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

Presented to
SEC Small Business Capital Formation Advisory Committee

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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

<table>
<thead>
<tr>
<th>Type of Buyer</th>
<th>Visibility of resources</th>
<th>Audit-related condition/delay</th>
<th>Will the neighbors know in detail?</th>
</tr>
</thead>
<tbody>
<tr>
<td>Private Company</td>
<td>No</td>
<td>No</td>
<td>No</td>
</tr>
<tr>
<td>PE Fund</td>
<td>By reputation</td>
<td>No</td>
<td>No</td>
</tr>
<tr>
<td>Small public company</td>
<td>Yes</td>
<td>Yes</td>
<td>Yes</td>
</tr>
<tr>
<td>Big public company</td>
<td>Yes</td>
<td>No (usually)</td>
<td>No (usually)</td>
</tr>
</tbody>
</table>
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:
  o For small companies acquisition targets, obtaining audited financial statements impose expense and a delay
  o Delay = uncertainty
  o Uncertainty makes a bidder less competitive
  o 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.