Saint Louis University Law Journal

Volume 57
Number 1 *(Fall 2012)*

Article 8

2012

Missing the Mark: An Examination of the Current Government Response to the Chinese Reverse Merger Dilemma

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INTRODUCTION

In response to the divisive rule amendments adopted by the Securities and Exchange Commission ("SEC" or "Commission") in 2005, Aden Pavkov depicted the conflicting messages sent by the SEC's action.[1] Observing the differing views held by those affected by the rule amendments, Pavkov portrayed the Commission both as a "vigilant constable" who slayed evil-spirited public shell companies guilty of devouring private firms and as a "nobleman-regulator" who ruthlessly deprived suffering private-company souls from any hope of survival.[2] The SEC had just made listing on the U.S. stock markets more difficult for private companies by (1) defining "shell company," (2) requiring shell companies to file additional information when completing a transaction that would cause them to lose their classification as shell companies, and (3) instructing issuers of stock to indicate whether their firms fell within the definition of a shell company.[3] Pavkov's clashing metaphors properly illustrate the two discordant roles played by the SEC when it adopted the rule amendments: on one hand, the SEC was a "vigilant constable" since its stringent amendments rescued private companies from the untrustworthy public companies that were often employed to reach public markets; on the other hand, the SEC was a "nobleman-regulator," for the new requirements stripped many private companies of the hope that they may obtain growth-spurring capital in the public markets.

Once again, the SEC, through its registered securities exchanges, has taken action against the source that triggered the 2005 Rule Amendments: reverse mergers.[4] Reverse mergers have again captured the attention of rule-makers

1. Aden R. Pavkov, *Ghouls and Godsends? A Critique of "Reverse Merger" Policy*, 3 BERKLEY BUS. L. J. 475, 477 (2006).

2. *Id.*

3. *Id.* at 501.

4. New York Stock Exchange Order Granting Accelerated Approval to the NYSE Proposed Rule Change Adopting Additional Listing Requirements for Companies Applying to List After Consummation of a "Reverse Merger" With a Shell Company, 76 Fed. Reg. 70,795 (Nov. 15, 2011) [hereinafter Approval to the NYSE Proposed Rule]; NASDAQ Stock Market Order Granting Accelerated Approval to Proposed Rule Change Adopting Additional Listing Requirements for Companies Applying to List After Consummation of a "Reverse Merger" With

due to their association with many recent instances of fraudulent behavior.[5] In May and July of 2011, key stock exchanges in the United States proposed rules that would impose even more stringent requirements on companies that completed reverse mergers in order to quickly gain access to the investments made on those exchanges.[6] On November 8, 2011, the SEC approved these requirements with a minor amendment.[7] Arising from this recent action is the same conflict that arose at the time of Pavkov's article: when the market shows signs of fault, is the solution to that fault best left to government regulation or to the market itself?

A reverse merger transaction involves a merger between a private company that is currently operating and a public shell company.[8] The Commission defines "shell company" as a company with "[n]o or nominal operations" and either "[n]o or nominal assets," "[a]ssets consisting solely of cash and cash equivalents," or "[a]ssets consisting of any amount of cash and cash equivalents and nominal other assets."[9] The two companies merge, and although the public company is the surviving entity, the private company generally assumes control and owns most of the assets of the resulting post-merger company.[10] Reverse mergers are advantageous because private companies can become public through reverse mergers, thereby gaining access to capital markets without the delay and expense associated with initial public offerings ("IPOs"), the traditional manner of going public.[11]

Although there are significant advantages to going public through a reverse merger, these transactions have recently caused concern due especially to accounting fraud allegations.[12] For example, Deer Consumer Products is a Chinese corporation that used a reverse merger to gain access to U.S. markets.[13] It has since been accused of manipulating revenue, earnings, and profit margins on its financial statements, causing its share price to plummet by

a Shell Company, 76 Fed. Reg. 70,799 (Nov. 15, 2011) [hereinafter Approval to NASDAQ Proposed Rule].

5. Approval to the NYSE Proposed Rule, 76 Fed. Reg. at 70,795; Approval to NASDAQ Proposed Rule, 76 Fed. Reg. at 70,800.

6. Approval to the NYSE Proposed Rule, 76 Fed. Reg. at 70,795; Approval to NASDAQ Proposed Rule, 76 Fed. Reg. at 70,799.

7. Approval to the NYSE Proposed Rule, 76 Fed. Reg. at 70,795; Approval to NASDAQ Proposed Rule, 76 Fed. Reg. at 70,800.

8. New York Stock Exchange Notice of Filing of Proposed Rule Change Amending Exchange's Listed Company Manual, 76 Fed. Reg. 49,513, 49,513 (Aug. 10, 2011) [hereinafter the NYSE Amending Exchange's Listed Company Manual].

9. SEC Definitions of Terms, 17 C.F.R. § 230.405 (2011).

10. The NYSE Amending Exchange's Listed Company Manual, 76 Fed. Reg. at 49,513.

11. *Id.*

12. *Id.*

13. Michael Vodicka, *American Stocks Thriving in China*, ZACKS.COM (June 2, 2011), http://www.zacks.com/commentary/17885/American+Stocks+Thriving+in+China?.

nearly fifty percent.[14] Another reverse merger company is China MediaExpress Holdings, Inc., whose main auditor resigned due to alleged inabilities to verify the accuracy of the company's statements[15] and whose largest customer was discovered to be nonexistent.[16] In response, the SEC has taken action against reverse merger companies by suspending trading in their securities, revoking their securities registration, and initiating enforcement proceedings against their auditing firms.[17] In addition, both the New York Stock Exchange ("NYSE") and the NASDAQ Stock Market ("NASDAQ") have filed proposed rules that would impose more stringent requirements on reverse mergers in order to protect investors from the increasingly common accounting fraud associated with reverse merger companies.[18] The Public Company Accounting Oversight Board ("PCAOB") is also responding by engaging in oversight negotiations with China,[19] the foreign country which has provided the most reverse merger transactions resulting in access to American markets.[20]

This comment will provide further analysis into both of the problems associated with reverse mergers, focusing on Chinese transactions due to the great number of and notable problems associated with such transactions, and the responses to these transactions. The action of regulators, including the SEC, NASDAQ, the NYSE, and the PCAOB, will be pitted against the action of the market itself. It is quite clear that reverse mergers, particularly Chinese reverse mergers, have had devastating effects on investors, and it is also clear that many of these companies have quickly confronted the market's response as firm after firm watches its share price disintegrate.[21] While commentators provided arguments supporting both more regulation and less, the SEC continued to delay the adoption of any additional rules.[22] Meanwhile, the market itself instigated the decline of share prices of many Chinese reverse

14. *Id.*

15. Holman W. Jenkins, Jr., *Is Every Chinese Firm a Scam?*, WALL ST. J., June 11, 2011, at A13.

16. Vodicka, *supra* note 13.

17. The NYSE Amending Exchange's Listed Company Manual, 76 Fed. Reg. at 49,513.

18. *Id.*; NASDAQ Notice of Filing of Proposed Rule Change to Adopt Additional Listing Requirements for Reverse Mergers, 76 Fed. Reg. 34,781, 34,781 (June 8, 2011) [hereinafter NASDAQ Proposed Rule].

19. Press Release, SEC, US and Chinese Regulators Meet in Beijing on Audit Oversight Cooperation (Aug. 8, 2011), http://www.sec.gov/news/press/2011/2011-164.htm.

20. *See* PUB. CO. ACCOUNTING OVERSIGHT BD., ACTIVITY SUMMARY AND AUDIT IMPLICATIONS FOR REVERSE MERGERS INVOLVING COMPANIES FROM THE CHINA REGION 3 (Mar. 14, 2011) [hereinafter OVERSIGHT BOARD].

21. *See* Dinny McMahon, *Stung, Chinese Firms Now Look to Go Private*, WALL ST. J., Sept. 2, 2011, at C1.

22. Approval to the NYSE Proposed Rule, 76 Fed. Reg. at 70,795; Approval to NASDAQ Proposed Rule, 76 Fed. Reg. at 70,799.

merger companies and even pushed some of these firms out of public trading.[23] Although the never-ending question still remains whether the market really is best left to mend itself, the current chain of events indicates that the SEC has, unintentionally, left the market to do so.

Ultimately, it may be concluded that government regulation is essential in this arena. Although government delay has caused the market to police itself, with help only from the SEC's revocation of the registration of some firms and its initiation of enforcement proceedings, and although the final rules as adopted by the Commission are insufficient since they are off-target, government regulation is crucial because the inability of required investigations of Chinese companies that list on the U.S. market renders market scrutiny inadequate. Neither pure regulation nor pure market freedom is sufficient. As demonstrated by the current chain of events, it is only through the mix of government regulation and market scrutiny that investors are amply protected before making their investments.

I. BACKGROUND TO CAPITAL MARKETS AND APPLICABLE LAW

In order to fully comprehend the effects of reverse mergers and the responses to the problems associated with them, it is important to have an understanding of the markets in which they act and the laws that govern those markets.

A. Capital Markets

There are two types of markets in which a corporation's securities are traded: a primary market and a secondary market.[24] The primary market is where the corporation sells its shares to investors and is where the traditional IPO takes place.[25] In contrast, the secondary market is where investors trade stocks among themselves, and the company which issued the shares is no longer a significant participant in the market.[26] The secondary market is actually created by the corporation going public, for when the initial shareholders begin trading the company's securities with other investors, the company gains access to the secondary market.[27] This secondary market is where the current accounting problems associated with reverse mergers affect

23. McMahon, *supra* note 21 ("Shareholders saw billions of dollars in paper losses over the past year after a wave of accounting irregularities surfaced at dozens of U.S.-listed Chinese firms, prompting exchanges to delist several companies," and noting that many Chinese reverse merger companies that sought access to the U.S. market are now seeking to go private with the help of private-equity groups that will buy out outside shareholders).

