Capital Markets

In this section, we examine trends and opportunities in various sectors of the financial markets.

2012 was a robust year for both the U.S. leveraged loan and high-yield markets, including record-breaking deal volume for the latter. These conditions provided fertile ground for borrowers and issuers in U.S. markets to fund significant numbers of dividend recaps and achieve structures and terms that afford them more flexibility within their debt instruments. In contrast, the past year was a disappointing one for Hong Kong's equity and Europe's lending markets due in part to concerns about potential changes in tax treatments, new legislation and other regulatory developments.

Issuers also are considering what could be viewed as encouraging changes in the U.S. regulatory landscape in connection with their finance activity. Nine months have passed since the JOBS Act was signed into law, and the legislation's IPO-related provisions have yielded interesting results related to the market practices for emerging growth companies seeking to go public. And with the proliferation of corporate social media, companies of all sizes planning an IPO are becoming increasingly mindful of the role of web-based communication in publicizing their businesses.

We also discuss certain industry-specific and geographic developments. The steady evolution of real estate investment trusts continues to appeal to investors: We look at two emerging areas driving this growth — renewable energy assets and excess mortgage servicing rights. In Germany, the equity markets are showing signs of increased activity, but uncertainty continues for those engaged in secondary share placements. And in Asia, the last year marked a sharp retreat for Hong Kong's equity markets. However, there are indications that market sentiment and prospects are improving, and we examine some of the notable factors that suggest a better outlook in 2013.

(Click on a title below to read the article.)

Happy New Year: Encouraging Signs for Leveraged Loans

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The U.S. leveraged loan market flourished in 2012, as borrowers took advantage of favorable pricing and terms amid strong investor demand. S&P Capital IQ Leveraged Commentary and Data (LCD) tracked $465 billion of leveraged loan issuance (up 24 percent from 2011), while Thomson Reuters LPC calculated $664 billion (up 17 percent from 2011).[1] This makes 2012 the third-highest year in volume of primary leveraged loan issuance, behind only 2006 and 2007.[2] The fourth quarter of 2012 was especially robust with $136 billion of loan issuance, the most since the post-credit crunch high of $141 billion in the first quarter of 2011.[3] Unlike 2006 and 2007, when mega-LBO deals drove the market, the 2012 market was driven primarily by opportunistic financings such as repricings, refinancings and dividend recaps. In fact, refinancings and repricings accounted for more than 50 percent of large syndicated institutional deal volume,[4] as borrowers took advantage of favorable market conditions throughout the year to loosen covenants, reduce interest rate margins, add new tranches of loans and extend maturity dates. LBO volume was moderate and weighted toward smaller deals than those that were prevalent during the height of the market in 2006 and 2007.

Dividend-related loan volume reached a record high of $56.4 billion for the year,[5] as private equity sponsors took advantage of issuer-friendly terms and strong EBITDA growth. Potential changes in dividend tax treatment added urgency to completing dividend recaps by year-end. Second-lien loan issuance also was strong: 2012 second-lien volume more than doubled to $17.1 billion, from $6.8 billion in 2011.[6]

One of the main factors contributing to positive market conditions in 2012 was the increased number of investors in both the primary and secondary loan markets. With an unexpectedly strong collateralized loan obligation (CLO) issuance in 2012 — topping the combined total of the past four years — structured finance vehicles rapidly increased their share of the primary institutional term loan market. According to Fitch Ratings, CLOs represent approximately 45 percent of the current leveraged loan buyer base through primary loan issuance and refinancings.[7] With more cash to put to work, and with secondary prices rallying and margins narrowing, CLOs pursued riskier wider-margin opportunities and thus participated more aggressively in lower-quality deals. Coupled with steady demand from banks and with loan mutual funds, pension funds and other institutional accounts enlarging their participations, borrowers took advantage of strong liquidity to push for more generous structure and terms. Given the unwavering investor demand for loans in late 2012, we expect borrower-favorable trends to continue in 2013.

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[1] Source: *S&P/Capital IQ/LCD*, Thomson Reuters LPC.

[2] *LCD*, Dec. 21, 2012.

[3] *Id.*

[4] Debtwire Analytics, 2Q12 Review.

[5] *LCD*, Dec. 21, 2012.

[6] *Id.*

[7] *Fitch Ratings*, Nov. 26, 2012.

Covenant-Lite Loans

Covenant-lite loans were increasingly available to borrowers in 2012, in particular those backed by private equity sponsors. Covenant-lite loans do not contain financial maintenance covenants that are tested regularly, although a financial maintenance covenant that "springs" into effect under certain conditions often is included solely for the benefit of the revolving lenders when applicable. A springing financial maintenance covenant generally is tested on a quarterly basis as well as when revolving loans are drawn, but only when the aggregate outstanding amount of revolving loans exceeds a negotiated threshold. Waivers of and amendments to springing financial maintenance covenants generally can be accomplished solely with the consent of a majority of the revolving lenders.

> "While covenant-lite loans almost disappeared from the market during the credit crisis, they have made a dramatic comeback over the last two years."

While covenant-lite loans almost disappeared from the market during the credit crisis, they have made a dramatic comeback over the last two years. In fact, covenant-lite deals comprised 29 percent of overall institutional loan volume in 2012, exceeding 2007's prior record of 25 percent.[8] The current popularity of covenant-lite loans can be attributed in large part to the predominance of CLOs, as well as the increasing influence of hedge funds, high-yield investors and other relative value investors who are familiar with the incurrence-test-only world of bonds.

First-Out Revolvers

First-out revolving credit facilities provide revolving lenders with structural priority over term lenders that share a lien on common collateral. These facilities have developed and are becoming more prevalent in response to the limited number of lenders willing to provide revolving credit facilities due to their lower economic returns (as they are drawn for shorter periods of time than term loans and often not to their full commitment).

The scope of "first-out" rights afforded to revolving lenders is not standard and continues to evolve in the market. While some deals simply provide that revolving lenders are paid first with the proceeds of collateral, others provide revolving lenders with payment priority with respect to proceeds of asset sales and other mandatory prepayments and even upon the occurrence of certain events of default. Revolving lenders' ability to control enforcement remedies as well as their rights in a bankruptcy often are highly negotiated and frequently depend on their leverage in any particular deal.

Amend-and-Extend Provisions

Amend-and-extend provisions allow borrowers to request that individual lenders extend the maturity date of their loans, generally in exchange for higher margins and other attractive terms that are applicable solely to the extended loans. Initially developed as a solution to address the limited ability of borrowers to refinance maturing debt during the credit crisis, amend-and-extend provisions have become a common feature of leveraged loans.

Borrowers may implement amend-and-extend provisions by making an extension offer to all lenders of a particular tranche of loans. Lenders are not obligated to extend the maturity of their loans and may choose to accept or reject any such offer. If an extension offer is accepted, the maturity of the loans of the accepting lender is extended and

[8] *LCD*, Dec. 21, 2012.

the terms of such loans are modified in accordance with the extension offer, without the need for the consent of other lenders.

Uncapped Incremental Facilities

Incremental facilities (sometimes called "accordion" facilities) have been a common feature of leveraged loans for many years. They provide borrowers with the ability to upsize their credit facilities without the need for lender consent. Traditionally, the size of these facilities was capped at a fixed amount. While many leveraged loans continue to include a fixed cap, a large number of deals in 2012 included an incurrence-based test that permits an unlimited amount of new incremental loans subject only to *pro forma* compliance with a specified leverage ratio. It will be interesting to see if these incurrence-based incremental facilities continue to gain traction in 2013.

Loan Buyback Provisions

Prior to the financial crisis, leveraged loans generally restricted the ability of borrowers and their affiliates to purchase outstanding loans made to such borrowers. These restrictions, however, began to be lifted during the financial crisis when practically all leveraged loans were trading at a substantial discount to par in the secondary market. Many credit agreements now permit borrowers, their sponsors and other affiliates to buy loans from some or all lenders, subject to certain common limitations.

> "A number of deals in 2012 permitted borrowers to make individual open-market loan purchases from lenders and this trend may continue to grow in 2013."

For example, in most cases, loans purchased by borrowers automatically are deemed to be repaid and canceled. In addition, borrowers generally have been required to conduct loan purchases through reverse Dutch auctions in order to provide all lenders with an equal opportunity to participate in such purchases. However, a number of deals in 2012 permitted borrowers to make individual open-market loan purchases from lenders and this trend may continue to grow in 2013.

Sponsors and other affiliates typically are permitted to conduct loan buybacks through open-market purchases with individual lenders. However, after they purchase loans and become lenders, they are not afforded the same treatment as other lenders. For example, the voting rights of most affiliate lenders generally are quite limited, as is their ability to receive lender-only information and attend meetings of lenders. Ownership by sponsors and other affiliates usually is limited to no greater than 25 percent of outstanding loans, although such limitation often does not apply to affiliates that are bona fide debt funds investing in loans and other long-term debt in the ordinary course of business. Often, these debt funds are subject to less stringent voting and information restrictions.

Call Protection

As interest rates have fallen and lenders attempt to preserve a portion of their anticipated rate of return, call protection has become a common feature of leveraged loans. Many new first-lien leveraged loans now include a "soft call" — a common term for a premium that is payable when a borrower refinances or amends a loan for the purpose of lowering interest rates. A soft call premium of 1 percent on the amounts refinanced or amended during the first year of a loan is most common. More onerous prepayment premiums continue to be included in most second-lien loans, where multiyear call premiums typically apply to most loan prepayments.

