HERBERT SMITH FREEHILLS

2020 AUSTRALIAN IPO REVIEW: KEY US SECURITIES DEVELOPMENTS

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CAPITAL MARKETS IN A TIME OF COVID-19

In response to the Covid-19 pandemic and the national lockdowns commencing shortly thereafter in March 2020, the SEC issued numerous orders and statements providing conditional regulatory relief and assistance to reporting companies impacted by the pandemic as well as guidance on Covid-19 disclosures.

The staff of the SEC's Division of Corporation Finance issued new Disclosure Guidance Topics No. 9 and 9A in March and June 2020, respectively, providing the SEC's views regarding disclosure that companies should consider with respect to Covid-19 and related business and market disruptions. The guidance suggests that companies should take a closer look at their disclosure obligations in connection with material operational changes made in response to Covid-19, as well as new financing activities to address the adverse financial impact of the pandemic. These operational adjustments might include, for example, increased telework, supply chain and distribution adjustments and changes related to health and safety of employees, contractors and customers, including in connection with transitions back to the workplace. The guidance also emphasizes that disclosure about the risks, management responses and evolving effects of Covid-19 entails a facts-and-circumstances analysis, and any disclosure should be tailored specifically to a company's situation. The SEC has urged companies to proactively revise and update disclosures as facts and circumstances change.

In particular, the SEC has flagged the following key points for issuers' consideration:

- **Due diligence** – queries and disclosure requirements relating to the effects of Covid-19 on issuers' operations and financial statements are expanding, hence issuers should expect more detailed due diligence questions, particularly regarding the effects of Covid-19 on their business. Similarly, the ability of parties wishing to conduct physical due diligence has been limited, and therefore novel arrangements to due diligence have been required (eg use of video conferencing).

- **Non-GAAP measures** – the SEC also raises the issue of non-GAAP financial measures and key performance measures in the context of Covid-19. Specifically, the SEC advises that companies using measures or metrics to adjust for or explain the impact of Covid-19 should address why management finds the measure or metric useful and how it helps investors assess the impact of Covid-19 on the company's financial position and results of operations. Companies should also pay particular attention to revenue recognition as an area that may require critical judgments and estimates as many companies may face challenging issues around delays in operating cash flows caused by Covid-19.

- **Disclosure of government assistance** – the SEC advises that companies receiving government financial assistance should consider the short- and long-term impact of that assistance on their financial condition, results of operations, liquidity, and capital resources as well as the related disclosures (eg MD&A and financial statements) and critical accounting estimates and assumptions.

Ultimately, companies will need to provide investors with insight regarding their assessment of, and plans for addressing, material risks to their business and operations resulting from Covid-19. Companies should consider making appropriate disclosures and updating previous disclosures, if necessary, to address the Covid-19 pandemic, including, but not limited to, the effect or potential effect of the outbreak on earnings, revenues, operations, supply chains and pending or planned transactions. Companies are also advised to consider disclosing risk management plans in place or in progress as the pandemic evolves.

OUR TAKE

Companies will need to conduct an on-going and holistic review of Covid-19 related risks and disclosures as the pandemic continues. In particular, companies should keep an eye on Covid-19 impacts across the totality of their business and operations as there may be less apparent consequences even for companies in sectors that have been relatively unaffected by the pandemic. We are pleased that yet again the SEC has emphasized that what type of disclosure is appropriate will depend on the facts and circumstances and that its guidance remains principles-based and provides flexibility for reporting issuers.

EVOLVING SEC GUIDANCE FOR CHINESE ISSUERS

Over the past decade, US investors have increased their exposure to companies based in or with the majority of their operations in China (China-based Issuers). As a result, China-based Issuers have drawn significant attention from the SEC, which has taken the position that investors generally will have substantially less access to recourse against China-based Issuers, in comparison to US domestic companies and foreign issuers in other jurisdictions.

