AUSTRALIAN IPO REVIEW 2021: KEY US SECURITIES DEVELOPMENTS

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Legal Briefings – By **Tom O'Neill, John O'Donnell, Jin Kong, Kelechi Okengwu and Elizabeth Bramon**

ESG – "E" TAKES GREATER PRIORITY IN THE UNITED STATES WITH MORE "S" AND "G" AS WELL

With the change of the US Administration in January 2021, climate change has yet again assumed a central role in US government policy with the United States re–committing itself to, most importantly, the Paris Agreement. The Biden Administration in October 2021 released its Roadmap to Address Climate–Related Financial Risk which sets out the Administration's vision for a "whole of government" perspective on climate financial risks and on a net zero, clean energy future. Other key developments in the United States have included the release in October 2021 by the US Financial Stability Oversight Council (the FSOC) of its Report on Climate-Related Financial Risk, which, for the first time, has identified climate change as an "emerging threat to the financial stability of the United States" and, among other things, reviews how FSOC members incorporate climate-related financial risk management into their regulated activities. The US Department of Labor has also proposed in October 2021 rules removing obstacles implemented by the Trump administration which are expected to facilitate focus on ESG concerns when selecting investments and exercising shareholder rights.

There have been significant initiatives under the new leadership at the US Securities and Exchange Commission (the SEC or Commission) and under US stock exchanges rules that have or will more directly affect the securities markets and foreign issuers of securities, including climate–related and other "S" and "G" disclosure and governance matters.

In March 2021, the SEC announced the creation of a Climate and ESG Task Force in the Division of Enforcement with 22 members. It is tasked with developing initiatives to proactively identify ESG–related misconduct. The initial focus has been on identifying material gaps or misstatements in issuers' disclosure of climate risks under existing SEC rules. The Climate and ESG Task Force is also focusing on analysing disclosure and compliance issues relating to investment advisors' and funds' ESG strategies. Climate–related risks were also identified as a priority for the SEC's Division of Examinations. In the course of a step–up of comment letters issued by the Division of Corporation Finance (CorpFin) on annual reports and other SEC filings, CorpFin in September 2021 published a sample comment letter highlighting comments that it may issue to SEC registrants regarding their climate change disclosures or the lack thereof. Like past guidance issued by the SEC in 2010, and consistent with principles outlined in later 2018 guidance applicable to emerging or uncertain risks in the cybersecurity area, the sample comment letter takes a principles and materiality–based approach. It notes that the most affected areas of disclosure are likely to be contained in the business description, legal proceedings, risk factors and management's discussion and analysis of results of operation and financial condition (MD&A).

CorpFin is also preparing proposed new climate change disclosure rules which are expected to be ready in early 2022. In flagging the potential content of the new rules in remarks in July 2021, SEC Chair Gary Gensler likened the new rules to such watershed historical disclosure milestones as the addition of risk factor requirements in 1964, MD&A in 1980 and stock compensation in the 1990s.

While the proposed rules have not been published, Chair Gensler's remarks in July have given a window into what we might expect:

- disclosures are likely to be mandatory and not voluntary;
- disclosures are likely to be required in SEC filings rather than separate sustainability or other reports;
- both qualitative and quantitative disclosures are likely to be required, including metrics and progress towards goals, in service of the objective of consistent and comparable disclosure;
- the rules may have as one of their bases the Task Force on Climate–Related Financial Disclosures (TCFD) framework, similar to many non–US disclosure regimes; and
- advertised names of funds and claims as to "green" progress may need to be backed up and explained, including potentially presenting the data on which they are based.

Two significant developments outside of the “E” in ESG include the SEC’s expression in September 2021 of its continued interest in human capital management disclosures and potential rulemaking on this topic. The new rules could deal with such matters as compensation, benefits, workforce demographics (including diversity), turnover, skills and development training as well as health and safety. Also, the SEC approved in August 2021 Nasdaq’s board diversity proposal, which is a “comply or explain” requirement requiring most companies to have two diverse directors or to explain why they do not, although foreign issuers are accorded greater flexibility.

