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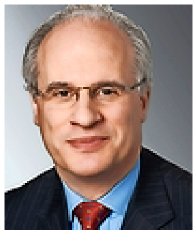
Of Unicorns, Private Companies and Public Scrutiny

SECURITIES OFFERINGS



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In children's books and fantasy literature, unicorns are mythical creatures, characterized by their rarity. In the startup world, unicorns are private companies that have been valued by investors at more than one billion dollars. Though the term was originally intended to invoke the rarity of successful startups, recent market developments have resulted in a sizeable, and growing, “Unicorn Club” or “blessing of unicorns.” There were only 39 unicorns in the United States when the term “unicorn” was first used in this context in late 2013. As of August 2017, CB Insights reported that there are 107 unicorns in the United States and 220 globally. A tracking report maintained by the Wall Street Journal follows venture capital-backed unicorns (in August 2017, the number tracked was 167), and in August 2017 noted that while the IPO market for technology companies remains “anemic” (with only six unicorns having gone public in the first seven months of 2017, and four are trading well below their first-day opening prices), investors continue to invest in venture capital funds, which in turn continue to invest in technology start-ups, including unicorns. The report also notes that the largest unicorns are getting larger. The increase in the number of unicorns reflects not only the success of startups in recent years, but also the growing frequency with which such companies opt to stay private for longer or seize acquisition opportunities rather than pursue initial public offerings, or IPOs. Indeed, scholars such as Erik P.M. Vermeulen have also described backdoor listings through reverse mergers or reverse takeovers as “a popular alternative” to IPOs.

Market developments have not only facilitated the increasing valuations that create unicorns, they have also allowed private companies to obtain capital without a pressing need for an IPO. Market uncertainty in recent years has made going public less attractive in the short term, while the exponential growth of private capital has also made IPOs less immediately necessary. Pressure from employees and funders to go public has lessened with the availability of private exchange platforms such as SecondMarket and SharesPost. In addition, examples of technology companies that had difficulty soon after their IPOs may have given private startups pause. These examples have been used by some observers to highlight the value of additional preparation, further development of business models and proven growth prior to the IPO in order to avoid an “IPO flop.” Regulatory developments have also enabled companies to stay private longer. Amendments to the 2012 Jumpstart Our Business Startups Act (the “JOBS Act”), for example, increased the thresholds that trigger the need for private companies whose securities are widely held to register that class of securities under the Securities Exchange Act of 1934 (the “Exchange Act”) and file public disclosure with the U.S. Securities and Exchange Commission (the “SEC”) as if they had undertaken an IPO in the United States. Finally, startups may seek to avoid the effort, related expense and regulatory hurdles involved in an IPO process, including the requirement to release financial information that such companies may prefer to keep private, until they determine they are sufficiently mature.

While 2017 reports of increasing IPO prospects have led some to believe that the tendency to stay private longer may be shifting, and while the new Chair of the SEC is on record as supporting reforms to encourage companies to go public, for some potential IPO candidates, there may still be significant benefits to delaying their IPO. We explore below the securities law considerations that potential IPO candidates may wish to focus on as they consider their capital markets options.

PRIVATE PLACEMENTS

The potential IPO candidate that pursues an IPO will have access to the public markets to raise additional funding and will also have access to acquisition currency by reason of its ability to offer freely transferable securities to sellers of target companies by filing a registration statement on Form S-4/F-4 without the burden of that filing being its first foray into the SEC registration process. An added benefit to going public is that the issuer will have the ability to file short-form registration statements (on Form S-8) to register share-based compensation for its employees. The IPO candidate that remains private nonetheless will have options to raise capital, to undertake certain acquisitions to build its business and to provide share-based compensation to employees, as described below.

Section 5 of the U.S. Securities Act of 1933 (the “Securities Act”) generally requires that any offer or sale of securities in the United States be registered with the SEC, unless an exemption is available. Failure to comply with the registration requirements of the Securities Act would constitute a “Section 5 violation,” which provides purchasers with potential rescission rights and exposes the issuer to possible criminal or civil sanctions for failing to register. As more fully discussed below, the primary exemptions companies that are not yet SEC reporting companies tend to rely on to avoid the Securities Act registration requirement are: (a) Section 4(a)(2) in connection with capital raising activities or acquisitions of businesses from a limited number of sellers, (b) Regulation D in connection with offers of securities to investors and employees that qualify as “accredited investors” and (c) Rule 701 in connection with grants of share-based compensation to employees and certain other classes of persons.

