Thursday, November 17, 2011 2:03 PM ET Exclusive

New listing requirements for reverse mergers could limit capital access for small firms

By Joel Poelhuis

New listings standards imposed by the New York Stock Exchange, NYSE Amex and the NASDAQ Stock Market and approved by the SEC will make it more difficult for companies that have undergone reverse mergers to list on the exchanges, but some critics have called the measure both overly broad and ineffective at its goal of deterring investor losses from fraud by foreign-based firms.

"I think that some of the foreign companies were the catalyst for this, but they certainly didn't structure it in a way to target only those companies," said David Donohoe Jr., founder of Donohoe Advisory Associates LLC and previously NASDAQ's chief counsel for the listing qualifications department.

The move came after a series of Chinese companies, including Longtop Financial Technologies Ltd., were delisted by the exchanges; several are also facing enforcement actions from the SEC for problems with financial statements. In June, the SEC issued a bulletin warning investors of the risks of companies that gain access to U.S. markets through reverse mergers and threatened further action.

The new rules would keep companies that had completed reverse mergers from listing on the three exchanges until they had been traded for one year on another exchange or in the U.S. over-the-counter market. Companies would also be required to maintain a minimum of a $4 trading price for "a sustained period," as well as for at least 30 of the 60 trading days prior to its listing application and approval by an exchange.

But some observers questioned whether the measures unfairly penalize one vehicle of going public while not doing enough to increase scrutiny of fraudulent practices.

James Baxter, chairman of New York Global Group, a private equity institutional investor focused on Asia, argued in a comment letter that, of 29 Chinese companies delisted from U.S. exchanges in 2011, 15 went public through IPOs and 12 through reverse mergers. Longtop went public in an IPO in 2007.

WestPark Capital Inc. CEO Richard Rappaport protested the new rules' lack of distinction between "legacy" reverse merger companies and those formed through the Form 10 process, which requires due diligence by underwriters and the listing exchange, SEC review of a registration statement and a letter from FINRA.

A common concern about the impact of the restrictions involved the difficulty smaller companies have in trying to access public capital. Rappaport told SNL the $1 million to $1.5 million cost involved in an IPO can be daunting.

Michael Weitzner, a managing partner at investment bank and adviser Battle Hill Capital LLC, agreed, telling SNL Financial that, "By and large, most reverse merger companies couldn't do a stand-alone IPO."

Donohoe said it is likely that the added requirement that they trade on another venue prior to listing on the major exchanges will discourage companies from using the reverse merger structure to access public markets. He said it is possible that this could encourage a comeback over the longer term in the smaller IPO market, which has eroded over the last decade.

"What you would hate to see is that this has the result of steering companies away from going public," Donohoe said, noting that disclosure standards in the OTC market are not as revealing for investors.

With the reverse-merger avenue less attractive, smaller companies could turn to special purpose acquisition vehicles, or SPACs, which go public and then use the capital to acquire private companies, according to Ridgeway Barker, chair of the corporate finance and securities practice group at law firm Kelley Drye & Warren LLP.

However, Weitzner told SNL he thought it was more likely that private equity could pick up some of the capital slack, saying the changes would not likely be a "watershed event" that revives the SPAC market.

In any case, the impact could fall more on technology and industrial companies than heavily regulated firms in the financial space. Barker said banks and insurance companies, which already have a substantial regulatory infrastructure, are more likely to follow the IPO route because they already have a leg up on compliance.

NYSE Euronext operates the NYSE, while The NASDAQ OMX Group Inc. operates the NASDAQ.

Article amended at 11:17 a.m. on Nov. 18, 2011, to reflect the correct spelling of David Donohoe Jr.