OUR TAKE

All proposed rulemaking by the SEC on ESG matters will be the subject of public comment periods where the proposals are likely to attract a large amount of comments and a wide divergence of views, and will be the subject of behind–the–scenes lobbying. It appears from a variety of its statements last year that the SEC is more inclined to entertain specific frameworks of quantitative disclosures in service of the principles of consistency and comparability across public companies, but it is impossible to believe that the new rules will not – as we believe they should – at some level remain principles–based and based on the concept of materiality. In addition, like the Nasdaq diversity rule, and similar to the approach taken by regulators in many non-US jurisdictions, the SEC may use the “comply or explain” principle in its 2022 rulemaking on ESG topics to bridge divergent views. As is often the case, as disclosure practices become embedded in public offerings in the United States, they gradually make their way into disclosure practices in the cross-border Rule 144A market.

SPACS IN 2021/2022 – SUCCESSES AND CHALLENGES WITH MORE TO COME

2021 was a record year for SPACs in the United States, but an uneven one across the different quarters and with a significant evolution of IPO deal terms as the year progressed. A booming first quarter was followed by a much more subdued second quarter (largely in response to regulatory developments) but a stronger finish, especially in the fourth quarter. The market for de–SPAC transactions also remained strong during the year with evolving deal terms. Outside the United States, 2021 was a year of first–time SPAC IPOs on a variety of exchanges including Hong Kong, Singapore, the Netherlands and the United Kingdom as well as cross–border de–SPAC transactions, mostly but not exclusively by SPACs that had conducted their IPOs in the United States with targets therefore becoming US public companies.

But 2021 was also the year that has foreshadowed expected major regulatory change in the United States.

In March, the SEC took the unusual step of warning retail investors about the dangers of investing in celebrity–sponsored SPACs. Then in April, the SEC cracked down on the market–wide practice of not accounting for the warrants that SPACs issue as liabilities on their balance sheets, which killed off most of the market in the second quarter. An influential SEC Investor Advisory Committee made several non–binding disclosure recommendations around such matters as the role of the SPAC sponsor; the economics of the "promote" and impact on dilution; a clearer description of the SPAC process as well as the intended target and means of value appreciation; the pressures involved in finding the right target; the range of acceptable terms for future "PIPEs"; the sponsor's manner of assessing the target and the sponsor's commitment as to pre-de-SPAC due diligence. In his accompanying comments, Chair Gensler noted the SEC was particularly focused on dilution, ensuring that all investors are protected and understanding through economic analysis how investors are advantaged and disadvantaged.

Much of the SEC's statements throughout the year have reflected a perception that de–SPAC transactions enjoy preferential treatment under the US securities laws as opposed to traditional IPOs, that SPACs present risks for retail investors and that de–SPACs should in effect not be considered as merger and acquisition transactions but as traditional IPOs. Of particular focus have been the rules governing publicity, the "safe harbours" governing inclusion of financial projections in de–SPAC prospectuses that do not apply to IPOs and the absence of traditional "gatekeepers" (e.g. IPO underwriters) in the de–SPAC process. The SEC has stated that SPAC regulatory reform is on its agenda and that it may propose new rules in 2022, possibly as early as April.

However, significant potential regulatory developments are not limited to potential SEC rulemaking. Two bills regarding SPACs have passed the House Committee on Financial Services and await full House action. One is aimed at eliminating disparities between de–SPACs and traditional IPOs in the use of forward-looking information. The other, more controversially, would prohibit retail investors from investing in SPACs unless certain conditions are met. In 2022, the Southern District of New York is expected to issue a decision in a lawsuit brought by a former SEC Commissioner urging that SPACs be regulated as investment companies under the Investment Company Act of 1940. The SEC has brought several enforcement actions regarding SPACs and it is a topic that remains firmly on the enforcement agenda for 2022. The most high profile of these cases involve material misstatements or omissions and the lack of due diligence in the de–SPAC process (which was exacerbated by the lack of gatekeepers). In October, Digital World Acquisition Corp. announced its de–SPAC transaction with Trump Media & Technology Group Corp. and in early November it disclosed that it received voluntary information and document requests from the SEC relating to communications between the SPAC and the target. There has been a significant increase in SPAC–related securities class action lawsuits, and in January 2022 there was a significant decision by the Delaware courts on breach of fiduciary duty and the application of the entire fairness standard of review.