Section 4(a)(2)

The general private placement exemption under the Securities Act is Section 4(a)(2) (formerly Section 4(2), prior to the JOBS Act), which exempts “transactions by an issuer not involving any public offering.” One of the foundational cases interpreting Section 4(a)(2) is SEC v. Ralston Purina Co., a 1953 Supreme Court case that held that the applicability of this exemption “should turn on whether the particular class of persons affected need the protection of the [Securities] Act. An offering to those who are shown to be able to fend for themselves is a transaction ‘not involving any public offering’” (346 U.S. 119, 125 (1953)). The Court examined, among other things, whether offerees had access to the type of information that would have otherwise been available in a registration statement, and subsequent courts have also focused on the offeree's sophistication, such as “whether the offerees knew what to look for in, and how to interpret, the available information concerning the issuer's business and profit potential” (Bowers v. Columbia General Corp., 336 F. Supp. 608, 624 (D. Del. 1971)). An employee of the issuer will not be deemed a sophisticated investor because of his/her employment status alone. In contemporary practice in connection with capital raising activities or acquisitions, where there are a limited number of investors or sellers of businesses exchanging shares for shares of the acquiror, issuers typically rely on Section 4(a)(2).

Since this exemption is predicated on the fact that it is available only for private offerings, there can be no “general solicitation” or “general advertising” of the offering by the issuer or its representatives under Section 4(a)(2). In turn, this means that, with respect to the investors that are approached, there must be a substantive, pre-existing relationship with such investors. The SEC has emphasized the importance of the existence and substance of a pre-existing relationship with potential investors as a key indicator of determining if a communication is a general solicitation or constitutes general advertising. Accordingly, the presence of a pre-existing relationship between an issuer (including through agents or affiliates, such as finders or placement agents) and a potential investor is strong evidence that general solicitation or general advertisement has not occurred.

Regulation D

Regulation D is a safe harbor exemption promulgated under Section 4(a)(2) that contains several regulatory exemptions from the Securities Act registration requirements, which are set forth in Rules 504, 506(b) and 506(c) (an additional exemption, Rule 505, has been repealed). Under the integration requirements of Rule 502(a), one cannot mix Rule 504 and 506 offerings within six months of one another. A central concept of Regulation D is the definition of “accredited investor,” which includes, among others, any of (a) the directors and executive officers of the issuer, (b) persons whose individual net worth, or joint net worth with such person's spouse, exceeds $1,000,000 (not including the value of one's primary residence), and (c) persons who have an individual income in excess of $200,000 in each of the two most recent years or joint income with such person's spouse in excess of $300,000 in each of those years and has a reasonable expectation of reaching the same income level in the current year.

Rule 504 of Regulation D, which as of January 20, 2017 has a $5 million limit, permits offers and sales to non-accredited investors, but disqualifies certain bad actors. Rule 504 is only available to companies that are not reporting companies under the Exchange Act, companies that are not investment companies and companies that are not blank check companies. Rule 506(b) of Regulation D permits offers and sales by an issuer in private placements to an unlimited number of “accredited investors” and up to 35 non-accredited investors; issuers are not required to verify the investors’ accredited investor status, but cannot engage in general solicitation or general advertising. Rule 506(c), created by the JOBS Act, allows for general solicitation and general advertising and permits issuers to make offers and sales to an unlimited number of accredited investors, but with an important limitation: issuers must take reasonable steps to verify that these investors are all accredited investors. In addition, under Rule 506(c), the issuer can engage in general solicitation to determine suitability but it cannot do so if any ultimate purchasers are not accredited investors. Once an issuer starts down the Rule 506(c) path (and also gets comfortable on the Rule 506(d) disqualification provisions), it cannot then go back to relying on Rule 506(b) or Section 4(a)(2) due to having undertaken general solicitation.