24. STEPHEN M. BAINBRIDGE, CORPORATION LAW AND ECONOMICS § 1.1(A) (2002).

25. *Id.*

26. *Id.*

27. *Id.* § 3.3(B).

investors who buy and sell the post-merger company's stocks.[28] Moreover, it is this secondary market that private companies aspire to reach when they consider going public through a reverse merger.[29] Secondary markets are desirable because they allow the company's securities to obtain liquidity, meaning investors can freely sell the company's securities without involving the company itself.[30] This, in turn, allows the company to raise capital in the primary market more easily and at lower cost because investors, in general, prefer liquid securities and are typically willing to pay more for them.[31]

When the effects of reverse mergers are discussed, commentators refer to the effects on investors, which are determined by analyzing how the problems that lie within a reverse merger transaction have affected the value of a company's stock.[32] Here, the focus is on common stock, rather than preferred stock (which are given superior rights over those of common stock and often have priority in terms of dividends and liquidation).[33] When analyzing the value of stock, "market capitalization" is a term that is often used. This is a general measure of the size of the company and is estimated by multiplying the share price of a company's stock by the number of shares that have been purchased by investors, which, as opposed to those shares that have been retained by the corporation, are called outstanding shares.[34] The PCAOB has used market capitalization to demonstrate that Chinese reverse mergers generally retain less value compared to Chinese IPOs, suggesting reverse mergers will provide less return for investors than IPOs.[35]

28. *See* McMahon, *supra* note 21 ("Shareholders saw billions of dollars in paper losses over the past year after a wave of accounting irregularities surfaced at dozens of U.S.-listed Chinese firms . . . . Many of these companies came to the U.S. because they were too small and lacked the influence to win a listing on China's state-run exchanges. Plus, there was ample demand from U.S. investors. Most listed through so-called reverse mergers . . . .").

29. *Id.*

30. BAINBRIDGE, *supra* note 24, § 3.3(B).

31. *Id.*; *see also* JOHN F. SEEGAL, SECURITIES LAW TECHNIQUES § 13.01, *available at* LEXIS (suggesting, *inter alia*: that going public allows a company to raise capital, results in fewer operating restriction than a private placement, and usually creates "a trading market in the stock which provides continuing liquidity for the stockholders[.]").

32. *See* McMahon, *supra* note 21.

33. BAINBRIDGE, *supra* note 24, § 3.2(B)(3).

34. Krogman v. Sterritt, 202 F.R.D. 467, 478 (N.D. Tex. 2001) (defining market capitalization as the number of shares multiplied by the prevailing share price).

35. OVERSIGHT BOARD, *supra* note 20, at 1 ("As of March 31, 2010, the market capitalization of the 159 CRM companies identified by ORA staff was $12.8 billion, less than half the $27.2 billion market capitalization of the 56 Chinese companies that completed U.S. initial public offerings ("IPOs") during the period covered by this research note.").

Another way in which market capitalization affects reverse merger stocks is through its connection to market *efficiency*.[36] In *Basic Inc. v. Levinson*, the Supreme Court adopted the efficient market theory, noting that the market price of shares traded on well-developed markets reflects all publicly available information.[37] Thus, an efficient market is one that adequately digests information in order to move the price of a company's stock when new information relating to the company's financial character is publicized. Market efficiency is therefore very beneficial to investors involved in markets in which reverse merger companies have engaged in fraudulent practices because those investors will be cautioned about foul corporate practices when stock prices fall.[38] Market capitalization has been considered one of the most important factors in determining market efficiency because firms with larger market capitalization are less likely to have pricing inefficiencies since they will be more heavily targeted by market researchers.[39] Thus, market capitalization can be of great importance to an investor when determining whether to make a particular investment.[40]

36. *Krogman,* 202 F.R.D. at 478 (Market capitalization "may be an indicator of market efficiency because there is a greater incentive for stock purchasers to invest in more highly capitalized corporations.").

37. 485 U.S. 224, 246 (1988) ("Recent empirical studies have tended to confirm Congress' premise that the market price of shares traded on well-developed markets reflects all publicly available information, and, hence, any material misrepresentations."); *see also* William O. Fisher, *Does the Efficient Market Theory Help Us Do Justice in a Time of Madness?*, 54 EMORY L.J. 843, 850 (2005) (As explained by Fisher, there are three forms of the efficient market theory: (1) the weak form, which claims that "a stock's price is at least substantially independent of past price performance," (2) the semi-strong form, which was adopted by the Supreme Court in *Basic*, which suggests that "current prices fully reflect public knowledge," and (3) the strong form, which hypothesizes that "both public and private information are fully reflected in the price of a stock.").

38. Note, however, that market efficiency is not necessarily an indication of the true value of the stock. Instead, it simply suggests that publicly available information is reflected in the stock's price. *See* Fisher, *supra* note 37, at 850 ("At least in its simplest form, the theory does not rest on a notion that the market price is the 'right' price in the sense of correctly capturing the value of a company, but simply that the price of the company's stock moves when new information relating to the company's fortunes becomes public.").

39. *See* O'Neil v. Appel, 165 F.R.D. 479, 503 (W.D. Mich. 1996) (noting (1) that one of the most important factors in determining market efficiency is firm size, which is measured by market capitalization, and (2) that investors have an incentive to invest in larger firms (with larger market capitalization) because those firms have an "incentive to eliminate mispricing," for "market participants have greater incentives to invest resources in assessing the value of larger capitalization firms." On the other hand, pricing inefficiencies are more prominent with smaller companies which have smaller market capitalization.).

40. *See id.*

B. Applicable Law

The law governing the current reverse merger problems consists of both state corporate law and federal securities law. While the merger transaction itself is subject to state law, the trade of the post-merger company's stock is regulated by federal law.[41] Furthermore, the securities exchanges themselves have their own regulations regarding trades made within their markets.[42] Each of these aspects of reverse merger law is discussed below.

1. Corporate Merger Law

Corporate mergers are a matter of state law. This analysis will focus on Delaware corporate law, embodied in the Delaware General Corporation Law ("DGCL"), for several reasons: (1) Delaware is the leading state for corporate law,[43] (2) more than half of the corporations listed for trading on the NYSE are incorporated in Delaware,[44] (3) there is evidence that shell brokers often acquire shell companies that are incorporated in a "secrecy-friendly" state, such as Delaware,[45] and (4) the buyer in Chinese reverse mergers is often a holding company based in Delaware, with its operations in China.[46] Not only does the DGCL allow for mergers between Delaware corporations and corporations of other states, but the DGCL also allows any company incorporated in Delaware to merge with corporations from other countries so long as the foreign country's laws permit such a merger.[47] In transacting a merger, the pre-merger corporations enter into an agreement of merger, which must be filed with the state and includes information such as the terms and conditions of the merger, the mode of carrying the merger into effect, and the manner of converting shares.[48] The DGCL also indicates that mergers between domestic and foreign companies must be "adopted, approved, certified, executed, and acknowledged" by each domestic corporation in the same manner as when a domestic corporation merges with another domestic

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41. *See* Michael Rapoport, *Alarms Sounded on 'Reverse Mergers'*, WALL ST. J., June 10, 2011, at C2 ("But the commission doesn't have the authority to ban reverse mergers, even if it wanted to, SEC officials say, as corporate mergers are issues of state law.").

42. SEC, *The Laws that Govern the Securities Industry*, http://sec.gov/about/laws.shtml (last visited June 2, 2012).

43. LEWIS S. BLACK, JR., DELAWARE DEPT. OF STATE, DIV. OF CORPORATIONS, WHY CORPORATIONS CHOOSE DELAWARE 1, 1 (2007).

44. BAINBRIDGE, *supra* note 24, § 1.3(A).

45. Nanette Byrnes & Lynnley Browning, *Special Report: China's Shortcut to Wall Street*, REUTERS (Aug. 1, 2011), http://www.reuters.com/article/2011/08/01/us-shell-china-idUSTRE7702S520110801.

46. *Id.*

47. 8 Del. C. § 252(a) (2011).

48. *Id.* § 252(b)–(c).

corporation.[49] This means that, unless required by the corporation's certificate of incorporation, a vote of the stockholders of the public shell company is not necessary to authorize the reverse merger, so long as the agreement of merger does not amend the surviving company's certificate of incorporation and each share of stock of the public company that is outstanding immediately prior to the effective date of the merger is to be an identical outstanding or treasury share of the surviving corporation after the merger.[50]

Stephen Bainbridge's *Corporation Law and Economics* provides a brief overview of the mechanics of corporate mergers, which can be applied to reverse merger transactions. First, the public shell company becomes the surviving entity, as designated in the merger agreement, and the separate existence of the private corporation ceases.[51] Second, all property, contracts, liabilities, and pending legal proceedings associated with the pre-merger corporations become assigned to the surviving public corporation.[52] Third, the articles of incorporation and bylaws of the public company are amended and become effective.[53] Lastly, the shares of the pre-merger corporations are converted, and former shareholders are entitled only those rights provided in the merger agreement or by statute.[54]

2. The Law Behind Public Trades

Three federal laws regulate public companies and their securities. The first is the Securities Act of 1933, which is predominantly concerned with the primary market and is premised on the dual motive of mandating disclosure of material information and preventing fraud.[55] It requires any offer or sale of securities using the means and instrumentalities of interstate commerce to be registered with the SEC.[56] By requiring registration with the federal Commission, the 1933 Act ensures that buyers of securities receive complete and accurate information about the public companies and their stocks before they make investments. Registration forms that must be filed by all companies which sell their securities in the United States require: "a description of the company's properties and business; a description of the security to be offered for sale; information about the management of the company; and financial

49. *Id.* § 252(c).

50. *Id*. § 251(f).

51. BAINBRIDGE, *supra* note 24, § 12.3(A).

52. *Id.*

53. *Id.*

54. *Id.*

55. WILLIAM A. KLEIN, J. MARK RAMSEYER, & STEPHEN M. BAINBRIDGE, BUSINESS ASSOCIATIONS: AGENCY, PARTNERSHIPS, AND CORPORATIONS 404 (7th ed. 2009).