OUR TAKE
In 2021 the SPAC market was called upon to respond to numerous regulatory and market challenges, and yet 2021 was a record year for SPACs. We expect the level of regulatory scrutiny will increase further in 2022 and regulation will become more concrete, culminating in SEC–proposed rulemaking which will be the subject of vigorous comment. Based on the SEC's formal and informal statements during the course of 2021, we expect regulatory focus will be on many of the non–binding recommendations of the SEC's Investor Advisory Committee – dilution, cost and structure – the disparities between de–SPACs and traditional IPOs, as well as the disadvantages of SPACs that may be identified during the economic analysis that the SEC has said it will conduct.

OTHER SEC ENFORCEMENT PRIORITIES

The SEC has articulated a detailed enforcement agenda for 2022 beyond what has been previously mentioned regarding ESG and SPACs.

On 18 November 2021, it released its enforcement results for the fiscal year ended 30 September 2021. Challenges to the agency persisted as the Covid-19 pandemic continued to impact the status quo: the SEC reported filing 697 total actions for the year – down 3% from FY 2020 and down 19% from FY 2019. But standalone actions – new actions not tied to other matters – were up slightly in 2021: 434 standalone actions were filed in 2022 as compared to 405 actions in 2020, a 7% increase. The release, combined with recent statements by Chair Gensler and Enforcement Director Gurbir S. Grewal, reflects the SEC's enforcement priorities. In a word, the priority is to be aggressive. As Chair Gensler stated: "As these results show, we go after misconduct wherever we find it in the financial system, holding individuals and companies accountable, without fear or favour, across the US$100–plus trillion capital markets we oversee." The SEC's release observes that it filed many "first–of–their–kind enforcement actions" in areas that Chair Gensler has repeatedly emphasised as being priorities.

Indeed, the Commission touted recent actions involving financial fraud and issuer disclosure, improper conduct by investment professionals, market integrity, FCPA, and fraudulent securities offerings, among others. The following additional priorities merit attention.

CRYPTO MARKETS

In his September 2021 Testimony Before the United States Senate Committee on Banking, Housing and Urban Affairs, Chair Gensler observed that there was not enough investor protection in the crypto market, noting that the market is "more like the Wild West or the old world of 'buyer beware' that existed before the securities laws were enacted." During the fiscal year, the SEC has focused on cases alleging that digital assets met the definition of a security and were required to be registered with the Commission before being offered or sold to investors. Of note, the SEC charged several entities and individuals with unregistered and / or fraudulent offerings of digital asset securities, including the first enforcement action involving securities purportedly using decentralised finance (DeFi) technology and governance tokens. Regarding digital asset exchanges, Chair Gensler has made clear that he believes that a large portion of them are operating as unregistered securities exchanges. We expect that the SEC will continue to aggressively pursue the offer and sale of unregistered digital assets and unregistered exchanges.

INSIDER TRADING

Although the overall number of insider trading cases decreased from the prior year, insider trading remains a high priority for the SEC. This year, the SEC pursued its first enforcement action involving the selling of “insider tips” on the dark web, and brought a case against an executive on a novel theory of “shadow trading”.

In addition, the SEC is considering proposed amendments to Rule 10b5–1, including new disclosure requirements, to address gaps in how companies and company insiders – chief executive officers, chief financial officers, other executives, directors, and senior officers – trade in company shares. Specifically, the proposals establish a number of new disclosure requirements for issuers about (a) any trading plans adopted during the reporting quarter; (b) insider trading policies and procedures and (c) the granting of spring–loaded options to executives.

GATEKEEPERS

In an October address to lawyers in the SEC enforcement bar, Director Grewal emphasised the need to hold “gatekeepers” accountable, stating: “When gatekeepers are living up to their obligations, they serve as the first lines of defence against misconduct. But when they don’t, investors, market integrity and public trust all suffer.” Mr. Grewal cited recent cases against attorneys and accountants as evidence of the Commission’s resolve to hold gatekeepers’ feet to the fire.

POLICY CHANGES AT THE ENFORCEMENT DIVISION

Director Grewal has also announced a number of policy changes in support of the aggressive approach to enforcement. One of the most noteworthy of these is a return to the policy of requiring a respondent to an SEC action to admit wrongdoing in appropriate cases. Prior to 2012, virtually all SEC cases were settled on the basis that the respondent neither admitted nor denied the allegations. In recent years, there has been shifting emphasis on the need for admissions, depending on the current chairperson of the Commission. Under Messrs. Gensler and Grewal, it is clear that the approach will be an aggressive one and that admissions will be required in certain cases.