Rule 701

Rule 701 provides an exemption from registration under the Securities Act for securities issued to employees (including officers, directors, partners, trustees, consultants and advisors of the issuer) pursuant to written compensatory benefit plans or written employment contracts by companies that are not then subject to the SEC reporting regime (whether they are U.S. domestic or foreign). This exemption is available only to the issuer of the securities; affiliates of the issuer may not rely on Rule 701 to offer or sell securities, although in an effort to provide support for startup companies, the Rule does apply to shares issued to employees of affiliated subsidiaries. Rule 701 is not available to exempt capital-raising efforts.

Rule 701 provides limitations on the amount of securities that can be issued in reliance on the exemption during any 12-month period. Rule 701 does not technically limit the amount of securities that may be offered in reliance on the Rule, but since securities underlying option grants must be counted as sales as of the date of the option grant (and are valued at their exercise price regardless of whether the options are subject to vesting or other restrictions), offers are in effect subject to the threshold requirements. Sales of common shares and other securities are calculated at the date of sale. The aggregate sales price for options sold in any 12-month period cannot exceed the greater of: (a) 15% of the total assets of the issuer, (b) 15% of the outstanding amount of the class of securities being sold in reliance on the Rule and (c) $1 million. If an issuer exceeds the applicable thresholds in respect of the amount of securities that can be sold, the sales in excess of the applicable threshold will not benefit from the exemption (though the issuer may be able to rely on Regulation D, if applicable).

DISCLOSURE CONSIDERATIONS

The exemptions discussed above have different disclosure requirements and, given the competitive environment that many startup companies face, some companies may prefer one type of offer over another if it means they can keep certain financial information out of the public eye until the company is better positioned for such public disclosure.

There are no specific disclosure requirements for private placements under Section 4(a)(2) or those made solely to accredited investors under Regulation D. However, as these are only exemptions from the registration requirements of the Securities Act, issuers are not exempt from the anti-fraud provisions of the U.S. securities laws, in particular Section 10(b)-5 of the Exchange Act and *Rule 10b-5* promulgated thereunder, which prohibit any act or omission resulting in fraud or deceit in the purchase or sale of securities. In addition, were non-accredited investors included in a Regulation D offering, the issuer would need to consider the disclosure necessary to comply with Regulation 502(b), which calls for financial statements and other information, to the extent material to an understanding of the issuer's business, similar to that which would be provided in a registration statement for an IPO.

The disclosure considerations for Rule 701 are more complicated. In addition to the mathematic limits as to the amount of securities that can be issued in reliance on Rule 701 noted above, if an issuer has sold more than $5 million of securities pursuant to Rule 701 in any 12-month period, the issuer is subject to specific disclosure obligations under Rule 701(e). (The $5 million figure refers to the aggregate sales price of securities sold in reliance on the Rule 701 exemption in the United States. If sales of securities do not exceed $5 million in any applicable 12-month period, the additional disclosure requirements do not apply and the issuer need only deliver a copy of the underlying plan (the Financial CHOICE Act passed by the House in June 2017 would direct the SEC to increase the Rule 701(e) threshold from $5 million to $20 million).) If sales of securities do exceed the threshold, the 701(e) disclosure obligations require, among others, the “delivery” of risk factor disclosure and recent financial information, in each case at a reasonable period prior to the date of sale (i.e., time of exercise or conversion, in the case of stock options, or the time of grant, in the case of restricted stock units). If sales of securities do not exceed $5 million in any applicable 12-month period, the additional disclosure requirements do not apply, and the issuer need only deliver a copy of the underlying plan.

The financial information to be provided pursuant to Rule 701(e) must include a balance sheet and statements of income, cash flow and shareholders’ equity, for each of the two fiscal years (or for such shorter time period that the issuer has been in existence) preceding the date of the most recent balance sheet and for any interim period between the end of the most recent of such fiscal years and the date of the most recent balance sheet being filed. Such financial statements must be prepared in accordance with U.S. Generally Accepted Accounting Principles ("U.S. GAAP") or International Financial Reporting Standards as approved by the International Accounting Standards Board ("IASB IFRS"), or, if that is not the case, a reconciliation to U.S. GAAP. It may be possible for a foreign private issuer to reconcile its financial statements to U.S. GAAP only on an annual basis, and to provide this along with its most recent unreconciled interim financial statements. The Rule is silent on this subject, so SEC staff may have authority to provide interpretive relief if an issuer chooses to request it. The financial statements that are delivered under Rule 701(e) must be no more than 180 days old. The 180-day requirement effectively means that the financial statements must be available on at least a quarterly basis, unless sales of securities (including options exercises) are limited to particular times of the year (based on the availability of the financial statements).

