015).

[46] *Id.*

[47] *Id.*

[48] *Id.*

[49] *Id.*

[50] *Considering an IPO? The Costs of Going and Being Public May Surprise You*, PRICEWATERHOUSECOOPERS LLP (Sept. 2012), https://www.pwc.com/us/en/transaction-services/publications/assets/pwc-cost-of-ipo.pdf.

[51] *See supra* Part III and accompanying notes.

[52] *Private Company Insights: Balancing the motivation for an IPO with the pros and cons*, ERNST & YOUNG, http://www.ey.com/Publication/vwLUAssets/Private_company_insights-IPO-Pros_and_Cons/$FILE/Private%20company%20insights%20-%20IPO%20-%20Pros%20and%20Cons.pdf (last visited Nov. 15, 2015).

[53] *Id.*

[54] *Id.*

method can also increase the company's overall value.[55] This is because the uncertainty surrounding the company's performance is reduced, since the company is required to disclose so much information.[56]

While the benefits derived from going public via an IPO are numerous, there are also drawbacks for a company that uses this method to become public. A primary drawback is the cost.[57] As previously discussed, the process to go public via the IPO method is very expensive. This cost is one that the company takes on in order to effectuate the IPO process.[58] In addition to the costs associated with the actual IPO, a company will also incur ongoing costs to remain public.[59] This is because a company is required to "compl[y] with its Exchange Act reporting obligations, . . . applicable provisions of Sarbanes-Oxley, . . .[and] the listing standards of its chosen exchange or NASDAQ."[60]

Apart from costs, there are organizational changes that will inevitably take place as a result of going public. Once a company goes public, executives of the company are no longer accountable just to one another.[61] The accountability shifts to shareholders and an independent board of directors.[62] In addition, executives will have to work within the stock market regulations when making decisions surrounding the company.[63] This means the company would have to disclose all material changes that take place within the company regardless of whether they are positive or negative.[64] These reporting obligations include making detailed disclosures surrounding a

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[55] *Id.*

[56] *Id.*

[57] *Id.*

[58] Jonathan Deverill, *Thinking of "Going Public"? Some Pros And Cons Explained*, MONDAQ, CONNECTING KNOWLEDGE & PEOPLE (Nov. 11, 2013), http://www.mondaq.com/x/274102/Commodities+Derivatives+Stock+Exchanges/Thinking+Of+Going+Public+Some+Pros+And+Cons+Explained.

[59] *Id.*

[60] Snell & Wilmer, LLP, *Going Public*, THE CORP. HANDBOOK SERIES 5 (2006), https://www.sec.gov/info/smallbus/gbfor25_2006/goingpublic.pdf.

[61] Deverill, *supra* note 58.

[62] *Id.*

[63] *Id.*

[64] *Id.*

company's "business and operations, . . . the compensation of its directors and officers, related-party transactions, and other matters."[65]

Officers and directors within a company will also have certain filing obligations and will be subject to trading restrictions due to their role within the company.[66] Failure to disclose the required information on public disclosures or material misstatements made on such disclosures, including SEC filings, will subject the company, its directors, and/or officers to legal liability under federal securities laws.[67] Generally, the duties of a company's officers and directors increase substantially, and thus, they become more "susceptib[le] to claims for breaches of such duties."[68]

B. Rule 144 Placements

Rule 144 is an exemption provided in the 1933 Act that applies to "certain offers and sales of qualifying securities by certain persons other than the issuer of the securities."[69] The securities sold under the Rule 144 exemption are otherwise restricted securities that were "acquired in unregistered, private sales from the issuing company or from an affiliate of the issuer."[70] Any person who is in a position to "direct the management and policies of the company in question" would be considered an affiliate of an issuer.[71] Large shareholders, members of a company's board of directors, and company executives are also included in this definition.[72] Referred to as the "safe harbor exemption," Rule 144 allows the securities to be resold to the public once certain conditions are met.[73]

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[65] Snell & Wilmer, LLP., *supra* note 60, at 5.
[66] *Id.*
[67] *Id.*
[68] *Id.*
[69] Lloyd S. Harmetz, *Frequently Asked Questions About Rule 144A*, MORRISION & FORESTER, LLP (2016), http://media.mofo.com/files/Uploads/Images/FAQRule144A.pdf.
[70] *Rule 144: Selling Restricted and Control Securities*, U.S. SEC. & EXCH. COMM'N (Jan. 16, 2013), https://www.sec.gov/investor/pubs/rule144.htm [hereinafter *Rule 144*].
[71] *Id.*
[72] *Id.*
[73] *Id.*

To go public using the Rule 144 exemption, a company must go through a multistep process, which begins with a private placement to a qualified institutional buyer (QIB).[74] After the securities are sold to a QIB, the company has two filing options.[75] The company can either file an IPO registration statement with the SEC or "file and go effective with a shelf registration statement from which the privately placed securities . . . can be sold publicly from time to time."[76] The length of time a QIB must hold the securities before they can be sold to the public depends on whether or not the issuer is a company that has "complied with the periodic reporting requirements of the Securities Exchange Act of 1934."[77] If the company does file periodic reports, the QIB only has to hold the security for six months.[78] Otherwise, the QIB must wait twelve months for a non-reporting company.[79] During the waiting period, "the privately placed securities are [only] eligible for trading among QIBs."[80]

Going public using the Rule 144 placement method has several advantages. This method allows a company to get access to needed capital much faster.[81] While the filing requirements of Rule 144 placements are similar to that of IPOs, a company does not have to file any documents with the SEC until after the company receives the proceeds from the private placement.[82] This allows the company to "receive the offering proceeds without [first] having to go through the SEC review process."[83] A company is still technically privately held during the private placement process, and this gives the company an added benefit of having more time to comply with SEC

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[74] Snell & Wilmer, LLP, *supra* note 60, at 6. *See generally* 17 CFR 230.144A (expressly states that private placements that are only to QIBs are exempt from registration and defines what institutions would be considered a QIB, noting that no individual investors are included in the definition).

[75] Snell & Wilmer, LLP, *supra* note 60, at 6.

[76] *Id.*

[77] *Rule 144*, *supra* note 70.

[78] *Id.*

[79] *Id.*

[80] Snell & Wilmer, LLP, *supra* note 60, at 6.

