Indonesia - OECD Corporate Governance Policy Dialogue

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Rules on Backdoor Listings: a Global Survey

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Background

The OECD has engaged closely with Indonesia to support its reform efforts and benefit from its experience. This co-operation takes place through the OECD Corporate Governance Committee, the Asian Roundtable on Corporate Governance, a new Southeast Asia Corporate Governance Initiative and the Indonesia-OECD Policy Dialogue on Corporate Governance.

The first phase of the Indonesia-OECD Policy Dialogue concentrated on enhancing disclosure of beneficial ownership and control as part of overall efforts to improve corporate governance standards and practices in Indonesia. In 2013, a report on *Disclosure of Beneficial Ownership and Control in Indonesia: Policy Options for Indonesia* was released and assessed the costs, benefits and practicality of different policy approaches and suggested options to better identify ultimate beneficial owners in Indonesia. The report has been instrumental in supporting the development of policies to improve access to reliable information about ownership, including the identity of the controlling owners, and control structures of listed companies. This issue is also a global priority and part of G20 efforts.

The second phase of the Indonesia-OECD Policy Dialogue focuses on the issue of transparent and fair rules governing market discipline, specifically back-door listings. A Technical Seminar on Backdoor Listings was held in December 2013 to discuss the challenges and different regulatory approaches to backdoor listings, critical to the efficient and transparent functioning of the market for corporate control and overall market growth and development. Subsequently as follow up, a Workshop on Transparency of Backdoor Listings was held on 30 October 2014, to further exchange country and expert views and experiences on backdoor listings in order to propose best practices and policy options for the Indonesia Financial Services Authority with regards to transparency of backdoor listings. This report was used as a background document for the workshop. It provides a comparative study of regulatory responses to backdoor listings in other markets, and discusses whether there is a need to promulgate specific regulation for backdoor listings in Indonesia.

1. Introduction

Financial and capital markets play a key role in the funding of high growth companies, the exploration of natural resources, the operation of mines and the development of real estate. There is little doubt that companies in these highly capital-intensive and volatile sectors will eventually have to float their shares on a stock exchange to get access to capital to expand the operations (and keep the exploration going), enhance the company's reputation, attract and retain talented employees, and provide liquidity to shareholders. The traditional path to listing in an equity market is an initial public offering (IPO). However, companies that consider a first sale of stock to the public are often overwhelmed by the costly and time-consuming legal and financial regulations that must be complied with while pursuing an IPO.

These costly and lengthy regulatory requirements, together with sluggish IPO markets and their unavailability to smaller firms, have long been reasons for private companies and their shareholders to look for alternatives to IPOs. A popular alternative is to pursue a backdoor listing, most often accomplished through a reverse merger or reverse takeover.[1] Both alternatives 'transform' a private company into a publicly traded company by combining directly or indirectly with a listed company (whether through a merger, exchange offer or otherwise). A backdoor listing has not only allowed companies to focus more on their business and less on compliance with 'going public' rules and regulations, but also to gain access to more liquid and robust (often foreign) stock markets. In addition to the cheaper and quicker access to capital and liquidity, backdoor listings have also been employed to receive tax benefits that stem from tax-loss carry-forwards in the public shell. If the backdoor listing involves a public company that operates in the same or complementary industry or sector as the private company, synergies are often the reason for the backdoor listings. Moreover, besides the fact that a private company becomes instantly 'listed' on a stock exchange, a backdoor listing (often a reverse merger) usually gives the shareholders of the private company the opportunity to receive the majority of the shares of the public entity, allowing them a tight grip on control (as if they still run a private company).[2]

Consider venture capital-backed RMG Networks, a Chicago-based global provider of smart visual solutions, which went public through a reverse merger in the United States in April 2013, bypassing the IPO procedures. RMG Networks was first acquired by SCG Financial Acquisition Corporation. As a result the shareholders of RMG Networks received stock in SCG. Subsequently, the listed company's profile was

[1] In this study, the terms 'backdoor listing', 'reverse merger', and 'reverse takeover' are often used interchangeably. Backdoor listings, reverse mergers and reverse takeovers are viewed as alternatives to an IPO. However, it is recognized that there are technical legal differences in the implementation of each of the alternatives.

[2] See David N. Feldman, Comments on Seasoning of Reverse Merger Companies Before Uplisting to National Securities Exchanges, Harvard Business Law Review, Volume 2, 2012. See also David N. Feldman, Reverse Mergers, Taking a Company Public Without an IPO, Bloomberg Press, New York, 2006.

changed from SCG to RMG. Australian mining company, Auroch (which was acquired by the already listed Terranova Minerals and renamed in Auroch Minerals) is another example of a company that turned to a reverse merger to go public in 2011 after the IPO market in Australia derailed (due to the sudden decrease in the global commodity prices amid fears of an economic downturn in China). Reverse mergers have become increasingly popular in the mining industry in Australia: 76 percent of the Australian reverse mergers were conducted by mining companies in 2012.[3] Interestingly, we see similar trends in other countries and/or sectors. Indeed, backdoor listings are a common 'IPO alternative' in the real estate development sector. For instance in October 2013, the Hong Kong Parkview Group Limited acquired the commercial property portfolio in China from the non-listed subsidiary of Cofco Corporation and changed its name to Cofco Land Holdings Ltd.[4]

Because backdoor listings are often not excessively burdened by complex listing rules and regulations, it is argued that they are also prone to fraud and abuse. The question thus arises of whether policymakers and regulators should introduce special rules and regulations that govern backdoor listings. This question becomes even more important in areas where we see a dramatic increase in the popularity of backdoor listings (as is the case in Indonesia, the Philippines and in the Australian mining industry).[5] It is difficult to provide an easy answer. What is remarkable in this respect is that recent research appears to indicate that a backdoor listing is usually a sustainable alternative to the 'front door' IPO.[6] This view is supported by an empirical and provocative study which suggests that Chinese companies which went public in the United States by merging with public shell companies outperformed the US companies that also used the backdoor to pursue a listing.[7] Particularly, the Chinese reverse merger companies were less leveraged and more profitable than their peers. The study argues that the negative sentiment surrounding reverse mergers (and the subsequent reaction of regulators) is exaggerated (based on cases that attracted negative attention in the media) and not justified by the economic reality.

This study, which has been requested by the Indonesian Financial Services Authority (Otoritas Jasa Keuangan – OJK), attempts to shed light on whether it is necessary to promulgate specfic rules and regulations in the area of backdoor listings. The objective is to support OJK in its efforts to improve listing

[3] See Stephen Bell, 'Back Door' May Be Closing for Miners, Wall Street Journal (Deal Journal Australia), 31 January 2013.
[4] See Esther Fung, Chinese Developers Take the Backdoor to Hong Kong Listings, Wall Street Journal (MoneyBeat), 1 July 2013.
[5] See ASIC (Australian Securities & Investments Commission), Emerging Market Issuers, Report 368, August 2013. See also Asuka Kondo, Philippine Stock Exchange Sees Surge in Backdoor Listings, Nikkei Asian Review, 1 August 2014.
[6] See Matthew John LoSardo and Junliang Zhu, A Further Exploration of Reverse Takeovers as an Alternative to Initial Public Offerings, Honors Thesis, Duke University, 2012.
[7] See Charles M. C. Lee, Kevin K. Li, and Ran Zhang, Shell Games: Have U.S. Capital Markets been Harmed by Chinese Companies Entering via Reverse Mergers? Working Paper, 2013.

and corporate governance standards in Indonesia. A comparative study not only shows how regulators in other jurisdictions handle backdoor listings, but also highlights the costs, benefits and practicality of various different regulatory approaches. Certainly, there are probably more examples of instances where a reverse merger has been a prudent and effective alternative to an IPO (calling for a laissez-faire type of approach). However, there is also evidence suggesting that lower quality firms pursue listings through a reverse merger (justifying the introduction of special rules and regulations). This study shows that regulatory responses vary depending on each country's respective experience with backdoor listings. For instance, the introduction of more stringent, complex rules and procedures for backdoor listings (i.e., reverse mergers) can be found in the United States due to the scandals surrounding backdoor listings involving Chinese companies. Sweden, which has minimal experience with the backdoor listing phenomenon, has adopted a more moderate (hybrid) approach that combines a 'case-by-case' determination of the applicable rules with a system designed to create awareness among investors about suspicious backdoor listing activities. More specifically, the NASDAQ OMX Stockholm can place a reverse merger company on temporary 'observation status' to alert investors about the risks and uncertainties associated with a backdoor listing. There is something to the flexible Swedish system. Companies that are unable or unwilling to conduct an IPO (due to eligibility issues and/or a sluggish IPO market) still have access to capital and/or liquidity more quickly and with fewer costs.

The study proceeds as follows. The next Section explains why regulators in Indonesia should pay attention to the backdoor listings phenomenon. Section 3 provides an overview of the general trends and facts regarding backdoor listings in the United States, the United Kingdom and Australia. Section 4 compares the regulatory and economic environments for reverse mergers in the United States, the United Kingdom, Australia, China, Hong Kong and Sweden. Section 5 provides a glimpse into the future of reverse mergers by taking into account the changing policy and regulatory landscape designed to make it easier for companies to trade on stock exchanges. In fact, in an effort to spur economic growth and job creation, policymakers, regulators and exchange operators are increasingly unveiling measures to relax rules and regulations governing IPOs. This is illustrated by the signing of the Jumpstart Our Business Startups Act (JOBS Act) in the United States on 5 April 2012. The Act introduces the 'Emerging Growth Company' (EGC) status. Companies that are able to secure the EGC-status will be offered a transition period – or an 'on-ramp' period – during which they are exempted from a number of regulatory requirements associated with going public. It is only to be expected that a speedier and cheaper IPO process will have a reductive effect on the total number of backdoor listings. Section 6 concludes and offers several policy recommendations.

2. Why Should Regulators in Indonesia Care About Backdoor Listings?

Indonesia is an example of a country that experienced an increasing number of backdoor listings since 2009 for previously explained 'cost and timing' reasons.[8] Table 1 contains several recent and important cases. There are currently no special 'backdoor listings' rules in Indonesia. The regulator (OJK) and the Indonesia Stock Exchange deliberately chose not to immediately introduce new 'backdoor listing' regulation. That is not to say that the process of effectuating a backdoor listing is entirely unregulated (and always needs more transparency). Table 2 provides an overview of capital market regulations which may apply to a backdoor listing in Indonesia. Indonesian backdoor listing transactions usually include a 'rights issue' procedure to raise capital or enable a new shareholder (usually the 'standby buyer') to acquire control of an already listed company.[9] Certainly, companies that issue new shares have to acknowledge preemptive rights obligations, which allow existing shareholders to purchase new shares and avoid dilution of their ownership stake. With the new capital raised, the listed company acquires the shares of one or more private companies, which could trigger the application of disclosure of 'material transactions' rules. The change of the listed company's objectives and name usually completes the backdoor listing.

