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Shell companies as IPO alternatives: an analysis of trading activity around reverse mergers

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Abstract

While shell companies are convenient vehicles for small private firms to go public via a reverse merger, they are also often mentioned in the popular press in conjunction with stock price manipulation. Recently the Securities and Exchange Commission (SEC) has imposed stricter rules on these companies to speed up disclosure of financial information and curb potential abuses. Our article looks at the trading activity around reverse mergers. Clearly, the merger is taken as significant news as the trading activity increases immediately following the merger announcement. This observation suggests that the SEC may have had good reason to speed up the required filings and provide timely information to the public. We find sporadic, but statistically significant positive returns surrounding the merger reflecting the increase in value of the shell companies that is also evidenced in the (statistically insignificant) positive CARs following merger

announcements. However, our results do not show any evidence of persistent insider trading or price manipulation in these stocks.

Acknowledgements

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Notes

¹ The term 'blank check' is the result of shell companies making primary offerings with no specified goals as to how the proceeds would be used, essentially asking the investors for a 'blank check'.

² 'Moving the market: SEC may impose stricter rules on behaviour of shell companies', WSJ, 14 April 2004; 'Regulators suspend trading in 26 stocks', Reuters, 8 June 2004.

³ See SEC Release No. 33-8407, 'Proposed Rule: Use of Form S-8 and Form 8-K by Shell Companies'.

⁴ 'Companies Opting for Easy Way to Go Public Still Remain Rare', The Wall Street Journal, 26 June 2002, Section B15F.

⁵ They also list the typical steps in a reverse merger—actively searching for a shell, possibly through a law or an accounting firm, followed by contacting the shareholders of the shell to determine their willingness to sell, and to determine the post-merger ownership structure of the 'operational' company, due diligence, especially on liabilities of the shell company (perhaps by enlisting a reputable broker or law firm to lend credibility to the transaction) and finally steps to improve the liquidity and tradability of the stock—such that it reflects the true nature of the business and allows its use as currency for further deals.

⁶ 'Reverse Mergers on the rise: Chinese companies, especially, use controversial route to get US listing', The Investment Dealers' Digest, 21 July 2003, New York, p. 1.

⁷ 'Elvis is Star Attraction In Small Firm's Revival-Bulletin Board Stock Soars as Deal Will Make It Owner of Presley's Rich Legacy', The Wall Street Journal, 28 December 2004, C3.

⁸ Effective 23 August 2004, this is reduced to four business days after the event. See SEC Release No. 33-8400, 'Final Rule: Additional Form 8-K Disclosure Requirements and Acceleration of Filing Date'. The window period was modified in the March 2004 Final Rule to 71 calendar days. This coupled with the proposed four business days makes it ~75 days till investors see the financial statements, similar to the previously allowed 15 plus 60 days.

⁹ See footnote 32, SEC Release No: 33-8407.

¹⁰ <http://www.fool.com/EveningNews/1995/EveningNews951201.htm> 'Magellan Manager Playing Market Games?'

¹¹ Wall Street Journal, 4/14/2004, Vol. 243, Issue 73, pC3, 'SEC May Impose Stricter Rules on Behavior of Shell Companies'.

¹² We chose this window to cover the required time allowed between the merger agreement and Item 2 filing (15 calendar days) and the required time for filing the Item 7 after the Item 2 filing (60 calendar days).

¹³ However, the merger can be perceived as bad news: if there is no disclosure regarding the private company, the investor does not know if the company is an asset or liability.

¹⁴ WORLD ASSOCIATES INC/NV/(WAV)'s price drops from \$0.90 on 24 October 2000 to \$0.03125 on 25 October 2000.

¹⁵ DECORIZE INC (DCZ)'s price increases from \$0.03 on 6 July 2000 to \$3.25 on 9 July 2000.

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