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2019 AUSTRALIAN IPO REVIEW: KEY US SECURITIES DEVELOPMENTS

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US REGULATORS BALANCE PRINCIPLE BASED DISCLOSURE WITH A GREATER FOCUS ON KEY DISCLOSURE TOPICS

The US capital markets continue to provide a valuable source of funding for Australian companies. Larger Australian IPOs and capital raisings continue to be structured to access US investors and our securities practice has enabled us to act for issuer and underwriter on both the Australian and US law aspects of equity and debt offerings in 2019.

Developments in US federal securities law and regulation and, more generally, the policy direction of US lawmakers and the US Securities and Exchange Commission (the **SEC**) have significant implications for securities offering execution practices around the world, both in the context of IPOs and other offerings registered with the SEC, as well as offerings exempt from SEC registration undertaken pursuant to Rule 144A and as traditional private placements. All of these offering structures are used by Australian issuers.

The past year has seen the SEC continue its efforts to adopt a more principles based disclosure regime with a focus on certain key disclosure topics:

- maintained emphasis on cybersecurity risks, including setting expectations that internal accounting and other controls should take such risks into account, plus new guidance on how to identify cybersecurity and related risks;
- ongoing modernisation of the disclosure regime under the primary disclosure regulations, Regulation S-K and Regulation S-X;

- proposals to simplify bank issuers' industry information by rethinking the current Industry Guide 3 information; and
- generally maintaining a principles based approach for ESG disclosure, albeit against a backdrop of increasing pressure for more prescriptive disclosure from investors and a reminder that material ESG issues must be disclosed.

The year has also seen a number of significant developments to promote capital formation, including:

- opening "test the waters" communications to all issuers, allowing companies considering a US offering to gauge sophisticated US investor appetite prior to a formal launch of the offering;
- proposals to consider changes to the definitions of Accredited Investors and Qualified Institutional Buyers, potentially widening the pool of investors available under the most common offering exemptions.

In 2020, we expect the SEC to continue its disclosure modernisation efforts and move further towards a principles based disclosure regime. However, the SEC's focus on cybersecurity, intellectual property and ESG disclosure indicates that it will place even greater emphasis on how issuers apply these principles to determine materiality.

CYBERSECURITY AND INTELLECTUAL PROPERTY RISKS: EMPHASIS ON DISCLOSURE AND INTERNAL CONTROLS

According to SEC Chairman Jay Clayton in October 2019, cybersecurity issues remain a priority for the SEC as public companies continue to experience damaging attacks to their computer systems and the theft of large amounts of personal information about their customers. In 2019, the SEC concentrated particularly on cyber resiliency, with the release of a report in January 2020 reflecting its latest observations on cybersecurity and resiliency practices. Amongst its key observations, the SEC highlighted the importance of frequent routine testing and monitoring of cybersecurity policies and procedures as well as the need to promptly adapt and update internal procedures to address any gaps or weaknesses in these policies. According to Chairman Clayton, "people need to understand you [referring to companies] are not only trying to protect what you have, but also be in a position that if something happens, you can rebuild it and get back to a functioning mode."

Some corporate governance professionals and investors have been advocating for a requirement that one member of corporate boards be a cybersecurity expert. A subcommittee of the SEC's Investor Advisory Committee discussed about two years ago whether the SEC should require public companies to include information about whether any member of the board has experience, education, or expertise in cybersecurity and if it does not, explain why it believes it is not necessary for the company to adequately manage cybersecurity risks. Given Chairman Clayton's comments, the SEC seems poised to continue reviewing cybersecurity risks.

The SEC also focussed on disclosure obligations that companies should consider relating to intellectual property and technology risks associated with international business operations, particularly in jurisdictions that do not have levels of protection comparable to US protections for corporate proprietary information and assets. In December 2019, the SEC division of corporate finance issued guidance (the **IPT Guidance**) identifying sources of international intellectual property and technology risk, such as direct intrusions by private parties and foreign actors, including those affiliated with or controlled by state actors, through both cyber intrusions and physical theft. In addition, the IPT Guidance discussed sources of indirect risks—such as reverse engineering by joint venture partners or other parties, as well as requirements to compromise protections or yield rights to technology, data or intellectual property—that companies may face in order to conduct business or access markets in foreign jurisdictions.