Table 1: Backdoor Listings in Indonesia

Year	Standby Buyer (rights issue)	Target Company	New Name Target Company
2009	PT Ratu Prabu	PT Arnoa Binasejati Tbk	PT Ratu Prabu Energi Tbk
2011	Amstelco Plc Ltd	PT Indo Citra Finance Tbk	Amstelco Indonesia Tbk
2011	PT Smart Telecom Tbk	PT Mobile-8 Telecom Tbk	Smartfren Telecom Tbk
2012	J&Partners Asia Ltd	PT Pelita Sejahtera Abadi Tbk	J Resources Asia Pasifik Tbk
2014	PT Red Planet Hotels Indonesia Tbk	PT Pusako Tarinka Tbk	PT Red Planet Indonesia Tbk
2014	PT Indo Wana Bara Mining Coal Tbk	PT Sekawan Inti Pratama Tbk	

If the rules and regulations applicable to the process that eventually lead to a 'backdoor' listing in Indonesia require compliance with IPO-style disclosures and transparency rules and regulations, it could surely be argued, as is currently done by Indonesian regulators, that regulators should assume that the information in the market is sufficient for investors to make well-considered decisions about their current or future investments. This principle is also at the heart of the Listing Rules in the United Kingdom and Australia. However, since the applicable rules and regulations (as reflected in Table 2) were designed without regard to backdoor listings, it is perhaps preferable to introduce specific regulations or other

[8] See Firdaus Nur Iman, Higher Backdoor Listing Activity, Indonesia Finance Today, 21 February 2013.
[9] If the takeover is achieved in a 'rights issue' procedure, the transaction is exempted from the mandatory tender offer obligation under the laws of Indonesia.

rules and guidelines that specifically apply to backdoor listings. Clearly, these special rules and regulations enhance the legal certainty surrounding backdoor listings. More importantly, however, a special "backdoor listings" regime increases the regulatory effectiveness (particularly from the perspective of foreign investors) in that it encourages regulators to pay special attention to potential irregularities and concerns related specifically to backdoor listings. For instance, the United Kingdom and Australian regulators have the authority to respectively cancel or suspend trading in shares of the listed company that is involved in a reverse takeover if the publicly available information about the transaction does not suffice. These 'safety net' provisions essentially require the listed company to comply with the listing requirements before the shares can be re-admitted to the stock exchange. Other possible regulatory responses that the regulators in Indonesia may consider will be discussed in more detail in the next Sections of this study.

Table 2: Capital Market Regulations in Indonesia

Bapepam-LK (OJK) Regulation No. IX.D.1 Concerning Preemptive Rights
Bapepam-LK (OJK) Regulation No. IX.H.1 Concerning Takeovers of Listed Companies
Bapepam-LK (OJK) Regulation No. IX.G.1 Concerning Mergers and Consolidations of Listed Companies or Issuers
Bapepam-LK (OJK) Regulation No. IX.I.1 Concerning Convening and Conducting General Meetings of Shareholders
Bapepam-LK (OJK) Regulation No. IX.M.1 Concerning Disclosure Requirements for Certain Shareholders
Bapepam-LK (OJK) Regulation No. IX.E.1 Concerning Transactions with Affiliated Parties and Conflicts of Interest
Bapepam-LK (OJK) Regulation No. IX.E.2 Concerning Material Transactions and Changes in Core Business
Bapepam-LK (OJK) Regulation No. IX.J.1 Concerning Material Changes in the Articles of Association of Listed Companies
IDX Regulation No. 1-A Concerning the Listing of Shares and other Securities

Source: Tumbuan & Partners

3. Trends and Developments in the Area of Backdoor Listings

Companies need capital as they go through the stages of their life cycles. These life cycles typically start with turning an idea into a start-up company. The start-up company attempts to raise capital from venture capital funds and other private investors. These investors support the start-up by contributing money and services, which brings the company to the next stage in its development. Ideally, this continues until the moment the company seeks to raise capital from the 'public' by pursuing an IPO, giving private investors and venture capitalists an opportunity to gradually exit their investment.

The IPO, however, triggers the obligation to comply with a plethora of rules and regulations required by regulators to protect the shareholders, and other stakeholders in listed companies and prevent managerial misbehavior. These rules and regulations can be divided into three categories: (1) listing requirements to determine whether a company is eligible to go public, (2) disclosure and transparency rules to provide financial and other information to the market, enhance investor confidence, and (3)

corporate governance requirements to ensure that the company's affairs are conducted in the interests of all concerned. Clearly, the regulatory framework makes the process of an IPO expensive and time-consuming. The costs of an IPO include the fees paid to investment banks, accountants, auditors, lawyers and other service providers and consultants for advice and for preparing the registration statements, prospectus and other legal documents. Low valuations and disappointing IPO performances are also reasons for companies to forego the IPO route.[10]

It is therefore probably not surprising that companies that need capital to fund growth and/or provide liquidity to investors have always been looking for quicker, often cheaper and more flexible alternatives to get access to stock markets. When it comes to floating the shares, the idea of avoiding the costs and complexity associated with IPOs is certainly very appealing, particularly to companies that operate in volatile and frequently changing markets.[11] Moreover, control over the timing of the listing and the information flows about the going public process is usually very important to these companies. Indeed, control over both the timing and the information not only enables a smoother transition from the non-listed status to being listing on public markets, but also provides these companies with the opportunity to withdraw their plans without alerting the public. Backdoor listings, particularly through reverse mergers or reverse takeovers, are examples of these alternatives to IPOs that gained popularity in recent decades and at the same time were often subject to controversy because an increasing number of them failed to live up to the expectations of investors in the post-listing period.

The next Sections will discuss trends and developments in the area of backdoor listings. We begin with the United States, where the boom in Chinese reverse mergers and its subsequent collapse has recently led to more stringent rules and regulations and then provide an overview of the documented experiences in the United Kingdom, Australia and Sweden. A remarkable observation is that although backdoor listings occur on a global scale, there are significant differences between the characteristics, motivations and implications of these alternative listing options. These differences can to a large extent be explained by differences in the legal framework applicable to backdoor listings, but also by supply-demand dynamics. Consider the Australian Stock Exchange, which is dominated by the volatile mining sector. Companies seeking access to the capital market have almost always been able to find a financially distressed listed vehicle that could serve as a shell for a backdoor listing. For instance, high tech companies in Australia are often able to obtain the listed status through shell companies that had been active in the mining industry. Undoubtedly, some of these high tech companies have or will become targets themselves and are thus

[10] See Stacy Lawrence, Reverse Mergers Attract Top-Tier Biotechs in Sluggish IPO Market, Nature Biotechnology, Vol. 24, 2006.

[11] See, for instance, Peter Brown, Andrew Ferguson and Peter Lam, Choice between Alternative Routes to Go Public: Backdoor Listing versus IPO. Working Paper, 2010.

fundamental in attaining the backdoor listing aspirations of new mining companies.[12] In other jurisdictions, such as the United States, the supply and demand balance has been achieved through a network of promoters of reverse mergers.

3.1 The Boom and Collapse of Reverse Mergers in the United States

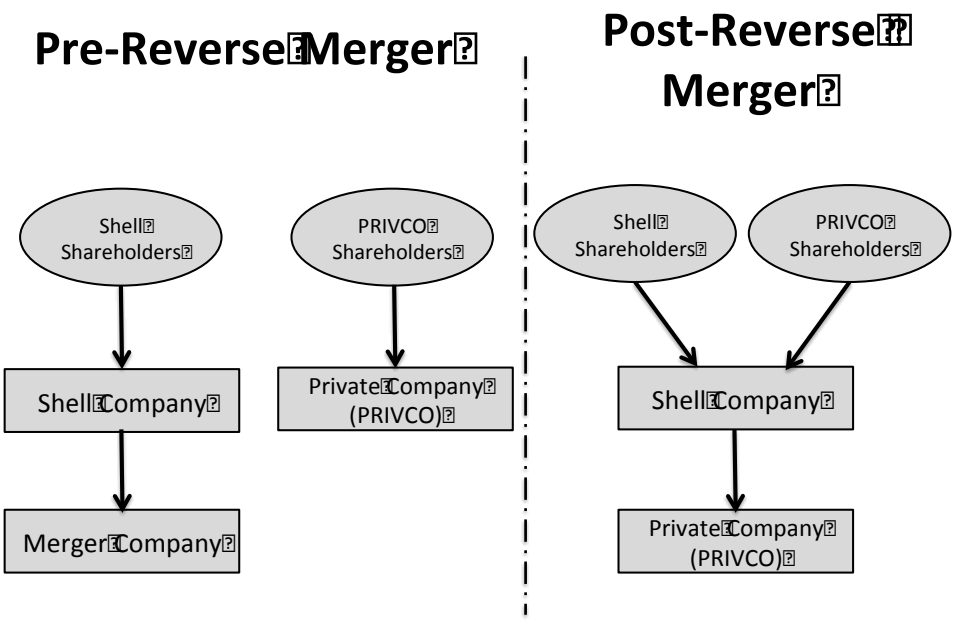
Reverse mergers have become an attractive alternative to an IPO in the United States in the previous decade. The number of reverse mergers was even higher than the number of regular IPOs in 2008.[13] In a reverse merger, a private company that wishes to go public through the 'backdoor' merges with a public shell. Clearly, in order to maintain the trading status, the public shell must survive the merger (this explains the term 'reverse'). In the United States, trades in the public shell companies are usually carried out through electronic quotation venues such as the Over-the-Counter Bulletin Board (OTCBB) or the 'Pink Sheets' system (referring to the color of the paper the quotations were printed on). This over-the-counter (OTC) market mainly deals in low-grade securities issued by firms in economic distress or 'microcap' issues that fail to qualify for a regular listing on a stock exchange. Most of the shares traded in these OTC markets are of such low value - 'penny stock', shares trading under US $1 each are common here - that they form perfect targets for reverse mergers.

Here it should be noted that backdoor listings are often accomplished through a 'reverse triangular merger', instead of a direct merger (see Figure 1). This form of merger enables the parties to circumvent expensive and time-consuming disclosures under the listing rules and securities regulations. Let us look at the 'reverse triangular merger' in more detail. The publicly listed company typically creates a new wholly owned subsidiary, which subsequently merges into the private company. The merger must be approved by the public shell (as shareholder of its new subsidiary) and the shareholders of the private company. Approval from the shareholders of the public shell company can be avoided if the company trades on the OTCBB. As a result of the merger, the private company becomes the wholly owned subsidiary of the public shell, which in return issues shares to the shareholders of the private company. Finally, the name of the shell is changed (usually to the name of the private company – the directors and officers of which usually replace those of the listed shell as well). Clearly, the lack of regulatory scrutiny has caused, irrespective of how effective reverse mergers might be for meeting the needs of a broad range of companies, increasing concerns about the degree to which these mergers are used as a means of committing fraud or other securities violations (particularly in the area of misleading financial statements).

[12] See Owen Richards, How Primary and Secondary Markets Work, ASX Investor Update, June 2012.
[13] See Igor, Semenenko, Reverse Merger Waves, Market Timing and Managerial Behaviour, International Research Journal of Applied Finance, Vol. 2, 2011.

The fact that reverse mergers are prone to abuse and inappropriate listings is not new. In the early days of the reverse merger practice (1970s and 1980s), a number of opportunistic promoters were fraudulently establishing new shell companies that subsequently raised capital through their IPOs. After the shell company was established, they leaked speculative information about an upcoming (reverse) merger to the market in the hope that the stock price would rise, which would then give them the opportunity to sell shares and make a significant profit. In response to this fraudulent practice, the Securities and Exchange Commission (SEC) passed a number of amendments to the Securities Act 1933 in 1992. The most important rule in this context is Rule 419. This Rule introduced a 'blank check company', which is a company that: '(i) is a development stage company that has no specific business plan or purpose or has indicated that its business plan is to engage in a merger or acquisition with an unidentified company or companies, or other entity or person and (ii) is issuing 'penny stock.' Moreover, Rule 419 introduced special rules for the blank check companies. For instance, under Rule 419 it was required to place virtually all cash raised during the IPO in escrow. Furthermore it was prohibited to trade in the shell's stock prior to a reverse merger. Rule 419 also introduced a time limit of eighteen months to complete a transaction, failing to do so would lead to a return of the invested cash to the shareholders.