[81] *Id.*

[82] *Id.*

[83] *Id.*

registration requirements before becoming public.[84] Another benefit is that during the filing process, stock is tradable among QIBs, which creates the possibility of the company receiving "a higher valuation for its stock than it would in a typical private placement."[85]

One disadvantage of a Rule 144 placement is that the company is not able to avoid the long and costly process of registering with the SEC.[86] In addition, a company typically has an agreement with QIBs stating that registration will occur within a specified time frame.[87] For the company who does not meet the deadlines contained in the agreement, this would also be disadvantageous because the agreement may require the company to pay penalty for missing those deadlines.[88]

C. Direct Public Offering

A direct public offering is a way for a company to go public without the middleman underwriter.[89] This method of going public is ideal for "smaller businesses that lack either the resources or the stature to attract an underwriter or banks or insurance companies with a built-in investor base that are converting to stock corporations."[90]

In 2012, the government passed the Jumpstart Our Business Startups Act (JOBS Act) in an effort to loosen the regulatory requirements for smaller businesses by creating avenues for them to raise capital more easily.[91] The JOBS Act is specifically aimed at businesses with less than $1 billion in revenue and relaxes accounting

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[84] *Id.*
[85] *Id.*
[86] Snell & Wilmer, LLP, *supra* note 60, at 6.
[87] *Id.*
[88] *Id.*
[89] Laura S. Unger, *Speech by Acting Chairman: Raising Capital on the Internet*, U.S. SEC. & EXCH. COMM'N (May 9, 2001), https://www.sec.gov/news/speech/spch471.htm.
[90] *Id.*
[91] Jessica Holzer, *JOBS Act Sputters on IPOs*, THE WALLSTREET JOURNAL (Mar. 27, 2012 at 7:29 PM EST), http://www.wsj.com/articles/SB10001424127887323361804578388683308322162.

standards and reporting requirements for those companies that wish to go public.[92]

While the direct public offering method itself has been used for a long time, the JOBS Act created a "crowdfunding exemption" that allows a company to market its shares directly to potential investors online.[93] A company can use the Internet to attract geographically broad investment interest from potential investors as well as distribute required regulatory materials to them.[94] While ideal for small businesses, the ability to solicit potential investors online through a direct public offering can also benefit larger corporations who wish "to leverage their name recognition on a global basis."[95] This is because, like with smaller companies, they are able to use their resources to solicit a broad number of potential investors from various locations throughout the globe.[96]

Many of the advantages of a direct public offering are similar to the advantages of an IPO. Like an IPO, a direct public offering offers a company the ability to have greater access to capital, increased visibility, and "enhanced credibility."[97] Additional benefits of a direct public offering are lower costs.[98] This is because an underwriter is not used in the direct public offering process.[99] Companies market their shares directly to the public using the Internet.[100]

While their benefits are similar to IPOs, going public using the direct public offering method presents its own set of challenges. The costs associated with a direct public offering could still end up being

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[92] *Id.*

[93] *SEC Adopts Rules to Permit Crowdfunding Proposes Amendment to Existing Rules to Facilitate Intrastate and Regional Securities Offerings,* U.S. SEC. & EXCH. COMM'N, https://www.sec.gov/news/pressrelease/2015-249.html.

[94] Unger, *supra* note 89.

[95] *Id.*

[96] *Id.*

[97] DPO Guide, *Direct Public Offering,* DIRECT PUBLIC OFFERINGS, http://www.dpoguide.com/DirectPublicOfferings.aspx (last visited Nov. 15, 2015).

[98] *Getting Started on Direct Public Offerings,* ENTREPRENEUR, http://www.entrepreneur.com/article/52818 (last visited Nov. 15, 2015) [hereinafter ENTREPRENEUR GUIDE].

[99] *See supra* Part III and accompanying notes.

[100] *Id.*

substantial.[101] This is because the company is responsible for finding its own potential investors, thus raising its own capital.[102] Companies who utilize the direct public offering method of going public do not have the benefit of professionals to help them find investment capital.[103] In fact, a Bank of America study found that "a direct public offering can cost anywhere from $50,000 to $125,000."[104] This can be a substantial cost for smaller companies who are only raising $1 million in capital.[105]

Liquidity is another drawback of the direct public offering method of going public.[106] Because shares are commonly marketed to fewer investors in a direct public offering than in an IPO, the shares that investors hold would not be as liquid.[107] With fewer shares in circulation, fewer potential investors may be willing to purchase shares of the company. This can also make the marketing efforts in direct public offerings more difficult, as investors would be aware of liquidity concerns.[108]

V. The Birth of reverse Mergers

A. How Reverse Mergers Work

Another way for a company to go public involves the private company merging with a preexisting public entity.[109] Commonly referred to as a reverse merger, this method allows the private company to bypass the IPO process while gaining access to the public market at a lower cost.[110] In a reverse merger, a publicly

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[101] Entrepreneur Guide, *supra* note 98.
[102] DPO Guide, *supra* note 97.
[103] *Id.*
[104] Entrepreneur Guide, *supra* note 98.
[105] *Id.*
[106] *Id.*
[107] *Id.*
[108] *Id.*
[109] Marc Zwilling, *Is a Reverse Merger The Way To Fund Your Startup?*, Forbes.Com (May 2, 2014, 8:06 PM), http://www.forbes.com/sites/martinzwilling/2014/05/02/is-a-reverse-merger-the-way-to-fund-your-startup/#2715e4857a0b3858e0e1717f.
[110] *Id.*

traded company with little assets acquires the privately held company.[111] Similar to the IPO, a Rule 144 placement, or the direct public offering process, the reverse merger process is another way for a company to gain access to capital and liquidity by becoming publicly traded.[112] "A reverse merger often is perceived to be a quicker and cheaper method of 'going public' than an . . . [IPO]."[113] This is because of the reduced legal and accounting fees associated with a reverse merger, as compared to an IPO.[114] The lower costs are due to the fact that, unlike an IPO, the 1933 Act imposes no formal registration requirements on reverse mergers.[115] Those companies merely have to file the Form 8-K with the SEC and comply with the previously discussed rules.[116]

B. Evolution of Reverse Mergers Legislation

While it is not clear when the reverse merger process initially began, the general investing public was first made aware of this method when the SEC publicly disclosed its awareness of the process and addressed its concerns regarding potential fraudulent activities surrounding reverse mergers.[117] In its 1969 public release, the SEC specifically said that it felt the reverse merger process was "in possible violation of the registration requirements of the [1933 Act] and of the antifraud and antimanipulative provisions of the [1933 Act] and the [1934 Act]."[118] Despite the public release in 1969, many decades would pass before anything was adopted or proposed

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111 *Investor Bulletin: Reverse Mergers*, SEC. & EXCH. COMM'N OFFICE OF INVESTOR EDUC. & Advocacy, https://www.sec.gov/investor/alerts/reversemergers.pdf (last visited Feb. 1, 2016).