The SEC has recognized competitive and other concerns that issuers may have in providing financial information to employees that is not otherwise publicly available. In addressing these concerns, the SEC noted in 1999 (when it amended Rule 701 to lift a $5 million cap on Rule 701 issuances but imposed the disclosure requirement as the price for doing so) that "[i]n view of the substantial amounts of securities that may now be issued under Rule 701, we believe that a minimal level of disclosure consisting of risk factors and Regulation A unaudited financial statements is essential to meet even the lower level of information needed to inform compensatory-type investors such as employees and consultants." The SEC also noted that "[p]rivate issuers can use certain mechanisms, such as confidentiality agreements, to protect competitive information. Alternatively, an issuer could elect to stay below the $5 million threshold to avoid these disclosure obligations." Mechanisms that issuers typically use to maintain confidentiality of the financial information provided pursuant to Rule 701(e) include confidentiality provisions to which the employees are subject and the use password-protected web sites to provide access to employees. The evolution of technology, together with the heightened concerns about risks to competitive positions posed by "leaks" of financial information, has focused greater attention on mechanisms to better ensure that financial information in fact remains confidential, which mechanisms, while borrowing from SEC views on "access equals delivery" concepts, nonetheless must remain within the scope of what the SEC would consider as adequate "delivery" for rule 701(e) purposes.

Rule 701(e) disclosure must be provided to all recipients in the Rule 701 offering if the issuer believes that sales will exceed the $5 million threshold in the relevant 12-month period, not only to those who acquire securities after the issuer exceeds the $5 million threshold. Moreover, as noted above, such disclosure must be provided a reasonable period of time before the applicable date of sale. If disclosure has not been provided to all recipients before sale, the issuer will lose the exemption for the entire offering when sales exceed the $5 million threshold. There are no separate thresholds for foreign private issuers. It should be noted, as is the case with Regulation D as discussed above, Rule 701 is only an exemption from SEC registration under the Securities Act and the antifraud provisions of the securities laws, in particular Section 10(b)-5 and *Rule 10b-5*, conti nue to apply in any case, notwithstanding the limited formal requirements as to information provided.

If an issuer wishes to offer securities to non-accredited investors and does not want to comply with the disclosure requirement of Rule 701, it typically would not mix a Regulation D offering to accredited investors with a Section 4(a)(2) private placement to non-accredited investors as that could be viewed as an improper attempt to avoid complying with the information requirement of Rule 502(b). Because of the concept of integration under Regulation D, the issuer would need to rely on Section 4(a)(2) for all grants. Ultimately that implicates the information requirement: investors need the requisite sophistication and should have access to the information that otherwise would be provided under Regulation D to the extent material to an understanding of the issuer and its business. Access can be satisfied by showing actual disclosure or availability and, if relying on access absent actual disclosure, the issuer must show a privileged relationship that affords effective access.

RECENT TRENDS IN SEC FOCUS AND ISSUER APPROACHES

In summer of 2016, it was reported that the SEC had sent inquiries to a number of private, late-stage companies enquiring about their compliance with the securities laws, in particular Rule 701 issuances. These letters followed a speech given by then SEC Chair Mary Jo White in March 2016 aimed at tech startups and their sponsors, in which she noted that pre-IPO companies are not beyond the purview of the SEC and that investor protection and ensuring accurate disclosure are especially critical for companies that may not have the same internal controls and governance systems as public companies. In her speech, Chair White focused, among other things, on the accuracy of company information pre-IPO, and said:

A current feature of the pre-IPO financing market that puts these questions in sharp (and local) relief is one that has gathered considerable attention recently – unicorns. … Beyond the hype and the headlines, our collective challenge is to look past the eye-popping valuations and carefully examine the implications of this trend for investors, including employees of these companies, who are typically paid, in part, in stock and options. These are areas of concern for the SEC and, I hope, an important focus for entrepreneurs, their advisers, as well as investors. At the SEC, the questions we are asking do not fundamentally differ from the questions we ask about all transactions. They include whether the information supplied to investors is accurate and complete – that is, whether it accurately reflects the performance and prospects of the company. Making sure that is so becomes more compelling when the transactions are smaller and the investors are more retail. And, for those involved in advising, investing and nurturing unicorns, there is an important related question – how do $1 billion valuations affect all of the relevant investors – both those investing in the unicorn round, and those that came before and after, whether in private or public transactions.