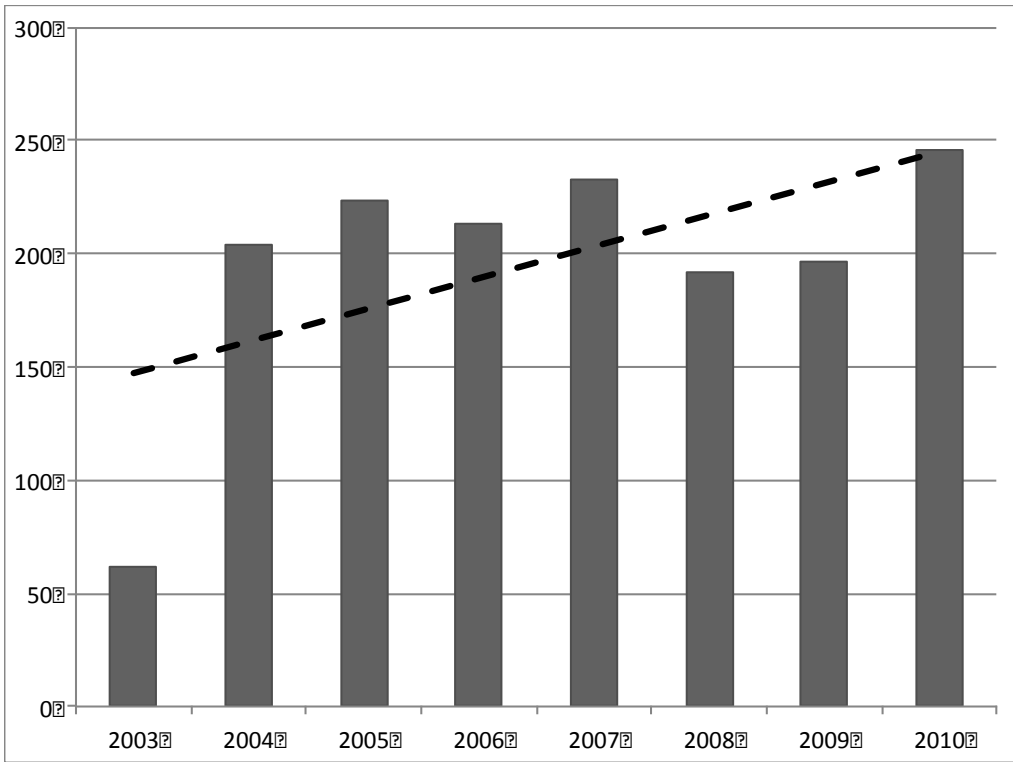
Figure 1: The Reverse Merger (in the United States)



Source: David N. Feldman, Reverse Mergers, Taking a Company Public Without an IPO, Bloomberg Press, New York, 2006.

The regulatory restrictions on blank check companies are the reason for the emergence of Special Purpose Acquisition Vehicles (SPAC). Interestingly, SPACs largely mirror the blank check companies of the 1980's that caused Congress to adopt Rule 419. The business plan for a SPAC is simple. A SPAC is a shell company without historical operations that was taken public through an IPO solely for the purpose of acquiring an operating business, which is typically not pre-determined prior to listing, within an eighteen to twenty fourth month timeline. For entities looking to list through a reverse merger, a SPAC can be a favorable partner (for a variety of reasons) by offering the operating company an immediate cash infusion directly from the proceeds of the SPAC's IPO as well as a liquid trading market for its securities. Though a merger with a SPAC eliminates the primary downsides associated with a traditional reverse merger, a merger via an SPAC is often only a pipe dream for less than exceptional operating companies and the likelihood of such a deal is at the whim of the SPAC's management group.

Figure 2: The Number of Reverse Mergers by Year



Source: DealFlow Media – The Reverse Merger Report

Despite the introduction of Rule 419 and the restrictions on the use of SPACs, the reverse merger or reverse takeover was utilized at a greater frequency as a mechanism to list publicly in the lead up to 2010 (see Figure 2). In fact, as was already mentioned, the number of reverse mergers eclipsed the IPO count in 2008 for the first time in the United States (Figure 3). However, this growing trend was not necessarily the consequence of a shift towards a more preferable listing option. Literature denouncing reverse mergers

as a suitable substitute to IPOs is plentiful and some venture so far as to say that they are not even comparable. For instance, a recent empirical study argues that going public via an IPO is simply not feasible for many companies that do not exhibit significant growth potential, meet minimum revenue and income levels or purely due to an inability to convince an investment bank to underwrite its offering, typically the gatekeepers to the public. It also shows that most 'reverse merger' companies begin trading in over-the-counter (OTC) markets.[14] Here it should be noted that gaining access to traditional forms of additional capital and ensuring a liquid market for its shares that typically come along with an IPO listing are virtually non-existent when pursuing a reverse merger. It should therefore not be surprising that a reverse merger does not facilitate a large infusion of new capital as it is inherently not a capital-raising endeavor because there is no exchange of cash for shares in the transaction.[15] This observation raises the question of why a company should pursue a reverse merger.

3.1.1 The Benefits of Reverse Mergers

There exists a cohort of promulgating instances where the use of a reverse merger is effective. For instance, a reverse merger can be a viable mechanism to tap into previously untapped sources of additional capital for companies that have exhausted other financing options and do not meet the demanding performance criteria necessary to pursue an IPO. Here the access to PIPE financing (private investment in public equity – which is excluded as a financing source for private companies) as a potential source of invaluable capital for entities with no other viable alternatives is important.[16] A track record of institutional investments in underperforming public companies with relatively illiquid stocks makes this financing option not only a realistic avenue for smaller, less reputable entities, but also a means to eventually obtain a listing in a higher segment of one of the major stock exchanges.[17]

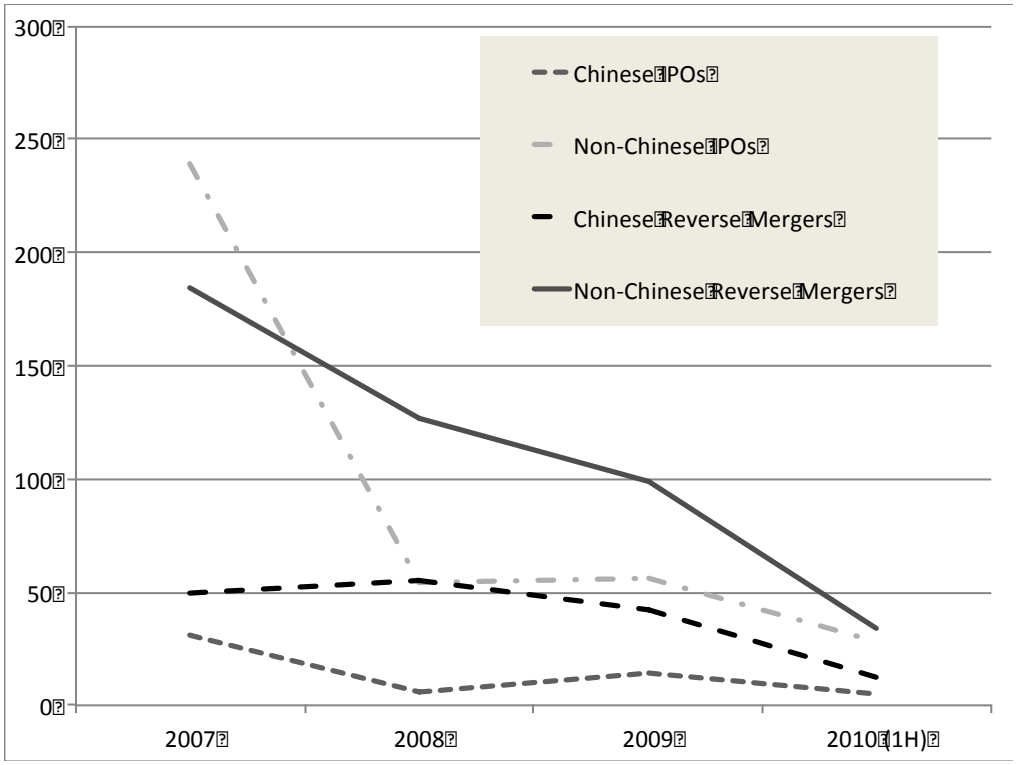
In addition to access to additional avenues of capital, reverse mergers tend to be both a quicker and cheaper listing option relative to its IPO counterpart. On average a backdoor listing through a reverse merger can be completed in as little as a couple of weeks and is unquestionably timelier than an IPO, which can take months. From a cost standpoint, IPOs can run a bill north of the six-figure mark while reverse mergers can run for about a couple hundred thousand under the standard circumstances. It is important however to qualify the speed and cost effectiveness of a reverse merger as it is often touted as a surefire benefit in the favor of reverse mergers when that is not always the case. Reverse mergers on the slower end of the spectrum (four months) can in fact take as long as some IPOs. Additionally, the cost

[14] See Charles M. C. Lee, Kevin K. Li, and Ran Zhang, Shell Games: Are Chinese Reverse Merger Firms Inherently Toxic?, Working Paper, 2013.
[15] See William Sjostrom, The Truth About Reverse Mergers, Entrepreneurial Business Law Journal, Vol. 2, 2008.
[16] See David N. Feldman, Reverse Mergers + PIPEs: The New Small-Cap IPO, Business Law Brief, 2005.
[17] See Helen Luk, Sneaking In Through the Backdoor, A Plus, May 2011.

argument in favor of a reverse merger becomes questionable as well after factoring for the expenses associated with a listing along with the consideration paid to shell promoters in the form of cash and an equity stake.

Finally, companies that face difficulty in accessing domestic capital markets and attracting funding to help them reach the next stage in their development often use reverse mergers to enter the US market. This is particularly true if stock exchanges have a competitive interest in encouraging foreign listings. Consider the Chinese companies that listed in the United States via reverse mergers. According to data collected by the Public Company Accounting Oversight Board (PCAOB), 159 Chinese companies completed a reverse merger between 1 January 2007 and 31 March 2010. Because the reverse merger route let them avoid the scrutiny that is usually required by the state and federal rules and regulations in the United States, the reverse merger count outnumbered the number of Chinese companies that completed an IPO in the United States in the same period (see Figure 3). Clearly, even though legally accepted, this trend was only possible with the help of a network of US advisors and consultants, such as underwriters, investment banks, lawyers and auditors.[18]

Figure 3: Reverse Mergers versus IPOs in the United States



Source: PCAOB

[18] David Barboza and Azam Ahmed, China to Wall Street: The Side-Door Shuffle, The New York Times, 23 July 2011.