Precap Provisions

"Precapitalized" or "precap" provisions permit the sale of a borrower to a qualified purchaser without triggering a change-of-control defaulting event. These provisions were included in a handful of deals in 2012 and may become more common in 2013, as borrowers of syndicated loans continue to enjoy more flexibility in altering their capital structure without the need to refinance. Qualified purchasers generally are limited to sophisticated private equity purchasers that invest a minimum amount of equity in connection with the acquisition. Other requirements include minimum credit metrics with respect to the health and/or credit ratings of the loan parties following the transaction, and *pro forma* compliance with leverage ratio covenants. An increase in interest rate margins or payment of fees also may be required in connection with the change of control.

The inclusion of precap provisions may be the next step in the evolution of documentation flexibility in leveraged loans. Time will tell if precap provisions will join amend-and-extend provisions, loan buybacks and increased refinancing flexibility as common features of leveraged loans.

European Borrowers

One of the key themes of 2012 was the influx of European borrowers into the U.S. loan markets due to the weakness in the European lending market. In 2012, European borrowers issued $28.4 billion in leveraged loans in the U.S., a significant increase from $8.8 billion issued in 2011.[9] This includes the October refinancing for Fresenius Medical Care in the amount of $3.2 billion (€2.5 billion), the largest U.S. loan for a European borrower since the 2009 debtor-in-possession (DIP) facilities for LyondellBasell. U.S. loan transactions with European borrowers may raise various structural and documentation issues due to distinctions between the European and U.S. markets. For example, to increase deal certainty many European deals employ the concept of "certain funds" in acquisition financings requiring diligence to be completed and most loan documentation to be agreed upon before the acquisition agreement is signed. In addition, U.S. and European guaranty and collateral packages differ, and local laws governing secured transactions in European jurisdictions may present guaranty or collateral limitations not present in the U.S.

Regulatory Considerations

The flood of new regulations applicable to banks and the lending market — Basel III, the Foreign Account Tax Compliance Act (FATCA), risk retention, leveraged lending guidance, the Volcker Rule and Federal Deposit Insurance Corporation (FDIC) assessment rules — already has affected and likely will continue to affect the loan market for years to come.

Upon implementation, certain provisions of the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank) and Basel III will compel banks and certain other financial institutions to raise and maintain additional capital to satisfy stricter capital requirements, which may increase a lender's cost of funding or reduce its rate of return. Loan agreements traditionally have enabled lenders to pass on to the borrower increased costs resulting from changes in law implemented after the closing of the facility. Such provisions may cover the future implementation of the Dodd-Frank Act

[9] *LCD*, Dec. 21, 2012.

and Basel III. Given that Dodd-Frank already has been enacted and Basel III has been adopted (although the implementations of rules still are pending in the United States), it has become common for yield protection provisions to expressly allocate to the borrower the risk of any increased costs arising from enactment of Dodd-Frank and Basel III. As Dodd-Frank and Basel III continue to be implemented, loan agreements likely will continue to evolve.

In light of the London Interbank Offered Rate (LIBOR) manipulation scandal last summer, the Wheatley Review, released in September by Her Majesty's Treasury, recommended a 10-point plan for the comprehensive reform of LIBOR, but did not propose abandoning it altogether. Although the Wheatley Review questioned the use of LIBOR for products such as variable-rate mortgages, it seemed to accept its usage in the syndicated loan market. As a result of the proposed reforms, the British Bankers Association (BBA) no longer would have a role in setting LIBOR. Even though the scandal may have dealt a critical blow to LIBOR's credibility, it does not appear to have diminished the usage of LIBOR in the loan market. Whether regulatory reforms impact the usage or calculation of LIBOR remains to be seen.

The US High-Yield Market: A Record-Breaking 2012 and What to Expect in 2013

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With primary issuances totaling more than $340 billion, the U.S. high-yield market experienced record deal volume in 2012, exceeding the prior record of $287 billion in 2010 and representing an increase of more than 50 percent from 2011. Lower returns on other investments led to increased demand for high-yield paper in 2012, ultimately resulting in record-low yields.[10]

Under these issuer-favorable conditions, companies were able to negotiate more aggressive covenant packages and raise funds for more opportunistic purposes, including leveraged buyouts (LBOs) and dividend payments, in addition to taking advantage of lower rates to reduce interest expense and extend maturities through refinancings. Many issuers also came to market with structures generally considered riskier from an investor perspective, including "high-yield lite" bonds, which lack either or both a debt incurrence covenant and/or a restricted payments covenant, and "payment-in-kind" (PIK) notes, which allow the issuer to pay interest with additional notes.

So where will 2013 take the U.S. high-yield market? Many of the key drivers of the record volume in 2012 remain in place, but other macroeconomic and market-specific factors may temper expectations.

Key Trends of 2012

Use of Proceeds: Dividend Deals and Acquisitions/LBOs

The issuer-favorable climate in 2012, particularly in the fourth quarter, led to more speculative uses of proceeds, including for LBOs and dividend payments. For 2012, 61 percent of total deal volume was used for refinancings, 23 percent to fund

[10] HighYieldBond.com; Debtwire High Yield Database.

acquisitions (including LBOs) and 6 percent to fund dividends. However, in the fourth quarter, this mix shifted: Only 48 percent of total deal volume was used for refinancings, 28 percent to fund acquisitions (including LBOs) and 13 percent to fund dividends. For the month of October alone, almost 20 percent of deal volume was to fund dividends (the highest level since April 2011) and 33 percent was to fund acquisitions (including LBOs).[11]

Covenant Trends and Quality

The issuer-favorable climate in 2012 also led to more aggressive covenant packages and riskier structures from an investor perspective. Credit quality deteriorated to near-record levels in the September to November period, according to Moody's. The reduction in credit quality was a result of lower-rated credits going to market with more aggressive structures, including PIK notes, and more flexible covenant packages, including "high-yield lite" notes.[12]

PIK Notes. PIK notes allow the issuer to skip cash interest payments by paying interest in additional bonds, thereby removing the guaranteed fixed income offered by cash-pay bonds. Companies typically issue PIK notes at a holding company level, with proceeds frequently used for dividends to shareholders, including private equity sponsors.

More than 15 PIK issuances, totaling almost $6 billion, were completed in 2012. This volume represents an 83 percent increase over the previous three years combined, although still far below the 2007 level of $15.6 billion.[13] Of these issuances, $4.5 billion, or approximately 78 percent, were to fund dividend payments to shareholders, primarily private equity sponsors. The total number of PIK issuances in October and December 2012 exceeded the total of all PIK issuances between January 2011 and September 2012.[14]

Further illustrating the issuer-favorable state of the market in 2012, both Taminco's and Interactive Data's holding company PIK dividend deals priced lower than their previously issued LBO notes, even though the LBO notes are structurally senior. Taminco's $250 million 9.125 percent (cash) / 9.875 percent (PIK) five-year senior unsecured notes (which priced at 99 percent, for a cash yield of 9.38 percent) bear a cash coupon rate lower than its $400 million 9.75 percent eight-year second-lien notes issued at par in early 2012 to finance its LBO. Similarly, Interactive Data's $350 million 8.25 percent (cash) / 9 percent (PIK) five-year senior unsecured notes (which priced at 99 percent, for a cash yield of 8.50 percent) bear a coupon rate lower than its $700 million 10.25 percent eight-year senior unsecured notes issued at par in 2010 to finance its LBO.

Covenant Trends. During 2012, and in particular by October, issuers were enjoying the best of both worlds — more flexible covenant packages and historically low yields.

High-yield bonds issued by sponsor-owned issuers, which typically have looser covenants than those bonds issued by nonsponsor issuers, continued to have covenant packages that provided the issuers with greater operating flexibility — particularly in

[11] Debtwire High Yield Database.

[12] Credit Outlook, Moody's Investors Service, Nov. 15, 2012.

[13] HighYieldBond.com.

[14] Debtwire High Yield Database.

optional redemptions and add-backs of restructuring charges and *pro forma* cost savings to EBITDA (a feature cited by Moody's in November 2012 as increasing a company's financial flexibility and weakening investor protections).

More generally, high-yield bonds in 2012 continued to see the loosening of certain covenants, including restricted payments, affiliate transaction and asset sale covenants. In addition, certain provisions that have appeared intermittently over the years gained traction in 2012, including a double-trigger change of control (which also requires a ratings decline and historically was only included in investment-grade issuances), change-of-control drag-along rights and covenant termination (instead of just covenant suspension) if the notes have an investment-grade rating. Additionally, 2012 saw the further utilization of "first-and-a-half lien notes," which fall between first- and second-lien notes, a relatively recent and novel structure that issuers have used to address secured leverage and lien covenant concerns.

High-Yield Lite Issuances. Some companies also were able to take advantage of the issuer-favorable atmosphere in the market to issue high-yield lite bonds, which, in the parlance of Moody's, are high-yield bonds lacking either or both a restricted payments covenant and/or a debt incurrence covenant. According to Moody's, 30 percent of November issuances had high-yield lite covenant packages, compared with approximately 17 percent historically. Typically, high-yield lite issuances are by more highly rated speculative credits, just below investment grade. However, in 2012, several lower-rated issuers also were able to access the market with high-yield lite bonds.

Potential Market Moderation and Managing Expectations

While 2013 could be another positive year for the high-yield market, there are factors that may moderate results compared to 2012.