56. 15 U.S.C. § 77e(a) (2006).

statements certified by independent accountants."[57] These registration statements become public after a company files them with the SEC.[58]

The second federal law that regulates publicly traded companies is the Securities Exchange Act of 1934, which also requires securities listed and traded on national securities exchanges, such as NASDAQ and the NYSE, to be registered.[59] It is therefore concerned primarily with secondary market transactions.[60] Registration under the 1934 Act requires certain filings and annual reports to be made available to shareholders, including audited financial statements, management analysis of the firm's financial condition, and financial data.[61] Through the 1934 Act, Congress created the SEC, which was given authority to register, regulate, and oversee brokerage firms, transfer agents, clearing agencies, and the exchanges themselves.[62] Furthermore, the Act empowered the SEC to require periodic reporting of information by publicly traded companies and to discipline all entities regulated by the SEC that engage in prohibited conduct.[63] Although private companies bypass the public offer registration through reverse mergers, they are still subject to the 1934 Act due to the fact that the surviving company is publicly traded. The public shell company involved in a reverse merger transaction also must file a Form 8-K, which requires companies to report significant events about which investors should be informed.[64] Lastly, section 5.06 mandates the disclosure of a change in shell company status, which occurs through a reverse merger transaction since the resulting public company is no longer a shell and instead maintains the operations and assets of the formerly private company.[65]

The third federal law, the Sarbanes-Oxley Act, was enacted in 2002 and implemented significant reforms to securities law.[66] In response to the Enron bankruptcy and public reaction to similar corporate accounting and mismanagement issues, Congress enacted the Act to enhance corporate disclosure and to improve the effectiveness of information given to investors by imposing more stringent reporting requirements.[67] The Act also established the PCAOB, which oversees public accounting firms and institutes auditing, quality control, and ethics standards to be used by public accounting firms

57. *The Laws that Govern the Securities Industry*, *supra* note 42.
58. *Id.*
59. *Id.*
60. KLEIN ET AL., *supra* note 55, at 404.
61. 15 U.S.C. § 78*l*(b).
62. *The Laws that Govern the Securities Industry*, *supra* note 42.
63. *Id.*
64. OVERSIGHT BOARD, *supra* note 20, at 2.
65. *Id.*; *see also* SEC, Form 8-K, http://www.sec.gov/answers/form8k.htm.
66. *The Laws that Govern the Securities Industry*, *supra* note 42.
67. *Id.*; *see also* Larry E. Ribstein, *Market v. Regulatory Responses to Corporate Fraud: A Critique of the Sarbanes-Oxley Act of 2002*, 28 J. Corp. L. 1, 1–2 (2002).

when performing audits for publicly traded corporations.[68] Thus, the accounting firms that audit the reverse merger companies that list on U.S. exchanges are subject to oversight by the PCAOB.

3. Rules of the Exchanges

Each stock exchange also has its own initial listing and maintenance criteria that apply to all companies that trade on the exchange. In fact, the 1934 Securities Exchange Act requires the exchanges to register with the SEC, establish rules permitting the discipline of misbehaving market participants, and ensure market integrity and investor protection.[69] The rules proposed by the exchanges are published for comment and require SEC approval.[70] Each exchange may also decide to remove, or delist, securities based on the number of shareholders, trading volume, the number of publicly held shares, aggregate market value of shares outstanding, and the total global market capitalization.[71] Since the NYSE has been involved in proposing new listing requirements for reverse mergers, it is interesting to note that the NYSE has been recognized as both the most respected exchange and the most stringent exchange in terms of listing requirements.[72]

C. The Effect of Securities Law on the Decision to Go Public Through a Reverse Merger

As previously mentioned, a company would desire to gain access to secondary markets in order to earn capital and encourage investment in their company.[73] However, with securities law in mind, there are many reasons why this same company would want to avoid going public through a traditional IPO and to seek a reverse merger transaction instead. First, IPOs are required to be registered by securities law, and registered public offerings are very expensive.[74] Second, there exist certain liability provisions that are associated only with registered public offerings, which would lead to more costs in the future should the provisions come into play.[75] Third, a company may be too small for an initial public offering to be viable.[76] On the other hand, while the

68. 15 U.S.C. § 7211 (2006).

69. *The Laws that Govern the Securities Industry*, *supra* note 42.

70. 15 U.S.C. § 78s(b).

71. *See* Pavkov, *supra* note 1, at 508 (describing the NYSE's considerations for removal of a security).

72. *Id.*

73. BAINBRIDGE, *supra* note 24, § 3.3(B).

74. *Id.* §3.5(D).

75. *Id.*

76. SEEGAL, *supra* note 31 (suggesting that the smallest size IPO a major underwriter will consider is $15,000,000 and that the least number of shares that should be offered to ensure adequate "public float" is 1,500,000).

public shell company must report a reverse merger transaction with the SEC, there is no regulatory oversight of the transaction, although it results in public market access, and there are often few impediments in the way of listing on an exchange.[77] Thus, there is an incentive for those who wish to gain access to capital markets to avoid registration and, instead, go public through a reverse merger. It is important to note, however, that while reverse mergers save private companies from the burdens of registering before going public—like companies using an IPO—the surviving reverse merger companies are still required, post-merger, to adhere to the disclosure rules that apply to all publicly traded companies since the surviving entity to a reverse merger is, in fact, the publicly traded company.[78]

II. EFFECTS OF REVERSE MERGERS ON U.S. MARKETS

With the background of capital markets and their laws in mind, the effect of reverse mergers on the securities markets may effectively be analyzed. While all reverse mergers have the potential to raise the concerns discussed above, it is appropriate to focus on those which involve Chinese private companies due to the great number of such transactions and the particular attention they have received recently as their securities have continuously invoked investor and regulator concern.[79]

A. Chinese Reverse Mergers

Twenty-six percent of all reverse mergers that obtained access to American exchanges between 2007 and 2010 involved Chinese private companies that merged with public companies traded on the U.S. market.[80] Not only do Chinese companies comprise a very large number of reverse mergers that gain access to American investment, but Chinese companies also use the reverse merger process more than the traditional IPO process for obtaining listing on the NYSE, NASDAQ, and other U.S. exchanges.[81] The reverse merger transaction has become prevalent among Chinese corporations because small

77. Byrnes & Browning, *supra* note 45; Rapoport, *supra* note 41; *see also* the NYSE Amending Exchange's Listed Company Manual, 76 Fed. Reg. at 49,513 ("While the public shell company is required to report the reverse merger in a Form 8-K filing with the Securities and Exchange Commission . . . generally there are no registration requirements under the Securities Act of 1933 . . . at that point in time, as there would be for an IPO.").

78. *See* Securities and Exchange Act of 1934, 15 U.S.C. §§ 78a–oo (2006) (SEC is empowered with requiring publicly traded companies to file reports).

79. See OVERSIGHT BOARD, *supra* note 20, at 3 (showing that between January 2007 and March 2010, there were 159 Chinese reverse mergers, composing 26% of total reverse mergers, and, in fact, Chinese companies use the reverse merger process more than the initial public offering process).

80. *Id.*

81. *Id.*

Chinese corporations are often unable to go public in the United States through an IPO since investment banking firms frequently refuse to underwrite for them.[82] Yet American investors welcome the growth potential of these companies, allowing them to obtain access to their investments through reverse mergers.[83]

It appears that the appeal of U.S. markets to Chinese firms is a combination of both the difficulty of those companies to go public in their own country and their desire to reach American investors. The Chinese stock exchanges are state-run and mandate strict requirements for those desiring to go public, making it quite challenging for companies to do so.[84] Many of the companies that do not have the influence or the capacity to gain public listing on Chinese exchanges wind up seeking access to U.S. markets.[85] Additionally, the U.S. markets allow these smaller, less influential companies to access American investors who are receptive to Chinese stocks due to their desire to profit from the growing Chinese market.[86]

As Chinese reverse mergers have increasingly gained access to U.S. markets, the discovery of their association with numerous instances of fraudulent behavior has caused great concern.[87] Such fraudulent behavior has rapidly depreciated the value of the stocks of many Chinese reverse merger companies.[88] The Bloomberg Chinese Reverse Merger Index indicates that as of October 22, 2011, Chinese reverse merger share prices had taken a year-to-date decline of 59%.[89] As of October 22, 2011, NASDAQ, S&P 500, and the Dow Jones Industrial Average had all enjoyed a one-year increase in share prices by 7.45%, 6.82%, and 8.9%, respectively.[90] In contrast, Chinese reverse

82. Rapoport, *supra* note 41.

83. *Id.* ("Reverse mergers have grown popular in China in part because it is hard for Chinese companies to go public in their own country. Meanwhile, U.S. investors are eager for ways they can tap investment opportunities in the huge, growing Chinese market.").

84. McMahon, *supra* note 21; Rapoport, *supra* note 41.

85. McMahon, *supra* note 21.

86. Rapaport, *supra* note 41.

87. David K. Cheng, Cindy Zhu, & David Lee, *Reverse Mergers by China-based Companies: Is This the End?* 43 Sec. Reg. & L. Rep. (BNA) 1433, 1433–34 (July 11, 2011).

88. McMahon, *supra* note 21 ("Shareholders saw billions of dollars in paper losses over the past year after a wave of accounting irregularities surfaced at dozens of U.S.-listed Chinese firms, prompting exchanges to delist several companies. . . . The Bloomberg Chinese Reverse Mergers Index has fallen about 60% since mid-November, when sentiment started turning against the sector amid widening allegations of misconduct").

89. Bloomberg Chinese Reverse Merger Index (as visited on Oct. 22, 2011), http://www.bloomberg.com/quote/CHINARTO:IND. "Year-to-date" refers to the time period beginning January 1 (the start of the calendar year) up to the present date.