OUR TAKE

The disclosure of cybersecurity risks and an issuer's maintenance of internal controls to protect against cyberattacks will continue to be a major focus for the SEC. In October 2019, SEC Chairman Clayton indicated that the SEC's Division of Corporation Finance is closely monitoring cyber-related disclosures to make sure issuers are accurately describing the risks related to cybersecurity, which includes an indication of whether or not an issuer has experienced a data breach due to a cyberattack. These risks also include, according to Chairman Clayton, the potential lack of protection of intellectual property. The SEC has also recently cautioned public companies to be mindful of cyber threats when designing and maintaining internal accounting controls.

THE MODERNISATION OF THE SEC'S DISCLOSURE REGIME CONTINUES

Over the last several years, through concept releases and other legislative mandates, the SEC has sought to modernise its business and financial disclosure requirements. These modernisation efforts have mainly been focussed on making the SEC's disclosure requirements be more principles-based and generally less prescriptive.

2019 saw significant progress in this ongoing modernization effort. In May 2019, changes came into effect limiting discussion of financial results in the Management's Discussion and Analysis of Financial Condition and Results of Operations (**MD&A**) disclosure to two years rather than three (provided that the earliest omitted year is discussed in a previous SEC filing, and its omission would not be misleading). Also in May, the SEC proposed changes to Rule 3-05 of Regulation S-X, which currently requires that a registrant that acquires a significant business provide separate financial statements for the target. The number of years of financial statements to be provided depends on one of three tests: the investment test, the asset test, or the income test. The proposed amendments would adjust and simplify the calculations for these tests to help reduce complexity and financial statement preparation costs without sacrificing material information that investors may need to evaluate these transactions.

On 8 August 2019, the SEC issued proposed amendments to Item 101 (Business Description), Item 103 (Legal Proceedings) and Item 105 (Risk Factors) of Regulation S-K. The proposed amendments to Items 101(a) (description of the general development of the business), 101(c) (narrative description of the business), and 105 (risk factors) emphasize a more principles-based approach because, according to the SEC, the current disclosure requirements may not reflect what is material to every business, and, as past developments have demonstrated, disclosure requirements, and in particular prescriptive disclosure requirements, can become outdated in these areas. In contrast, the proposed changes to Item 103 (Legal Proceedings) call for a more prescriptive approach because that requirement depends less on the specific characteristics of individual registrants.

On 30 January, 2020 the SEC further proposed amendments to certain financial disclosure requirements in Regulation S-K, including amendments to Item 303 (the MD&A). The key proposed changes to Item 303 include the following:

- eliminating the specific requirement to discuss the impact of inflation and price changes, though a discussion of such matters would still be required if the trend shows they have had or are reasonably expected to have a material impact on net sales, revenue or income from continuing operations;

- replacing the requirement that a registrant discuss off-balance sheet arrangements with a requirement to integrate disclosure of off-balance sheet arrangements within the broader context of MD&A;

- eliminating the requirement to provide a contractual obligations table;

- permitting registrants to compare the most recently completed quarter to either the corresponding quarter of the prior year, as currently mandated, or to the immediately preceding quarter; and

- requiring disclosure of critical accounting estimates.

OUR TAKE
We would expect the SEC’s proposals to Regulation S-K and Regulation S-X to be substantially adopted in the form proposed. Ideally, the amendments will lead to a greater degree of consistency between SEC and international disclosure standards, and give issuers greater flexibility to disclose material information in the manner they see fit. For foreign private issuers that are subject to SEC’s reporting requirements, the proposed changes to the financial statement requirements for acquired entities (under Rule 3-05 of Regulation S-X) should be particularly helpful as they are likely to reduce the circumstances in which additional target financial statements would be required to be provided, and to simplify the application of rules that have become increasingly complex.

"TESTING THE WATERS" BECOMES AVAILABLE FOR ALL COMPANIES

In September 2019, the SEC adopted Rule 163B, which permits any issuer, or those working on an issuer's behalf, such as an underwriter, to "test the waters" among certain investors to gauge appetite for a potential registered offering in the United States before filing a registration statement.

