

Middle Market M&A: Proposed Changes to Reg S-X Rule 3-05

Presented to

SEC Small Business Capital Formation Advisory Committee

Matt Swartz

Partner

Pillsbury Winthrop Shaw Pittman, LLP



pillsbury

Matt Swartz background

- “Always thinks through everything from a reasonable market perspective of what’s fair.” *Chambers USA, 2018*
- 24 years as corporate, securities, M&A lawyer
- 100+ M&A transactions for buyers and sellers
- Practiced in Silicon Valley and Washington D.C.
- Served as director on corporate boards, including two with successful M&A exits
- Fun fact: Nebraska credentials!

Summarizing my view of the proposed changes to Reg. S-X 3-05 in one word...

Bravo!

Summarizing my view of the proposed changes to
Reg. S-X 3-05 in two words...

Bravo, however...

Auction/“Managed Process”

- Typical middle market company sales process: “managed process”
- Which buyer has the most compelling offer? Factors:
 - Price
 - Certainty to close
 - Does the buyer have the money?
 - Reputation and speed to close
 - Special requirements (e.g. CFIUS, audits)
- “Cultural fit”

General Types of Acquirors

- Private company
- Investment fund (private equity)
- Public company

Timing and certainty of closing, discretion

Type of Buyer	Visibility of resources	Audit-related condition/delay	Will the neighbors know in detail?
Private Company	No	No	No
PE Fund	By reputation	No	No
Small public company	Yes	Yes	Yes
Big public company	Yes	No (usually)	No (usually)

Target concerns about public company acquiror

- Is there a greater risk of not closing?
- **Yes** if small public company acquiror (likely to meet significance tests)
- No if large public company acquiror (because significance test likely not met)

The burden

- Regulation S-X 3-05 financial statement requirement:
 - For small companies acquisition targets, obtaining audited financial statements impose expense and a delay
 - Delay = uncertainty
 - Uncertainty makes a bidder less competitive
 - The expense and uncertainty of audits required make smaller public companies:
 - Less appealing acquirors for targets
 - Less able to grow by acquisition (because targets prefer other buyers)

Will proposed 3-05 Rule changes make it better?

- Yes, by diminishing the likelihood of a “significance” determination (revised tests) and the burden on targets (changes to target financial statement requirements)
- Particularly good change: Allowing IPO companies to omit pre-acquisition target financial statements where already included in consolidated financial statements for one year.
- Will the changes make small public companies more competitive acquirors? Yes, probably. But they are still at a disadvantage compared to other common buyers.

A good step. what else could the Commission do?

- Move farther away from the audit requirement of “significant” targets, place more emphasis on detailed pro-forma information and explanation: **relevance vs. reliability**.
- Acquisitions by private equity funds have increased significantly over the last 15 years, while IPOs, particularly small IPOs, have declined significantly.
- Study the financial diligence of successful private equity firms: these successful acquirors do not always require audited financial statements from targets that don’t already have them

Thank you!

- Thank you for having me as your guest,
- Thank you for your service to our country and dedication to sound capital markets, and
- Thank you for the thoughtful reform that the Commission has proposed.