90. NASDAQ Composite Index (as visited on Oct. 22, 2011), http://www.bloomberg.com/quote/CCMP:IND; S&P 500 Index (as visited on Oct. 22, 2011), http://www.bloomberg.com/

merger share prices *decreased* by 58.41% in one year.[91] The rapid decline of Chinese reverse merger share prices has been exacerbated by short sellers, who, realizing the likelihood of faulty share price foundations, target these companies.[92] Short sellers research listed companies to discover signs of fraud and then enter into short sale contracts involving the stocks of fraudulent-behaving companies, betting that their share prices will fall.[93] After the short sale contract is complete, the short seller publishes his research, causing a decline in the price of the companies' securities.[94]

Publicly traded Chinese companies Deer Consumer Products and China MediaExpress Holdings, Inc. provide examples of how drastic the market effects of fraudulent behavior of Chinese reverse mergers can be. At the end of 2010, Deer Consumer Products carried a share price of over $11.[95] When suspicion aroused regarding the company manipulating revenue, earnings, and margins, its share prices plummeted, ending at $5.73 in July of 2011.[96] Since the day that China MediaExpress Holdings, Inc.'s biggest customer was first found to be non-existent, its shares have fallen from $12.25 to a mere 10 cents.[97] In March of 2011, China MediaExpress's outside auditing firm resigned, claiming that "it could no longer 'rely on the representations of management.'"[98] Although these are only two examples of Chinese reverse merger companies that have engaged in fraudulent behavior, it is clear from Bloomberg's index of Chinese reverse merger stock behavior in the aggregate that skepticism about fraud has come to plague Chinese reverse mergers as a class.[99] Since the efficient market theory has established that stock price is reflective of the market's digestion of publicly available information, as opposed to the stock's true value,[100] this phenomenon may simply be a product of the vast publication of problems associated with some reverse merger companies. The publication of foul information about certain Chinese reverse

quote/SPX:IND; Dow Jones Industrial Average Index (as visited on Oct. 22, 2011), http://www.bloomberg.com/quote/INDU:IND.

91. Bloomberg Chinese Reverse Merger Index (as visited on Oct. 22, 2011), http://www.bloomberg.com/quote/CHINARTO:IND. Note that this is different from the "year-to-date" percentage and instead refers to the time period beginning one year from the present date to the present date.

92. Cheng, Zhu & Lee, *supra* note 87, at 1433–34.

93. *Id.*

94. *Id.*

95. Vodicka, *supra* note 13; Stock Quote of Deer Consumer Products, Inc., ZACKS.COM (as visited on Sept. 27, 2011), http://www.zacks.com/stock/quote/DEER.

96. Vodicka, *supra* note 13.

97. *Id.*

98. Jenkins, *supra* note 15.

99. *See generally* Bloomberg Chinese Reverse Merger Index, http://www.bloomberg.com/quote/CHINARTO:IND (last visited Oct. 22, 2011).

100. *See supra* Part I.A.

merger companies may spoil the stock prices of law-abiding Chinese reverse merger companies simply because investors become skeptical about all transactions of this type coming from China.[101]

B. Concerns About Auditing

The discovery of fraudulent behavior associated with many reverse mergers, particularly with Chinese reverse mergers, has triggered the much-publicized concern about the auditing of reverse merger companies.[102] The financial statements of companies listed on U.S. exchanges are subject to audits performed by outside auditing firms registered with the PCAOB.[103] Accurate auditing is essential to protecting investors who rely upon the financial statements filed by companies listed on the exchanges, and auditing requirements were actually employed by regulators in order to protect investors.[104] Auditors travel to the company to be audited and perform assessments of that company's financial position, ensuring the financial statements and disclosures made by the company accurately represent its true financial character.[105] Also, auditors confirm that the company has abided by applicable accounting and disclosure standards.[106]

As a result of the Sarbanes-Oxley Act, the auditors of publicly traded companies are subject to the oversight of the PCAOB.[107] In fact, all companies, whether domestic or foreign, whose stock trades on the U.S. market must use an auditor that is registered with the PCAOB. Such auditor is thus required to meet the standards for auditing, quality control, and ethics set by the Board.[108] These outside auditing firms can be either American or foreign.[109] About 900

101. *See* McMahon, *supra* note 21 (China Fire & Security Inc.'s share price declined sixty percent in one year even though the company was not involved in the investigations or allegations associated with many Chinese reverse mergers).

102. As indicated by the multiple articles about reverse mergers in *The Wall Street Journal*. A search on LexisNexis of the terms "reverse merger" within the same sentence as "audit/auditing/auditor" produced ten articles in the year of 2011.

103. 15 USC § 7211(c) (2006).

104. James R. Doty, Chairman, Pub. Co. Accounting Oversight Bd., Looking Ahead: Auditor Oversight, Council of Institutional Investors 2011 Spring Meeting (Apr. 4, 2011), http://pcaobus.org/News/Speech/Pages/04042011_DotyLookingAhead.aspx.

105. *Id.*

106. *Id*.

107. 15 U.S.C. § 7211(a).

108. 15 U.S.C. § 7211(c); 15 U.S.C. § 7212(a) ("[I]t shall be unlawful for any person that is not a registered public accounting firm to prepare or issue, or to participate in the preparation or issuance of, any audit report with respect to any issuer.").

109. *See* James R. Doty, Chairman, Pub. Co. Accounting Oversight Bd., Update on PCAOB Developments, PCAOB SAG Meeting (Mar. 24, 2011), http://pcaobus.org/News/Speech/Pages/03242011_DotyStatement.aspx.

foreign auditing firms are registered with the PCAOB,[110] including fifty-three auditing firms that are located in China and fifty-three that are located in Hong Kong.[111]

As previously explained, the management and most of the assets of the entity surviving the reverse merger transaction are retained by the previously private company.[112] In a Chinese reverse merger transaction, this private company is Chinese. Thus, Chinese reverse mergers typically result in a corporation with its operations conducted in China, while its securities are traded in the United States.[113] Since their securities are traded on U.S. exchanges, the financial statements of these Chinese companies must be audited by PCAOB-registered auditors.[114] A study of Chinese reverse mergers between 2007 and 2010 indicates that U.S. auditing firms audited 74% of the Chinese companies, while 24% of those companies were audited by registered Chinese auditing firms.[115]

In some cases involving the auditing of Chinese reverse merger companies, PCAOB inspectors have flagged auditing deficiencies and have initiated enforcement proceedings against auditors for violating PCAOB auditing standards.[116] However, the PCAOB has also indicated that it is likely that accounting firms registered with the PCAOB are not "conducting audits of companies with operations outside the U.S. in accordance with PCAOB standards."[117] The PCAOB has noted that although U.S. auditing firms are slated to audit the majority of Chinese reverse merger companies, the U.S. auditing firms often allow all or some of the auditing to be performed by local Chinese auditing firms, in some instances due to language barriers.[118] This outsourcing reduces the likelihood that the U.S. auditing firm retains a true understanding of the company's financial condition, let alone a well-grounded ability to assert that the company's reports and financial statements are accurate.[119] The PCAOB has developed specific standards for auditors that employ other independent auditors to perform parts of its work, as the U.S.

110. *Id.*

111. Pub. Co. Accounting Oversight Bd., *Registered Public Accounting Firms with the PCAOB As of Wednesday, December 21, 2011*, http://pcaobus.org/Registration/Firms/Documents/Registered_Firms_by_Location.pdf.

112. The NYSE Amending Exchange's Listed Company Manual, 76 Fed. Reg. at 49,513.

113. OVERSIGHT BOARD, *supra* note 20, at 2.

114. *Id.*

115. *Id.* at 6.

116. Doty, *supra* note 109.

117. OVERSIGHT BOARD, *supra* note 20, at 2.

118. *Id.*

119. *See generally id.* at 2 (explaining the concern that U.S. registered accounting firms are conducting audits not in accordance with PCAOB standards for companies outside the United States).

auditing firms often do with local Chinese auditors.[120] However, the PCAOB alleges that many U.S. firms are failing to abide by those standards, particularly by allowing the local Chinese auditor to complete virtually all of the work.[121] One U.S. auditing firm hired a Chinese accounting firm to help audit a Chinese corporation and then allowed the Chinese auditors to both perform and maintain substantially all of the auditing.[122] Meanwhile, the U.S. firm failed to even send personnel to the China region to oversee or aid in performing the work.[123] Moreover, the PCAOB has also expressed concern that even the innocent inability of U.S. auditing firms to understand the local business environment in China may negatively impact the audits of those companies.[124]

Even more problematic, concern has arisen that the PCAOB is unable to investigate the auditing of all Chinese reverse merger companies, which is particularly troublesome due to the fraudulent behavior that has recently been revealed.[125] Although the PCAOB can inspect audits performed by U.S. auditing firms on foreign entities, the PCAOB has consistently confronted resistance in attempting to do so with the local Chinese auditing firms that are often employed.[126] Even Chinese auditing firms registered with the PCAOB have been off-limits to inspectors.[127] Moreover, apparently Chinese regulators have also confronted difficulty in overseeing Chinese corporations, for, as explained by a private investigator in Hong Kong, "[i]n emerging markets such as China, it's hard to get documentary evidence."[128] The inability for both U.S. and Chinese regulators to oversee the auditing of Chinese corporations exacerbates the reverse merger problem, as there are limited checks on the financial statements of these companies. Also, as the United States and China continue to negotiate as to how best to develop a coordinated solution to the reverse merger issue, the inability of either country to monitor Chinese companies and their auditors will provide further resistance against any such solution.

An example of a Chinese reverse merger company that has experienced the effects of accounting fraud allegations is Sino-Forest Corporation, which is

120. *Id.* at 7.

121. *Id.* at 7–8.

122. OVERSIGHT BOARD, *supra* note 20, at 8.

123. *Id.*

124. *Id.*

125. Mary L. Schapiro, Chairman, Sec. & Exch. Comm'n, Speech by SEC Chairman: Remarks Before the Women in Finance Symposium (July 12, 2011), http://www.sec.gov/news/speech/2011/spch071211mls.htm.