Prior to the adoption of this rule, issuers had limited ability to communicate with investors prior to filing a registration statement and launching a public offering. Some issuers with less than US$1.07 billion in annual revenue—Emerging Growth Companies (**EGCs**) —could "test the waters" with Qualified Institutional Buyers (**QIBs**) and Institutional Accredited Investors (**IAIs**) before launching an offering without running afoul of the US securities laws. All other issuers were barred from any written or oral communications with investors prior to filing a registration statement.

Now, with the adoption of Rule 163B, all issuers have the ability to approach investors they reasonably believe to be QIBs and IAIs in order to conduct market soundings prior to undertaking a registration statement filing with the SEC. The communications made with these investors will not need to be filed with the SEC or have specific legends on them.

However, issuers using Rule 163B should be aware of several important features of their communications with QIBs and AIs. First, "test the waters" communications are considered "offers" under Section 5 of the *US Securities Act of 1933* (the **Securities Act**) and are subject to liability for materially deficient disclosure, such as the Section 12(a)(2) of the *Securities Act* and the antifraud regime under Rule 10b-5 of the *US Exchange Act of 1934*. As a result, "test the waters" information should be reviewed carefully for any misleading or incorrect information or omissions, and material consistency with a later registration statement or prospectus. For US domestic reporting issuers, the information would also be subject to Regulation FD's requirement to disclose material non-public information that has been selectively disclosed to certain market participants (although Regulation FD does not apply to most non-US issuers, in practice many choose to comply as a result of home jurisdiction requirements).

OUR TAKE

The SEC's liberalization of the "test the waters" regime is a welcome development that levels the playing field between EGC and non-EGC issuers and should facilitate capital formation. Early investor meetings can provide an opportunity for issuers to gauge investor demand for the purposes of determining offer size and other terms, which can result in a more efficient offering process and a higher likelihood of success. Early investor feedback can also have potential financial and reputational cost savings (in the event the issuer decides, after the investor feedback, to not file the registration statement).

However, we would expect that, as has been the case in capital markets outside the US, the content of communications and the selection of relationship QIBs/IAIs that receive them will be tightly controlled. For example, it is likely that the working group will limit information included in any "test the waters" communications to that which can be later included in the registration statement/prospectus. This would in our view be a sound practice.

DISCLOSURE OF BANK ISSUERS' INDUSTRY INFORMATION MAY BECOME LESS ONEROUS

In September 2019, the SEC proposed changes to its Industry Guide 3, which requires bank holding companies to provide detailed statistical disclosures in prospectuses for SEC-registered offerings and ongoing reporting, and which serves as the starting point for similar disclosure in private offerings, such as Rule 144A private placements.

Changes to the Industry Guide 3 are arguably long overdue, with the last major update over 30 years ago. One of the main focusses of discontent among issuers following Guide 3 disclosure standards has been the burden for non-US bank issuers in preparing their disclosure when using non-US GAAP financial standards. Notwithstanding modest increases in overlap between US GAAP and IFRS since the introduction of Guide 3, it was written with US GAAP in mind with relatively little flexibility for issuers whose financial information is prepared in local GAAP or IFRS.

The SEC has accordingly proposed to revise its requirements for Guide 3 disclosure by, among other things:

- confirming that the guidance applies to foreign bank issuers, which the SEC believes under the proposed rules will have sufficient flexibility to comply notwithstanding certain differences between US GAAP and IFRS;
- reducing Guide 3 annual reporting periods to match the reporting periods for the financial statements included in a prospectus;

- requiring disclosure of specific credit ratios in relation to allowances for loan losses;
- eliminating many (but not all) of the investment securities and loan portfolio disclosures currently required under Guide 3 (given the overlap with US GAAP / IFRS requirements);
- requiring new disclosure of the level of uninsured deposits at the end of each reporting period, as well as separate data for repurchase (repo) transactions; and
- codifying the revised Industry Guide 3 as part of Regulation S-K.

OUR TAKE
The SEC's proposals, if enacted, would not in our view represent a sea change, but they do create a more focussed approach on the metrics which drive net income generation, credit risk and funding risk. With respect to foreign private issuers in particular, the proposed rules address some of the challenges foreign banks have faced in providing the disclosures, by introducing more flexibility, linking disclosures to IFRS financial statements and exempting foreign private issuers from certain requirements that are not applicable under IFRS. In this sense they are very welcome developments for foreign private issuers.