Many key drivers of the 2012 record volume are continuing into 2013. In particular, the Federal Reserve policy anchoring interest rates remains in effect, and yields of other investments remain low. Corporate default rates also remain at low levels. In addition, the U.S. has dodged the worst of the automatic tax increases with the partial resolution of the fiscal cliff.

"While 2013 could be another positive year for the high-yield market, there are factors that may moderate results compared to 2012."

However, market-specific and macroeconomic factors may temper results. A large number of high-quality issuers with debt maturities in 2013 and 2014 already have refinanced over the past two years, leading some to believe that the market will be left with lower-quality issues combined with low yield and little value for investors. Further, many private equity-owed issuers already took advantage of the 2012 market to fund dividends in anticipation of facing potential tax increases in 2013. In addition, the difference in yields between leveraged loans and high-yield bonds narrowed at the end of 2012, making loans more attractive, particularly if they have a senior position in the capital structure. Further, macroeconomic concerns persist, including those related to the still-unresolved U.S. fiscal cliff issues as well as eurozone fiscal policies and economic growth.

Despite these signs of caution, if issuers and investors are able to adjust their expectations following a record-setting 2012, 2013 may be another interesting year for the U.S. high-yield market.

The JOBS Act: What We Learned in the First Nine Months

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Nine months have passed since the Jumpstart Our Business Startups Act (the JOBS Act), a package of legislative measures intended to ease regulatory burdens on smaller companies and facilitate public and private capital formation, was signed into law.[15] While certain portions of the JOBS Act have yet to be implemented pending SEC rulemaking, the provisions related to IPOs have been effective since enactment. These provisions seek to encourage companies with less than $1 billion in annual revenue to pursue an IPO by codifying a number of changes to the IPO process and establishing a transitional "on-ramp" that provides for scaled-down public disclosures for a new category of issuers termed emerging growth companies (EGCs).[16]

Using nine-month data from the final prospectuses of 53 EGCs that successfully completed underwritten IPOs with gross proceeds of at least $75 million between April 5, 2012, and December 15, 2012, below is a summary of a number of developing market practices for EGC IPOs and certain related interpretative guidance issued by the staff of the U.S. Securities and Exchange Commission (Staff and SEC, respectively).

JOBS Act Benefit for EGC	Nine-Month Trends — Highlights
Confidential Submissions	**Strong acceptance.** A significant majority of EGCs that commenced their IPOs after April 15, 2012, submitted at least one confidential draft registration statement.
Reduced Financial Statement and Selected Financial Data	**Weak acceptance.** A substantial majority of EGCs continued to include three years of audited financial statements and, of those, most included five years of selected financial data.
Testing-the-Waters Communications	**Mixed acceptance.** Use largely has been deal-specific and is still evolving.
Publication and Distribution of Research Reports	**Mixed acceptance.** Underwriters generally are not publishing pre-deal research and publishing post-IPO research only after expiration of the 25-day prospectus delivery period.
Limited Executive Compensation Disclosures	**Strong acceptance.** Virtually all EGCs that commenced their IPOs after April 15, 2012, have provided scaled executive compensation disclosure.

[15] *See Skadden Corporate Finance Alert*: 'Jumpstart Our Business Startups Act' Signed Into Law" (Apr. 5, 2012), *available at* http://www.skadden.com/insights/corporate-finance-alert-%E2%80%98jumpstart-our-business-startups-act%E2%80%99-signed-law.

[16] An EGC is defined as an issuer (including a foreign private issuer) with total annual gross revenues of less than $1 billion during its most recently completed fiscal year.

Auditor Attestation Reports Under Section 404(b) of Sarbanes-Oxley	**Strong acceptance.** Virtually all EGCs have included disclosure that they intend to or may take advantage of the exemption to delay providing the auditor attestation report.
Extended Transition for New GAAP	**Weak acceptance.** A substantial majority of EGCs have elected not to take advantage of the extended transition period for compliance with new GAAP standards.

Reforms to the IPO Process

In an effort to remove some of the traditional obstacles in the IPO process, the JOBS Act codified a number of substantive and procedural reforms, the most prominent of which are analyzed below.

Confidential Submission of Draft Registration Statements

An EGC may submit its IPO registration statement confidentially in draft form for Staff review, provided that the initial confidential submission and all amendments are publicly filed with the SEC no later than 21 days prior to the EGC's commencement of its roadshow. The new confidential submission process, formerly available only to foreign private issuers in select circumstances, permits an EGC to commence the SEC review process without publicly disclosing sensitive strategic, proprietary and financial information. Further, in the case of adverse market conditions, weak investor demand in response to testing-the-waters communications or regulatory concerns, an EGC may withdraw its draft registration statement and terminate the IPO process without ever making a public filing, thus removing a potential disincentive to commencing an IPO, and permitting the immediate pursuit of a private placement.

Strong Acceptance. While the decision to take advantage of the confidential submission process always should be made based on the particular facts and circumstances facing an EGC, we believe that market practice will continue to trend strongly in favor of confidential submissions. Some EGCs, however, may determine not to do so for a variety of reasons. For example, we are aware of a number of EGCs that did not use the confidential submission process based on the belief that a public filing would help attract bidders in the case of a "dual track" IPO/M&A process.

Practice Points

- **Press Releases.** The SEC cannot reject a confidential submission even if an EGC issues a press release that publicly announces the offering. However, any press release must comply with limitations imposed by Rule 135 to avoid gun-jumping issues.[17] We note that, to date, very few EGCs have issued press releases announcing a confidential submission.
- **Mergers and Acquisitions.** While the JOBS Act focused on IPOs and scaled disclosures for newly public companies, it does not contain language precluding

[17] Rule 135 permits an issuer to discuss the "anticipated timing of the offering." Thus, so long as the confidential submission is noted narrowly in the context of the timing of the offering, the press release will comply with Rule 135 (assuming the conditions of the rule are otherwise satisfied).

its application to registered business combinations conducted by EGCs. The Staff recently confirmed that an EGC may submit confidentially a draft registration statement for a merger or exchange offer that constitutes an IPO of its equity securities.[18]

- **Publicly Filing Confidential Submissions Ahead of the Roadshow.** Confidentially submitted registration statements have to be filed publicly at least 21 days before an EGC conducts its roadshow. The Staff has provided informal guidance that it does not view internal sales force presentations as commencing the roadshow so long as the sales force does not make outbound calls on that date and the net roadshow has not been activated.

Reduced Financial Statements and Selected Financial Data

An EGC is permitted to present only two years of audited financial statements in its IPO registration statement, as compared to the three years required for non-EGCs. An EGC presenting only two years of audited financial statements in its IPO registration statement may limit the number of years of selected financial data to two years as well.[19]

Weak Acceptance. Several reasons typically are cited by EGCs for the decision to include three years despite the JOBS Act change. The primary reason is that the extra year of audited financial statements is necessary to show investors the longer-term trends and historical growth trajectory of the company, which may have a positive impact on marketing the offering as well as satisfy liability concerns. Also, buy-side investors often have been demanding the third year of audited financial statements. The decision to include two versus three years of audited financial statements did not appear to be linked to the size of the offering.

Practice Points

- **Abbreviated Financial Statements of Acquired Businesses and Equity Method Investees.** An EGC registration statement that is required to present only two years of audited financial statements also may limit the audited financial statements of acquired businesses and equity method investees under Regulation S-X to two years.[20]
- **Abbreviated Financial Statements in Non-IPO Registration Statements.** Notwithstanding that the accommodation for abbreviated financial statements is limited to an EGC equity IPO, the Staff has stated that it will not object if, in other Securities Act registration statements (covering, for example, a follow-on equity offering or a debt offering), an EGC does not present audited financial statements for any period prior to the earliest audited period presented in the IPO prospectus.[21]

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[18] SEC, JOBS Act Frequently Asked Questions, Generally Applicable Questions on Title I of the JOBS Act (Title I FAQs), at Question 43. The Title I FAQs can be found here: http://www.sec.gov/divisions/corpfin/guidance/cfjjobsactfaq-title-i-general.htm.

[19] Title I FAQs, at Question 11.

[20] *Id.*, at Question 16. Question 45 expands this guidance to an EGC business combination registration statement, and provides that an EGC that is not a shell company and includes only two years of audited financials in its business combination registration statement needs to present only two years of audited financial statements of a (non-smaller reporting) target company notwithstanding its significance. *Id.* at Question 45.

[21] *Id.*, at Question 12.

- **No Abbreviated Financial Statements in a Form 10 Filed in Connection With a Spin-Off of an EGC.** The accommodation permitting an EGC to file only two years of audited financial statements is limited to sale transactions registered under the Securities Act. A typical spin-off will not involve a sale that would trigger Securities Act registration. Accordingly, any Form 10 filed by the EGC in connection with the spin-off must contain three years of audited financial statements (unless the EGC is a smaller reporting company, in which case two years would suffice).[22]

Testing-the-Waters Communications

The JOBS Act significantly eases the Section 5 restrictions on gun-jumping by permitting an EGC, or a person authorized to act on the EGC's behalf, to make oral and written offers to qualified institutional buyers (QIBs) and institutional accredited investors before or after the filing of a registration statement to gauge their interest in the offering.