What is noteworthy in this regard is that in instances where proper accounting and corporate governance standards are lacking and an IPO is not a realistic mechanism to go public, a listing in a foreign country through a reverse merger can provide ancillary benefits as well. Listing requirements that require strict adherence to accepted corporate governance and accounting standards offer tangible benefits to entities and can directly lead to improvements in operating performance as a consequence.[19] As entities that previously were unable to go public via an IPO do so through a reverse merger, the adoption of higher corporate standards by these newly listed companies can help galvanize improvements in governance and financial reporting in their 'home' jurisdictions. Research suggests that the Chinese companies that pursued a reverse merger in the stock exchanges in the United States were more likely to come from better-regulated provinces and were atop the corporate pyramid despite the relatively recent examples of questionable Chinese firms taking part in a reverse merger.[20] The emergence of widespread Chinese reverse mergers can have a profoundly beneficial trickle-down effect on jurisdictions that currently employ principles below that of internationally accepted corporate practices and standards. The inherent possibility of an unsuccessful listing through a reverse merger in comparison to the potential mishaps that can arise in an IPO in the form of undersubscribed shares ensures that the ancillary benefits in the form of adhering to higher corporate standards can be reaped at a bare minimum.

3.1.2 The Challenges of Reverse Mergers

Despite the benefits of reverse mergers, there are some undeniable facts that support the notion that there exists a case of adverse selection in the pool of entities pursuing a listing through the 'alternative' listing route (see Figure 4). This notion is supported by the delisting of 42 percent of the entities listed via the backdoor within its first three years.[21] Reverse takeovers are typically exercised by smaller and lesser-known entities relative to their larger, more reputable counterparts that list through an IPO giving rise to a negative signaling effect for those that elect to pursue a backdoor listing.[22] This notion of an adverse selection in entities pursuing a reverse merger is echoed in the literature that showcases the decision tree that lay ahead of Chinese companies, which account for a large majority of the reverse mergers in the late 2000s, when pursuing a public listing.[23] Empirical data reveals that, despite the benefits of reverse

[19] See Yongli Luo, Fang Fang and Omar A. Esqueda, The Overseas Listing Puzzle: Post-IPO Performance of Chinese Stocks and ADRs in the US Market, Journal of Multinational Financial Management, Vol. 22, 2012.

[20] See Abigail S. Hornstein, The Impact of Local Governance Institutions on Foreign Market Listings: The Case of Chinese Firms, Wesleyan Economics Working Paper, 2013. The shenanigans of some of the Chinese companies will be discussed in more detail in Section 2.1.2.

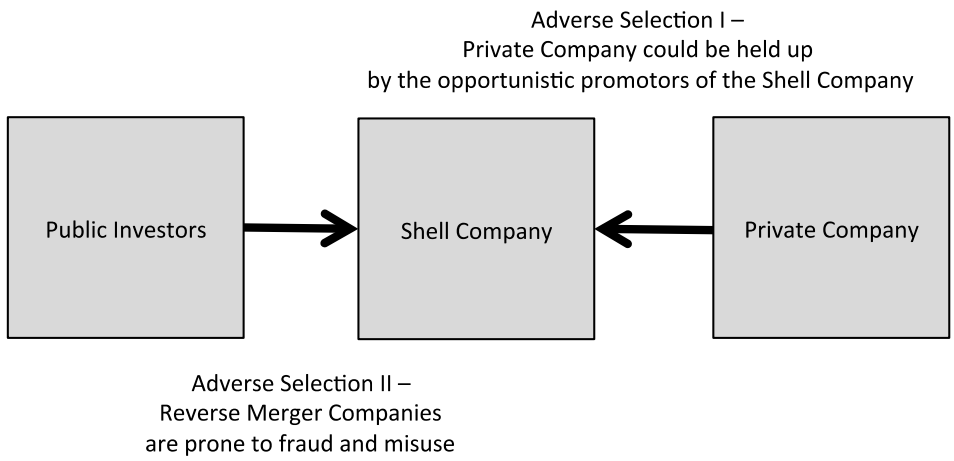
[21] See Frederick Adjei, Ken Cyree and Mark Walker, The Determinants and Survival of Reverse Mergers vs IPOs, Journal of Economics and Finance, 02/2008.

[22] See Augusto Arellano-Ostoa and Sandro Brusco, Understanding Reverse Mergers: A First Approach, Business Economics Working Papers, 2002.

[23] See Jan Jindra, Thorben Voetmann and Ralph A. Walkling (2012), Reverse Mergers: The Chinese Experience, Working Paper, 2012.

mergers, the most well-known and profitable Chinese companies generally elect to pursue an IPO. By contrast, there are a significant number of examples of smaller Chinese entities that listed through a reverse merger that are subject to a greater frequency of class action lawsuits, are less profitable, exude lower balance sheet liquidity, and are highly leveraged.[24]

Figure 4: The Double-Sided Adverse Selection Problem in Reverse Merger Processes



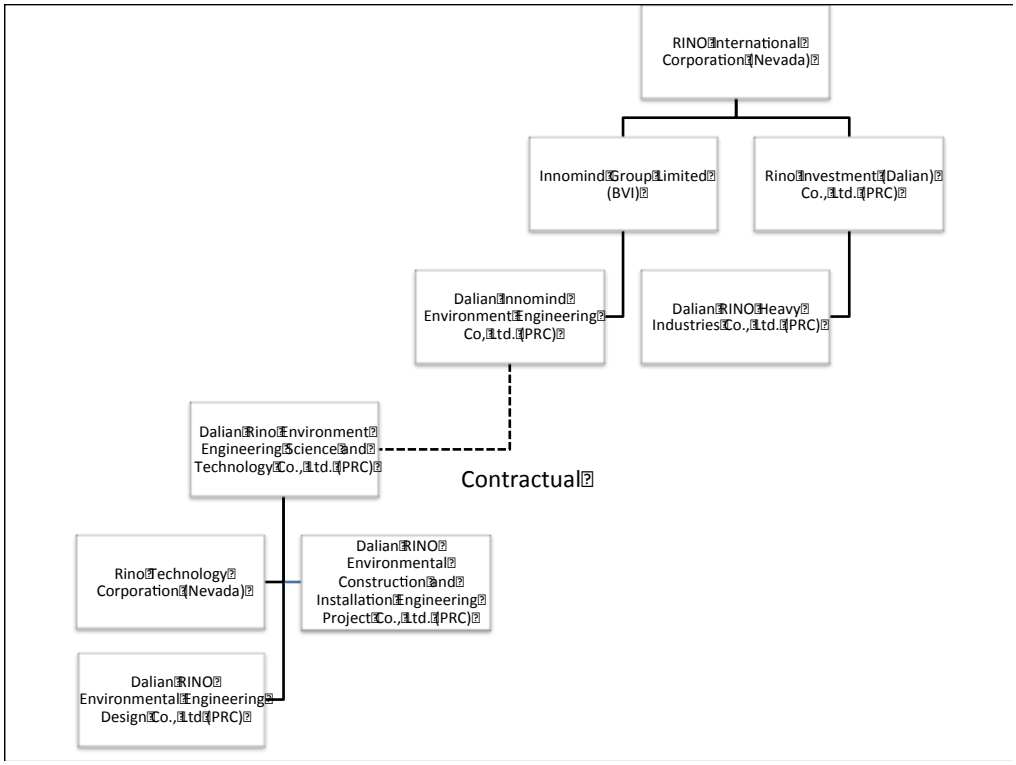
Consider RINO International, a company that designed, manufactured, installed and serviced patented wastewater treatment systems and relative equipment through its subsidiaries and contractually controlled affiliates in China (see Figure 5).[25] After the group of companies had unsuccessfully tried to raise capital (both debt and equity) in the Chinese market, it acquired US 'listed' company, Jade Mountain (a failed medical devices company) in a reverse merger in October 2007 and started to make its way in the US capital market. The Chinese group was able to secure US$25 million in a private placement shortly

[24] The 159 Chinese firms that pursued a reverse merger in the United States in the period between 1 January 2007 and 31 March 2010 had a combined market capitalization of US $ 12.8 billion (which is less than 50 per cent of the of the market capitalization of the 56 Chinese companies that completed a US IPO. See Wharton University of Pennsylvania, Reverse Mergers: A Looming U.S.-China Showdown over Securities Regulation?, 5 March 2013.

[25] Companies are usually 'contractually controlled' through a 'variable interest entity' (VIE) structure. This structure is a chain of corporate vehicles and contractual arrangements, designed to comply with China's restrictive foreign direct investments (FDI) measures that protect many domestic industries and service sectors. As a first step, an offshore legal entity will be established. The offshore entity owns and controls one onshore wholly foreign-owned enterprise (WFOE) or foreign-invested enterprise (FIE). The onshore company gains control over a domestic company that operates in one of the restricted sectors by entering into several service agreements. These agreements allow foreign investors to hold controlling stakes in Chinese companies.

after it had completed the reverse merger. It then started to flourish on the over-the-counter market. After its upgrade to the NASDAQ on 13 July 2009, it was able to raise US$ 100 million in a direct offering at US$ 30.75 per share in December 2009.

Figure 5: The Group Structure of RINO International on 31 December 2009



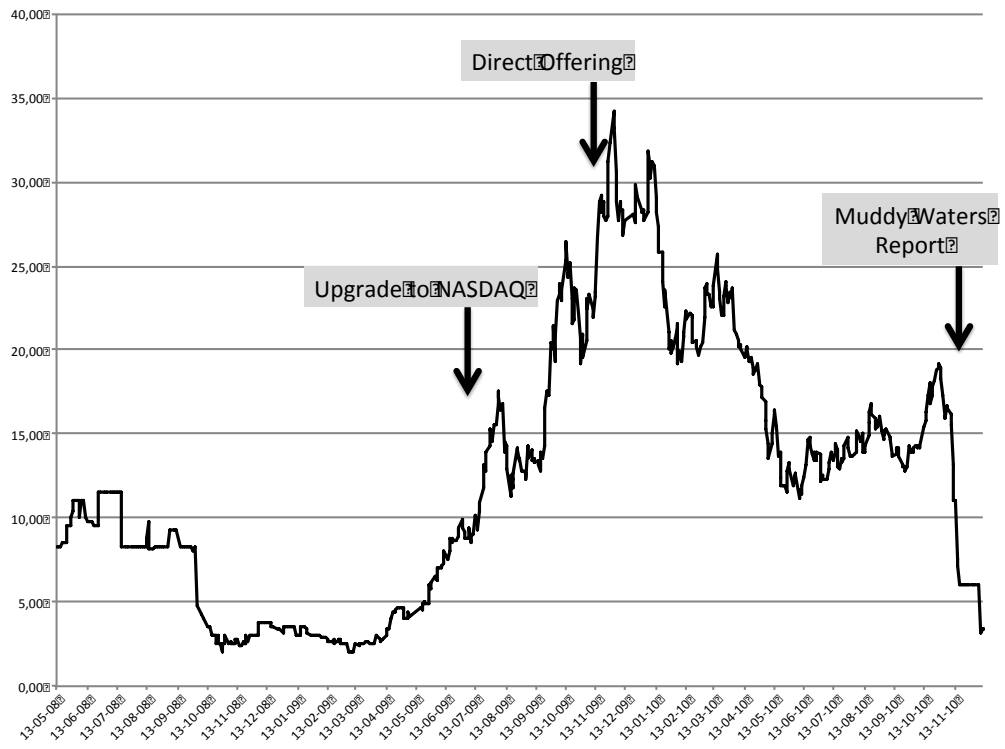
Source: Annual Report RINO International

From there it all went down hill (see Figure 6). For instance, RINO shares traded at US$11.87 in May 2010 (65 percent below its 2009 high of US$ 32.35). The knockout punch came with the publication of a devastating report by Muddy Waters, a US investment research company on 10 November 2010.[26] The report concluded that (1) RINO's sales were much lower than claimed in the financial statements, (2) many of RINO's customers did not exist, (3) the discrepancies between the financial statements in the United States and in China were significant and widespread (the consolidated revenue was 94.2% lower in China), (4) RINO's accounting practices indicated serious flaws and signs of 'cooked books', and (5) RINO's management had fraudulently diverted funds from the group for their personal use. Shortly after the publication of the report on 18 November 2010, the board of directors of RINO admitted the audited financial statements for the years 2008 and 2009 were indeed incorrect and could no longer be relied upon. The SEC suspended trading in RINO's stock and subsequently the company was delisted from the

[26] See RINO Shares Take a Beating in the US, Global Water Intelligence, Vol. 11, 2010.