112 *Id.*

113 *Id.*

114 *Id.*

115 *Id.*

116 *Id.*

117 Aden R. Pavkov, *Ghouls and Godsends? A Critique of "Reverse Merger" Policy*, 3 BERKELEY BUS. L.J. 475, 513 (2006).

118 SECURITIES AND EXCHANGE COMMISSION, SEC RELEASE NO. 33-4982, APPLICATION OF THE SECURITIES ACT OF 1933 AND THE SECURITIES EXCHANGE ACT OF 1934 TO SPIN OFFS OF SECURITIES AND TRADING IN THE SECURITIES OF INACTIVE OR SHELL CORPORATIONS (1969).

by the SEC to directly address their concerns surrounding reverse mergers.[119]

1. Securities Act Rule 419 & Exchange Act Rule 15g-8

In its attempt to deter fraud within the securities market, particularly when it came to penny stocks, Congress instructed the SEC to create rules surrounding "blank check companies offering penny stock."[120] In response to the Congressional directive, in 1992 the SEC adopted Securities Act Rule 419 (Rule 419) and Exchange Act Rule 15g-8 (Rule 15g-8).[121] Rule 419 requires that nearly all of the monies and securities received in connection with a penny stock offering be deposited into a separate escrow or trust account.[122] The deposited funds can not be removed until the issuer satisfies the requirements of a successful acquisition or, in the case of no actual acquisition, after the passage of eighteen months.[123] As requested by Congress, the SEC applied this rule specifically to blank check companies, which it defined "as a development stage company that is offering a penny stock . . . that has no specific business plan or purpose or has indicated that its business plan is to engage in a merger with or acquisition with an unidentified company or companies."[124] "Rule 15g-8 prevents trading of securities held in the . . . [a]ccount."[125]

While Rule 419 and Rule 15g-8 did have an effect on the reverse merger process, the regulations did not specifically mention reverse mergers.[126] The rules only addressed blank check companies.[127] The

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[119] Pavkov, *supra* note 117.

[120] ¶ 12,885 BLANK CHECK OFFERINGS, 2009 WL 2318094.

[121] *Id.*

[122] Joseph I. Goldstein, *An Investment Masquerade: A Descriptive Overview of Penny Stock Fraud and the Federal Securities Laws*, 47 BUS. LAW. 773, 832-33 (1992).

[123] *Id.* at 833. If no acquisition has taken place eighteen months "after the effective date of the initial registration statement, funds held in the escrow or trust account must be returned to investors. . . ." *See* SECTION 616. RULE 419—OFFERINGS BY BLANK CHECK COMPANIES, 2014 WL 2128672.

[124] 1B Going Public Corp. § 12:153.

[125] ¶ 12,885 BLANK CHECK OFFERINGS, 2009 WL 2318094.

[126] Pavkov, *supra* note 117, at 498.

regulations also did not include companies that were beyond the development stage but had no assets or operations, such as "those public entities [within the] post-bankruptcy [stages]."[128] Therefore, the regulations did not completely eliminate or restrict the reverse merger process.

2. The first rule amendment surrounding reverse mergers

After the implementation of Rule 419 and Rule 15g-8, the SEC made various comments surrounding reverse mergers.[129] In 1999, the SEC even made a proposal that would prevent shell companies from using Form S-8, which was typically used by those companies who wanted to issue its securities to employees.[130] The argument was that shell companies were using the form, without much oversight as an easy method of registering securities to consultants, who were not employees in the traditional sense.[131] The SEC ultimately decided that they would not pursue the implementation of the 1999 proposal.[132]

In 2004, the SEC proposed new rules that had a direct effect on shell companies, and in 2005, they made rule amendments to adopt their 2004 proposal.[133] The SEC used this opportunity to close an important loophole found within Rule 419.[134] Rule 419 only applied to blank check companies and excluded companies who did not have assets or operations but were still technically publically traded companies.[135]

The new rules aimed to include those companies within the new regulations by defining shell companies.[136] According to the SEC's

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[127] *Id.*
[128] *Id.*
[129] *Id.* at 500-01.
[130] *Id.*
[131] *Id.* at 501.
[132] Pavkov, *supra* note 117, at 501.
[133] *Id.*
[134] *Id.* at 502.
[135] *Id.*
[136] Mitchell C. Littman & Susan G. Curtis, *Reverse Mergers Will Require Increased Disclosure In Shorter Period,* LITTMAN KROOKS LLP,

definition, a shell company is "a registrant that has no or nominal operations and meets one of the three alternate criteria: (1) has no or nominal assets; (2) has assets consisting solely of cash and cash equivalents; or (3) has assets consisting of any amount of cash and cash equivalents and nominal other assets."[137] The rule also included companies with "minimal ongoing business."[138] The SEC intentionally failed to define the term "nominal assets."[139] They also added two footnotes aimed at ensuring the elimination of any potential loopholes that people may use to circumvent the new rules.[140]

Under the rule adopted in 2005, the SEC required public shell companies to file an 8-K no later than four business days after another entity has reverse merged into it.[141] The disclosures required are "the same type of disclosure that would be provided if the former shell company were registering its securities under the Securities Act of 1934."[142] This essentially requires the company to also provide audited financial statements, slowing down the actual reverse merger process.[143] "The new rules [were] intended to assure that investors in public shell companies that acquire or are acquired by ongoing businesses have access on a timely basis to the same kind of information as is available to investors in public companies with continuing operations."[144]

Typically, publicly traded companies are able to register employee security offerings within an employee benefit plan using a form called Form S-8.[145] The new rule also prohibited shell companies from using this form until the passage of 60 business days from the completion of the reverse merger.[146] The goal of the

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http://www.littmankrooks.com/pdf/NYLJ%207-25-05%20-%20Reverse%20Mergers.pdf (last visited Feb. 4, 2016).