Mixed Acceptance. The frequency and degree to which EGCs or their authorized representatives have conducted testing-the-waters communications in the past nine months is not readily apparent from SEC filings, as these communications do not need to be publicly filed with the SEC. In our experience, however, the use of these communications has been uneven and largely deal-specific. Current market practices related to testing-the-waters communications are best understood if the communications are separated into pre- and post-filing communications. Pre-filing communications (which typically precede any confidential submission) increasingly are being used in connection with "Meet the Management" presentations between EGCs and underwriter-selected QIBs. The substance of these meetings generally is focused on explaining the EGC's "story," with a view toward assisting the EGC in determining whether to proceed with an IPO. Financial statements and performance-related information are not part of the presentation, and there generally is no discussion of valuation or solicitation of non-binding indications of interest.

> "In our experience, the use of testing-the-waters communications has been uneven and largely deal-specific."

Post-filing testing-the-waters communications, on the other hand, have been used, albeit less frequently, to explore valuation for EGCs that had a "story" or were a part of an industry that was the subject of heightened interest from investors. Not surprisingly, the timing of these more substantive discussions is heavily influenced by buy-side interest. Companies should note that many underwriters prefer to schedule substantive testing-the-waters meetings only after the draft registration statement has been through at least one (and preferably two) rounds of Staff legal and accounting comments, in an effort to ensure that the content of the communications will conform to the prospectus. Consideration must be given to the launch date of the offering, as investors increasingly have been unwilling to entertain a testing-the-waters meeting close in time to the actual roadshow. In this regard, a number of buy-side and sell-side participants have questioned whether the exploration of value in connection with testing-the-waters communications would present sufficient upside to investors to justify their attention given their limited resources.

In sum, market practice in this area — similar to when free writing prospectuses were first permitted — is developing slowly and cautiously. We expect practices will continue to evolve over the course of the next year.

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[22] The Form 10 may include only three years of selected financial data under Item 301 of Regulation S-K.

Practice Points

- **Liability.** Given that the JOBS Act does not exempt issuers and underwriters from potential anti-fraud liability for any oral or written testing-the-waters communications, EGCs and their authorized personnel generally should follow the same procedures and protocols as would be the case for a roadshow (*e.g.*, conforming the communications to the statutory prospectus disclosure and generally avoiding the use of projections). EGCs should not treat a testing-the-waters presentation as a "mock" roadshow; rather, management should be prepared to deliver a final and refined pitch as would be the case with the roadshow.

- **SEC Comments.** Unlike an issuer free writing prospectus, a testing-the-waters communication does not need to be filed with the SEC. EGCs, however, should expect to receive a standard comment from the Staff requesting that any "written materials" used in connection with testing-the-waters communications be provided supplementally to the Staff in connection with its review of the registration statement. Senior Staff recently stated that "written materials" include slide decks or similar visual aids, even if the materials are taken back after the presentation.[23] The Staff will analyze these materials primarily with a view to ensuring consistency between any testing-the-waters communications and the prospectus. Because of the prospect of having to include these materials in the prospectus, EGCs and underwriters generally prefer oral presentations. We believe underwriters will continue to require that written materials be taken back after a presentation notwithstanding that they will have to provide the materials to the Staff.

- **Use of a "Pink Herring" Prospectus.** In connection with testing-the-waters meetings, some EGCs have posted a password-protected version of the confidential registration statement on the Internet roadshow and disabled the print option. These precautions are intended to ensure that the EGC is not deemed to be using a non-compliant prospectus in violation of Section 5, which requires that a valid preliminary prospectus be publicly filed and include a bona fide price range.

- **Representations/Indemnification.** As with free writing prospectuses, EGCs are being asked to make representations to the underwriters with respect to the information contained in testing-the-waters materials and to indemnify the underwriters for any damages arising from material misstatements in or omissions from the materials.

- **Gauging Investor Interest Versus Soliciting Orders.** In August 2012, the Staff addressed the impact on testing-the-waters communications of the limitations under Exchange Act Rule 15c2-8(e), which requires a broker-dealer to provide a customer a preliminary prospectus prior to any solicitation of orders. The Staff guidance confirmed that Rule 15c2-8(e) applies only after the filing of a registration statement, and clarified that underwriters may discuss price, volume and market demand and solicit nonbinding indications of interest without being considered to be improperly soliciting a customer's order.

- **Mergers and Acquisitions.** The Staff recently confirmed that an EGC may use testing-the-waters communications with QIBs and institutional accredited investors in connection with a merger or exchange offer.[24] While qualifying testing-the-waters

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[23] Paula Dubberly, Division of Corporation Finance Deputy Director, Policy and Capital Markets, Remarks at PLI Securities Regulation Institute (Nov. 7, 2012).

[24] Title I FAQ, at Question 42.

communications would not be deemed pre-filing offers or post-filing prospectuses that would need to be timely filed under Rule 425 to ensure the protections of the Rule 165 safe harbor, the JOBS Act did not provide similar relief from the gun-jumping provisions of the proxy and tender offer rules. As such, tender offer communications and proxy solicitations by the EGC outside the business combination registration statement would be subject to the relevant filing and legending requirements of the Exchange Act.

Publication and Distribution of Research Reports

"Underwriters, at least for now, appear to have settled on a cautious approach to the publication and distribution of pre-deal and post-deal research, based largely on liability concerns."

The JOBS Act permits a broker-dealer to publish or distribute a research report about an EGC that proposes to register an equity offering under the Securities Act or has a registration statement covering an equity offering pending, and the research report will not be deemed an "offer" under the Securities Act, even if the broker-dealer is participating or will participate in the offering. Together with recent NYSE and FINRA rulemaking,[25] the JOBS Act also eliminates, for IPOs of EGCs, the existing FINRA-based 40-day (for managing underwriters and co-managers) and 25-day (for other syndicate members) quiet periods imposed immediately after IPOs and the 15-day (for managers and co-managers) quiet period extension imposed prior to and after the expiration, waiver or termination of a lock-up agreement. Anti-fraud liability under Exchange Act Section 10(b) and Rule 10b-5 thereunder and state law is not impacted by the JOBS Act provisions addressing the publication and distribution of research reports.

Mixed Acceptance. Underwriters, at least for now, appear to have settled on a cautious approach to the publication and distribution of pre-deal and post-deal research, based largely on liability concerns. First, we are not aware of any underwriters publishing research before or during a traditional offering by an EGC. Second, as it relates to post-deal research, underwriters have settled on a "best practices" consensus that research should be published no earlier than 25 days after the date of the EGC IPO, so as not to compete with the IPO prospectus during the prospectus delivery period. We believe that market practices related to deal research will continue to evolve with the passage of time.

Streamlined or Exempt Disclosures

Under the JOBS Act, an EGC is eligible to make scaled disclosures or rely on exemptive relief from certain disclosure and other requirements for up to five years following its IPO. The EGC may elect to forego reliance on any disclosure accommodation or exemption available to it. As explained below, EGCs have moved aggressively to take advantage of many of these accommodations.

Limited Executive Compensation Disclosures

EGCs are permitted to avoid the detailed compensation disclosures that otherwise would be required by Item 402 of Regulation S-K and instead provide scaled executive compensation disclosure under the requirements generally available to smaller reporting

[25] *See Skadden Corporate Finance Alert:* "FINRA Amendments Adopted to Implement JOBS Act Changes," (Oct. 2012), *available at* http://www.skadden.com/insights/finra_amendments_adopted_implement_jobs_act_changes. The liberalization of analyst participation in pitch meetings for IPOs by EGCs is beyond the scope of this article.

companies. Accordingly, insofar as relevant to IPOs, an EGC may (1) omit the detailed Compensation Discussion and Analysis (CD&A); (2) provide compensation disclosure covering the top three (including the CEO), rather than the top five, executive officers; and (3) omit four of the six executive compensation tables required for larger companies.

Strong Acceptance. Data shows that a large majority of IPOs commenced after mid-April by EGCs that otherwise would be required to include traditional executive compensation disclosures (*i.e.*, excluding offerings by foreign private issuers, externally managed REITs, commodity pools, etc.) are taking advantage of the reduced disclosure.

Practice Points

- **Abbreviated CD&A.** In our experience, most investors primarily are interested in the historical executive compensation data and, to the extent they desire an analysis and discussion of a company's executive compensation disclosures, these investors may be more interested in a forward-looking discussion of the company's executive compensation philosophy and practices as a newly public company as compared to the executive compensation decisions made while a private company. Absent special circumstances, however, the inclusion of an abbreviated CD&A generally is not necessary to market successfully an EGC IPO.

Auditor Attestation Report Under Section 404(b) of Sarbanes-Oxley

EGCs are exempt from the requirements under Section 404(b) of Sarbanes-Oxley to have an auditor attest to the quality and reliability of the company's internal control over financial reporting. The exemption remains valid for so long as the company retains its EGC status. It should be noted that, in many cases, the practical effect of this exemption is to extend relief already available to almost all newly public companies. That is, under current SEC rules, all newly public companies, regardless of size, generally have until their second annual report to provide the auditor attestation report, and smaller public companies (generally those with a public float less than $75 million) are permanently exempted.

Strong Acceptance. Virtually all EGCs have included disclosure that they intend to or may take advantage of the exemption to delay providing the auditor attestation report under Section 404(b). Many companies that did not affirmatively state that they would be taking advantage of the exemption preserved their optionality by disclosing that they "had not made a decision" as to whether to take advantage of the exemption. The decision almost universally is tied to potential significant savings in terms of time and money. However, there is some debate whether the perceived savings are overestimated given the costs that companies already incur in connection with IPO due diligence related to internal controls and will incur related to management's opinion on internal control over financial reporting. Further, for any EGC that quickly graduates to large accelerated filer status, the exemption offers no relief that would not otherwise be available based on the newly public company exemption set forth in the instructions to Item 308 of Regulation S-K.