126. Doty, *supra* note 109.

127. *Id.*

128. Alison Tudor, *China Firms Face Research Armies*, WALL ST. J., June 28, 2011, at C1.

listed on the Toronto Stock Exchange.[129] After allegations of accounting errors surfaced, Sino-Forest's shares declined eighty percent in one month alone.[130] What is interesting about Sino-Forest is that, even after these fraud allegations have surfaced and the corporation's stock price deteriorated, Sino-Forest has been suggested as being the best Chinese company for investment.[131] This is indicative of just how troublesome the unknown may be, for the alternative to investing in Sino-Forest is investing in Chinese companies whose auditing practices may be completely off-limits to the PCAOB's oversight. As warned by one involved in the field of securities, this alternative may be more threatening than investing in a corporation whose accounting fraud allegations have already been publicized.[132] Sino-Forest is audited by Ernst & Young, a very large and respected auditing firm, and had created a market capitalization of six billion dollars before accounting fraud was alleged.[133] Examples of practices that contributed to Sino-Forest's stock decline include its use of fifty-eight holding companies that were unwilling to release financial records and its requirement that auditors could examine only 28 of the 267 bank accounts Sino-Forest holds in China.[134] Furthermore, Sino-Forest provides an example of how business is conducted in China—through informal and shady agreements with state or party officials.[135] As the Sino-Forest example demonstrates, business in China is based upon personal relationships with officials, and it is the loss of these relationships that Chinese companies fear from the departure of their officers.[136] Thus, financial tampering by the well-connected may be tolerated by a company's board of directors in order to maintain strong relationships with powerful officials.

C. *Non-Reverse Merger Chinese Companies*

Although reverse mergers have caused Chinese firms to attract the attention of regulators and market participants alike, the issues associated with

129. Craig Wong, *Sino-Forest's Fall Heard*, WINNIPEG FREE PRESS, December 27, 2011, at B9.

130. Peter Stein, *Chinese Firms Need to Open Up Books*, WALL ST. J., June 20, 2011, at C3 (noting that Sino-Forest's shares declined in price by 80% between May and June of 2011).

131. Paul Roderick Gregory, *Chinese Stock Alarm? Sino-Forest May Be the Best of the Bunch*, FORBES (Nov. 27, 2011, 1:07 PM), http://www.forbes.com/sites/paulroderickgregory/2011/11/27/chinese-stock-alarm-sino-forest-may-be-the-best-of-the-bunch/.

132. *Id.*

133. *Id.*

134. *Id.*

135. *Id.* ("The Sino-Forest case reveals that business is done in China through informal agreements with state or party officials, who grant access to licenses, resources, and markets only if they are paid under the table. There can be no official records of these payments. Auditors are not allowed to see bank accounts, and transactions are muddied by a proliferation of shadowy intermediaries, which are likely owned by state and party officials or their families.").

136. Gregory, *supra* note 131.

the accounting practices of Chinese firms are not limited to reverse merger transactions.[137] It is apparent that Chinese firms present similar problems when they have gone public through the traditional IPO.[138]

For example, Renren, Inc. is a Chinese social-networking company that reached U.S. markets through an IPO and is now trading at about half of its IPO price.[139] Renren critically changed information available to investors just before going public by indicating that it expected to face a smaller growth rate than initially anticipated, and later, the head of its audit committee resigned.[140] Although the auditor resigned without providing an explanation, investors can assume that the resignation was triggered by fraudulent activity, which has been the reason for other auditor resignations.[141] Both of these events led to investor skepticism and a declining share price.[142] Longtop Financial Technologies, another Chinese firm that went public in the United States through an IPO and now lists on the NYSE, experienced a fifty percent share price decline after it was confronted with accusations that the company made false statements and manipulated its balance sheets in order to publish better profit margins.[143] The SEC brought administrative proceedings against Longtop on November 10, 2011, alleging Longtop violated the Securities Exchange Act of 1934 by failing to file appropriate reports and failing to provide accurate information within its reports.[144]

Accordingly, it appears that regardless of whether Chinese companies have obtained market access through IPOs or reverse mergers, the fact that they are China-based companies is cause for concern. In fact, *The Wall Street Journal* has noted that all Chinese companies, IPOs and reverse mergers alike, lack arrangements with the PCAOB to allow proper inspection of audits performed in China.[145] Moreover, the use of local Chinese auditing firms to do much of the work that the PCAOB anticipates U.S. firms will do is just as apparent with companies that go public through IPOs.[146] Over two dozen Chinese firms listed

137. *See* Stein, *supra* note 130 (noting the problems associated with both reverse merger and IPO companies based in China); Vodicka, *supra* note 13 (suggesting that it is not sufficient to simply bypass reverse mergers and invest in a regular IPO company).

138. *See* Stein, *supra* note 130; Vodicka, *supra* note 13.

139. Stein, *supra* note 130.

140. *Id.*

141. *See id.*; *see also* Jenkins, *supra* note 15 (stating that China MediaExpress's auditing firm resigned due to an inability to rely on management's representations).

142. Stein, *supra* note 130.

143. Vodicka, *supra* note 13 (noting that Longtop shares declined from $35 per share to $18); Tudor, *supra* note 128 (noting that Longtop is listed on the NYSE).

144. Longtop Fin. Techs. Ltd., Exchange Act Release No. 65734, 2011 WL 5444409 (Nov. 10, 2011).

145. Stein, *supra* note 130.

146. *See id.*

in the United States declared resignations of their auditors or other major accounting announcements in March and April of 2011 alone.[147]

D. How Investors Are Affected

Although studies show that Chinese companies have only accounted for 26% of reverse mergers and 13% of IPOs that ended in U.S. market access in the past four years,[148] the accounting irregularities associated with Chinese firms are of particular cause for concern since American investors have been so eager to invest in Chinese firms, perhaps allowing their zeal to blind them in their hopes of making a profit off of such promising investments.[149] China has experienced tremendous growth in the past few years, which has prompted foreign investors, including Americans, to invest in Chinese stocks and to anticipate great profit from China's persistent growth.[150] The research director of Muddy Waters Research, a company that investigates the true worth of Chinese firms trading their securities in the United States, has noted that Chinese companies actually target foreign investors with their accounting frauds.[151] For example, some firms have been discovered reporting larger profits to the SEC than those they report to the Chinese State Administration for Industry and Commerce.[152] As a result of such targeting, the publication of accounting problems linked to many U.S.-listed Chinese firms has confronted shareholders with billions of dollars in losses over the past year.[153] It is interesting to note, however, that while fraudulent activity has been associated with both Chinese reverse mergers and Chinese IPOs, the PCAOB reports suggest that Chinese reverse merger companies are still less valuable than Chinese companies that go public through the traditional IPO process.[154] As of March 31, 2010, total market capitalization for Chinese companies that

147. Jenkins, *supra* note 15.

148. OVERSIGHT BOARD, *supra* note 20, at 3–4, tbls.1 & 2.

149. *See* Owen Fletcher & Dinny McMahon, *Investors Spooked by China: Small-Stock Accounting Scandals Are Breeding Deeper Fears*, WALL ST. J., Oct. 1, 2011, at B1 ("For years investors, swept up in the broader China growth story, gave Chinese companies that listed their stocks on U.S. exchanges the benefit of the doubt on governance and regulatory issues."); *see also* Rapoport, *supra* note 41 ("U.S. investors are eager for ways they can tap investment opportunities in the huge, growing Chinese market.").

150. *See* Vodicka, *supra* note 13 ("Anyone who's been paying attention to the Chinese economy for the last few years knows the country is growing by leaps and bounds. Even after economists recently downgraded growth projections for the far-east juggernaut, Q2 GDP is still expected to clock in at an impressive 9%."); *see also* Tudor, *supra* note 128 ("Investors around the world eager to profit from China's fast-growing economy want to know the risks.").

151. Jenkins, *supra* note 15 ("For the most part, they keep their noses clean in China. If these guys were pulling the same thing in China, the punishment is a bullet to the head.").

152. Jenkins, *supra* note 15.

153. McMahon, *supra* note 20.

154. OVERSIGHT BOARD, *supra* note 20, at 4.

completed IPOs was more than double that of Chinese companies that had gone public through reverse mergers.[155] As explained previously, this suggests that investors should have greater incentive to invest in Chinese IPOs than in Chinese reverse mergers since firms with larger market capitalization are less likely to have pricing inefficiencies due to the likelihood that market participants will spend more resources analyzing the value of those firms.[156]

When reverse merger companies report fraudulent and misleading financial information, investors inappropriately value their securities. The Supreme Court has explained the importance of accurate financial information in the securities market, for the price of a company's stock is determined by the available material information regarding the company and its business.[157] Thus, misleading information causes investors to place inappropriate value on the securities associated with that information.[158] Fraudulent reports suggest that the assets of the companies are greater than they actually are, causing investors to invest when they otherwise may not have.[159] On the other hand, investors have also been affected by the work of others interested in Chinese firms such as private-equity groups and short sellers. Private-equity groups have recently been working with several Chinese companies to buy out outside shareholders, helping the firms go private.[160] Most of these firms first went public through reverse mergers, but as allegations of fraud surfaced and investigations increased, these same firms are now seeking privatization.[161] The work of private-equity groups has allowed many of these companies to increase their share price.[162] For example, China Fire & Security was listed on NASDAQ and selling at $6.26 per share before a private-equity fund began looking to buy out its shares.[163] Six months later, however, China Fire &

155. *Id.*

156. O'Neil v. Appel, 165 F.R.D. at 479, 503 (W.D. Mich. 1996) (suggesting that investors have an incentive to invest in larger firms (with larger market capitalization) because those firms have an "incentive to eliminate mispricing," for "market participants have greater incentives to invest resources in assessing the value of larger capitalization firms," yet, on the other hand, pricing inefficiencies are more prominent with smaller companies, which thus have smaller market capitalization); *see supra* Part I.A.

157. *See* Basic Inc. v. Levinson, 485 U.S. 224, 244 (1988) (quoting *In re* LTV Securities Litig., 88 F.R.D. 134, 143 (N.D. Tex. 1980) ("[T]he market is interposed between seller and buyer and, ideally, transmits information to the investor in the processed form of a market price. . . . The market is acting as the unpaid agent of the investor, informing him that given all the information available to it, the value of the stock is worth the market price.")).

158. *See id.* at 247.

159. *Id.* ("An investor who buys or sells stock at the price set by the market does so in reliance on the integrity of that price.").