[137] *Id.*

[138] *Id.*

[139] *Id.*

[140] *Id.*

[141] *Id.*

[142] Littman & Curtis, *supra* note 136.

[143] *Id.*

[144] *Id.*

[145] *Id.*

[146] *Id.*

prohibition was to keep the shell companies from using the simplified Form S-8 process as a capital raising method.[147]

3. Rule amendments of 2011

In 2011, the SEC again made changes to its rules in an effort to "tighten U.S. stock exchange listing standards for companies that have gone public through a reverse merger."[148] The New York Stock Exchange (NYSE), the Nasdaq Stock Market (NASD), and the NYSE Amex proposed this newly amended rule.[149] The rule's goal was to place more restrictions on foreign companies who were trying to enter the U.S. stock market through the reverse merger process.[150] Ultimately, the SEC wanted "to provide investors with easier access to financial reports issued by reverse-merger companies, whose shares are listed on the U.S. stock exchange."[151]

Under the new rules, companies who utilized the reverse merger process to become publicly traded had to wait one year, called a "seasoning period," after the reverse merger.[152] During the seasoning period, the company had to file several required reports with the SEC, and the company's shares had to have traded on an over-the-counter (OTC) market, a separate foreign exchange, or a domestic exchange.[153] The SEC was making it harder for these types of companies to list on the major exchanges within the U.S. Additionally, the 2011 rules required companies to "maintain[] a minimum trading price for 'a sustained period,' [and for] 30 of the 60 trading days" leading up to the listing application and actual listing date with the exchange.[154]

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[147] *Id.*

[148] Randolf W. Katz, *SEC Approves Tougher New Rules for Reverse Merger Companies*, BAKERHOSTELER (Nov. 14, 2011), http://www.bakerlaw.com/alerts/SEC-Approves-Tougher-New-Rules-for-Reverse-Merger-Companies-11-14-2011.

[149] *Id.*

[150] *Id.*

[151] *Id.*

[152] *Id.*

[153] *Id.*

[154] Katz, *supra* note 148.

The SEC provided a few exceptions to the new listing rules for reverse mergers that meet certain requirements. Companies that are conducting a reverse merger are exempt if they "have filed at least four annual reports with the SEC since completing the reverse merger" or have completed an underwriting public offering with proceeds of $40 million or more to the company.[155] The public offering could be underwritten either subsequent to the reverse merger or concurrently with it.[156] Essentially, companies who have access to a large influx of capital and have filed four annual reports with the SEC would not have to subject themselves to the one year cooling off period or any of the other things established by the new rule.

VI. Successful Reverse Mergers

A. Berkshire Hathaway

Beginning as a "failing textile firm," Berkshire Hathaway is a company with humble beginnings that grew to become "one of the largest companies in the world."[157] Led by its chairman, CEO, and largest shareholder, Warren Buffet (Buffet), Berkshire Hathaway is a conglomerate of wholly owned subsidiary companies, many of which are household names, like Geico Corp. and Dairy Queen.[158] While many people are familiar with various companies owned by Berkshire Hathaway, people often forget that it developed from what is "[a]rguably the most famous reverse merger."[159] Buffet essentially bought controlling interest of the failing textile company and merged his insurance empire into it.[160]

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[155] *Id.*

[156] *Id.*

[157] Erik Holm, *What is Berkshire Hathaway?*, The Wall Street Journal (Apr. 30, 2015, 2:40 PM), http://blogs.wsj.com/moneybeat/2015/04/30/what-is-berkshire-hathaway/.

[158] *Id.*

[159] James Altucher, *The delicate art of a good reverse merger*, FT.Com (Jan. 17, 2005, 10:48 PM), http://www.ft.com/intl/cms/s/0/febcc59a-68d7-11d9-9183-00000e2511c8.html#axzz3xflPw4j0.

[160] *Id.*

The original textile company was called Hathaway Manufacturing Company, and a man named Horatio Hathaway started it in 1888.[161] The cotton milling company was extremely successful until after World War I, when the cotton industry begun to decline.[162] During the decline, the company was ran by Seabury Stanton (Stanton) who, through his personal finances, kept the company open.[163] In the 1950s, Stanton merged Hathaway with a milling company called Berkshire Fine Spinning Associates, Inc.[164] Berkshire Hathaway was born.[165]

Buffet became involved with Berkshire Hathaway beginning in 1962, after the company saw a sharp decline in its stock price during the late 1950s.[166] Buffet viewed the company as a cheap investment and gradually purchased shares in the company, increasing his concentration to 49 percent.[167] He used his shareholder votes to appoint himself as CEO, and then appointed a President to run the day-to-day operations.[168]

In 1967, after coming to the realization that the textile industry was becoming unprofitable, Buffet began to eye the insurance business.[169] He purchased two companies called National Indemnity and National Fire and Marine Insurance.[170] "This first investment in insurance was the start of Berkshire Hathaway's rise to the investment legend it has become today."[171] The private insurance companies merged into the already publicly traded textile company, and the name Berkshire Hathaway remained in tact.[172]

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[161] Julian Livy, *History of Berkshire Hathaway*, BUFFETSECRETS.COM (Jan. 21, 2013), http://www.buffettsecrets.com/berkshire-hathaway.htm.

[162] *Id.*

[163] *Id.*

[164] *Id.*

[165] *Id.*

[166] Livy, *supra* note 161.

[167] *Id.*

[168] *Id.*

[169] *Id.*

[170] *Id.*

[171] *Id.*

[172] Livy, *supra* note 161.

B. Jamba Juice

Jamba Juice is a California based company that began as Juice Club in 1990 before changing its name to Jamba Juice in 1995.[173] Its founder was Kirk Perron (Perron), and his vision was to create "a healthful fast-food restaurant that relied on the sale of smoothies."[174] While currently very successful, Jamba Juice was also a company with humble beginnings.