Practice Points

- **Management's Report Under Section 404(a) of Sarbanes-Oxley.** An EGC is not exempt from having to provide management's opinion on internal control over

financial reporting. As is the case with virtually all newly public companies, however, an EGC generally would not provide management's opinion until it files its second annual report with the SEC.

- **CEO and CFO Certifications.** The Section 404(b) exemption does not change the requirement for an EGC's CEO and CFO to provide compliance certifications under Sections 302 and 906 of Sarbanes-Oxley in 10-Ks and 10-Qs.

Extended Transition for New GAAP

EGCs are not required to comply with new or revised financial accounting standards until those standards apply to private companies. Under this provision, an EGC will be permitted to follow a longer, private company transition where there is a different effective date for an accounting standard specified for private companies.

Weak Acceptance. We believe the reasons that EGCs are declining the extended transition period for new or revised financial standards in larger numbers are two-fold. First, EGCs and their advisers are concerned that taking advantage of the extended transition period will cause comparability concerns in the marketplace to those of peer competitors. Second, an EGC IPO registration statement still must satisfy the line-item requirements of the relevant Securities Act form, including as it relates to then-current accounting disclosures required by Regulation S-X. Thus, the transition provides only a prospective benefit and therefore is of limited utility, especially when the comparability issues are considered.

Practice Points

- **Opt Out/Opt In.** A determination by an EGC to opt out from or reject the transition period for complying with new or revised financial accounting standards is irrevocable. An EGC should notify the Staff of its choice at the time of the initial confidential submission or, if it chooses not to make a confidential submission, at the time it first publicly files its registration statement.[26] An EGC that initially decides to opt in or take advantage of the extended transition period may determine at any time to opt out (*i.e.*, abandon the extended transition period and comply with the accounting standard effective dates applicable to non-EGCs). This decision, which will be irrevocable, must be disclosed prominently in the EGC's next periodic report or registration statement.[27]

> "A determination by an EGC to opt out from or reject the transition period for complying with new or revised financial accounting standards is irrevocable."

- **Determining "New or Revised Financial Accounting Standards."** The term refers to any update issued by the Financial Accounting Standards Board to its Accounting Standards Codification after the JOBS Act enactment date, April 5, 2012.[28]

- **Extended Phase-In for Foreign Private Issuers.** A foreign private issuer that qualifies as an EGC and reconciles its home country GAAP financial statements to U.S. GAAP can take advantage of the extended transition period for complying with new or revised financial accounting standards in its U.S. GAAP reconciliation.[29]

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[26] Title I FAQs, at Question 13.

[27] Title I FAQs, at Question 37.

[28] Title I FAQs, at Question 33.

[29] Title I FAQs, at Question 34.

Conclusion

We believe that the majority of the reforms, accommodations and exemptions discussed above have become or increasingly will become an established part of the EGC IPO "playbook." However, as is the case with any significant reforms, we expect market practices will continue to develop and the true impact of the JOBS Act on the IPO market only will become apparent with the passage of time.

Jumping the Gun: Social Media and IPO Communications Issues

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Increasingly, companies are using social media, such as Facebook, Twitter, YouTube and other platforms, to engage with clients, customers, employees, shareholders and other key constituents. Promising a fast and low-cost means of disseminating information, social media also offers the potential for even broader distribution through third-party word-of-mouth advocacy. However, when a company plans an IPO in the United States, social media's powerful benefits can pose significant risks.

To date, the SEC has not brought an action for violation of its IPO publicity restrictions involving social media; however, as corporate social media continues to proliferate, it is likely only a matter of time before the SEC acts. Companies preparing to go public need to understand the various SEC rules restricting communications during the IPO process. Instituting well-defined policies and procedures governing social media is critical to avoiding inadvertent violations and the penalties that can follow, which may potentially impact the IPO.

Gun-Jumping

"Gun-jumping" is an expression, not defined in the U.S. securities laws, that generally refers to a violation of U.S. securities law restrictions on issuer publicity and communications before, during or after a public offering. U.S. securities laws prohibit communications that improperly stimulate interest in the securities offered in an IPO. For an IPO, the restrictions start as early as the time the company reaches an understanding with the managing underwriter (potentially before the company even holds its IPO organizational meeting) and end 25 days after the pricing of the offering. Gun-jumping consequences can be serious and can include recission, a cooling-off period delaying the IPO or sanctions/fines.

"Gun-jumping" restrictions are wide-reaching: They apply to all forms of communications and cover press releases, media interviews, website postings, emails, internal company announcements, Facebook posts, Twitter tweets, YouTube videos and online commentary. The often casual and spontaneous nature of social media communications, combined with the ability to disperse messages instantly and broadly, heightens the risk of inadvertent gun-jumping. Additionally, companies often subject social media communications to less stringent review than traditional print publications or press releases.

Given the broad application of "gun-jumping" restrictions, it is possible that the SEC could consider seemingly ordinary, noncontroversial communications as "gun-jumping." For example, if appropriate care is not taken, a significant increase in Internet advertising or a company website revamp immediately preceding an IPO could be viewed as "gun-jumping" if it is deemed to be stimulating interest in the IPO.

> "Companies preparing to go public need to understand the various SEC rules restricting communications during the IPO process."

While a company is not responsible for third-party commentary posted on its social media platforms (including a company website), re-tweeting a third-party Twitter post could raise a red flag. The same holds true for repackaging posted commentary from third parties in company communications, particularly if the company is viewed as sponsoring or affirming the commentary.

Prominent Gun-Jumping Examples

While the following examples of gun-jumping did not involve corporate social media, they are instructive of the general risks and may point to areas in which future notable violations could occur through the use of interactive platforms.

- **Google.** In April 2004, approximately one week before Google Inc. filed its IPO registration statement with the SEC, the company's co-founders gave an interview to *Playboy* magazine. Four months later, the interview appeared in the magazine with the cover title "The Google Guys: America's Newest Billionaires." At the time, the media speculated that the SEC would impose a cooling-off period. While the SEC did not delay the much-anticipated IPO, in the face of SEC comments, Google included the text of the article as an appendix to the prospectus and, as a consequence, assumed prospectus liability for the article's contents. In doing so, Google (and its lawyers) proceeded with care: After careful review of the article's text, Google appended an addendum correcting what it believed were factual inaccuracies. The company also included a risk factor in the prospectus, which disclosed that, while Google "would contest vigorously any claim that a violation of the Securities Act occurred," the company could be subject to rescission claims if its involvement in the *Playboy* article were held by a court to violate the Securities Act.
- **Groupon.** In June 2011, Groupon, Inc. filed a registration statement with the SEC for its proposed IPO. The financial media and investment blogs were skeptical of Groupon's use of a non-GAAP accounting metric that made the company appear profitable. Groupon's business model also was questioned, as critics cited low barriers to entry into the industry and the potential of deep-pocketed competitors to the company. In August 2011, Groupon's CEO and co-founder sent an email to employees, which contained impassioned defenses of Groupon's business. The email leaked and quickly went viral. Because of SEC scrutiny and poor market conditions, Groupon's IPO was delayed for months. In addition, the SEC required Groupon to include the email as an appendix to the prospectus, and Groupon, like Google, assumed prospectus liability for the email's contents. Groupon also included a risk factor, which began, "In making an investment decision, you should not rely on an email sent by our Chief Executive Officer to certain employees that was leaked to the media without our knowledge."

SEC Actions in Other Areas Relating to Social Media Use

While the SEC has not yet brought an action for a gun-jumping violation involving social media, the SEC recently delivered a prominent notice to Netflix, Inc. and its founder and CEO Reed Hastings relating to a personal Facebook post under Regulation FD (an SEC

rule adopted in 2000 that prohibits selective disclosure of material, nonpublic information and aims to promote full and fair disclosure).

- **Netflix.** In December 2012, Netflix received a Wells notice from the staff of the SEC indicating their intent to recommend that the SEC institute a cease-and-desist proceeding and/or bring a civil injunctive action against Netflix and Hastings for violations of Regulation FD and certain Securities Exchange Act provisions. The notice related to Hastings' post to a personal Facebook page with more than 200,000 subscribers that stated, in relevant part, that Netflix's monthly viewing exceeded 1 billion hours for the first time.[30] While the materiality of the statement may be debated,[31] the SEC action drew attention as it suggests that a Facebook post — even if distributed to more than 200,000 people and made available on a platform that anyone can access — still is not a recognized method under Regulation FD. Critics of the SEC's action noted that the Facebook posting likely reached more people and was read more immediately than would have been the case with an SEC filing. Critics also expressed surprise that the SEC took its prominent stance on social media based on facts that, to some, seemed innocuous compared with violations alleged by the SEC in the past.

One takeaway from the Netflix case is clear: Communications on social media platforms are now a focus of the SEC. Accordingly, issuers preparing for an IPO should pay careful attention to their social media activities.

"One takeaway from the Netflix case is clear: Communications on social media platforms are now a focus of the SEC."

Brief Primer of the Gun-Jumping Rules[32]

Understanding the three distinct periods in which different SEC guidelines and restrictions apply may provide a practical framework for issuers in managing their social media use.