WHAT IS AN "AI" OR "QIB"? THE ANSWER MAY CHANGE

The terms "AI" and "QIB" are staples in the US private offering landscape: Accredited Investors (**AIs**) are generally individual investors with high net worth or income or entities that meet the minimum requirements for some Regulation D private placements. QIBs are the largest institutional investors handling millions of dollars in investments, and are the target investors for a Rule 144A private placement. Together, AIs and QIBs are the target investors for the most commonly used US private offering exemptions.

In December 2019, the SEC proposed amendments to the definitions of AI and QIB to provide clarification and to expand the scope of eligible investors. Under the existing rules, individuals may be AIs if they have, individually or with a spouse, net worth of more than US$1 million or income over US$200,000 (US$300,000 jointly with a spouse). Under the proposals, individuals could qualify for AI status based on their financial expertise, certain professional certifications or designations, or their status as a private fund's "knowledgeable employee" (irrespective of net worth or income). The proposal would also permit entities meeting an investments test to qualify as AIs, as well as family offices with at least US$5 million in assets under management and their family clients.

Under existing rules, QIBs are certain entities that own and invest at least US$100 million in unaffiliated investments (other, lower thresholds are available for some types of entities). The SEC's recent proposal adds, among other things, additional categories of entities that can meet the US$100 million threshold, including limited liability companies and any other entity type not already listed in the definition, clarifying that all entities—not only those listed in the definition—that meet the US$100 million threshold may be QIBs, a point that had previously been left to doubt.

The proposals are open for comment until 16 March, 2020 with the SEC to consider any final rules after that time.

OUR TAKE

The proposals to amend the definitions of AI and QIB are part of a larger effort by the SEC to review the current private offering framework, as stated in a June 2019 SEC concept release, to open more opportunities to investors while balancing concerns about investor protection. Although the proposed changes to the definition of QIB serve mainly to clarify the existing scope rather than reinvent the wheel, and would not cause a major shift in Rule 144A practice, the proposed changes to the AI definition would make it easier for more individuals to qualify, which could potentially widen the availability of the Rule 506(b) and 506(c) private offering exemptions under Regulation D. Issuers should expect further, similar changes in the coming years to the US private offering exemptions.

INCREASING FOCUS ON ESG IS LIKELY HERE TO STAY

2019 saw a noticeable increase in attention given to ESG matters. More than ever, the public and investors alike are voicing questions in particular on how companies are responding to their environmental impacts and the push for diversity and inclusion within those companies. Investors' demand for information as well as scientific and social realities are increasingly suggesting that issuers should devote serious consideration to whether and how to disclose ESG matters.

The SEC and industry bodies have also taken note of the increased focus in recent years, with ESG featuring in a number of statements from certain SEC commissioners. In response to recent SEC proposals to amend the primary disclosure regulation, Regulation S-K, SEC Commissioners Robert Jackson and Allison Herren Lee stated that investors view climate risk as an important factor in making investment decisions notwithstanding the current lack of specific climate risk disclosures in corporate reporting. They also do not believe that climate risk cannot be accurately quantified and noted that "Whatever one thinks about disclosure of climate risk, research shows that we are long past the point of being unable to meaningfully measure a company's sustainability profile." There have also been legislative proposals in the US House of Representatives and US Senate which, though unlikely to be passed into law in the near term, would specifically require US public companies to identify and evaluate the potential financial impact of climate change.

The SEC's overall approach, however, has been consistently "wait and see": rather than considering any prescriptive requirements for ESG disclosures, the agency has instead relied on its longstanding principles-based approach, ie, that "material" matters, including ESG matters, warrant disclosure. The SEC has justified this stance— which clashes somewhat with investor demands and emerging regulations outside the United States—out of hesitation to prescribe rules that may not work for every issuer, particularly since key metrics and third-party evaluation frameworks for ESG topics are not fixed from issuer to issuer or industry to industry, and investors are still learning how to analyse any available metrics in the wider context of an investment decision.

OUR TAKE

In 2019 ESG was, more than in any prior year, a topic of discussion among issuers, investors, and regulators alike. While we don't anticipate a firm rulemaking from the SEC in 2020 on ESG disclosures and reporting, the year will also pose an increasing opportunity for industry groups and investors to demand more information from issuers—so we anticipate more issuers providing disclosure on ESG topics than ever before.

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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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