During its initial year, "daily sales hovered around the $500 level," and the company's future was uncertain.[175] By the end of the second year, the company was seeing a profit, and Perron decided to expand through franchising.[176] This method of expansion was not viewed as a good long-term move because it created a risk of "losing quality control," and the company lacked the capital it needed to train managers and "monitor the quality of the product."[177] Therefore, Perron decided to utilize venture capitalist to generate capital, which resulted in raising over $60 million.[178]

As Jamba Juice grew, Perron's desire to become a publicly traded company also grew.[179] In 2005, Jamba Juice was "earning between $13.5 million and $15.25 million."[180] Their unaudited financial statements showed rapid growth between 2003 and 2004.[181] Prior to the acquisition, Services Acquisition Corp. International (Services Acquisition Corp.) had 20.4 million outstanding shares, and there was concern surrounding the fact that that number would expand exponentially after the merger, creating dilution.[182]

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[173] FUNDING UNIVERSE, http://www.fundinguniverse.com/company-histories/jamba-juice-company-history/ (last visited Feb. 4, 2016).

[174] *Id.*

[175] *Id.*

[176] *Id.*

[177] FUNDING UNIVERSE, *supra* note 173.

[178] *Id.*

[179] *Id.*

[180] *Id.*

[181] Matthew Goldstein, *Juice is in Jamba*, THE STREET (Mar. 28, 2006, 7:17 AM EST), http://www.thestreet.com/story/10275895/1/juice-is-in-jamba.html.

[182] *Id.*

Services Acquisition Corp. was a company developed specifically to acquire another business.[183] This is what is commonly referred to as a blank check company or shell company.[184] It became public in 2005 and raised around $127 million during its initial public offering.[185] Former executives from AutoNation, Blockbuster, and Boca Resorts managed the company.[186]

Despite the dilution concern, shareholders were impressed with Jamba Juice's rapid growth, and on November 28, 2006, shareholders of Services Acquisition Corp. agreed to acquire privately held Jamba Juice.[187] Jamba Juice ultimately "became a wholly-owned subsidiary of [Services Acquisition Corp.]," and Service Acquisition Corp.'s name was changed to Jamba Inc.[188] As part of the reverse merger agreement, shareholders agreed to issue over 30 million more shares, which raised financing capital of $224.9 million.[189] A stock option plan was approved, and the authorized share number was increased from 70 million to 150 million shares.[190]

VII. Reverse Mergers and Fraud

While there are many more examples of companies who have successfully gone public using the reverse merger process, apart from the ones described above, a genuine concern of the SEC is the consummation of fraud using the very same methods. In fact, on an investor bulletin released by the SEC in June 2011, they caution investors about the potential pitfalls of investing in reverse merger companies.[191] The SEC stated, "Many companies either fail or

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183 *Services Acquisition Corp. International and Jamba Juice Company Announce Approval of Merger and Name Change*, Piper Jaffray, http://www.piperjaffray.com/pdf/jamba_juice_news_release_112806.pdf (last visited Feb. 1, 2016) [hereinafter Piper Jaffray].

184 *Id.*

185 *Id.*

186 *Id.*

187 *Id.*

188 *Id.*

189 Piper Jaffray, *supra* note 183.

190 *Id.*

191 *Investor Bulletin: Reverse Mergers*, *supra* note 111.

struggle to remain viable following a reverse merger."[192] They also pointed out that "there [had] been instances of fraud and other abuses involving reverse merger companies."[193]

A. Pump & Dump Schemes

Pump-and-Dump Schemes are one method of fraud commonly found within the reverse merger process. It is essentially a market manipulation technique, in which misleading statements are made to boost the price of the stock.[194] Typically, the statements are made on various Internet mediums such as social media, online chat rooms, or bulletins.[195] The scheme is most commonly utilized with small or microcap companies.[196] Stock promoters will post messages creating an urgency to purchase or sell a particular stock before the price drops or increases drastically.[197] These stock promoters are typically either company insiders or are paid by the company or fraudster.[198] They "stand to gain by selling their shares after the stock price is 'pumped' up by the buying frenzy they create."[199] Once a stock reaches the desired level, the fraudsters then dump their shares.[200] This most frequently results in the stock price dropping, and outside investors lose their money.[201]

While pump-and-dump schemes technically can happen outside of a reverse merger, the Federal Bureau of Investigation (FBI) has found that it occurs most often within that context.[202] Fraudsters

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[192] *Id.*
[193] *Id.*
[194] "*Pump-and-Dumps" and Market Manipulations*, U.S. SEC. & EXCH. COMM'N, https://www.sec.gov/answers/pumpdump.htm (last visited Jan. 15, 2016). [hereinafter *Pump-and-Dumps*].
[195] *Id.*
[196] *Id.*
[197] *Id.*
[198] *Id.*
[199] *Id.*
[200] *Pump-and-Dumps*, *supra* note 194.
[201] *Id.*
[202] *Market Manipulation Fraud*, FED. BUREAU OF INVESTIGATION https://www.fbi.gov/about-us/investigate/white_collar/market-manipulation-fraud (last visited Jan. 12, 2016).

typically develop a private company and use that company to acquire a publicly traded shell company.[203] "In [the] reverse merger, the fraudsters sell their shares in the private company to the publicly traded shell in exchange for shares in the public company."[204] After the completion of the merger, the fraudsters "change the name of the newly formed public company."[205] This allows them to make their privately held company public without much SEC regulatory oversight, which in turn makes it easier for them to carry out their pump-and-dump scheme.[206]

The pump-and-dump scheme is typically conducted in the OTC markets, although they could technically occur on any exchange.[207] Stocks on this particular market tend to consist of smaller companies and are considered penny stocks.[208] As a result, they are thinly traded and do not typically have a lot of shares outstanding, making them perfect targets for this type of fraud.[209]

B. Recent Examples of Fraudulent Reverse Mergers

1. U.S. SEC v. Sierra Brokerage Services, Inc.

In May 2008, the U.S. District Court for the Southern District of Ohio[210] granted the SEC's request for summary judgment surrounding claims that Aaron Tsai (Tsai) violated federal-securities laws surrounding his company MAS XI.[211] As a result, he and several other defendants were ordered to pay disgorgement and were "permanently enjoin[ed] and restrain[ed] . . . from violating, directly or indirectly, Sections 5(a) and 5(c) of the Securities Act, . . .