1. **Pre-Filing Period: No Offers (Not Even Oral Ones).** During the pre-filing period (after the company is "in registration" but before the registration statement is filed), no offer, whether oral or in writing, may be made under Section 5(c) of the Securities Act. Section 2 of the Securities Act defines "offer" as "every attempt or offer to dispose of, or solicitation of offers to buy, a security or interest in a security for value." Courts have given expansive interpretation to what constitutes an "offer," which includes any activity that creates a buying interest in an offered security. Most importantly, an issuer's intent is not required for a violation to be deemed to have occurred.

2. **Waiting Period: No Written Offers.** During the waiting period (after the registration statement is filed but before effectiveness), issuers may make oral offers, but written offers may only be made through a prospectus that complies with the Securities Act.

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[30] The full post read: "Congrats to Ted Sarandos, and his amazing content licensing team. Netflix monthly viewing exceeded 1 billion hours for the first time ever in June. When House of Cards and Arrested Development debut, we'll blow these records away. Keep going, Ted, we need even more!"

[31] Attached to the same Current Report on Form 8-K disclosing the Wells notice was a response from Mr. Hastings arguing that the information, in addition to having been already public, was not material.

[32] *See Skadden Corporate Finance Alert*: "Securities Offerings and Gun Jumping: What You Can and Cannot Do" (November 2012) *available at* http://www.skadden.com/insights/corporate-finance-alert-securities-offerings-and-gun-jumping-what-you-can-and-cannot-do for a comprehensive description of safe harbors and exceptions to SEC's gun-jumping restrictions and practical guidance on what issuers can and cannot do with respect to communication activities generally.

3. **Post-Effective Period.** Once the SEC declares an issuer's registration statement effective, the issuer must continue to comply with communications restrictions until the end of the prospectus delivery period (25 days after the pricing of the IPO). A prominent example of an issuer navigating this requirement is Facebook, which waited until day 26 to respond to questions on its business model.

Safe Harbors and Exceptions

Numerous "safe harbors" and SEC exceptions to the gun-jumping restrictions do exist (*e.g.*, the JOBS Act allows "emerging growth companies" to test interest in a potential IPO with qualified institutional buyers and institutional accredited investors, Securities Act Rule 169 allows nonreporting issuers to continue regularly released business information excluding forward-looking statements and Securities Act Rule 163A provides a safe harbor for certain communications made more than 30 days before the registration statement is filed).[33] In general, companies planning an IPO should keep the following rule of thumb in mind: The U.S. securities laws are not meant to disturb "business as usual" activities and communications. If the communication consists of factual business information and is consistent with past practice, it generally will not violate gun-jumping restrictions.

Managing Social Media During the IPO Process: A Practical Guide

Before starting the IPO process (or, with respect to certain employees who will not know about the IPO beforehand, immediately after the initial registration statement filing), companies should:

- Identify the group of specific individuals within the company who will be authorized to conduct or sign off on all social media communications. For example, even if a sales force regularly employs social media to pitch products, it is not unusual for companies planning an IPO to temporarily halt or more closely monitor the sales force's use of social media during the IPO process to institute a measure of control over communications.
- Establish a social media policy that clearly sets forth the company's expectations with respect to social media communications, and which includes a list of unambiguous "dos and don'ts." The policy, which should be disseminated to all employees and others who may act on the company's behalf, should state that responses to any inbound inquiries through social media platforms are restricted to the small group of identified individuals, and to whom any inbound inquiries should be directed.
- Provide training to ensure persons subject to the social media policy understand how to comply. If the CEO or CFO delivers the message, it will help ensure employees and other persons subject to the policy understand and appreciate its importance.
- Make clear that it is everyone's responsibility to comply with the policy. Each person should understand that a single noncompliant communication could result in potentially severe consequences, such as suspension or delay of the IPO.
- Educate front-line managers and supervisors to monitor compliance with the social media communications policy.

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[33] *See Skadden Corporate Finance Alert*: "Jumpstart Our Business Startups Act Signed Into Law" (Apr. 5, 2012), *available at* http://www.skadden.com/insights/corporate-finance-alert-%E2%80%98jumpstart-our-business-startups-act%E2%80%99-signed-law for a summary of the JOBS Act and a description of the JOBS Act's "testing-the-waters" provisions.

- Develop a process to control the type of information (*e.g.*, only factual business information) and how corporate information will be disseminated by social media platforms.
- Instruct company directors that their own personal or professional use of social media must follow company policy.

Finally, companies should consider having internal and/or outside counsel review all information before it is posted on its website or social media outlets. In several SEC actions relating to Regulation FD and the Foreign Corrupt Practices Act (FCPA), the SEC chose not to bring action against the company (and instead brought actions against the alleged infringing individuals only) where the SEC found the company had instituted a "culture of compliance," which included a written policy, controls and training. While instituting a "culture of compliance" may not prevent an SEC action with respect to an IPO gun-jumping violation, it may influence how the SEC views the violation and mitigate the penalty of noncompliance.

Intent is not required for the SEC to determine that gun-jumping has occurred and, given the number of followers an issuer may have on social media platforms, it may not be difficult for the SEC to find a violation. Thus, the best advice is for issuers to operate within SEC guidelines throughout any process that ultimately may culminate in an IPO.

A REIT Evolution: Renewable Energy and Excess Mortgage Servicing Rights

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In recent years, there has been a steady evolution of real estate investment trusts (REITs) and an increase in entities that have announced their intent to convert to REIT status, as well as an expansion of asset categories that they hold and the corresponding income sources (*e.g.*, cell phone towers, billboards, prisons, etc.). This progression likely will continue in the future, and new areas to watch include renewable energy assets (*e.g.*, wind and solar projects) and, in the mortgage REIT sector, excess mortgage servicing rights.

Renewable Energy Projects

The recent proliferation of renewable energy projects has been spurred in large part by federal income tax incentives. These incentives include: (1) a production tax credit (based upon sales of energy by a project within the first 10 years after it is placed in service); (2) an investment tax credit (a one-time, up-front tax credit equal to 30 percent of the cost of tangible personal property employed in the project); (3) cash grants from the U.S. Treasury (in amounts equal to, and in lieu of, the investment tax credit); and (4) accelerated depreciation (including first-year bonus depreciation equal to 50 percent of the cost of certain machinery and equipment used in such projects). The tax credits and cash grants are mutually exclusive alternatives for any given project. All or a portion of the investment tax credit or cash grant with respect to a particular project is recaptured upon a disposition of the project within a prescribed five-year period.

The existing tax incentives are designed to benefit tax-paying persons (*i.e.*, U.S. individuals and taxable corporations, or partnerships owned by such persons), which means that REITs, which generally incur little or no income tax, historically have not played a role in owning or financing assets associated with renewable energy projects. This may change, however, for one or both of two reasons. First, tax laws that provide the incentives currently are scheduled to sunset at the end of 2013. Although such incentives have been slated to expire on numerous occasions in the past, only to be extended each time, (including at the end of 2012 as part of the recent "fiscal cliff" legislation) in light of the escalating government budget deficits and the acknowledged need for greater revenues, the prospects for further extension are less certain in the current environment. The second factor that may bring change is that as the current owners of renewable energy projects exhaust the tax benefits available under existing law, they may, depending upon their circumstances and objectives, have a compelling incentive to divest.

REITs, with their own special and different tax benefits, could provide an abundant source of capital for acquiring or financing renewable energy projects or portions thereof. Unlike regular taxable corporations, REITs are entitled to deduct dividends that they pay to their stockholders and are required to distribute substantially all of their earnings each year. As a consequence of these two rules, REITs are viewed as yield vehicles that pay little or no income tax, and therefore have ready access to the capital markets, including important segments of investors that have, up until now, largely been excluded from renewable energy projects — namely, U.S. pensions and other tax-exempt entities, foreign portfolio investors (including governments and sovereign wealth funds) and retail investors.

To enjoy their special tax status, REITs must comply with myriad qualification requirements, including rules regarding the composition of their assets and income, which are designed to ensure that they invest principally (though not necessarily exclusively) in real estate, as well as distribution, stockholder diversification and other requirements. Subject to certain limits, REITs may house some activities in taxable subsidiary corporations *(i.e.*, taxable REIT subsidiaries, or TRSs) which, unlike the parent REIT, are subject to tax on their income but can facilitate indirect involvement in activities that otherwise would be precluded by the tax qualification requirements applicable to the parent.

The overarching principle in designing a REIT's role in a renewable energy project is to employ a structure that splits the economics associated with the project between a taxable entity (or a partnership owned by taxable entities), which can maximize the utilization of any available tax incentives linked to tangible personal property used in the project, and a REIT, which can hold or finance the real estate elements of the project in a tax-efficient manner. Such structures could take a variety of forms, and a given REIT might employ different structures in connection with different projects.

One such structure could involve a REIT holding the real estate components of a project (such as the land, towers, pads and supporting structures, and/or the gathering and transmission assets), and leasing them to a third-party lessee that could own the power generation assets. If desired, rent could be based, at least in part, on the lessee's gross (but not net) income from the project. In the case of an existing project, as distinct from a newly developed project, the structure might be effectuated via a sale/leaseback transaction (*e.g.*, the REIT buys the real estate elements from the current owner of the project, and leases them back).

As a possible alternative, a REIT could act as a mortgage lender to finance the real estate components of the project. As with the above leasing structure, the arrangement could provide for contingent interest based on the borrower's gross (but not net) income from the project. A mortgage also could provide the REIT with a share of the potential upside in the value of the mortgaged real estate via a shared appreciation provision. Unlike a leasing structure, the mortgage borrower/owner of the generation assets even could be a TRS. (This is not permitted in the case of a leasing structure because of restrictions under the REIT tax rules on the receipt of rents from related parties.)