Director Grewal has also indicated that the agency will increasingly seek to impose officer and director bars in cases involving scienter–based violations, including against individuals who are not currently officers or directors of public companies. He also reiterated the importance of other agency “tools” and “remedies,” including conduct based injunctions, and undertakings by the enforcement target, such as an agreement to hire an independent compliance consultant.

OUR TAKE

Since President Biden took office in January 2021, and then appointed Mr. Gensler as Chair of the SEC, there has been a steady drumbeat of tough talk from the agency about aggressive enforcement. Although the SEC's enforcement actions in FY 2021 represented a decrease in total enforcement actions from prior years, that decrease should not be viewed as a sign of leniency, but rather driven by the Covid-19 pandemic–related side effects. Indeed, contemporaneously with the annual enforcement report, the SEC also announced that whistleblower tips skyrocketed – the SEC received 12,210 tips in fiscal 2021, a 76% increase over the prior fiscal year, and awarded US$564 million in whistleblower awards to 108 individuals. This level of whistleblower activity forebodes a significant increase in enforcement activity. Thus, in FY 2022, companies should build well–rounded compliance programs, focus on internal controls and required disclosures, and stay alert in a fast–developing regulatory environment, especially pertaining to SPACs, ESG and crypto.

CHINA–BASED ISSUERS CONTINUE TO FACE OBSTACLES TO LISTING IN THE UNITED STATES

Last year we reported on the increasing attention that companies based in, or with the majority of their operations in, China (China–based Issuers) received from US authorities in 2020. That year marked the passage of the Holding Foreign Companies Accountable Act (HFCAA), which required companies to be delisted from US exchanges if the jurisdiction in which their reporting auditors are based prevents the Public Company Accounting Oversight Board (PCAOB) from inspecting their audit papers for three consecutive years – a law which affects primarily China–based Issuers. At the same time, 2020 also marked the beginning of a wave of delistings pursuant to Executive Orders of China–based Issuers with alleged ties to the Chinese military. Overall, recent years have seen increasing regulatory scrutiny of Chinese companies against an often–tense political backdrop.

The trends of 2020 largely continued in 2021. In 2021, the SEC finalised its rules under the HFCAA, which implement the mechanisms by which the SEC can identify registrants that may become delisted on the basis of the PCAOB's non–access. Based on the timings of the final rule, such delistings would be possible from 2024. The final rules also require such registrants to submit documentation to the SEC showing that the registrant is not owned or controlled by a foreign governmental entity. A foreign issuer must also make disclosures in its annual report regarding its audit arrangements and any government influence on the issuer.

In addition, the SEC Chair Gary Gensler has asked the SEC Staff to seek certain disclosures from China–based Issuers seeking to register shares. This aims to help investors understand the risks of the Variable Interest Entity structure that many Chinese companies use to list in the United States (given that direct listings of certain China–based Issuers in the United States are not permitted by the Chinese government for certain industries, an offshore shell is created for listing). Disclosures that a China–based Issuer may later be delisted under the HFCAA are now also required. Chair Gensler has also asked the Staff to "engage in targeted additional reviews of filings for companies with significant China–based operations," further signalling that China–based Issuers remain under the microscope.

For its part, the Chinese regulatory authorities also took steps to make Chinese and Hong Kong exchanges more attractive venues for Chinese companies' listings. For example, in 2021 Chinese authorities announced that government approval would be required prior to an "overseas" listing for technology companies holding the data of more than one million users. These rules take effect in February 2022, and would provide the Chinese government with a veto right over a Chinese tech company's proposed listing in the United States, for example, but not Hong Kong.

OUR TAKE

The relationship between the United States and China continues to be competitive, dynamic and sometimes conflicting, and the implications for China–based Issuers seeking a listing in the United States can accordingly be complex. This can create a regulatory environment for China–based Issuers that makes listing on Chinese or Hong Kong exchanges increasingly attractive to such issuers. Indeed, we have been seeing more US–listed Chinese companies seek secondary or, following a recent Hong Kong rule change, dual primary listings in Hong Kong. In the past few years Hong Kong has been a popular venue for primary and secondary listings of China–based Issuers that would otherwise have a sole listing in the United States – a trend we expect to continue.