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[203] *Id.*
[204] *Id.*
[205] *Id.*
[206] *Id.*
[207] *Id.*
[208] *Market Manipulation Fraud, supra* note 202.
[209] *Id.*
[210] The Sixth Circuit of the U.S. Court of Appeals affirmed the district court's decision in 2013. *See* U.S. SEC v. Sierra Brokerage Services, Inc., 712 F.3d 321 (6th Cir. 2013).
[211] U.S. SEC v. Sierra Brokerage Servs., Inc., 608 F. Supp. 2d 923, 973-74 (S.D. Ohio 2009) *aff'd*, 712 F.3d 321 (6th Cir. 2013).

Sections 13(d)(1) and 16(a) of the Exchange Act, . . . and Rules 13d-1 and 16a-3."[212] While Tsai was not the only defendant in this case, his activities will be focused on here because they were instrumental in the facilitation of a fraudulent scheme.

Tsai was a Taiwanese resident who was in the business of creating public shell corporations "so that they could be merged with private companies that want to go public."[213] As registered representative of five brokerage firms between 1998 and 2000, Tsai had extensive experience within the securities industry.[214] He passed several securities industry exams early in his career and owned a SEC registered broker dealer called MAS Capital Securities Inc.[215] Tsai created over 101 public shell companies throughout his career.[216]

MAS XI was one of the public shell companies that Tsai created and had incorporated on October 7, 1996 in Indiana.[217] "MAS XI was a shell company with no business activity or operations of its own. It existed only to issue shares of stock and to be available for a reverse merger."[218] Tsai "register[ed] the company as a voluntary reporting company with the SEC [in order to attract reverse merger candidates] and to clear its stock for trading on the Over–the–Counter Bulletin Board."[219] The company's articles of incorporation authorized the issuance of 80 million shares.[220] Tsai issued 8.5 million shares of common stock and reported to the SEC that he owned 8.25 million of the 8.5 million shares.[221]

Tsai transferred the remaining 250,000 shares to five individuals that he claimed were former directors.[222] The reality was that, despite the company's bylaws requiring it to have three directors on

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[212] *Id.* at 974.
[213] *Id.* at 927.
[214] *Id.*
[215] *Id.*
[216] *Sierra Brokerage Servs., Inc.*, 608 F. Supp. 2d at 927.
[217] *Id.* at 929.
[218] *Id.*
[219] *Id.*
[220] *Id.*
[221] *Id.*
[222] U.S. SEC v. Sierra Brokerage Servs., Inc., 608 F. Supp. 2d 923, 930 (S.D. Ohio 2009) *aff'd*, 712 F.3d 321 (6th Cir. 2013).

its board, Tsai was the only actual director.[223] He served as the company's treasurer, president, and Chief Executive Officer (CEO).[224] The five people who received shares of MAS XI as former directors had no actual role in the company's operations.[225] "At least three of the five former directors were unaware of ever having been MAS XI directors."[226] Tsai had each of the five former directors sign blank stock powers that allowed him to freely transfer the shares later.[227] "The blank stock powers were essentially blank forms which did not include information such as the number of shares that could be transferred or the name of the company at the time the former director shareholders signed them."[228]

Tsai attempted to register MAS XI for public trading on the over-the-counter market (OTC), but NASD, the market's regulators, did not approve the stock for public trading because the shares eligible for trading were concentrated in the hands of the five former directors.[229] Tsai then decided to find twenty-eight additional shareholders and increased the total number of shareholders to thirty-three.[230] He accomplished this by approaching "friends or people he met at bible study," and did not inform the five former directors of how many shares they would be parting with.[231] He then reapplied for listing on the OTC with NASD and was approved based on the newly provided information.[232]

In December 1999, Tsai met consultant Yongzi Yang (Yang) through a mutual associate.[233] Yang was hired to find an American shell company, and then merge Bluepoint into the shell.[234] The following month, they reached a formal agreement to merge the two

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[223] *Id.* at 931.
[224] *Id.* at 929.
[225] *Id.* at 930-31.
[226] *Id.* at 930.
[227] *Id.* at 931.
[228] *Id.*
[229] U.S. SEC v. Sierra Brokerage Servs., Inc., 608 F. Supp. 2d 923, 930 (S.D. Ohio 2009) *aff'd*, 712 F.3d 321 (6th Cir. 2013).
[230] *Id.*
[231] *Id.*
[232] *Id.* at 931-32.
[233] *Id.* at 932.
[234] *Id.*

companies.[235] Bluepoint was a very risky company to invest in due its failure to generate revenue, but this information was never disclosed to the investing public.[236] Instead, Tsai cancelled his 8.2 million shares ahead of the merger, and once the merger was approved, the company "effected a fifteen-for-one stock split . . . [turning] the 250,000 shares held by the 33 MAS XI Shareholders . . . [to] 3.75 million shares."[237] Upon the completion of the reverse merger, MAS XI became Bluepoint.[238]

The newly formed company had 20 million outstanding shares, 15.5 million of which were restricted with around 4.5 million unrestricted shares available.[239] The thirty-three original investors account for 3.75 million of the 4.5 million unrestricted shares.[240] Executives of Bluepoint were allocated restricted shares, and "Tsai also [held] another 450,000, restricted shares."[241] Tsai found investors to purchase the remaining unrestricted shares.[242] While it appeared that the shares were in the hands of many investors, the reality was that a few people, including Tsai, controlled a significant percentage of the company.[243] To circumvent the SEC's requirement that "a stock purchaser [who] acquir[es] beneficial ownership of more than 5% or more of the company's securities [must] disclose his ownership to the SEC by filing a Schedule 13D within ten days of the acquisition,"[244] Tsai and his co-conspirators transferred some of their shares to family members, thus falling below the reporting threshold percentage.[245]

Leading up to the first official day of trading, Tsai's codefendants began their attempt to pump up the price of the stock using an

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[235] *Id.*
[236] *Id.*
[237] *Id.*
[238] U.S. SEC v. Sierra Brokerage Servs., Inc., 608 F. Supp. 2d 923, 932 (S.D. Ohio 2009) *aff'd*, 712 F.3d 321 (6th Cir. 2013).
[239] *Id.* at 933.
[240] *Id.*
[241] *Id.*
[242] *Id.*
[243] *Id.*
[244] *Id.* at 955.
[245] U.S. SEC v. Sierra Brokerage Servs., Inc., 608 F. Supp. 2d 923, 933-34 (S.D. Ohio 2009) *aff'd*, 712 F.3d 321 (6th Cir. 2013).