More sophisticated and creative structures also would be possible, in which a REIT owns and leases certain real estate assets (*e.g.*, gathering assets and transmission lines) while financing other assets (*e.g.*, the land, tower and pads on which wind turbines are placed) via a mortgage loan, or where a TRS owns generation assets and sells energy to a buyer (*e.g.*, a public utility), and the parent REIT owns the gathering and transmission assets that it leases to the same public utility so that it can transport the energy.

Although REITs previously have not been involved in renewable energy projects, they may provide a ready and robust source of capital in connection with the real estate elements of such projects in the future, to the extent that existing tax law incentives sunset or are exhausted with respect to a particular project — thereby facilitating complete or at least partial exits by the current owners of such projects. Depending on the specific circumstances, tax-deferred exit strategies may also be viable (*e.g.*, through the operating partnership structures commonly used by many public REITs). Although structuring challenges will be very real, the political and economic conditions could lead to a groundswell of participation by REITs in such projects in the not-too-distant future.

"Although structuring challenges will be very real, the political and economic conditions could lead to a groundswell of participation by REITs in renewable energy projects."

Mortgage Servicing Rights

While REITs may own mortgage loans and service them (*e.g.*, collect interest and principal payments, enforce remedies upon a default, etc.) for their own account, income derived from providing services to third parties generally is treated as nonqualifying, or "bad," income under the REIT rules. This would include fees for servicing mortgage loans owned by other investors. However, the IRS has ruled privately that the acquisition of "excess mortgage servicing rights" by a REIT may, if structured properly, give rise to qualifying real estate assets and the receipt of qualifying mortgage interest for purposes of the REIT gross asset and income requirements, respectively. This would allow REITs to acquire mortgage servicing rights from banks that are looking to exit the mortgage servicing business or from independent mortgage servicers who want to operate on a capital-light basis.

Here is how it works. Owners of large portfolios (or pools) of mortgage loans (*e.g.*, Fannie Mae, Freddie Mac and private securitization vehicles such as real estate mortgage investment conduits (REMICs)) often engage a third party to service the loans and may compensate the servicer by granting it a share of the interest income generated by the pool (*e.g.*, 35 basis points per year) — a so-called "interest strip" or "servicing strip." The strip also may be accompanied by a share of certain items of ancillary income derived from the pool, such as late fees. Often the servicer is a bank or other entity that originated the mortgage loans comprising the pool, bundles them and sells the resultant pool, or interests in the pool (*e.g.*, to Fannie Mae, etc.), while retaining the servicing strip.

Moreover, the amount of the servicing strip often exceeds the arm's-length reasonable compensation amount for the pure servicing activity — and really represents a retained economic interest in the underlying mortgage pool. By way of illustration, in the example in which the total amount of the servicing strip is 35 basis points per year, the value of the actual services for which compensation is provided might only be, say, 10 basis points. In that case, the remaining 25 basis points to which the servicer is entitled represents a retained interest in the underlying pool. These are so-called "excess" servicing rights (*i.e.*, the excess over 10 basis points in this example).

To the extent that a REIT purchases such excess servicing rights and does not undertake to service the mortgages, its investment may be treated as a "good" REIT asset (*i.e.*, an undivided interest in a pool of qualified mortgage loans), and the income derived over the life of the arrangement in this example could be treated as "good" mortgage interest for purposes of the REIT income tests. A REIT may even purchase the entire interest strip (*e.g.*, 35 basis points in the example), place the actual servicing component (*e.g.*, 10 basis points) in a TRS or other affiliate, along with the associated servicing obligations, and retain the excess rights (*i.e.*, 25 basis points) as a REIT-compliant investment asset. Because a private ruling issued by the IRS only may be relied upon by the taxpayer to whom it is issued, it may be advisable for a REIT that is interested in investing in excess mortgage servicing rights to seek a private ruling before undertaking such a transaction.

* * *

Investments by REITs in both renewable energy and mortgage servicing assets may be widely available and attractively priced in the months and years ahead. Current owners may seek to monetize assets and strengthen balance sheets under pressure from regulators, as an outgrowth of new laws and as existing tax incentives are exhausted.

What the New German Prospectus Liability Regime for Selling Shareholders Means for Private Equity Exits

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In 2011, the German Federal Court of Justice (FCJ) issued a judgment regarding the legal basis and scope of prospectus liability for selling shareholders in equity offerings of German corporates, which significantly changed the legal structuring of such transactions in Germany. More than a year later, with equity capital markets in Germany showing signs of increased activity going into 2013, shareholders, issuers, bankers and legal practitioners still are trying to define the new market standard for secondary share placements in Germany.

Background

In 2000, the German government (through its state-owned development bank Kreditanstalt für Wiederaufbau, KfW) implemented the third tranche of its privatization of Deutsche Telekom (DT) through a global share placement (the DT3 Offering), including public offerings of DT shares in Germany and the U.S. on the basis of a

prospectus. The transaction was structured as a secondary offering of DT shares only, without any placement of newly issued shares resulting from a capital increase of DT. In other words, KfW (as shareholder of DT) received all proceeds of the transaction. In the underwriting agreement relating to the DT3 Offering, DT assumed the entire prospectus liability risk (*i.e.*, DT indemnified the underwriting banks without receiving a back-to-back indemnity from KfW).

Between 2001 and 2005, DT was the target of several prospectus liability lawsuits on the basis of allegedly wrong and/or omitted information in the DT3 Offering prospectus. In 2005, DT agreed to settle the lawsuits for approximately $120 million and to pay a significant amount of related legal fees. DT requested reimbursement of the settlement amount and legal fees from KfW, but they and the German government rejected it.

DT subsequently brought a claim against the German government and KfW for reimbursement of the settlement amount and legal fees. The company stated that the assumption of prospectus liability in the DT3 Offering constituted an impermissible repayment of equity contributions to KfW, since the DT3 Offering was for KfW's benefit only; DT received nothing.

Court Decisions

District Court of Bonn. In 2007, the District Court of Bonn ruled in favor of DT and confirmed that the company had a claim for the repayment of benefits received by KfW up to the value of the assumed prospectus liability risk. Contrary to the prevailing view at the time, nonquantifiable benefits for the issuer such as increased free float, broadening of the international investor base, and publicity and marketing benefits in connection with a secondary share offering were not viewed as sufficient compensation to justify the assumption of prospectus liability by DT for the DT3 Offering.

Higher Regional Court of Cologne. On appeal in 2009, the Higher Regional Court of Cologne ruled in favor of KfW and found that the nonquantifiable benefits to DT from the DT3 Offering constituted a permissible compensation, in line with past practice, for the assumption of prospectus liability in a secondary share offering.

Federal Court of Justice (FCJ). In its ruling in May 2011 (the DT3 Decision), the FCJ agreed with the District Court of Bonn in principle and ruled that (1) nonquantifiable benefits for a German corporation are not suitable compensation for the assumption of prospectus liability in connection with a secondary share placement, (2) such compensation must comprise objectively quantifiable and financial benefits to avoid an impermissible repayment of contributions to shareholders, (3) the assumption of prospectus liability can, in principle, only be compensated by an enforceable and substantiated indemnification granted by the selling shareholder to the corporation, and (4) controlling selling shareholders also may be subject to claims for damages on the basis of the rules applicable to so-called *de facto* groups.

Scope of DT3 Decision

Pursuant to the DT3 Decision, the indemnification of the issuer by the selling shareholder against prospectus liability in connection with a secondary share placement must be for value (*werthaltig*) and enforceable. The compensation of the issuer must be quantifiable on the basis of a balance sheet analysis (*bilanzielle Betrachtung*). While

it is unclear how this test can be implemented in practice, the substantiated "full-value" analysis requires a prognosis that possible prospectus liability claims can be paid when due, which means in order for an indemnifying selling shareholder to satisfy the DT3 Decision requirements, tangible assets must be available, money must be kept in escrow, a liability insurance policy must be available or similar actions must be taken to establish "value."

Notably, the FCJ did not distinguish between transactions that only involve a secondary share placement (such as the DT3 Offering) and transactions that involve both a capital increase and a secondary share placement. It also did not distinguish between IPOs and transactions involving already publicly listed corporations.

Consequences for German Equity Capital Markets Transactions

The DT3 Decision has significant implications for the way equity capital markets transactions are structured and executed in Germany.

Corporation/Issuer. In the event that a German corporation assumes prospectus liability in connection with a secondary share placement, its management and supervisory board members may be held personally liable in the event that no enforceable indemnity is given, or costs are not reimbursed, by the selling shareholder.

As a result, a German corporation preparing a prospectus in connection with a secondary share placement must enter into an indemnification agreement with the selling shareholder with respect to any potential prospectus liability.

> "The DT3 Decision has significant implications for the way equity capital markets transactions are structured and executed in Germany."

Selling Shareholder. Following the DT3 Decision, selling shareholders in a German secondary share placement are obligated to assume the prospectus liability risk and reimburse the issuer for all related costs and expenses.

Such indemnity is less of an issue for corporations that have an operating business and a sufficient asset base. However, selling shareholders with no operating business — such as private equity investors — may find it difficult to demonstrate that the indemnity to the issuer required by the DT3 Decision is substantiated (*werthaltig*). In particular, private equity funds distribute (and typically are required to do so under the constituting documents) the proceeds from a secondary share placement to their investors, leaving the selling shareholder following the closing of a secondary share placement typically with no significant assets (other than remaining shares held in the issuer in the event of a partial exit) to back up the indemnity in a manner required by the DT3 Decision.