NASDAQ on 8 December 2010. Predictably, investors in RINO filed a class action lawsuit over alleged violations of US securities laws on 15 November 2010.

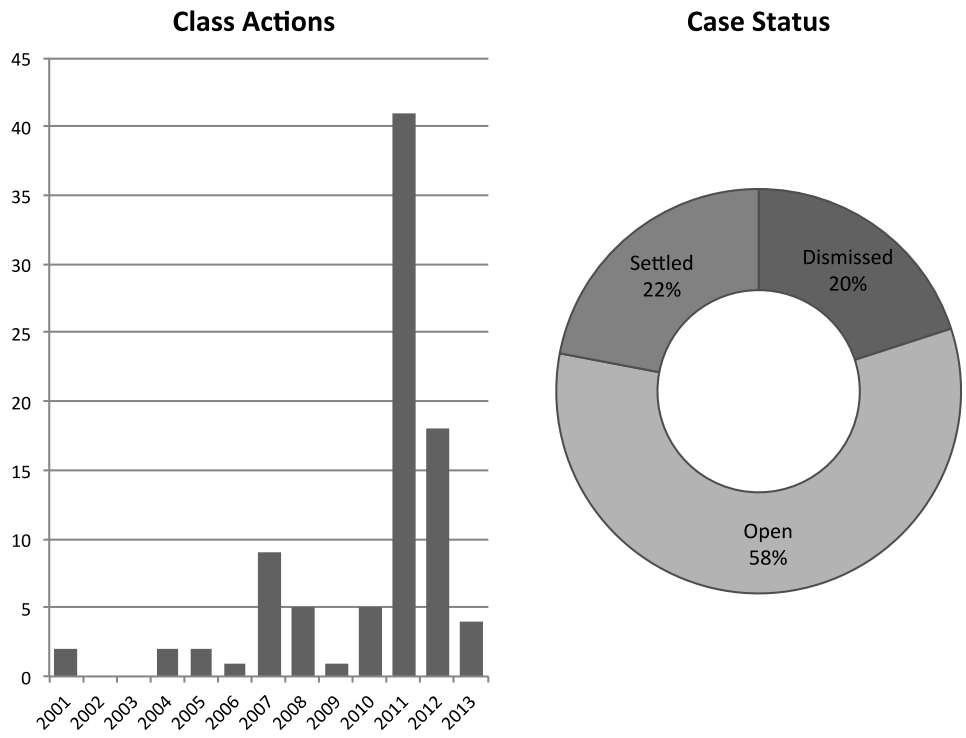
Figure 6: RINO International Corporation – Stock Price History



Source: www.nasdaq.com

RINO International was not the only Chinese company that entered the US stock market and subsequently ended up in a lawsuit after it had violated securities rules and regulations, particularly related to financial misrepresentation, failure to disclose material facts and/or deficient internal control systems (see Figure 7). Academic research reveals that US listed Chinese companies that pursued a reverse merger are not always in compliance with the internationally accepted accounting standards. As is customary, the adoption of these standards is a prerequisite as well as a requirement to maintain a public listing for entities pursuing a reverse merger regardless of the accounting practices employed in local jurisdictions. This listing obligation underscores the growing importance of audits and places a tremendous amount of responsibility on the auditors of these (often times) foreign entities as they usually serve as the only safeguard between the foreign entity and ensuring that domestic investors receive reliable statements.

Figure 7: Class Actions Against US Listed Chinese Companies (both IPOs and Reverse Mergers)



Source: AON COFCO

What is remarkable in this respect is that filings with the SEC reveal that Chinese reverse mergers tended to retain their own auditors post-merger as opposed to those of the former shell company.[27] Audit quality concerns in these mergers were only to be expected when compliance with PCAOB accounting standards increasingly faltered. The large majority of accounting firms employed by Chinese reverse mergers were only inspected by the PCAOB on a triennial basis rather than the typical annual basis, which had only compounded concerns over fraud whirling around Chinese reverse mergers (see Table 3). It should also be noted that the questionable audit quality and non-compliance has stemmed partially from added difficulty for US registered accounting firms to conduct comprehensive audits on companies based abroad due to language barriers, accounting standard discrepancies, use of under qualified assistants, the lack of enforcement of accounting laws in China, and additional expenses as well.

[27] See Benjamin A. Templin, Chinese Reverse Mergers, Accounting Regimes, and the Rule of Law in China, Thomas Jefferson Law Review, Vol. 34, 2011.

Table 3: PCAOB Inspection Accountancy Firms Chinese Reverse Merger Companies

	Number of Chinese Companies	Percentage	Market Capitalization ($M)	Percentage
Annual Inspection	10	6%	390	3%
Triennial Inspection	147	94%	12,453	97%

Source: Capital IQ, PCAOB

Though poor performing Chinese reverse merger companies are inextricably tied to the general perception of reverse mergers as they account for a large proportion of entities pursuing backdoor listing through public shell companies, research indicates that the negative spillover effects of fraudulent activity or reporting by Chinese companies have not harmed other non-Chinese companies' reverse merger activities. Reverse mergers involving non-Chinese entities appear to largely escape the wrath of investors as the stock market reaction to news of fraud are focused on Chinese companies as opposed to questioning reverse mergers in general as a viable mechanism to list publicly.[28] Still, the global turbulence in the credit markets, triggered by the turmoil in the subprime mortgage market in 2007-2008, largely brought an end to the reverse merger bonanza as well as the laissez-faire era in the reverse merger process in the United States. In response to the reverse merger scandals, the government introduced legislation that subjects reverse mergers to registration requirements and provisions targeted at improving the companies' accountability. The reverse merger regulation will be discussed in more detail in Section 4.

3.2 The Importance of a Regulatory Framework: Experiences in other Countries

The benefits and challenges of the reverse mergers in the United States can easily be plotted in a SWOT (Strengths, Weaknesses, Opportunities and Threats) matrix (see Figure 8). Let us first focus on the weaknesses and threats in more detail. Since investors in listed companies that have pursued a reverse merger have usually less information to make well-considered investment decisions, a backdoor listing provides managers or controlling shareholders ample opportunity to act for their own benefit at the expense of not only the investors, but also other stakeholders. Arguably, a regulatory framework, consisting of listing rules and other securities laws and regulations, helps reduce the weaknesses and threats associated with backdoor listings. It could even be argued that appropriate rules and regulations can make backdoor listings a more attractive alternative for non-listed companies to enter the public capital market.

[28] See Masako Darrough, Rong Huang and Sha Zhao, The Spillover Effect of Chinese Reverse Merger Frauds: Chinese or Reverse Merger?, Working Paper, 2012.

Figure 8: SWOT Analysis Backdoor Listings in the United States

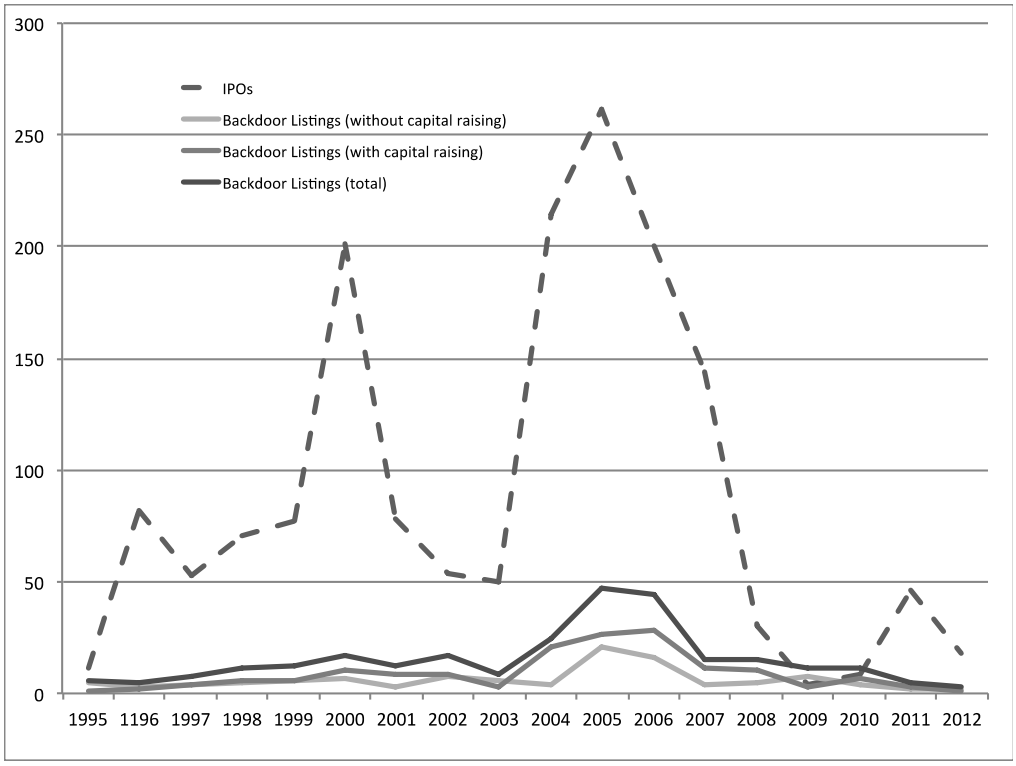
Strengths	Weaknesses
○ Lower costs ○ Less time consuming ○ No initial listing requirement ○ Less complex procedure ○ Imperviousness to equity market ○ Control over timing listing ○ Possibility of losing without raising capital ○ *Synergies (United Kingdom)*	○ No underwriter certification to support the company ○ Feeble initial trading ○ Complicated/non-clean shell companies to deal with ○ Auditing conflicts ○ Trading volume
Opportunities	**Threats**
○ Small but promising company can go public ○ PIPE financing ○ Possible tax benefits ○ *Follow on offering (United Kingdom)*	○ Risk of damaging the firm reputation ○ Company's stock might trade at a discount rate ○ Probability of reverse stock split

Source: Adapted from Samiksha Ojha, Richa Maheshwari and Star Jain, Reverse Mergers: The Way Forward, IOSR Journal of Business and Management, Vol. 10, 2013

Consider the experiences with backdoor listings in the United Kingdom. As will be discussed in more detail in the next Section, the regulator generally seeks to cancel the listing of a company's shares following completion of a reverse merger. Companies that intend to pursue a backdoor listing are thus forced to fulfill re-admission requirements (as if a company were applying for an IPO). It will not be surprising that the application of more stringent rules significantly affect the SWOT analysis, particularly with respect to the threats and weaknesses. However, the development of a regulatory framework also leads to changes in the perception of the strengths and opportunities of backdoor listings. For instance, a recent empirical study shows that re-admission requirements not only reduce the benefits of lower costs and a more speedy process, but also alters the motivation for pursuing a backdoor listing.[29] It also finds that in a regulatory environment, backdoor listings are often used by private companies that (1) are mainly interested in the synergies that can be achieved by merging with (or taking over) a listed operating company (this is often combined with raising new capital (see Figure 9)), and (2) seek access to a wider exposure to investors and liquidity when the IPO market is weak (see the period 2008 to 2010).