"internet touting campaign."[246] Once stock trading began, the codefendants coordinated trades to keep the stock price above "the threshold for penny stock status" and to "giv[e] the appearance of more market activity than had actually occurred."[247] Tsai made around $250,000 from his involvement in the reverse merger, and his codefendants made millions from their "illicit sales of Bluepoint shares."[248]

2. U.S. v. Gordon

In May 2010, a federal jury in Tulsa, Oklahoma found George David Gordon (Gordon) and his co-conspirators guilty of securities fraud, and in 2013, the U.S. Court of Appeals affirmed Gordon's "15-year, eight-month sentence."[249] Prior–to his indictment on January 15, 2009,[250] Gordon worked in Tulsa, Oklahoma as a securities attorney.[251] In 2004, Gordon began working with two stock promoters (co-conspirators) named Mark Lindberg (Lindberg) and Josh Lankford (Lankford) by helping them "establish[] and promot[e] the stock of numerous companies."[252] He utilized a "pump-and-dump" scheme by "artificially inflating the value of various stocks, and then turning around and selling them for a substantial profit.[253]

One specific company that Gordon targeted was National Storm.[254] "National Storm was a roofing and siding company in

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[246] *Id.* at 935.

[247] *Id.* at 936.

[248] *Id.* at 969.

[249] David Harper, *George David Gordon loses appeal of stock-fraud conviction, prison sentence*, TULSA WORLD (Mar. 16, 2013, 12:00 AM, updated Sept. 24, 2013, 9:19 PM), http://www.tulsaworld.com/news/courts/george-david-gordon-loses-appeal-of-stock-fraud-conviction-prison/article_221180ef-ab27-5430-9492-39f11f4d38cb.html.

[250] U.S. v. Gordon, No. 09-CR-13-JHP, 2010 WL 503108, at *1 (N.D. Okla. 2010).

[251] U.S. v. Gordon, 710 F.3d 1124, 1128 (10th Cir. 2013).

[252] *Id.* at 1129.

[253] *Id.* at 1128.

[254] *Id.* at 1129. Gordon was also convicted for targeting companies Deep Rock and Global Beverage and using similar methods to inflate their stock prices. *Id.* at

Illinois with annual revenues of around $8 million."[255] Gordon, along with Lindberg, met with the president of National Storm in 2005, where an agreement was made for them to go public.[256] The plan was for National Storm to become public through the reverse merger process, and an arrangement was made for it to merge with a company called The 18th Letter. [257] The 18th Letter was a public shell company that went public in 2002.[258] It belonged to an associate of Gordon's named Richard Singer (Singer), who was also the sole shareholder.[259]

Gordon instructed Singer to pay his friends a sum of money to pretend as though they held shares of The 18th Letter, and then prepared backdated corporate records that fraudulently reported Singer's friends as shareholders for at least two years.[260]

> Gordon [then] forwarded to . . . Singer a legal opinion letter pursuant to SEC Rule 144, signed by an associate attorney, Robert Bertsch, stating that The 18th Letter's shares were freely tradeable under Rule 144's criteria because the shares had been purchased by the respective owners two years ago.[261]

Gordon provided the opinion letter to a transfer agent, thus allowing the security to be traded publicly utilizing the over-the-counter market.[262]

In 2005, Gordon used a stock promoter who initiated a campaign to generate interest in National Storm.[263] The stock promoter sent out "thousands of faxes [and emails] touting—strong market expectations for National Storm's future growth."[264] The material

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1131-32. Given the striking similarities between the methods used with all three companies, only Gordon's fraudulent conduct with regards to National Storm will be discussed.

[255] *Id.* at 1129.

[256] *Id.*

[257] *Id.*

[258] U.S. v. Gordon, 710 F.3d 1124, 1129 (10th Cir. 2013).

[259] *Id.*

[260] *Id.*

[261] *Id.*

[262] *Id.*

[263] *Id.* at 1130.

[264] U.S. v. Gordon, 710 F.3d 1124, 1130 (10th Cir. 2013).

disseminated to the public through these campaigns contained false and misleading statements.[265] For example, statements were made in the materials that suggested the company was highly touted by Wall Street analysts when in fact that was not true.[266] Gordon and his co-conspirators coordinated trades and concealed the ownership of National Storm's shares to pump up the share price of the company.[267] Once the price reached the targeted amount, they began selling their investments in National Storm and made over $5 million dollars in profits.[268]

3. Benjamin Wey's Securities Fraud Indictment

In 2015, Benjamin Wey (Wey) of New York Global Group (NYG) was indicted for securities fraud surrounding "three reverse mergers" that he orchestrated.[269] He was accused of using family members to secretly gain control of the companies going public and engaging in stock price manipulation.[270] "Specifically, Wey caused entities controlled by a sibling and other nominees to obtain large portions of the shares of certain U.S. shell companies trading over the counter."[271] Wey instructed the individuals to purchase shares of shell companies that were trading on the NASDAQ's OTC market, and made sure that "no single one of the Nominees held a greater than five percent beneficial ownership interest in any of the

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[265] *Id.*

[266] *Id.*

[267] *Id.* at 1129.

[268] *Id.*

[269] Bob Van Voris, *New York Global Group's Wey Charged in Reverse-Merger Fraud*, BLOOMBERG BUS. (Sept. 10, 2015, 7:33 AM, updated Sept. 10, 2015, 2:09 PM), http://www.bloomberg.com/news/articles/2015-09-10/new-york-global-group-founder-charged-with-securities-fraud.

[270] *Id.*

[271] *Benjamin Wey, Founder and President of New York Global Group, Arrested and Charged in Manhattan Federal Court for Securities Fraud Arising Out of Fraudulent Reverse Merger Schemes Involving Chinese Companies*, FED. BUREAU OF INVESTIGATION, https://www.fbi.gov/newyork/press-releases/2015/benjamin-wey-founder-and-president-of-new-york-global-group-arrested-and-charged-in-manhattan-federal-court-for-securities-fraud-arising-out-of-fraudulent-reverse-merger-scheme-involving-chinese-companies (last visited Feb. 4, 2016) (emphasis omitted) [hereinafter *Benjamin Wey*].