That the issues surrounding Rule 701 violations are not hypothetical is underscored by the enforcement action brought by the SEC in 2005 against Google, Inc. and its general counsel for failure to comply with the disclosure requirements of Rule 701. The SEC concluded that reliance on Section 4(a)(2) was not appropriate, as Google had failed to consider the financial sophistication of the employees and in any event had failed to provide information consistent with a registration statement. Google undertook a rescission offer (in view of the potential rights of purchasers to seek rescission, though admittedly in an IPO context purchasers would be unlikely to accept the offer), but as the SEC noted the rescission offer does not cure the violation of the registration requirements. Google and its general counsel were subject to cease-and-desist orders; there were no financial penalties.

There are three principal considerations raised by this enforcement action. First, it and any number of public statements by SEC officials since highlight the fact that violations may be pursued notwithstanding the amounts involved or the fact that there was no economic harm. Second, the enforcement action and recent SEC staff focus on unicorns also underscore the importance of internal controls. Third, the enforcement action highlights the risks faced by corporate gatekeepers, in this case, Google's general counsel. There has been a noticeable trend in recent years for the SEC enforcement staff to focus on individual culpability, largely framed in terms of pursuit of corporate gatekeepers, which includes in-house counsel as well as members of audit committees and senior executives. As the then Director of the SEC Division of Enforcement noted at the time of the Google Order, "[t]he securities laws exist to ensure full disclosure to investors, including employees accepting stock options as compensation. Companies cannot freely decide that they do not need to comply with the law."

If companies are not focused on these compliance issues, they may not realize until after the fact that they violated U.S. securities laws, which then raises enforcement and rescission issues. For example, T-Mobile included the following risk factor disclosure in its IPO registration statement: "Because we may have issued stock options and shares of common stock in violation of federal and state securities laws and some of our stockholders and option holders may have a right of rescission, we intend to make a rescission offer to certain holders of shares of our common stock and options to purchase shares of our common stock." Compensation arrangements invariably receive close scrutiny by the SEC at the time of an IPO, both in terms of compliance with the registration requirements (namely compliance with the terms of available exemptions) and in terms of accounting treatment (namely, so-called "cheap stock" issues, which may prompt companies to reduce option and other grants in the period leading up to an SEC filing, in order to reduce the charge to earnings in the first reporting period after an IPO). As part of the registration statement filed in connection with an IPO, registrants must disclose all sales of securities made pursuant to an exemption from registration during the preceding three years and the basis on which the sales were made (Item 15 of Form S-1; Item 7 of Form F-1). It is not unusual as part of the SEC staff comment process for a comment to be made on this disclosure.

The price to companies for securities law violations is high. We note that, in more recent years, the SEC enforcement staff has also imposed monetary penalties for violations of the securities laws (violations of antifraud rules and shareholder notification rules), which in prior periods may well have escaped the formal attention of the staff or resulted in cease-and-desist orders. As was the case in Google, the SEC enforcement staff is known for pursuing high profile enforcement actions as a means of gaining industry attention and modifying behavior.

FOREIGN PRIVATE ISSUERS

Even in a period of somewhat fewer IPOs internationally, a number of factors have made the U.S. public markets more attractive to issuers from Europe in recent years. The JOBS Act streamlined certain aspects of the IPO process for emerging growth companies, including foreign private issuers. Market trends such as a relatively more issuer-friendly IPO process in the United States and the strength of U.S. public markets in the last few years have also led to the relative growth of the U.S. public markets.