[29] See Anna Faelten, Naaguesh Appadu and Mario Levis, The Poor Man's IPO: Reverse Takeovers in the UK, World-Finance-Conference, 2013.

Figure 9: IPOs versus Backdoor Listings on the London Stock Exchange



Source: Anna Faelten, Naaguesh Appadu and Mario Levis, The Poor Man's IPO: Reverse Takeovers in the UK, World-Finance-Conference, 2013.

What is interesting about the experience in the United Kingdom is that it shows that specific rules and regulations do not necessarily make backdoor listings less attractive. On the contrary, for long the 'backdoor listing' practice in the United Kingdom was more widespread than in the United States.[30] Because a regulatory framework arguably brings balance between strengths and weaknesses (as well as opportunities and threats), it is understandable that policymakers and regulators are increasingly redirecting their attention to basic questions concerning the optimal level of regulatory intervention in the reverse merger process. Consider the gradual adoption of stricter rules on backdoor listings by the China Securities Regulatory Commission (CSRC). In 2011, the CSRC stated that non-listed companies that seek access to the capital market by pursuing a backdoor listing are required to comply with similar disclosure standards as apply to IPOs.

The requirements imposed by the CSRC for a listing via the backdoor were thus no more extensive or arduous than a traditional front door listing through an IPO. What is remarkable in this respect is that companies that wished to go public in 2013 had few other options than to engage in a backdoor listing

[30] See Peter Roosenboom and Willem Schramade, Reverse Mergers in the United Kingdom: Listed Targets and Private Acquirers, in Greg N. Gregoriou and Luc Renneboog, International Mergers and Acquisitions Activity Since 1990, Recent Research and Quantitative Analysis, Academic Press, 2007.

process since the CSRC has suspended IPOs in October 2012. However, it would probably be rather naïve to turn a blind eye on the fact that most of the highly reported scandals surrounding backdoor listings involved Chinese companies and the role this may have played in discussions surrounding regulatory changes in China. Indeed, more stringent rules and requirements were announced in December 2013. For instance, companies looking to enter the Chinese capital market through the backdoor must fulfill UK-style re-admission requirements. Still more stringently, new rules prohibit backdoor listings at ChiNext, an exchange for high potential growth companies in China. The next Section will discuss a range of possible regulatory responses, varying from specially designed stringent rules and regulations to a more flexible regulatory approach.

4. Regulatory Responses to Backdoor Listings

In order to analyze and assess the regulatory responses to the current 'backdoor listing' practice around the world, this Section provides an overview of the legal trends and developments in this area. Regulatory responses to the rise in the backdoor listings count have understandably varied depending on each country's respective experience in this area. The regulatory responses can roughly be split into three distinct and separate approaches. On one end of the spectrum, the United States has undertaken a number of initiatives spearheaded by organizations such as the SEC and the PCAOB to curb the issues stemming from reverse mergers in the form of issuing investor warnings to more stringent listing rules for these reverse mergers. Sweden has only limited experience with backdoor listings (and has yet to express a level of concern anywhere similar to that of the United States). However, in order to ensure that investors have sufficient information to distinguish between prudent and imprudent backdoor listings, the Rule Book of OMX NASDAQ Stockholm contains a light touch signaling system that enables regulators to give companies that are involved in backdoor listings a temporary 'observation status'. Regulatory responses to the widely publicized backdoor listings/reverse mergers worldwide waver between these two extremes as evidenced by the changes (or lack thereof) in the respective listing rules following these developments in the United Kingdom, Australia and Hong Kong. In general, these jurisdictions allow regulators to assess backdoor listings on a case-by-case basis (and intervene when they are of the opinion that information asymmetries justify the application of re-admission requirements).

4.1 Special Rules and Regulations for Backdoor Listings

In light of the string of alleged fraudulent activity and accounting gaffes concentrated within entities that have undertaken reverse mergers in the latter portion of the 2000s, the SEC and the PCAOB acted in swift accordance in an attempt to halt such further incidents. In addition to issuing an investor bulletin highlighting the additional potential risks associated with investing in companies that were engaged in a

backdoor listing process,[31] the SEC imposed a wave of more stringent listing rules in order to simply be eligible to list publicly. Additional listing requirements imposed include maintaining a closing share price beyond a certain threshold, complying with all periodic filing requirements of financial reports, and having been traded in the United States on the OTC market or another regulated exchange for at least one-year prior ('seasoning rules'). These amendments that were ultimately approved by the SEC in November 2011 consistently referred to concerns about the inaccuracies of financial statements produced by reverse merger companies (see Table 4).[32]

In addition, the PCAOB proposed to implement a set of supplementary auditing standards in the fall of 2011 as well by requiring audit reports to disclose and identify the names of audit firms or individuals that provided more than 3 percent of the total hours spent on the most recent audit.[33] The rationale for this additional requirement is twofold. First and foremost, such a standard helps fulfill consistent requests from investors for further information about the firms that are performing audits on their investments. Second, the names of auditing firms that are located in jurisdictions beyond the PCAOB's current investigatory scope is publicized under this mandate and hence allows investors to be better informed about the quality of firms conducting a company's auditing. This is particularly relevant in China where the PCAOB along with other foreign regulatory bodies are currently barred from inspecting China-based audit firms on the grounds of sovereignty and state secrecy. Though the PCAOB is consistently attempting to further cooperation with jurisdictions that are particularly salient such as China, which makes up almost 5 percent of the PCAOB registered firms, additional measures including the publication of the names of foreign auditing firms is a step toward greater transparency in audit practices in favor of investors.

Table 4: Reverse Merger Rules and Regulations in the United States

Stock Exchange	Regulator	Reverse Merger Rules	Timeline of a Reverse Merger
NASDAQ, NYSE and NYSE Amex	SEC	Under the new rules, NASDAQ, NYSE, and NYSE Amex will impose more stringent listing requirements for companies that become public through a reverse merger. Specifically, the new rules would prohibit a reverse merger company from applying to list until: o The company has completed a one-year "seasoning period" by trading in the U.S. over-the-counter market or on another regulated U.S. or foreign exchange following the reverse merger, and filed all required reports with the Commission, including audited financial statements.	Timeline before and after the implementation of the new rules: Approx. 14 weeks (before) / 6 – 12 months (after)

[31] See SEC, Investor bulletin on reverse mergers, June 2011, http://www.sec.gov/investor/alerts/reversemergers.pdf.
[32] SEC, *SEC approves new rules to toughen listing standards for reverse merger companies*, press release, 9 November 2011, http://www.sec.gov/news/press/2011/2011-235.htm.
[33] Moreover, the PCAOB and China entered into a cooperative agreement in October 2012 under which PCAOB inspectors are allowed to observe the oversight activities of Chinese regulators. In return, the agreement allows the Chinese regulators to observe the work of the PCAOB.

- The company maintains the requisite minimum share price for a sustained period, and for at least 30 of the 60 trading days, immediately prior to its listing application and the exchange's decision to list.

Under the rules, the reverse merger company generally would be exempt from these special requirements if it is listing in connection with a substantial firm commitment underwritten public offering, or the reverse merger occurred long ago so that at least four annual reports with audited financial information have been filed with the SEC.

4.2 Re-Compliance Regulation

In contrast to their neighbors across the Atlantic, the United Kingdom has until recently not expressed much concern in the form of increased or tighter listing requirements for companies pursuing backdoor listings. Perhaps the relatively minimal academic and policy attention compared to the United States is a consequence of the stopgaps that were already built into the London Stock Exchange Listing Rules (which generally resulted in the suspension of the listing of the acquiring companies shares unless sufficient information was provided to the market). However, the lack of a significant reform in the United Kingdom should not be confused with a lack of awareness on the matter. Following alleged irregularities at subsidiaries of Bumi, an Indonesian company that listed on the London Stock Exchange through a reverse merger in the summer of 2011,[34] the Financial Services Authority (FSA) – now the Financial Conduct Authority (FCA) – introduced new rules with the aim to prevent reverse takeovers of companies that are not eligible for listing (at one of the listing segments) and tighten the governance around these takeovers in October 2012.[35] In fact, the FSA already issued a consultation paper in January 2012 that outlined a number of proposals aimed at strengthening governance and disclosure issues that have been identified.[36] Listing rules that effectively restrict listed shell companies established with the intention of acquiring an operating business from becoming premium listed is also implemented as a direct byproduct of these discussions.[37] The new London Stock Exchange Listing Rules generally require entities pursuing a backdoor listing to automatically re-apply for a public listing following the approval of a reverse merger by the shareholders in a general meeting. The final rulebook for the high-growth segment of its Main Market (Rulebook) of 27 March 2013) contains a similar 're-admission' mechanism (see Table 5).

[34] See David Oakley, City Watchdog to Tighten Listing Rules, The Financial Times, 2 October 2012.
[35] See Jamie Dunkley, FSA Outlines Listing Rule Shake-Up, The Telegraph, 3 October 2012.
[36] Financial Services Authority, Amendments to the Listing Rules, Prospectus Rules, Disclosure Rules and Transparency Rules (CP12/2), January 2012.
[37] Financial Services Authority, Enhancing the Effectiveness of the Listing Regime and Feedback on CP12/2 (CP12/25), October 2012.

Table 5: Backdoor Listing Rules and Regulations in the United Kingdom

Stock Exchange	Regulator	Backdoor Listing Rules
London Stock Exchange	FCA	LR 5.6.19: The FCA will generally seek to cancel the listing of an issuer's equity shares or certificates representing equity securities when the issuer completes a reverse takeover. LR 5.6.23 G to LR 5.6.29 G set out circumstances in which the FCA will generally be satisfied that a cancellation is not required. Where the issuer's listing is cancelled following completion of a reverse takeover, the issuer must re-apply for the listing of the shares or certificates representing equity securities and satisfy the relevant requirements for listing.
London Stock Exchange (High Growth Segment)	FCA	B5: Reverse Takeovers Where an Issuer wishes to undertake a reverse takeover, it must: 26.1. comply with the requirements of section B3 as if it were a notifiable transaction 26.2. send an explanatory circular to its shareholders and obtain their prior approval in a general meeting for the transaction which constitutes the reverse takeover, and 26.3. ensure that any agreement that effects such transaction is conditional on that shareholder approval being obtained. Suspension in relation to a reverse takeover: 29.1. An Issuer must contact the Exchange via the Primary Market Regulation Team as early as possible: 29.1.1. before announcing a reverse takeover which has been agreed or is in contemplation, to discuss whether a suspension of trading of the securities under the Admission & Disclosure Standards is appropriate, or 29.1.2. where details of the reverse takeover have leaked, to request such a suspension of trading.

The financial regulatory body in Australia has had a rather tepid response to the wave of fraudulent backdoor listings similar to their British counterparts. In fact, there are no specific references to backdoor listings or reverse takeovers in the Listing Rules of the Australian Stock Exchange (ASX). However, ASX Listing Rules Guidance Note 12 (which was published in December 2013) provides legal certainty for the companies and their advisors by explaining how backdoor listings are regulated under Listing Rules 11.1 to 11.3 (see Table 6). As is required at the London Stock Exchange, the Australian Securities Exchange generally compels a listed entity involved in a backdoor listing to re-adhere to listing requirements under ASX Listing Rule 11.1 (Proposed change to nature or scale of activities). However, in contrast to the new rules in the United Kingdom, non-compliance with the listing rules could lead to a suspension (not a cancellation) of the quotation.