In December 2020, the US government enacted the Holding Foreign Companies Accountable Act (HFCAA). The law requires that auditors of foreign companies that are SEC registrants allow the Public Company Accounting Oversight Board (PCAOB) to inspect the audit work papers for audits of non-US operations as required by the Sarbanes-Oxley Act of 2002. If a company's auditors fail to comply for three consecutive years, then the company's shares would be prohibited from trading in the US In particular, the HFCAA aims to address restrictions China has placed on the PCAOB's ability to inspect or investigate PCAOB-registered public accounting firms in connection with their audits of China-based Issuers that are SEC registrants.

US exchanges have also undertaken actions directed against China-based Issuers. For example, the NYSE announced in January 2021 that it would move forward with delisting three Chinese telecommunications companies targeted by an executive order from former President Trump due to alleged links to the Chinese military. Likewise, Nasdaq removed shares of four Chinese construction and manufacturing companies from indexes it maintains in December 2020 in response to a US order restricting purchase of their shares due to alleged links to the Chinese military.

In particular, the SEC has highlighted the following areas of focus:

- **Risks related to high-quality and reliable financial reporting** – one of the most significant risks by China-based Issuers results from current restrictions on the PCAOB's ability to inspect audit work and practices of PCAOB-registered public accounting firms in China and on the PCAOB's ability to inspect audit work with respect to China-based Issuer audits by PCAOB-registered public accounting firms in Hong Kong.

- **Risks related to access to information and regulatory oversight** – US regulators' access to information and regulators' ability to investigate or pursue remedies with respect to China-based Issuers may be limited under Chinese law. The SEC and other US authorities face substantial challenges in bringing and enforcing actions against China-based Issuers and their officers and directors.

- **Risks related to a company's organizational structure** – current regulations in China limit or prohibit foreign investment in Chinese companies operating in certain industries. To circumvent these restrictions, many China-based Issuers form non-Chinese holding companies that enter into contractual arrangements, intended to mimic direct ownership, with Chinese operating companies. These China-based Issuer structures pose unique risks to US investors as the agreements establishing the structures may be found to not comply with Chinese law, which could subject a China-based Issuer to penalties, revocation of business and operating licences, or forfeiture of ownership interests.

- **Risks related to the regulatory environment** – China's legal system is substantially different from the legal system in the US and may raise risks and uncertainties concerning the intent, effect, and enforcement of its laws, rules, and regulations, including those that restrict the inflow and outflow of foreign capital or govern a China-based Issuer's ability to conduct business.

OUR TAKE

The growth of Shanghai listings by China-based Issuers that are already US-listed (also known as "home coming" listings) have seen an uptick in recent years as a result of increased scrutiny towards China-based Issuers by the SEC. This trend is likely to continue, particularly in light of the passage of the HFCAA and the continued freeze in US-China relations, presenting competitive opportunities for Shanghai as well as other non-US stock exchanges. Non-China based issuers with extensive Chinese operations and/or subsidiaries relying on the work of Chinese auditors should keep an eye on developments in this space

RECENT TRENDS IN THE IPO MARKET: SPACS AND DIRECT LISTINGS

The past year saw a record number of listings by special purpose acquisition companies (SPACs). SPAC offerings in the US market numbered 46, 59 and 230, respectively, in 2018, 2019 and 2020. They also represented US$ 9.7 billion, US$ 12.1 billion and US$ 71 billion, respectively, in proceeds during that same time period. Of the SPACs that priced in 2018 and 2019, just under half have completed a merger to date. In the context of Covid-19 and the 2020 US presidential election, which brought increased uncertainty to global markets, SPACs led the way in helping companies meet funding requirements.

SPACs are publicly-traded shell or blank-check companies that have no operations and are formed for the purpose of raising capital in an IPO to acquire an existing private company. SPACs are currently, and have historically been, a US product as a result of key structural aspects in the US that have traditionally made them more attractive to investors. These include:

- **Redemption rights** – in the US, public stockholders voting against the proposed SPAC business combination also have the right to redeem their public shares for a pro rata portion of the proceeds of the IPO. It is also common to see sponsors and directors enter into a letter agreement pursuant to which they agree to waive their redemption rights.