Issuers."[272] Wey did this to escape the SEC's reporting requirements under federal securities laws.[273]

Once he secured control of the shell companies, through his siblings and others, Wey searched for Chinese companies that were interested in entering into the U.S. stock market through the reverse merger process.[274] Through his company NYG, Wey "facilitated the Chinese companies' reverse mergers with the U.S. shell companies . . . ."[275] Wey continued to have a controlling interest in the newly formed entities, through the siblings and nominees whom he directed to initially purchase the shell companies.[276]

When the reverse mergers were complete and the shares began trading, Wey, through a co-conspirator, used fraudulent devices to manipulate the stock price of the companies.[277] This was done by "orchestrat[ing] match trades in the securities of the Issuers, for the purpose of manipulating the prices of those stocks."[278] Simultaneously, Wey was instructing his siblings and others to liquidate their shares in the same companies, generating millions of dollars in profits.[279] The money would then transfer to offshore accounts before coming back into the United States and into bank accounts controlled by Wey.[280]

VIII. RECOMMENDATION

Despite the SEC's recent efforts to reduce reverse merger fraud, it is still a method frequently used by fraudsters to make money through market manipulation. Apart from the indictment of Wey in 2015,[281] the SEC has also charged five individuals in May 2014 for

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[272] *Id.*
[273] *Id.*
[274] *Id.*
[275] *Id.*
[276] *Id.*
[277] *Benjamin Wey*, *supra* note 271.
[278] *Id.*
[279] *Id.*
[280] *Id.*
[281] *Supra*, Part VII (B.)(3.) and accompanying notes.

securities fraud surrounding reverse mergers.[282] "The [SEC] . . . charged a Toronto-based consultant and four associates with conducting illegal reverse merger schemes to bring a pair of China-based companies into the U.S. markets so they could manipulate trading and reap millions of dollars in illicit profits."[283] Both instances are examples of fraudulent schemes discovered after the SEC's attempt to toughen the regulations for reverse mergers in 2011.[284]

While the 2011 rules toughened the listing standards for companies that went public, primarily surrounding their filing requirements, it also provided many exceptions that fraudsters could use to manipulatively gain access to the U.S. Stock market.[285] The problem, therefore, was not really solved. This begs the question of what could be done to prevent, or at least reduce, the occurrence of reverse merger fraud.

Short of eliminating reverse mergers, the SEC could get rid of all the benefits of going public using the reverse merger process. This could be done by increasing the listing fees and capital requirements for companies wishing to go public using the reverse merger method. By making the capital requirements comparable to that of companies using the IPO method of becoming public, it will make it more difficult for fraudsters to make money quickly through this method because the private company would have to first meet those requirements before beginning the reverse merger process.

The SEC could also eliminate the ability for a company to operate as a shell company. As discussed previously, reverse mergers occur when a private company merges into a public shell company.[286] In the cases discussed, the fraudulent scheme was perpetuated through the shell company, which tends to be the trend.[287] If the SEC eliminates the ability for a company to operate

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[282] *SEC Charges Toronto-Based Consultant and Four Others in Reverse Merger Schemes Involving China-Based Companies*, U.S. SEC. & EXCH. COMM'N, https://www.sec.gov/News/PressRelease/Detail/PressRelease/1370541731661 (last visited Feb. 4, 2016).

[283] *Id.*

[284] *Supra* Part V (B.)(3.) and accompanying notes.

[285] *Id.*

[286] *Supra* Part V (A.) and accompanying notes.

[287] *Supra* Part VII (B.) and accompanying notes.

as a shell company, the potential for reverse merger fraud to occur would be reduced.

The SEC could then mandate that private companies who wish to become public using the reverse merger process would only be able to merge with pre-existing companies. The agency could then regulate the amount of assets that a pre-existing publicly traded company must have in order to be eligible to absorb a private entity through a merger.

By requiring the publicly traded company to be fully operational and meet certain asset thresholds, this will help protect current and future investors. The pre-existing, fully operational company would have shareholders that it would have to answer to, that would be required to approve the merger in advance of its occurrence. By forcing them to meet certain guidelines, the SEC can be sure the public companies have a minimum amount of shareholders, have been trading publicly for a substantial amount of time, and have enough assets to meet the predetermined asset threshold. This is important because then future investors will have more access to the financials of the company that the private entity is merging in to. It will also further create an incentive for the public company to perform adequate due-diligence before agreeing to the reverse merger.

If the SEC opted to not implement even tougher rules to deter reverse merger fraud, another solution would be to ban the reverse merger process completely. With the emergence of the direct public offering process, the need to continue the allowance of reverse mergers is diminished.[288] The companies would have the ability to go directly to their potential shareholders and raise capital for their company.[289] They would then be able to go public, once capital requirements are met. While the liquidity issue within the DPO process may be a legitimate concern,[290] it is not much different from the very real liquidity issue that can also arise in a reverse merger.[291] The DPO process could prove just as beneficial if not more beneficial than the reverse merger due to the company's ability to easily market

[288] *Supra* Part IV (C.) and accompanying notes.
[289] *Id.*
[290] *Id.*
[291] *See supra* Part V (B.) and accompanying notes.

shares directly to potential investors,[292] without having to first find a preexisting publicly traded company to merge into.[293] Once a company has the amount of investor dollars it requires, the company can begin the process of going public.

IX. CONCLUSION

While tightening regulations even more could reduce the fraud that occurs surrounding the reverse merger process, an argument could be made that the impact of the tougher regulations could also prove harmful to the economy. This is because very strict regulations surrounding reverse mergers can prevent smaller and legitimate companies, both foreign and domestic, from accessing the U.S. Stock Market and contributing to the economy. It would eliminate the ability for additional reverse merger success stories like Berkshire Hathaway[294] and Jamba Juice[295] to emerge.

Although that argument is a valid one, and may be true, the amount of fraud perpetuated through this process is so large that the benefits of even tougher regulations outweigh the costs. The companies that have had success using the then-existing reverse merger process would likely be as successful using the tougher regulations advanced in Part VIII. Even if reverse mergers were eliminated, these companies would likely still succeed due to their overall pre-merger success and their ability to gain access to capital through another method of going public like direct public offerings. Therefore, the SEC should toughen regulations surrounding reverse mergers or eliminate them.

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[292] *Id.*

[293] *Supra* Part V and accompanying notes.

[294] *Supra* Part VI (A.) and accompanying notes.

[295] *Supra* Part VI (B.) and accompanying notes.