Exceptions to the re-admission process only exist if the backdoor listing does not constitute a significant change to the nature or scale of the activities of the listed company. However, a close reading of the previously mentioned Guidance Note 12 shows that the most common backdoor listings will lead to a significant change to the nature of an entity's activity. The following activities (associated with the mining industry) are explicitly mentioned in the Guidance Note: (1) an entity whose main business activity is manufacturing consumer goods deciding to switch its main business activity to mining exploration (or vice versa) and (2) an entity whose main business activity is exploring for minerals deciding to switch its main

business activity to exploring for oil and gas. As for the scale of the activities, the ASX considers a 25% change to the size of an entity's operations to be significant. It therefore comes as no surprise that empirical research found that approximately 79% of the backdoor listings that took place between 1992 and 2007 would have been required to re-comply with ASX's listing requirements.[38]

Table 6: Backdoor Listing Rules and Regulations in Australia

Stock Exchange	Regulator	Backdoor Listing Rules	Timeline of a Backdoor Listing
Australian Securities Exchange (ASX)	ASIC (Australian Securities & Investments Commission)	Application of Listing Rules 11.1 to 11.3. Listing Rule 11.1: notification of significant transaction. Listing Rule 11.2: Disposal of an entity's main undertaking. Listing Rule 11.3: Suspension of quotation Listing Rule 11.3 empowers ASX to suspend the quotation of an entity's securities until the entity has satisfied the requirements of Listing Rules 11.1 or 11.2. It is a discretion that ASX can exercise to secure compliance with the requirements of Listing Rules 11.1 or 11.2 and to ensure that the market is supplied with sufficient information about a proposed significant change to the nature or scale of a listed entity's activities for trading in its securities to be taking place on a reasonably informed basis.	Approx. 181 days when re-admission is required. Approx. 98 days when re-admission is not required.

Clearly, the Guidance Notes issued by the ASX not only increases the compliance rate with the regulatory requirements, but also enhances legal certainty and limits possible abuse of the rules. This is probably preferable to a case-by-case determination of the applicable rule. Consider in this respect the rules in Hong Kong. Rule 14.06(6) governs the listings of entities that undertake reverse takeovers. Rules 14.06(6)(a) and 14.06(6)(b) outline two common forms of reverse mergers, which effectively make up the so-called 'bright line' tests employed by the Hong Kong Stock Exchange to govern the validity of backdoor listings (see Table 7). However these two forms of reverse mergers that are outlined are far from being an all-encompassing list under the purview of the regulators. Three recent cases reflect how strict adherence to rules 14.06(6)(a) and 14.06(6)(b) does not necessarily ensure a successful listing for entities undertaking reverse takeovers. The final judgment on whether the proposed transaction is in fact a reverse takeover boils down to if the deal is an attempt to achieve a listing by ways of avoiding initial listing requirements or not.

[38] See Peter Brown, Andrew Ferguson and Peter Lam, Choice between Alternative Routes to Go Public: Backdoor Listing versus IPO. Working Paper, 2010.

Table 7: Backdoor Listings Rules and Regulations in Hong Kong

Stock Exchange	Regulator	Reverse Merger Rules	Timeline of a Reverse Merger
HKEx	(SFC) Securities and Futures Commission	14.05 A listed issuer considering a transaction must, at an early stage, consider whether the transaction falls into one of the classifications set out in rule 14.06. In this regard, the listed issuer must determine whether or not to consult its financial, legal or other professional advisers. Listed issuers or advisers which are in any doubt as to the application of the requirements in this Chapter should consult the Exchange at an early stage. The classifications are: (6) reverse takeover, which normally refers to: (a) an acquisition or a series of acquisitions (aggregated under rules 14.22 and 14.23) of assets constituting a very substantial acquisition where there is or which will result in a change in control (as defined in the Takeovers Code) of the listed issuer (other than at the level of its subsidiaries); or (b) acquisition(s) of assets from a person or a group of persons or any of his/their associates pursuant to an agreement, arrangement or understanding entered into by the listed issuer within 24 months of such person or group of persons gaining control (as defined in the Takeovers Code) of the listed issuer (other than at the level of its subsidiaries), where such gaining of control had not been regarded as a reverse takeover, which individually or together constitute(s) a very substantial acquisition.	Approx.: 3 months. If rule 14.06 applies: 6–12 months.

In the case of HKEx-LD57-2013, neither of the bright line tests were violated as the proposed transaction would not have resulted in a change of control as discussed in Rule 14.06(6)(a) nor would the target have acquired a controlling stake in the purchaser 24 months prior to the consummation of the acquisition as imposed by Rule 14.06(6)(b). Nevertheless, it was determined that the acquisition was an attempt at a reverse merger by the authorities. The Hong Kong Stock Exchange cited how the transaction would be a substantial acquisition and that the acquiring company's assets would only represent a minimal amount of the greater group's total assets as a signal of a reverse takeover. The regulatory authority highlighted how neither the acquired assets nor the assets of the merged entities would meet the requirements of Rule 8.05(1) as well indicating that the proposed transaction was in essence an extreme example of a reverse takeover. Rule 8.05(1) requires prospective listing applicants to meet three minimum thresholds: a trading record of 3 financial years, HKD 20 million in profits in the most recent year, and HKD 30 million in aggregate profits in the preceding two years.

HKEx-LD58-2013 is within the scope of the bright line test propagated by Rule 14.06(6)(a) effectively making the applicable acquisition highlighted within the case a reverse takeover. However, the acquiring company was under the impression that the proposed transaction did not constitute a backdoor listing, as the target would comply with the trading record requirements in order to list under Rule 8.05. The Exchange ultimately rejected such overtures as the transaction clearly was within the scope of Rule

14.06(6)(a) and that the acquirer, which was a shell company, was trying to list the target without having to go through the standard listing application process. Both the seller and acquirer cited a past decision (HKEx-LD95-1) in rebuttal, but it was deemed inapplicable, as the target did not inject assets into the acquirer to the extent that was the case in this particular case.

In HKEx-LD59-2013, the proposed transaction constituted a reverse takeover under Rule 14.06(6)(a) and effectively within the scope of the bright line test as in HKEx-LD58-2013. However, the Exchange granted a waiver in favor of the acquirer by dubbing the transaction as a substantial and connected transaction, but without falling under the category of a reverse takeover. The acquirer's submission that the target's patents were related to its business within the video gaming space and was thus not an attempt to attain a listing by avoiding the standard listing requirements was ultimately accepted. This particular case serves as a stark contrast to HKEx-LD58-2013 as a waiver was granted although the deal was within the scope of Rule 14.06(6)(a).

The implications of these three particular decisions highlight the increased level of uncertainty with regard to the application of listings in the form of reverse takeovers. Erecting deals around the Exchange's bright line tests can no longer ensure a successful listing via a reverse takeover. In essence, these developments suggest that the requirements imposed by the regulatory authority at the Hong Kong Stock Exchange is tightening as the vetting process of flagged transactions will be more extensive. Close consultation with the Exchange to clarify the potential interpretation of potential reverse takeovers may be a sensible measure to adopt.

4.3 A Light Touch – Flexible – Regulatory Approach to Backdoor Listings

The Listing Rules of NASDAQ OMX Stockholm embrace more flexibility in assessing backdoor listing processes. This approach is illustrated in Table 8. First, Rule 3.3.8 requires listed companies to disclose information to the market about significant changes in its identity. The information must be equivalent to what is required under the IPO regulations. In order to determine whether there is a significant change in identity, the Swedish regulator typically takes the following criteria into account: (1) changes in ownership structure, (2) the acquisition of a new business and (3) the change in market value of the listed company following an acquisition. What is interesting in this regard is that the exchange has the possibility to give a company's shares a temporary 'observation status' if the disclosed information is insufficient. The rationale behind this status is straightforward. It provides information to the market and warns investors and potential investors that there are risks and uncertainties associated with the company or its shares. The observation status is a flexible, but powerful mechanism to remind investors to be cautious about investing in companies that are subject to a reverse takeover (see Listing Rule 2.7 (v)). The observation status can only be granted for a limited period of time, usually not more than six months.

Table 8: Reverse Merger Rules and Regulations in Sweden

Stock Exchange	Regulator	Reverse Merger Rules
OMX NASDAQ Stockholm	The Swedish Financial Supervisory Authority	Rule 3.3.8 Change in Identity: If substantial changes are made to a company during a short period of time, or in its business activities in other respects, to such a degree that the company may be regarded as a new undertaking, the company shall disclose information about the changes and consequences of the changes. Rule 2.7 Observation Status: The Exchange may decide to give the company's shares or other securities observation status if the company has been subject to a reverse take-over or otherwise plans to make or has been subject to an extensive change in its business or organization so that the company upon an overall assessment appears to be an entirely new company.

Clearly, other measures in backdoor listing procedures that are available to the Swedish regulator are the cancellation or suspension of the trading in the shares of a listed company. However, if the regulator is of the opinion that more drastic interventions are necessary, flexibility remains an important element in the regulator's decision-making process. Consider Immune Pharmaceuticals Inc., the byproduct of a reverse merger between a privately held Israeli based bio-pharmaceutical company (Immune Pharmaceuticals Limited) with a listed American developer in pain and cancer treatment (EpiCept Corporation). The newly merged entity hoped to be able to achieve a public listing on the NASDAQ OMX in Sweden following the transaction. It also had intentions to list on a US securities exchange in the future as well. Daniel Teper, Immune Pharmaceuticals Inc. Chairman and CEO, highlighted the limitations for Israeli capital markets to fulfill the financing needs of companies operating within the life sciences space that are not concurrently listed in the United States as the primary cause for pursuing a public listing. A reverse merger was ultimately elected as the mechanism to list, as an IPO was initially not a feasible option at the time of the consummation of the merger. However, even though an active listed company (such as EpiCept as opposed to a shell company) was involved in the reverse merger, the newly merged Immune Pharmaceuticals Inc. was not immediately allowed to maintain its listing on the regulated NASDAQ OMX market in Sweden. Instead, the regulators approved trading of the shares of Immune Pharmaceutical Inc. on NASDAQ OMX First North Premium, a segment designed for high growth companies that are in the process of preparing for a listing at the main market. This brings us to another important element in the Immune Pharmaceuticals decision: The importance of the introduction of less regulated and more accessible segments to smaller companies that would otherwise consider to enter the market through the backdoor. The potential of segmented stock markets and their impact on backdoor listings will be discussed in the next Section.