For such private equity investors, the purchasing of insurance cover, pledge of collateral and/or escrow arrangements are possible alternatives to manage the German prospectus liability risk in practice — all of which come at an additional cost. In most cases, the purchase of insurance will only support, but not replace, the indemnity obligations of selling shareholders, because obtaining insurance cover in excess of €200 million to €300 million is difficult in the German market.

If a selling shareholder controls a German corporation, it also may be held liable as a controlling shareholder pursuant to the rules for so-called *de facto* groups if it does not compensate the corporation through indemnification for any damages resulting from a possible prospectus liability relating to a secondary share placement.

Underwriters. Although the customary indemnity from prospectus liability granted by a German corporation to the underwriters in connection with a secondary share placement generally is viewed as being enforceable, the absence of an enforceable indemnity from the selling shareholder to the corporation also could affect the enforceability of such indemnity to the underwriters, if they are aware of the fact that the indemnity from the selling shareholder to the corporation is not for value (*werthaltig*) or not enforceable.

To make sure the underwriters have a valid indemnity claim against the corporation, they are well-advised to conduct at least some due diligence with respect to the substance of the indemnity that runs from the selling shareholder to the corporation. As a result, it has become market standard that underwriting agreements relating to German equity capital markets transactions also involving a secondary share placement include a representation by the corporation with respect to the valid existence of an indemnification agreement with the selling shareholder that meets the requirements of the DT3 Decision, as well as a condition precedent with respect to the execution and delivery of such agreement.

Legal Opinion Qualification. The legal opinions delivered by German counsel in secondary share placement transactions likely will include a qualification with respect to the enforceability of the underwriting agreement as it relates to the question whether the indemnity from the selling shareholder to the corporation is for value (*werthaltig*), since the analysis relates to a factual and not a legal issue.

Structural Alternatives for Selling Shareholders

To avoid the consequences of prospectus liability as defined in the DT3 Decision, selling shareholders have few structural alternatives:

- In an IPO scenario, conduct the initial transaction as a primary share offering only, and follow up with an undocumented placement after the expiration of the lockup period. While possible as a legal matter, this IPO structure will be difficult to implement from a valuation and liquidity perspective. The transaction structure must not be viewed as circumventing the need for a documented offering.
- In a secondary share placement scenario, implement block trades — typically on the basis of accelerated book-buildings with institutional investors — without the public offering of shares and without any marketing documentation. These transactions do not fall within the scope of the DT3 Decision.
- Reincorporate the issuer in another (European) jurisdiction with less stringent capital maintenance requirements (non-German holding structure). However, a foreign domiciliation of a previously German issuer will raise tax, governance and general market issues that need to be analyzed carefully on a case-by-case basis.
- Structure the transaction to distribute cash to shareholders prior to the IPO and refinance through proceeds from the primary-only offering.

Outlook

In connection with secondary share placements in Germany, selling shareholders (*e.g.*, private equity firms) will need to evaluate their options for managing the prospectus liability risk on a case-by-case basis. In transactions involving private equity investors as

selling shareholders, it is to be expected that the issues presented by the DT3 Decision will be addressed through some combination of an indemnification agreement between the selling shareholder and the issuer, the purchase of insurance cover and — depending on the size and structure of the offering — possibly the strengthening of the asset base of the selling shareholder (*e.g.*, a portion of the proceeds to be held in escrow) for a certain time period following the closing of the transaction.

In addition, because of the increased prospectus liability risk in Germany, selling shareholders are expected to retain separate legal counsel and be more actively involved in the due diligence and prospectus drafting processes.

Because of the personal liability risk resulting from an impermissible repayment of contributions to shareholders, following the DT3 Decision individual board members of German corporations also typically will retain their own legal counsel in connection with secondary share placements to ensure that the indemnification by the selling shareholders is enforceable and substantiated (*werthaltig*).

The DT3 Decision is one of the most disputed court decisions affecting capital markets transactions in Germany in recent years. Due to its broad tenor, German legal commentators and practitioners have been actively debating the DT3 Decision's potential impact on transaction structures that differ from the structure of the DT3 Offering (which involved a secondary share placement without any proceeds to the issuer), such as IPOs and mixed primary and secondary share offerings. It remains to be seen whether the attempts by legal commentators, practitioners and other market participants to limit the scope of the DT3 Decision — through applying a pro-rated liability scheme for mixed primary and secondary share placements — will be adopted and confirmed by the German courts.

Hong Kong Equities Look for Brighter 2013

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Following their leading role in primary equity capital raising for the previous three years, 2012 marked a sharp retreat for Hong Kong's equity markets. Last year's Hong Kong IPO market likely will be remembered for the following:

- **A Significant Drop in Capital Raised.** According to the Hong Kong Stock Exchange (HKSE), $10.76 billion was raised in IPOs, a 67 percent drop from 2011, and the exchange's average daily turnover in value terms was down 24 percent for the year. Many of the larger equity deals during the year consisted of secondary fundraising by established issuers, with total secondary funds raised remaining steady compared to 2011 at $26 billion.
- **Greater Dependency on Committed Investors.** Almost all IPOs of meaningful size depended on significant sales in the IPO to "friends and family" or were substantially supported by multiple cornerstone investors prior to launch. A number of transactions saw the introduction of new bookrunners very late in the process, with participation and economics closely tied to the ability to deliver committed investors.
- **Fewer Non-Chinese Listings.** With the notable exception of the Sunshine Oilsands IPO, and in contrast to the past few years, last year saw few listings on the HKSE by

businesses based or controlled outside of China. Several high-profile deals, including the Graff Diamonds IPO, were delayed or canceled. Likely causes include the lower valuations, the poor aftermarket performance and liquidity of some overseas companies that listed in the past few years, and the perceived time and expense that the Hong Kong listing process entails.

- **An Increased Focus on Regulating the IPO Process.** One investment bank's license to advise on IPOs was revoked as the result of performing inadequate due diligence, and the Hong Kong Securities and Futures Commission (SFC) issued a set of proposals intended to bring about heightened levels of responsibility for investment bank sponsors of new listing applications. While it remains to be seen whether the SFC's proposal to make sponsors criminally liable for prospectus misstatements ultimately will become law, a number of the other proposals, including the public disclosure of draft prospectuses at the initial filing stage and the requirement for sponsors to have completed due diligence prior to the initial filing, are now set to come into effect on October 1, 2013. We believe the increased focus on the role of sponsors should be coupled with further steps to streamline the listing process.

What to Expect in 2013

While it is difficult to be certain, there are indications that market sentiment and prospects are improving.

> "2013 could be the year that the first of the previously U.S.-listed China businesses taken private by their founders is relisted in Hong Kong."

With the successful closing of the IPOs of PICC Group (the largest IPO of 2012 by value) and China Machinery Engineering (the most oversubscribed IPO of 2012) in December, and the Hang Seng Index close to an 18-month high, the Hong Kong markets seem poised for positive momentum into 2013. Moreover, several of the uncertainties that cast a shadow over the Hong Kong market throughout 2012 — slower Chinese economic growth, China's leadership transition and the 18th Communist Party Congress, financial uncertainty in Europe and the U.S. presidential election — seem less likely to cause concern this year.

The Hong Kong market also may reap an indirect benefit from the inability of the United States Public Accounting Oversight Board (the PCAOB) to inspect Chinese accounting firms. Under Sarbanes-Oxley, the PCAOB is required to periodically inspect all accounting firms that audit U.S. reporting companies. Citing national security concerns, Chinese authorities have not been willing to permit these inspections and, to date, the PCAOB's efforts to agree on a regime of joint inspections have been unsuccessful. The deadline for completion of inspections was December 31, 2012. As of this writing, the PCAOB has not made any public statements that it is taking action. However, the deregistration or suspension of registration of PRC-based accounting firms, including the affiliates of the "Big Four," could commence at any time if an agreement on inspections is not reached. Upping the ante, the SEC announced on December 3, 2012, that it was bringing charges against the Chinese affiliates of the Big Four accounting firms for violating U.S. securities laws by refusing, in the context of a number of ongoing SEC investigations, to produce documents relating to their audits of China-based U.S.-listed companies. Discussions are ongoing and there is still a likelihood that a deal on inspections will be reached before any accounting firms are deregistered. However, the prospect of being unable to find an auditor (and the eventual delisting and deregistration in the U.S. that would follow) could further undermine investor interest in U.S.-based China businesses, and could result in some affected companies deciding to exit the U.S. in

favor of Hong Kong as a listing venue, or to pursue a dual listing in both venues as a contingency measure (see "Global M&A/China M&A: Looking Ahead to 2013").

Finally, 2013 also could be the year that the first of the previously U.S.-listed China businesses taken private by their founders (a trend we commented on in *Insights* last year[34]) is relisted in Hong Kong. While such deals likely would be subject to a good deal of regulatory scrutiny in light of allegations of widespread financial and other irregularities, particularly among Chinese businesses that were listed in the U.S. through reverse takeovers, we believe that the majority of U.S.-listed companies that have gone private likely will be suitable candidates for eventual relisting in Hong Kong.

[34] *See* "Global M&A," *Skadden Insights* (January 2012), *available at* http://www.skadden.com/insights/global-ma-0.