160. McMahon, *supra* note 20.

161. *Id.*

162. *See id.*

163. *Id.*

Security's shares increased to $8.47 after the private-equity firm offered $9 per share to outstanding shareholders.[164] Private-equity firms thus add value to stock by providing assurance that the stock will be sold, thereby raising the stock price up to that of the private-equity firm's buyout price. Investors should be cautious, however, because there is some suspicion that such privatization plans are used merely as a subterfuge to raise share prices while the company has no true desire to go private.[165] Investors have also been affected by the work of short sellers, who reveal to investors the true value of the firms they investigate when they publish their research.[166] Their published research then triggers the deterioration of the firm's share price, as desired by the short sellers, and investors become well aware of the true value of those shares and of the condition of the associated firm.[167]

III. THE REACTION OF THE UNITED STATES

As previously discussed, the exchanges are required by the 1934 Securities Exchange Act to establish rules permitting the discipline of market participants and mechanisms that ensure market integrity and investor protection.[168] These rules are published for comment through the SEC and require SEC approval.[169] Both the NYSE and NASDAQ published proposed rules that the exchanges hoped would counter the numerous accounting irregularities associated with reverse mergers and improve investor protection.[170] Neither exchange, however, has developed any sort of proposed rule or commentary that addresses the same issues that arise with Chinese IPOs. The PCAOB has also made efforts to work with Chinese authorities to establish mandates that will ensure investigations of Chinese companies.[171]

A. Proposed Rule Provided by the NYSE

The NYSE filed its proposed rule with the SEC on July 22, 2011.[172] The proposed rule amended the exchange's "Listed Company Manual," which specifies the requirements that must be met to list and maintain listing on the

164. *Id.*

165. McMahon, *supra* note 20 ("Harbin Electric's stock is trading at a discount of about 25% to Abax's proposed buyout price, indicating investor concerns that the deal might not happen. As of Aug. 15, more than seven million shares had been borrowed for short selling, representing almost a quarter of shares available for trading.").

166. *See* Cheng, Zhu & Lee, *supra* note 87, at 1434.

167. *Id.*

168. *The Laws that Govern the Securities Industry*, *supra* note 42; *see supra* Part I.B.3.

169. *The Laws that Govern the Securities Industry*, *supra* note 42; *see supra* Part I.B.3.

170. The NYSE Amending Exchange's Listed Company Manual, 76 Fed. Reg. at 49,513; NASDAQ Proposed Rule, 76 Fed. Reg. at 34,781.

171. Schapiro, *supra* note 125.

172. The NYSE Amending Exchange's Listed Company Manual, 76 Fed. Reg. at 49,513.

exchange.[173] The NYSE's rule would require a reverse merger, in order to be eligible for listing, to (1) trade for at least one year in the U.S. over-the-counter market, on another national securities exchange, or on a foreign exchange, and file the appropriate forms with the SEC, and (2) file all required reports with the SEC beginning on the date of the consummation of the reverse merger.[174] Furthermore, the reverse merger would be required to maintain a minimum stock price of at least four dollars to remain listed.[175]

Through the publication of its proposed rule, the NYSE has announced its belief that the amendments are vital to increasing transparency to issuers and market participants alike by reducing the likelihood that reverse merger fraudulent behavior will be revealed after listing.[176] The NYSE noted that due to the accounting fraud allegations that have surfaced regarding reverse mergers, the NYSE has performed "heightened, risk-informed reviews" of reverse merger firms aspiring to list on the exchange.[177] Furthermore, the NYSE points out that it has broad discretion in determining whether a certain company may list on the exchange and that this discretion may be used to develop more rigid requirements for listing.[178] With respect to reverse mergers and the recent allegations, the NYSE believes the use of its discretion in establishing such requirements is warranted.[179] The NYSE has also made sure to note that this discretion also allows it to require additional disclosure or even deny listing for firms that appear to be worthy of caution.[180] The stipulation that the reverse merger must trade for at least one year in a capital market will, according to the NYSE, ensure the reliability of the firm's operations and financial reporting and will allow time for outside auditors to complete investigations of the company and detect any accounting irregularities.[181] The NYSE also states that this one-year period will allow for "regulatory and market scrutiny" of the firm, meaning that the work of short sellers and research groups will be less likely to deteriorate the stock prices of a company listed on the NYSE, since any irregularities would have been discovered in the one-year period prior to listing on the NYSE.[182]

173. *Id.* at 49,513–14.
174. *Id.*
175. *Id.*
176. *Id.* at 49.514.
177. The NYSE Amending Exchange's Listed Company Manual, 76 Fed. Reg. at 49,513.
178. *Id.*
179. *Id.*
180. *Id.* at 49,514.
181. *Id.*
182. *See* the YSE Amending Exchange's Listed Company Manual, 76 Fed. Reg. at 49,514.

B. Proposed Rule Provided by NASDAQ

NASDAQ has also published a proposed rule to adopt additional listing requirements for reverse mergers, which it filed with the SEC on May 26, 2011.[183] Under its proposed rule, a reverse merger company will not be eligible for listing unless the merged company had (1) traded for at least six months, (2) maintained a bid price of four dollars per share or higher on at least thirty of the most recent sixty trading days, and (3) filed appropriate reports.[184]

In the publication of its proposed rule, NASDAQ indicated a similar rationale to that of the NYSE for its rule and for its concern regarding reverse mergers.[185] NASDAQ noted that the reason for its proposed rule change was the recent attention to reverse mergers, the allegations of fraudulent activity, the warnings of the PCAOB, an enforcement proceeding initiated by the SEC regarding a reverse merger, and NASDAQ's own experience with reverse merger companies manipulating their prices to satisfy initial listing bid price requirements.[186] According to NASDAQ, its six-month "seasoning" requirement would provide more time for regulators to observe trading patterns and discover potentially manipulative trading, create a more legitimate shareholder base, and improve reliability.[187]

C. Efforts by the PCAOB

The PCAOB has recently worked with the SEC to ally with Chinese authorities in order to establish a mechanism through which the PCAOB and Chinese authorities would coordinate in joint oversight of the auditing of Chinese firms.[188] The PCAOB has been particularly hopeful about creating coordinated inspections of auditing firms that are registered with the PCAOB but based in China.[189] In July of 2011, the SEC and PCAOB met with officials from China.[190] This meeting was cause for optimism, for the American and Chinese officials agreed that cross-border audit oversight will improve the quality of public company auditing and will protect investors residing in both

183. NASDAQ Proposed Rule, 76 Fed. Reg. at 34,781.

184. *Id.* at 34,781–82.

185. *Id.* at 34,782.

186. *Id.*

187. *Id.* at 34,782–83.

188. *U.S. and Chinese Regulators Meet in Beijing on Audit Oversight Cooperation*, *supra* note 19.

189. Schapiro, *supra* note 125.

190. *U.S. and Chinese Regulators Meet in Beijing on Audit Oversight Cooperation*, *supra* note 19.

the United States and China.[191] As of December 2011, however, the PCAOB still had not reached agreement with China about joint inspections.[192]

D. The Views of Commentators

Although there were relatively few commentators on the proposed regulations of the exchanges, all of those who did provide comments felt that the regulations should not be adopted as drafted. While only one commentator believed that the regulations should be more stringent,[193] the others believed that the regulations proposed by NASDAQ and the NYSE were too extensive.[194] Evident from the comments were concerns that have been alluded to above: Are the regulations really targeting the right type of transactions?[195] Should the exchanges be concerned more specifically with foreign issuers?[196] Many commentators echoed the concern detailed above that reverse merger companies have not been the sole participants in fraudulent activity.[197] In fact,

191. *Id.*

192. James R. Doty, Chairman, Pub. Co. Accounting Oversight Bd., 2011 Statesman Dinner Remarks, Foreign Policy Association (Dec. 6, 2011), http://pcaobus.org/News/Speech/Pages/12062011_DotyStatesmanDinner .aspx.

193. Letter Comment from James Davidson, Hermes Equity Ownership Servs., to Elizabeth M. Murphy, Sec'y, Sec. & Exch. Comm'n (Aug. 31, 2011), http://www.sec.gov/comments/sr-nyse-2011-38/nyse201138-1.pdf.

194. *See, e.g.*, Letter Comment from Richard Rappaport, Chief Exec. Officer, WestPark Capital, Inc., to Elizabeth M. Murphy, Sec'y, Sec. & Exch. Comm'n (Sep. 2, 2011), http://www.sec.gov/comments/sr-nasdaq-2011073/nasdaq2011073-3.pdf [hereinafter WestPark Capital Comment] ("The overall effect of the proposed rule change would subject smaller capitalization issuers to a significantly more burdensome listing requirement that is unrelated to achievement of the stated objective.").

195. *See* Letter Comment from David Feldman, Partner, Richardson & Patel LLP, to Elizabeth M. Murphy, Sec'y, Sec. & Exch. Comm'n (Aug. 30, 2011), http://www.sec.gov/comments/sr-nasdaq-2011-073/nasdaq2011073-1.htm [hereinafter Feldman Comment] (showing concern that the Chinese IPOs are left out of the regulations and questioning whether targeting reverse mergers as a category of transactions is the correct solution: "a broad brush application to all transactions of a particular type may have the chilling effect of discouraging exciting growth companies from pursuing all available techniques to obtain the benefits of a public listed stock and greater access to capital while still maintaining appropriate investor protections").

196. *See* Letter Comment from Locke Lord LLP, to Elizabeth M. Murphy, Sec'y, Sec. & Exch. Comm'n (Oct. 17, 2011), http://www.sec.gov/comments/sr-nasdaq-2011-073/nasdaq2011073-4.pdf [hereinafter Locke Lord Comment] (suggesting additional listing requirements for companies controlled by non-U.S. residents).