5. The Future of Reverse Mergers

Empirical studies indicate that reverse merger activity has significantly decreased due to the negative publicity, the introduction of more stringent rules and regulations, the increased enforcement

(particularly by the regulators in the United States and Hong Kong) and regulatory scrutiny. According to data provider DealFlow Media 'only' 166 reverse mergers closed in 2011, which is a 36 percent decline compared to the number of reverse mergers in 2010. That said, the question is whether the measures to strengthen the rules and regulations governing reverse takeovers will eventually put an end to backdoor listings? The evidence is mixed. The number of and amount raised by Chinese reverse mergers has plunged approximately 53 percent and 95 percent respectively in 2011 (compared to 2010). In contrast, we observe a reverse merger boom in the mining industry in Australia (where follow-on offerings have always played a more important role when the IPO market was weak).[39]

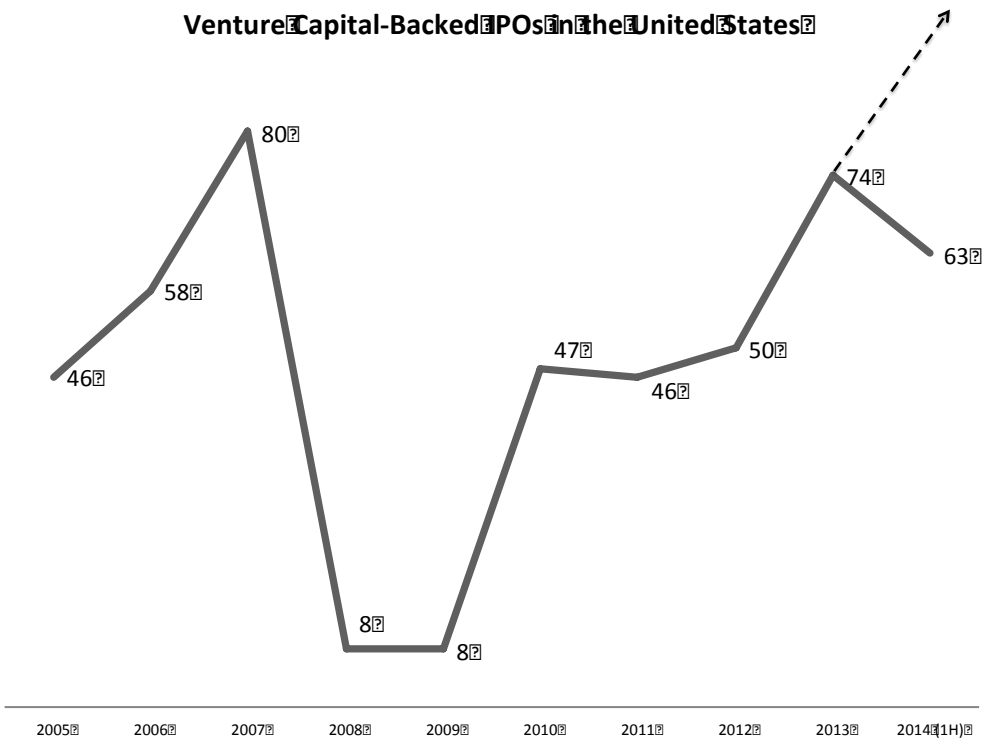
Still, it could be argued that the outlook for reverse mergers is dismal. The negative attention has caused companies to look at other financing alternatives, such as private placements or private sales.[40] What is also important in this respect is the gradually changing regulatory landscape for companies that consider floating their shares on a stock exchange. Policymakers and regulators have introduced (or plan to introduce) more flexible listing rules and regulations to stimulate IPO activity. These initiatives appear to be successful. For instance, the increase of the number of venture capital-backed IPOs in the United States in 2013 could arguably be attributed to the possibility of a firm to qualify as an 'emerging growth company' (EGC) under the JOBS Act.[41] The EGC label offers several benefits to high growth companies in the pre- and post-IPO period. In the pre-IPO period, an EGC will only be required to include two years – instead of the usually required three years – of audited statements in its IPO registration. More importantly, the special status introduces 'testing-the-waters' provisions, which allow EGCs to communicate with professional investors (qualified institutional buyers or institutional accredited investors) to determine investors' interest in the company prior to or following the date of the IPO registration statement. Moreover, the JOBS Act provides these companies with the possibility to confidentially submit a draft of its IPO registration statement for review to the SEC.

Also, the 'on-ramp' provisions grant important reliefs in the post-IPO period. For example, EGCs are exempted from the obligations under SOX Section 404(b) to provide an auditor attestation of internal control. Furthermore, the Act excludes EGCs from (1) complying with the full range of executive compensation disclosures and (2) say-on-pay votes on executive compensation. Finally, EGCs need not comply with any new or revised accounting standards until the date on which private companies are required to apply these standards to their organization. To see the success of the JOBS Act, consider the significant increase in the number of EGCs that have pursued a listing after having used the option to

[39] Stephen Bell, Reverse Takeovers Shine as IPOs Struggle, The Wall Street Journal, 23 January 2013.
[40] See David Thomas, The IPO Road Less Traveled: Form 10, BIOtechNOW, 25 February 2013.
[41] See Gillian Tett, Investors Enjoy a Sweet Aftertaste to the Candy Crush Crunch, The Financial Times, 27 March 2014.

confidentially file their registration statements. According to data provider Renaissance Capital, approximately two-thirds of the 131 IPO companies (including non-venture capital backed companies) in 2013 have availed themselves of the JOBS Act's confidential filing provision. Twitter is a recent example of an EGC that listed its shares on the New York Stock Exchange on 7 November 2013. Apparently, companies such as Twitter value having more control over the timing of the IPO, which is arguably provided by a confidential filing, higher than the likely discount in the stock price due to the reduced disclosure and reporting requirements for EGCs.

Figure 10: The Number of Venture Capital Backed IPOs in the United States



Source: Dow Jones VentureSource

We also see 'JOBS Act-type' initiatives in other parts of the world. In Europe, for instance, NYSE Euronext has introduced ENTERNEXT, the new pan-European Entrepreneurial Exchange with lighter rules and regulations tailored to the needs of small and medium-sized enterprises (SMEs), particularly high growth companies. Policymakers in the United Kingdom see the relaxation of listing rules as the key to reversing the trend of emerging growth companies being reluctant to entering the bureaucratic and overregulated world of listed companies. Not surprisingly, the renewed focus on listings of high growth companies has not been limited to the United States and Europe. Consider the introduction of the 'Korea New Exchange' or KONEX with the aim of helping SMEs to raise money from institutional investors and wealthy individuals. The exchange is considered as a stepping-stone for the more regulated main board, KOSPI,

and Korea's venue for high tech companies, KOSDAQ. KONEX is Korea's response to the JOBS Act: Companies that will be listed at KONEX face less stringent listing requirements and more flexible corporate governance rules.

Clearly, it is too early to draw any conclusions about the success of the 'JOBS Act-initiatives', but it is already evident that venture capital backed companies have started to consider the IPO option again in the United States (see Figure 10). The question is whether the benefits are large enough for companies to turn away from the backdoor listing route to the stock market.

6. Conclusion and Policy Recommendations

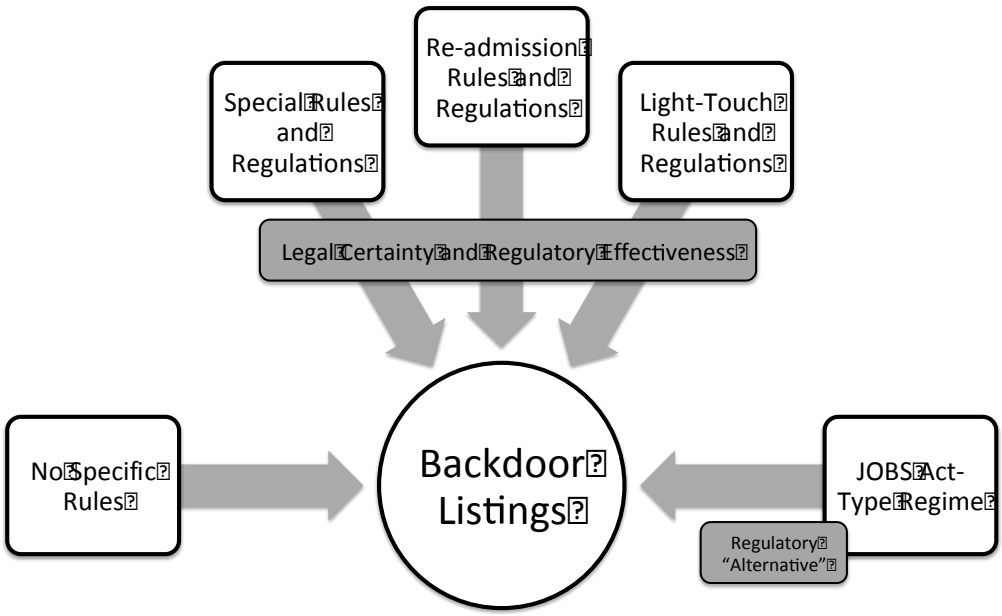
In the previous decade, backdoor listings became increasingly popular as a mechanism to list publicly. However, we have seen that this growing trend was not necessarily the consequence of a shift towards a more preferable or cheaper listing option. In the United States, reverse takeovers were typically exercised by smaller and lesser-known entities relative to their larger, more reputable counterparts that list through a traditional IPO. Synergy effects (that were created through a merger between two active operating companies) were often the reason for the wave of backdoor listings in the United Kingdom. In Australia, high potential growth companies and junior mining companies have usually found that a reverse takeover is quicker and easier than conducting a traditional IPO.

Still, there are a number of misconceptions surrounding the speed and cost-effective nature of backdoor listings. On average a reverse merger is unquestionably timelier than an IPO. However, a quick comparison of the timeline of a backdoor listing (that is relatively slower (4 months) with that of an IPO on the quicker end of the spectrum (4 to 5 months)) reveals how the speed and cost argument does not necessarily always hold true. After factoring for the expenses associated with a backdoor listing along with the consideration paid to shell promoters in the form of cash and sometimes an equity stake or the increased media attention and more stringent regulation, the cost argument in favor of these backdoor listings becomes questionable. A well-intentioned comparison of the listing options presides on the assumption that a backdoor listing and an IPO are alternatives to one another, which is on the contrary often times not the case especially for companies desperately looking for access to the capital market.

Nevertheless, there is evidence suggesting that particularly lower quality firms pursue listings through the backdoor. This notion of an adverse selection in entities pursuing such a backdoor listing is supported by empirical evidence that shows that a relatively high number of Chinese entities that listed through a reverse merger in the United States were subject to a greater frequency of class action lawsuits. In response, policymakers and regulators have increasingly started to consider or introduce legislation that also subjects reverse mergers to the more stringent IPO rules and regulations. These regulatory responses,

which can be divided into three categories, have understandably varied depending on each country's respective experience with reverse mergers. For instance, the United States has introduced a number of special regulatory initiatives to curb backdoor listings. The financial regulatory bodies in the United Kingdom, Australia and Hong Kong follow a 're-admission approach', which is viewed as a model for a new regulatory framework in China. NASDAQ OMX in Sweden has introduced a light touch approach which focuses on transparency and alerting the market.

Figure 11: Regulatory Options for Backdoor Listings



Is it always necessary to introduce rules and regulations that specifically deal with reverse mergers and takeovers (see Figure 11)? The backdoor listing cases in Indonesia seem to suggest that the introduction of specific rules and regulations is redundant when the 'backdoor listing process' already requires companies to comply with a stringent IPO-style disclosure and transparency regime. However, because the applicable regime is usually designed without 'backdoor listings' in mind, it may nevertheless be appropriate to introduce specific rules or guidelines to better accommodate backdoor listings while at the same time increasing the legal certainty and regulatory effectiveness (particularly from the perspective of foreign investors). The Australian Guidance Note is a good example in this regard. Clearly, the introduction of a specific regulatory regime may cause backdoor listings to lose their allure as effective (and relatively cheap) strategies to tap the financial market. As we have seen, the regulatory scrutiny and negative publicity has already led to a decrease in the number of reverse mergers on a global scale. What is interesting in this respect, however, is that the emergence of more flexible listing rules and regulations

and accessible IPO markets (such as introduced by the JOBS Act in the United States) make it less necessary for companies to pursue a backdoor listing in the future.

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