SEC SETS SIGHTS ON "GAMIFICATION" OF RETAIL INVESTING APPS

The beginning of 2021 saw a massive and unexpected price surge in the shares of the NYSE listed gaming company GameStop, as a result of a "short squeeze" coordinated through social media by retail investors. Although the price jump spawned gleeful headlines and Twitter posts, it came to a shuddering halt on 28 January when the app–based trading platform used to execute the investors' trades, Robinhood, temporarily suspended its users' ability to place trades in GameStop.

This suspension immediately raised outcry from investors, but also ratcheted up concerns from lawmakers and regulators over the relationships that app–based brokerage firms like Robinhood have with their retail investors.

One popular feature of such apps has drawn special regulatory interest since the GameStop incident: the “gamification” of trading. Gamification tactics enhance securities trading with game–like features, such as colourful, interactive displays and notifications, which may be used to attract and retain often young and inexperienced retail traders, and to encourage more active trading. One reason regulators may become concerned is when such features have the potential to distort investor behaviour and create conflicts between the apps’ interests and investors’. For example, the Financial Industry Regulatory Authority (FINRA) has noted its concern that broker–dealer apps that “include interactive and ‘gamelike’ features, as well as related forms of advertising and marketing” may, if improperly designed, risk falling afoul of compliance obligations such as disclosure rules and fiduciary responsibilities. This is particularly concerning, FINRA suggested, in light of the influx of new retail investors during the pandemic.

In August 2021 the SEC signalled its interest in understanding the potential risks of gamification by seeking public comment on this and other practices by digital trading platforms. While some of the comments received pointed to the potentially distortive – and destructive – behaviours that gamification can enable in inexperienced investors, some also noted how the apps have successfully provided access to underserved investors, helping to reach more people and democratise the field of investing. These contrasting perspectives, together with the popularity of apps such as Robinhood, illustrate the difficulty that the SEC will face if it now decides to engage in rulemaking to limit gamification.

OUR TAKE

The regulatory and political scrutiny given to the gamification phenomenon makes it seem unlikely that the SEC will choose to do nothing to address the gamification of retail trading apps. At the same time, the SEC must strike a careful balance to ensure that any regulation of such apps will respect retail investors’ need for access to the securities markets. This makes the regulation of retail trading apps a space to watch, as we would expect not only a dynamic regulatory framework here, but potentially technological changes as well, as the digital trading format matures.

PROPOSED MOVE FROM T+2 SETTLEMENT TO T+1 SETTLEMENT

In February 2021, the Depository Trust & Clearing Corporation (DTCC), which facilitates the clearing and settlement of securities in the US markets, announced a proposal to shift from T+2 settlement to T+1 settlement in the coming years.

Having successfully accelerated settlement from T+3 to T+2 in 2017, DTCC now suggests that the move to T+1 would further reduce settlement risk, enhance market efficiency and help free up liquidity that would otherwise need to be set aside until the completion of a trade. While DTCC itself cannot unilaterally alter the settlement cycle, during 2021 it was actively engaging with industry participants and trade associations to move away from the current T+2 market practice. More recently, in February 2022, the SEC proposed a rule change to shorten the settlement cycle to T+1 and will be seeking public comment on the move until April 2022. Any move to a T+1 settlement cycle would not occur until 2024 at the earliest.

In the more distant future, while accelerating settlement to T+0 may be “more aspirational” at this stage, according to DTCC’s CEO Michael Bodson, DTCC’s existing technology would already allow for trades to settle on the trade date. Since 2016 DTCC has also been exploring the potential for distributed ledger technology, such as blockchain, to be incorporated into the settlement process – a project it continued to explore actively in 2021, and likely will for the foreseeable future.

OUR TAKE

While the DTCC settlement cycle will remain at T+2 for at least the next two years, DTCC’s (and indeed the SEC’s) increasing focus on accelerating settlement and employing emerging technologies may prompt other major securities markets to explore the same. The next year will likely be a critical time for refining the approach to T+1 in the US markets and to gauge reactions to the proposal by market participants in both the United States and offshore.

KEY CONTACTS

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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