197. *See* Feldman Comment, *supra* note 195 ("Virtually all of these suggestions of wrongdoing involve Chinese companies that completed reverse mergers. The proposal fails to note that a number of other Chinese companies that completed full traditional initial public offerings with major underwriting and accounting firms face the very same allegations. In addition, many of the Chinese companies facing allegations went public through a reverse merger followed by a fully underwritten, SEC-reviewed public offering before a single share of stock traded. So if these allegations turn out to be true, it would not be a result of the manner in which

one commenting business initiated its own study of corporations that have been delisted from U.S. stock exchanges, finding that the majority of companies delisted had actually gone public through IPOs, rather than through reverse mergers.[198]

Even more discomforting to many commentators is the fact that reverse mergers have become an efficient and accepted alternative to the traditional IPO, and such regulations will clearly thwart the use of reverse merger transactions.[199] One commentator noted that for small businesses, which generate eighty percent of employment in the United States, reverse mergers are their only option to gain access to investors.[200] For these small businesses, the traditional IPO is too costly, and it is difficult for such companies to attract investment banks willing to complete an IPO for a small business.[201] Due to the fact that these regulations will have drastic effects on small capitalization issuers while failing to target many of the transactions that should be cause for concern, many commentators feel that the proposed rules overreach and lack the ability to achieve sufficient investor disclosure and protection.[202] Broad application of the proposed rules to all reverse mergers will subject small companies to significantly more burdensome listing requirements, thereby

the companies went public."); *see also* Letter Comment from David A. Donohoe, Jr., Donohoe Advisory Assocs. LLC, to Elizabeth M. Murphy, Sec'y, Sec. & Exch. Comm'n (Oct. 18, 2011), http://www.sec.gov/comments/sr-nasdaq-2011073/nasdaq2011073-5.pdf [hereinafter Donohoe Comment] ("While we recognize that there has been an increase in the number of reverse merger companies experiencing accounting difficulties, we are also cognizant of the fact that many companies that have gone public through initial public offerings ('IPOs') have also experienced accounting difficulties.").

198. Letter Comment from James N. Baxter, Chairman & Gen. Counsel, N.Y. Global Grp. Inc., to Elizabeth M. Murphy, Sec'y, Sec. & Exch. Comm'n (Oct. 17, 2011), http://www.sec.gov/comments/sr-nasdaq-2011-073/nasdaq2011073-2.pdf [hereinafter N.Y. Global Comment] (finding that of twenty-nine China-based companies that were delisted from U.S. exchanges in 2011, fifteen (52%) were IPO companies and twelve (41%) were reverse merger companies).

199. *See* Donohoe Comment, *supra* note 197 ("[G]iven that reverse mergers have become an acceptable and effective alternative to an IPO over the last decade, particularly since it has become increasingly difficult for companies to attract investment banks willing to complete an IPO for a small cap issuer and given the large upfront cost associated with an IPO, it is important to strike a balance so as not to allow the seasoning period to be unnecessarily long and therefore punitive."); *see also* N.Y. Global Comment, *supra* note 198 ("In many circumstances, reverse merger is the only available process through which a small U.S. company can raise growth capital through obtaining a listing on a stock exchange. . . . The reverse merger technique is simply an economical and rational method for small cap companies to efficiently access the capital market.").

200. N.Y. Global Comment, *supra* note 198.

201. *Id.*

202. *See* WestPark Capital Comment, *supra* note 194.

discouraging these growing companies from gaining capital market access, all the while allowing the larger IPO companies to fly under the radar.[203]

Interestingly, many commentators mentioned that an exception should be granted for reverse merger companies listing in connection with a firm commitment underwritten public offering, which essentially provides for the same level of protection as for an IPO.[204] Without a firm commitment, a reverse merger issuer, unlike an IPO issuer, may not have filed a registration statement with the SEC and may not have undergone the scrutiny associated with the underwriting process.[205] However, if the reverse merger company has made a firm commitment underwritten public offering, these differences are diminished.[206]

E. Final Rules of the Exchanges as Approved by the SEC

The SEC approved the proposed rules of both the NYSE and NASDAQ, along with their amendments.[207] Both amendments included an exception for the "firm commitment underwritten public offering" that many commentators proposed.[208] As explained above, firm commitment essentially makes the reverse merger more like the IPO.[209]

IV. GAPS WITHIN THE CURRENT U.S. RESPONSE

Clearly, from the recent depreciation of stocks affiliated with Chinese companies and the findings of fraud associated with many Chinese firms listed on U.S. exchanges, investors are in need of protection. As is often the case, as soon as the market went awry, Americans cried out for more regulation, questioning why regulators had not prevented the manipulative schemes.[210] The SEC, twice delaying its decision date, took over five months to issue a decision on the NASDAQ rule.[211] As for the NYSE rule, the Commission

203. *See* Feldman Comment, *supra* note 195.

204. *See id*.; *but see* N.Y. Global Comment, *supra* note 198 (noting that the companies that were delisted were underwritten and therefore subject to the same amount of scrutiny as an IPO).

205. Donohoe Comment, *supra* note 197.

206. *Id.*

207. Approval to the NYSE Proposed Rule, 76 Fed. Reg. at 70,795; Approval to NASDAQ Proposed Rule, 76 Fed. Reg. at 70,799.

208. Approval to the NYSE Proposed Rule, 76 Fed. Reg at 70,797; Approval to NASDAQ Proposed Rule, 76 Fed. Reg at 70,801.

209. *See supra* notes 197–199 and accompanying text.

210. Jenkins, *supra* note 15.

211. *See* Notice of Designation of a Longer Period for Commission Action on NASDAQ Proposed Rule Change, 76 Fed. Reg. 45,636 (July 29, 2011) (extending the forty-five day decision timeframe to September 12, 2011); *see also* Approval to NASDAQ Proposed Rule, 76 Fed. Reg at 70,799–801 (stating that NASDAQ filed its proposed rule on May 26, 2011, the Commission extended the approval date on July 25, 2011, then instituted proceedings on

delayed once and finally issued an order approving the rule four months after it was filed.[212] Now that the much-anticipated regulation is in place, whether such regulation is appropriate may be questioned. Although it was quite necessary to adopt regulations to shield against the issues associated with the current Chinese reverse merger dilemma in the future, the lag of SEC action left the market, for a considerable amount of time, to fend for itself.[213] Additionally, by failing to address the similar problems investors confront with Chinese IPOs, the regulation that investors finally received is incomplete.

Within this analysis of the current response of the U.S. government, both the opposing claims of need for government action and of need for market freedom will first be analyzed. Then, after a conclusion is made that a mix of both government action and market scrutiny are necessary since neither is sufficient on its own, how the regulation should be bolstered to properly protect investors from the issues that have recently attracted enormous publicity will be considered.

A. The Debate Between Pro-Government-Action and Pro-Market-Freedom

On one hand, the pro-government argument is that, in light of the fraudulent behavior that has been recently revealed, government regulation is essential to providing investor protection against such activity in the future. The role of government regulatory agencies, like the SEC, has been described as delivering a "blend of measures" to create positive externalities and to "promote good practices in the industry, prevent harms, and provide those harmed with remedies."[214] In the reverse merger context, the SEC's approval of the exchanges' new rules is essential to promoting truthful financial practices and reporting, preventing investor harm caused by fraudulent reporting, and providing investors who have been harmed with remedies. In fact, due especially to the inability of the PCAOB to perform its inspections of Chinese firms, this regulation may be the only way to categorically obstruct the fraudulent activity that has become characteristic of Chinese reverse mergers.

September 12 (as opposed to approving or disapproving the rule), and the Commission approved the rule on November 8, 2011).

212. *See* Notice of a Longer Period for Commission Action on the NYSE Proposed Rule Change, 76 Fed. Reg. 59,756 (Sept. 27, 2011) (stating that the NYSE filed its proposed rule on July 22, 2011, and extending the forty-five day time period for Commission action); *see also* Approval to the NYSE Proposed Rule, 76 Fed. Reg at 70,795 (adopting the final the NYSE rule on November 8, four months after the NYSE's July proposal).

213. *See* Shira Ovide, *Uh, Little Late. SEC Warns on Reverse Merger Companies*, WALL ST. J. BLOGS, DEAL J. (June 9, 2011, 12:55 PM), http://blogs.wsj.com/deals/2011/06/09/uh-little-late-sec-warns-on-reverse-merger-companies/ (describing the timing of the SEC's regulations as "[c]losing the barn door after the horses got out").

214. Marcia L. McCormick, *Federal Regulation and the Problem of Adjudication*, 56 ST. LOUIS U. L.J. 39, 39 (2011).

The failure of the PCAOB to access the internal work of these Chinese corporations indicates that perhaps the only remedy available to harmed investors, at least at this time, is the promise of governmental protection against such harm in the future.

Furthermore, the new rules are necessary as the only *ex ante* remedy, in the form of protection, for investors. This regulation is essential to ensure against similar loss to investors at the point in time when they decide to invest in reverse merger companies. Although the SEC has also acted by revoking the registration of dishonest corporations and by initiating enforcement proceedings against them, these actions are *ex post*; they fail to prevent the harm before it is caused by leaving investors unprotected before billions of dollars' worth of investments are lost on the market. Moreover, although much fraudulent activity has been exposed by short sellers and market researchers, and although many firms are again seeking privatization, it is unknown how many other companies were still listed on the exchanges prior to the new rules, with the same fraudulent façade as the ones revealed. The more stringent listing requirements adopted by the exchanges will at least ensure against the entry of even more manipulative firms. Additionally, the action by the SEC provides certainty to investors that *authoritative* steps, as opposed to those taken by the market itself, have been taken. This seems especially likely to promote consumer confidence and encourage investment. It is this certainty that regulators have acted that will remedy the weakening of consumer trust due to the simple provision of an *ex ante* remedy; for investors will fear less and will be more likely to continue investing because they know they are protected by legitimate and authoritative action. As will be explained, more regulation is needed in order to fully solve the problem with Chinese reverse mergers. When that solution occurs, the promotion of consumer confidence brought by authoritative steps will be a benefit to the market. Until the problem is resolved completely, however, it seems that encouraging investment is undesirable since investors are still susceptible to fraudulent practices.