- **Stockholder approval of the acquisition** – US SPAC's initial business combinations must usually be approved by a majority of the votes cast by public stockholders (subject to the stock exchange rules where the SPAC is listed).

- **Private investment in public equity (PIPE)** – given shareholders' ability to redeem their shares in US SPAC IPOs as well as situations where the purchase price of the entity the SPAC is attempting to acquire might exceed the equity in the SPAC, some US SPACs have employed forward purchase agreements with the SPAC founders obliging them to purchase additional units in the event of a capital shortage. Alternatively, many US SPACs undertake a PIPE deal, where additional capital is raised through a private offering to a selected investor or group of investors.

To date, SPAC listings have yet to take-off in other major capital markets, with most SPAC IPO activity outside of the US taking place in the London market, such as the December 2019 IPO of EverArc Holdings Limited and other markets in Europe (eg Amsterdam). London-listed SPACs have historically forgone features such as redemption rights, shareholder approval of acquisitions and PIPEs. However, the U.K. Financial Conduct Authority (FCA) has been increasingly interested in reforms, such as removal of the London Stock Exchange's share-suspension requirement upon the SPAC's acquisition of a private target, aimed at making London a more attractive destination for SPACs. The SEC has also been keeping a close eye on SPAC disclosures. In December 2020, it released CF Disclosure Guidance No. 11 which sets out a series of questions SPACs should consider when drafting disclosure for their IPOs and business combinations. The guidance is principally concerned with disclosure of conflicts of interest of sponsors, directors, officers, affiliates and the underwriting banks on a SPAC transaction.

Apart from SPACs, direct listings have also been gaining attention as a means for a private company to go public. A direct listing refers to the listing of a privately held company's stock for trading on a national securities exchange (such as the NYSE or Nasdaq) by means of an effective registration statement without conducting an underwritten offering and/or involving any underwriting services. Until recently, direct listings needed to involve the registration of a secondary offering of a company's shares on a registration statement publicly filed with, and declared effective by the SEC, at least 15 days in advance of launch. Companies were not permitted to raise new capital as part of the direct listing process, which made direct listings less attractive than traditional IPOs. Companies such as Spotify and Slack have undertaken direct listings.

On 22 December 2020, however, the SEC issued its final approval of rules proposed by the NYSE that permit a primary offering along with, or in lieu of, a direct secondary listing. Under the NYSE rules, the listing company must have a recent valuation from an independent third party indicating at least US$250 million in aggregate market value of the publicly held shares. The listing company must also certain financial and distribution standards, including having 1.1 million publicly held shares with a minimum initial reference price of US$4.00. In response to the SEC's approval, certain investor protection groups have expressed concern that, because of the absence of traditional underwriters, the primary direct listing process will lack a key gatekeeper present in traditional IPOs that helps prevent less well-managed (or even fraudulent) companies from going public.

OUR TAKE

SPACs and direct listings highlight increasing market interest in alternate structures for bringing companies to market without the burden of the traditional IPO valuation process. While traditionally US products, particularly in the case of SPACs, major capital markets such as London are increasingly seeking to embrace these alternate structures. We also expect increased SEC focus on these alternative listing structures going forward as highlighted by the SEC's concern regarding conflicts of interest between SPAC promoters and SPAC investors as well as their extensive deliberations on the approval of the NYSE direct listing rules. SPACs are also having a broader impact on the equity capital markets as purchase by a SPAC is increasingly seen as an alternative to a traditional IPO. We have seen and expect to see more "triple track" exits by sponsors or other sellers-trade sale, IPO or sale to a SPAC.

SEC DISCLOSURE EFFECTIVENESS: STREAMLINING S-K AND MD&A

On 19 November 2020, the SEC adopted amendments to Regulation S-K, including changes to its MD&A requirements that will make significant and long-overdue improvements. In general, the two key themes are streamlining existing disclosure and taking a more principles based approach. The amendments will become effective in February 2021, at which time advance voluntary compliance is permitted, so long as companies provide disclosure responsive to an amended item in its entirety. Compliance is not mandatory until a company reports on its first fiscal year ending on or after 210 days following publication.