Foreign private issuers may want to consider a few additional points that are specific to their circumstances. For example, if a foreign private issuer makes an acquisition in the United States and, as a result, plans to offer share-based compensation to target employees, or already has U.S-based employees and is offering share-based compensation, it can seek to rely on the exemption provided by Rule 701. The issuer will need to keep in mind, as stated above, that for issuers selling securities in excess of $5 million in any 12-month period, Rule 701(e) financial statements must be prepared in accordance with U.S. GAAP or IASB IFRS; otherwise the financial statements must be reconciled to U.S. GAAP. To the extent that an issuer is delaying its IPO, valuations in private rounds may increase the likelihood that the $5 million threshold is reached. Foreign private issuers incorporated in the EU, if public in their home jurisdiction, prepare their financial statements in accordance with

IFRS as published by the European Union and are likely to issue financial statements only on a semi-annual basis. These issuers will need to accommodate the Rule 701(e) requirements if they elect to rely on the exemption. Private companies considering a U.S. listing in connection with their IPOs may well have opted to prepare their financial statements in U.S. GAAP and embraced quarterly reporting. For this latter group, the key challenge will be meeting the Rule 701(e) delivery requirements at a time when it is keen not to have its financial statements broadly available.

Foreign companies that have “foreign private issuer” status (as defined in *Securities Act Rule 405* and Exchange Act Rule 3b-4) enjoy various accommodations not available to domestic SEC reporting companies. For example, foreign private issuers need not file quarterly reports and are not subject to U.S. proxy rules or Regulation FD (Fair Disclosure), and their executive compensation disclosure requirements are relatively limited. (A foreign company will qualify as a foreign private issuer if 50% or less of its outstanding voting securities are held by U.S. residents; or if more than 50% of its outstanding voting securities are held by U.S. residents and none of the following three circumstances applies: the majority of its executive officers or directors are U.S. citizens or residents; more than 50% of the issuer's assets are located in the United States; or the issuer's business is administered principally in the United States.) Foreign private issuers may want to keep in mind that they could lose their foreign private issuer status if, for example, they seek significant pre-IPO equity financing from U.S. investors and either end up with a majority of directors or executive officers that are U.S. citizens or residents or move their headquarters to the United States.

BLUE SKY CONSIDERATIONS

As startup companies grow and make strategic acquisitions (whether they are domestic companies or foreign private issuers), they may want to consider whether their activities also have state (“Blue Sky”) and cross-border securities laws implications. Offerings of securities in the United States must also comply with the securities laws of the states in which the offerees (in the case of share-based compensation, the employees) reside. There are exemptions in many of the states that track exemptions at the federal level, and companies should check the exemptions in each state where an issuer's employees are located. For example, California has an exemption (under Section 25110 of the California Corporations Code) that is available for grants that, among other conditions, comply with Rule 701, though there is a shareholder approval requirement unless grants under the exemption are made to not more than 35 residents in California. State securities laws may, but do not necessarily, track federal securities law concepts.

CONCLUSION

The SEC's recent decision to expand the option for confidential filing draft registration statement submissions in the early stages of the IPO process to all companies (not just emerging growth companies and not just foreign private issuers, in certain circumstances) aims to “encourage more companies to consider going public,” as SEC Chairman Clayton stated upon the announcement of this rule change. Market observers continue to watch with bated breath for an IPO resurgence in 2017, especially of those startups valued at more than $10 billion (also called “decacons”), but reports in the spring of 2017 suggest that the “value of late-stage private companies in the US and Europe has soared to more than $490bn, a fivefold increase over the past four years.”

In a potential move that highlights the privileged position of unicorns in terms of cash needs, Spotify is reported to be considering a direct stock exchange listing, without a concurrent IPO, reflecting the fact that it neither needs cash nor needs a formal IPO process to create market visibility. In March 2017, the NYSE sought SEC approval (which is still pending) of a change in its listing standards to facilitate direct listings by private companies, which could be attractive for a number of unicorns. If Spotify does a direct listing and the stock performs well, others may follow, reversing the downward trend in listings.

In any event, mature startups that opt to remain private longer and raise capital in the United States, make strategic acquisitions from sellers based in the United States and/or compensate U.S.-based employees must do so within the limits of the relevant U.S. securities law exemptions.