On the other hand is the cry of those who believe the market must be left alone, that regulation interferes with the market system. It is market scrutiny itself, they argue, that exposes and prevents fraud by condemning poor business behavior through share price deterioration.[215] The acts of short sellers and analysts have brought the faulty practices behind these companies into the spotlight and, as investors are informed of the true value of these companies, their share prices diminish. Supportive of the idea that the market can regulate itself is the fact that the market was actually forced to police itself in this way, and exhibited some success in doing so, before the SEC approved the proposed rules of the exchanges. As the SEC delayed decision-making, short sellers

215. Jenkins, *supra* note 15.

were productive in researching and exposing fraudulent companies.[216] Some firms, grasping the enormity of the sudden backlash against Chinese companies, are backing out, seeking privatization through the help of private-equity groups instead.[217] It appears that, with the help of short sellers and private-equity groups, the market did a fair job of tending to itself while new regulations were awaiting approval. This success supports the argument that the market can also root out any other existing public companies with similar accounting issues.

Pro-market advocates could also point to the small companies that many commentators worried would be overly burdened by the regulation. Such companies bring to mind the suffering private-company souls, who, though dying of thirst, were forced to share from a dripping faucet before the "nobleman-regulator" apathetically stopped the drip forever.[218] This analogy suggests that, like in 2005, the SEC can again be seen as a ruthless agency that kills off private companies through its regulatory regime over reverse mergers. As explained above, since private companies are often too small to gain access to capital, the reverse merger transaction may be the only way for some of them to grow.[219] Thus, by severely restricting access to the markets through reverse mergers, the SEC (through its exchanges) robs these small firms from any hope of survival. Assuming the firm commitment underwritten public offering exception does not have an effect on the practices of small firms, some market participants may be dissatisfied with allowing such a ruthless "nobleman-regulator" to kill off those firms, which may possess unanticipated potential for investors. Lastly, it could be argued that the ruthlessness of such regulation was unwarranted; the market was showing signs of mending itself and the less-intrusive action of the SEC—revoking registration and engaging in enforcement proceedings—was apparently providing a deterrent since SEC investigations were cited as a cause of the increased privatization plans.[220]

B. Both Government Regulation and Market Policing are Necessary to Protect Investors

Neither government regulation nor market scrutiny is sufficient on its own to properly protect investors. Even market scrutiny, buttressed by the pre-regulation use of SEC registration revocation and enforcement proceedings is inadequate. The conflict between government action and market freedom may effectively be analyzed by weighing the costs and benefits of one against the other.

216. *See supra* Part II.A.
217. *See supra* Part II.D.
218. Pavkov, *supra* note 1, at 477.
219. *See supra* Part III.D.
220. *See* McMahon, *supra* note 20.

The benefit of government regulation is clear: it provides the *ex ante* remedy to investors as described above.[221] Government regulation (through the exchanges) protects investors before a company can even list on the market, that is, before the investor-protecting work of short sellers even begins. In contrast, the benefit of *less* regulation is the ability of small companies to gain access to capital markets. Not only is this essential for the survival of some of these firms, but this ability is also beneficial to society itself because small businesses, in the aggregate, provide a great amount of employment.[222] Also, these small corporations may have the potential to become superior investment opportunities and may at some point provide abundant growth for the economy.

The cost of regulation can be seen as a burden imposed on small American companies that cannot go public through an IPO and must gain access to capital markets through the reverse merger process. This cost may completely bar these companies from gaining access to capital markets and, in turn, from raising the capital necessary for their survival. Moreover, this cost may be considered unwarranted by noting that only Chinese reverse mergers have received rigorous scrutiny for fraudulent behavior, yet Chinese companies comprise only twenty-five percent of reverse mergers that have listed on U.S. markets since 2007.[223] In contrast, the cost of *less* regulation is the loss in share prices to investors that occurs before market scrutiny protects future investors by flagging the true value of deceitful companies. This, as illustrated above, has been a tremendous amount of money.[224] The cost of allowing the market to remain less regulated is reduced if it is to be believed that short sellers, market research firms, and savvy investors do sufficiently investigate these companies to discover fraudulent behavior. However, the sufficiency of such investigation is diminished in the Chinese reverse merger context, for the shrewdness of investors and researchers is hampered by the inability of the PCAOB to inspect Chinese firms. Without internal inspection, market scrutiny cannot be relied upon to notify investors when a firm's reports are fraudulent.

Ultimately, a mix of government action and market scrutiny is appropriate. Government regulation protects investors before the market has an opportunity to investigate and respond to fraudulent behavior. Also, government regulation plays a significant part in protecting investors when the market cannot adequately investigate listed firms due to access failures. The policing practices of the market itself, however, are essential in times like the present when government action is delayed, leaving the market with no other choice

221. *See supra* Part IV.A.

222. *See supra* Part III.D.

223. Jessica Holzer, *U.S., China to Resume Discussions On Inspections of Chinese Auditors*, WALL ST. J., July 7, 2011, at C3.

224. *See supra* Part II.D.

than to flag companies that may be harmful to investors. This is where the work of short sellers and market research firms act to protect investors who are left unaided by government action. Moreover, it should be noted that even outside the reverse merger context, the market will always have a function in protecting investors. In as much as government rule-making can only employ broad mandates, it can never fully protect investors. Thus, there will always be a role for the market in investigating individual companies. Although this applies outside the reverse merger arena, it is especially true of the present regulations, which are discussed below.

C. Assuming Government Action Is Essential to Investor Protection, How the Current Regulation Must Be Improved

Turning to the adequacy of the government regulation itself, there are two reasons why the regulation is off-target, both of which also illustrate a benefit of market scrutiny considering the market does not make the same errors. First, what is clearly worthy of questioning is the failure of the new rules to confront the problems associated with Chinese IPO companies. If the concern is really about protecting investors, the adopted regulation is insufficient because it applies solely to reverse mergers. Although the market itself has flagged both IPOs and reverse mergers, as evident from the rapid share price declines of companies that have gone public through both procedures, apparently neither the exchanges nor the SEC have even considered IPOs. The proposed rules of the exchanges are off-target by omitting the IPOs that have faced the same market scrutiny.

Second, it seems more appropriate to adopt more stringent regulations specific to those companies whose auditing practices cannot be reached by the PCAOB. This will target the Chinese companies that go public through both the traditional IPO and the reverse merger. One commentator to the proposed rules supported this solution by suggesting that more scrutiny against non-U.S. controlled firms seeking to list on the U.S. market is warranted.[225] Enacting regulations that target all non-U.S. firms will capture the much-criticized Chinese firms as well as firms from other foreign countries that may hold similar business practices and pose similar inspection problems as Chinese firms.[226] Such regulation is appropriate because the alternative is to allow Chinese companies and perhaps other foreign companies to commit defective accounting and manipulation of financial statements. While these companies refuse to allow the agencies associated with the markets on which they list to

225. *See* Locke Lord Comment, *supra* note 196 (suggesting additional listing requirements for companies controlled by non-U.S. residents).

226. *See* Doty, *supra* note 109 (noting the benefits of joint inspections as an efficient means of overseeing the auditing of foreign publicly-traded corporations, and that the PCAOB has joint oversight with nine countries).

investigate them, the other listed companies are subject to inspection by the PCAOB and must abide by the rules. It seems even more proper when one notes that Chinese companies have been "aiming" their fraudulent behavior at American investors. Perhaps even more likely to hush protest against such a regulatory scheme is the fact that Chinese corporations do not dare commit such fraud in their own country because they know the severity of the consequences. Instead, they turn to the American market to employ their manipulative schemes. Again, the market does not commit this error, for while government regulation fails to target specifically Chinese or particularly non-U.S. stocks, the market does not.[227]

CONCLUSION

After much delay and much debate, the SEC's final rules adopting more stringent listing requirements for reverse merger companies seeking to list on NASDAQ and the NYSE are in place. Although the SEC did approve amendments excepting from the requirements those reverse merger companies listing in connection with a firm commitment underwritten public offering, the rules failed to address concerns that must be resolved in order to adequately protect investors: the inability to retain auditing oversight of companies in China and the skepticism that has recently plagued Chinese IPOs for the same reasons that reverse mergers have gained attention. If the goal of regulation is the greatest possible protection of investors, that goal has not yet been achieved. Only by imposing more requirements on non-U.S. companies, regardless of the manner through which they went public, will investors be adequately protected against the fraudulent behavior that was first exposed by Chinese reverse mergers.

Although the reverse merger issue illustrates the recurring dynamic between market policing and government regulation, it is essential to note that both have been and are required to be in place in order to provide investor protection against reverse merger securities. While the market has provided great protection through the work of short sellers, research analysts, and the price indicators of the market itself, in the current situation the market is insufficient to provide full protection. Because there is no system that monitors the accuracy of the financial statements of a great number of reverse mergers, government regulation that creates a barrier against such companies listing on U.S. exchanges is essential. Only through government regulation can investors be assured that authoritative bars against the current fraudulent practices are in place and that market activists have not failed to flag problematic securities due to their inability, and the inability of regulators in both the United States and China, to tap the true financial character of listed companies. On the other

227. Fletcher & McMahon, *supra* note 150.

hand, market scrutiny was particularly important during the recent regulatory proceedings due to the incessant delay of regulators. While investors waited for a final rule, the market was working to mend itself by researching companies and deteriorating the value of the fraudulently behaving ones.

How effective the final regulation will be in complementing market scrutiny is left to be seen. As a result of the rules leaving gaping holes in regulation through their omission of increased regulation of all Chinese companies, including IPOs, the attention of investors must now be turned to the PCAOB and its efforts to obtain stricter oversight of Chinese audits. Unfortunately, the PCAOB's negotiations with China are likely to be hampered by the inability of *either* country to gain oversight of Chinese firms and their auditors. It is this inability for the PCAOB to obtain oversight that exacerbates the need for stricter exchange rules. While Chinese IPOs are left undisturbed by the regulatory hand and oversight by the PCAOB is lacking, investors are not adequately protected. Assuming the PCAOB continues to meet resistance in its efforts to obtain joint oversight in China, the market will be forced to continue to fill the major gaps left by the new regulation until legislation that more fully addresses the problem is in place. Until such joint inspection is acquired, or until the SEC approves more comprehensive rules, encouraging investment will continue the trend of shareholder devastation, for investors will continue to be susceptible to fraudulent practices.

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* J.D. expected, May 2013. I would like to thank Professor Ann Scarlett, whose great insights informed this Comment. I would also like to thank Mom and Dad for their ceaseless love and support.