The adopted changes are based in large part on the SEC November 2016 Report on Modernization and Simplification of Regulation S-K, as well as a July 2016 concept release on the business and financial disclosure requirements in Regulation S-K. They are part of a broader "disclosure effectiveness initiative" undertaken by the SEC.

Among the key changes are the following:

- **Elimination of the requirement for 5 years of "selected financial data"** – the amendments eliminate Item 301 of Regulation S-K, which requires most companies to furnish selected financial data in comparative tabular form for each of the company's last five fiscal years. This change simplifies companies' compliance obligations by reducing reporting burdens.

- **Elimination of the contractual obligations table** – the amendments eliminate the requirement for a table of contractual obligations under Item 303(a)(5). Instead of the contractual obligations table, the amendments add a requirement in Item 303(b)(1) to discuss material cash requirements from known contractual and other obligations, including but not limited to commitments for capital expenditures. This change enhances disclosure of capital resources by requiring disclosure of cash requirements that are not necessarily capital expenditures. Although this disclosure is for the most part consistent with existing SEC guidance, companies will need to carefully consider their cash requirements and ensure that the required disclosure is provided.

- **Requirement for critical accounting estimates disclosure** – the amendments add a requirement, in Item 303(b) of Regulation S-K, to disclose critical accounting estimates. The new requirement calls for both qualitative and quantitative information to convey estimation uncertainty and financial impact of the estimate, but in each case only to the extent such information is material and reasonably available. Existing SEC guidance already requires that companies disclose critical accounting estimates, therefore these changes will clarify the required disclosures and aid compliance.

- **Elimination of separate section on off-balance sheet arrangements** – the amendments eliminate this requirement, and they add an instruction emphasizing the importance of discussing off-balance-sheet obligations in the broader context of MD&A disclosure when they have or are reasonably likely to have a material current or future effect. This change will incentivise better integration of off-balance sheet arrangements disclosure within the MD&A.

The various changes will also apply, via parallel amendments, to disclosures provided by foreign private issuers in annual reports on Form 20-F.

OUR TAKE

While the SEC's focus on more principles based disclosure for the MD&A rather than specific form requirements is a welcome development, some of the new requirements, such as the discussion of cash requirements for known contractual and other obligations, are likely to require additional disclosures and careful analysis from companies in close collaboration with their counsel. We would expect that much of the streamlining of disclosure for US public offerings will make its way into the Rule 144A market before too long.

SEC ADOPTS CHANGES TO THE AI AND QIB DEFINITIONS

On 26 August 2020, the SEC voted to adopt amendments modernizing and expanding the definition of “accredited investor” (AI), which will allow individuals to qualify as AIs based on professional certifications and experience that demonstrate financial sophistication, and expand the scope of covered institutions. The amendments do not change the current US$200,000 individual income and US$1 million net worth thresholds established by the SEC in 1982 or the US$300,000 joint income threshold established in 1988, and the amendments do not index these thresholds to reflect inflation. They do, however, expand qualifying natural persons to those who are able to assess the risks and merits of an investment opportunity based on their professional qualifications. The SEC also made changes to the definition of “qualified institutional buyer” (QIB).

As adopted, the amendments will:

- Add a new category of AIs, covering any non-enumerated entity owning investments (as defined under the Investment Company Act) in excess of US$5 million, so long as not formed for the purpose of investing in the offered securities.

- Allow individuals to qualify as AIs based on holding in good standing one or more qualifying professional certifications, designations or credentials.

- Add as AIs (1) “family offices” that have at least US$5 million of assets under management, which were not formed for the specific purpose of acquiring the securities offered, and whose prospective investment is directed by a sufficiently sophisticated person, and (2) “family clients” of such “family offices” if the investment by the “family clients” is directed by the “family office” in accordance with the rule.

- Add LLCs to the list of enumerated entities that qualify as AIs if such entity owns at least US$5 million in assets.

- Treat “knowledgeable employees” (defined under the Investment Company Act) of a private fund as AIs for investments in the fund (and affiliated funds).

