Market Dynamics

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Performance Management System

Beware The Reverse Merger Stock

Portfolios heavy with under-performing stocks almost never outperform the market.

Ignat's Law

The SEC initiated an investigation of reverse merge stocks in December of 2010 and issued a special bulletin in early June of 2011 warning investors of the potential for fraud in reverse merger stocks.

A collection of recent newsletters is available on the web site.

Please visit my web site at
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The first time I got to observe a reverse merger up close was in 1969 while I was working for a "Go-Go" investment advisory firm in glitzy Century City, California. I was so green and inexperienced that I didn't understand the deal or what was being done. I was given instructions to buy stock for the accounts I managed in an obscure OTC stock at about 20 cents per share. I didn't like what was going on and I felt that something was not quite right. When the deal was completed, only then did I learn how a reverse merger really worked,

As it turned out, the obscure OTC stock that we bought was a shell company with little or no actual operations. Unbeknownst to me, the start up company that as being financed by the venture capital side of my firm bought almost the entire outstanding stock of the shell company. They then completed a merger with their start up company and the shell company and then changed the name of the combined entity to the prior name of the start up company.

Evidently, a very important part of the deal was a prearranged commitment by Bear Stearns to make a market in the new company's stock I now understand that the market maker probably bought lots of stock in the shell company in anticipation of this merger. When they started making a market in the new stock the determination of the starting price was quite arbitrary. Stock that was bought for 20-25 cents starting trading at $8.00 per share. The market makers and the other people that were in on the deal made a whopping profit.

Evidently this whole maneuver was to take the start up company public without filing the necessary registration statement that is published in the prospectus that covers a new issue of stock in an IPO. From a regulatory perspective the deal was legal but it still had a unpleasant smell about it.

After the stock became publicly traded, the company was still under the requirement to file annual financial statements with the SEC. After a period of time, these statements reveled the true financial status of the company and the stock collapsed and later the company filed for bankruptcy.

Evidently the reverse merger technique has come back into vogue and quite a few Chinese companies have gained access to the US public stock market by using a reverse merger. This practice became more widespread in 2009 and now those chickens are coming home to roost.

I have seen reports that at least 15 Chinese stocks trading in the U.S. stock market have had trading in their stocks halted pending a fraud investigation. These reports also indicated some well known hedge funds and large mutual funds have stumbled into these fraudulent stocks and have had their investments frozen by the trading halts.

Evidently, sooner or later, the company's auditor discovers incorrect or false items in the company's financial statements and they have refused to certify the statements and the real story of fraud can no longer be covered up.

The special bulletin issued by the SEC called attention to the potential for fraud in reverse merger stocks. Caveat Emptor

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