- Add the term “spousal equivalent” to the AI definition and related note, so that spousal equivalents may pool their finances for the purpose of qualifying as AIs.

- Add as AIs with no accompanying financial test (1) investment advisers registered under Section 203 of the Advisers Act, investment advisers registered under the laws of the various states and exempt reporting advisers and (2) rural business investment companies (RBICs).

- Make changes to Rule 144A to expand the QIB definition to include registered investment advisers, exempt reporting advisers, RBICs, LLCs and institutional AIs not otherwise enumerated in Rule 144A so long as, in each case, Rule 144A’s US$100 million threshold for securities owned and invested is satisfied.

OUR TAKE

These are welcome changes to help harmonise the AI and QIB definitions and expand the types of US investors that may take part in securities offerings. Nevertheless, approaching AIs who qualify purely based on their sophistication and/or professional certifications may take some time to take hold as the SEC’s expansion of the AI and QIB definitions has not impacted existing 10b-5 liability considerations that should be weighed when targeting US investors.

THE ESG REVOLUTION: LOOKING AHEAD TO THE BIDEN ADMINISTRATION AND 2021

Climate-related disclosure has become one of the most widely discussed issues in capital markets in recent years and this will continue. Many influential institutional investors have called for specific, consistent and reliable disclosures of the risks and opportunities related to climate change to guide investment, lending and underwriting decisions. In his letter to CEOs in January 2020, Larry Fink, Chairman and CEO of BlackRock, emphasized that “climate change has become a defining factor in companies’ long-term prospects”. Historically, however, the SEC has long held that only “material” matters, including climate-related matters, warrant disclosure. The US Department of Labor also remains skeptical of climate-related disclosures; it is currently considering a proposal to limit when and how pension plan fiduciaries may consider non-pecuniary factors, such as climate-related metrics, when making investment decisions. If adopted, the proposal could have a chilling effect on the demand for “green” investment products, which may in turn reduce the level of enthusiasm for climate-related disclosures among US-based asset managers and asset owners.

However, there are signs that approaches may be changing in the United States. In May 2020, the SEC Investor Advisory Committee endorsed the adoption of a disclosure framework focused on environmental, social and governance (ESG) matters, reasoning that such a framework would ensure the flow of capital to US markets, promote the goal of investor protection and level the playing field between issuers. Likewise, the advent of President Biden’s administration could signal a shift in the legislative landscape across key policy areas including the adoption of a more prescriptive approach to climate-related risk disclosure in the United States. The Biden administration has already set targets for the US to achieve a 100% clean energy economy and net-zero emissions no later than 2050 along with concrete steps for the US to rejoin the Paris Agreement on Climate Change. Consistent with the SEC’s longstanding practice of accommodating foreign private issuers with respect to enhanced disclosure requirements, it is expected that ESG matters will at the very least have more prominent consideration in an SEC led by a chair nominated by President Biden.

Shifts by the SEC towards more prescriptive climate-related disclosure can be expected to mirror changes by regulators across the world. In the United Kingdom, companies are required to disclose global emissions in their annual reports as well as information regarding environmental matters. For example, companies are required to state the annual quantity of emissions in tonnes of CO_2 equivalent from activities for which the company is responsible. Changes were also adopted in December 2020 by the FCA to enhance the quality and consistency of climate-related risk and risk management disclosures in public reporting. Premium listed commercial companies (in accordance with the recommendations of the Task Force on Climate-Related Financial Disclosures) on the London Stock Exchange will be required to include climate-related disclosures in their public reporting on a "comply or explain" basis.

OUR TAKE

We expect ESG to be a key area of movement for the SEC in the coming years starting this year, particularly in light of the Biden administration's environmental focus and increasing pressure from legislators across the country. While we believe that the principles-based disclosures that have been embraced to date have been an appropriate and flexible framework, prescriptive climate and other ESG-related risk disclosures are likely to be given greater consideration than they have to date, in line with ESG disclosure obligations and trends around the world, such as in the United Kingdom.

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If you have any questions, or would like to know how this might affect your business, phone, or email these key contacts.

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