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MEREDITH CROSS TALKS IPOS, JOBS AND DISCLOSURE

BY RONALD OROL IN WASHINGTON

Washington insiders often point out that the JOBS Act, written to help small companies raise capital, somewhat contradictorily, both encourages and discourages initial public offerings.

But that's a good thing, said Meredith Cross, the Securities and Exchange Commission's corporation finance unit chief between 2009 and 2012, because that seemingly conflicting outcome is the result of giving companies needed flexibility in their capital raising efforts. Cross, a partner at Wilmer Hale in Washington, was a key architect of the agency's implementation of the law.

In a wide-ranging interview with The Deal's Ronald Orol, Cross offered behind-the-scenes details about the SEC's work on both the JOBS Act and the Dodd-Frank Act, the 2010 law enacted in the wake of the financial crisis.

Among the topics she discusses are the SEC's struggles to craft CEO pay rules and its unsuccessful efforts under her watch to dramatically reform the corporate disclosure system.

She also talks about what the SEC could do to make proxy advisory firms Institutional Shareholder Services and Glass, Lewis & Co. less powerful, why a nickel trading increment could help IPOs and how SEC staffers could go about re-evaluating who qualifies to invest in a hedge fund or small business, which the agency is statutorily required to review next year.

Cross is in her second stint at Wilmer Hale. Before leaving for the SEC in 2009, Cross was a partner at the firm and was co-chairwoman of the corporate practice. She had been at the SEC previously as well. Before joining Wilmer Hale in 1998, Cross was deputy director of the SEC's division of corporation finance. She joined the SEC in 1990. Earlier, Cross worked in the securities department of King & Spalding LLP in Atlanta.

The Deal: *The SEC is evaluating the appropriate role of proxy advisory firms such as ISS and Glass Lewis. They recently held a roundtable to discuss the issue. What are they up to?*

Meredith Cross: The corporate community wants the SEC to do something involving the proxy advisory firms. If they can come up with something to do that would make corporations more comfortable with proxy advisory firms — that — theoretically could offset some of their concerns with some of the other governance items that are under discussion.

What exactly could the SEC do on proxy advisory firms? There are a large number of investors who automatically follow their vote recommendations on proxy fights, CEO pay plans and other governance matters.

I understand from studies that the proxy advisory firms move around 20% of the vote when they put out their recommendations. The votes that are likely to be impacted are more likely to be those of smaller institutional investors. Larger institutional investors do their own internal analysis and have their own guidelines.

One of the reasons proxy advisory firms are important to the institutional investor community is because of guidance from the SEC and the Department of Labor to the effect that there is a fiduciary obligation to vote. You can't just decide not to vote. Then you have to know how to vote. You have to vote with some intelligence. You can't just vote automatically with management because you don't have time to investigate it. Because of that, people look to the proxy advisory firms for help, particularly as you add more voting requirements, including recently added say-on-pay proposals.

Some people rely heavily on the proxy advisory firms to figure out how to vote. I understand that there is a no-action letter from the Division of Investment Management at the SEC that tells the institutional investors that they can rely on proxy advisory firms in making the voting decisions. One idea that has been floated to reduce the influence of the proxy advisory firms is to reverse — in essence retract — that no-action letter so that investors would not get a free pass to rely on the proxy advisory firms for deciding how to vote. That would give the proxy advisory firms less power and would pressure investors that rely on proxy advisory firms to do more of their own due diligence.

Can you give me an example of what corporations are upset about?

There were a lot of complaints that the proxy advisory firms were

not really doing enough work in putting together their recommendations. I don't know whether or not that is the case from my time at the SEC, but the corporate community feels strongly that it is.

They have a proxy season, a seasonal thing for calendar companies, which is basically March, April, May, June, to do their work, and I have heard that they often hire temporary workers to help out during that busy time.

There was also a big complaint that proxy advisory firms were using peer groups for compensation voting recommendations that were not really reasonable.

For example, I recall that there were concerns raised that one of the proxy advisory firm's peer groups for a hotel company didn't include any hotel companies. This seemed like a reasonable complaint, so I asked the proxy advisory firms to come in and talk to us about how they were identifying their peer groups to try and get a better sense of that.

They did a very good job explaining their process, but they also did change how they did it the following year after getting more input from several quarters on the issue.

There are lots of concerns that they have conflicts of interest that they don't sufficiently disclose. That is another area the SEC could push on. Some companies feel they essentially have to buy the consulting services of the firms in order to get a good recommendation. I don't know if that is true, but that is something the SEC could push them on.

These are services that an investor wants to buy but at the same time, the corporate community is rightfully upset with how it works. Finding the right balance of how to address the competing concerns is very difficult.

As required by the Dodd-Frank Act, the SEC put out a proposal to compare the ratio of CEO pay to median employee pay. Global corporations have an option to calculate a statistical sample of total population of their employees but companies with multiple pay processing systems around the world argue it will be difficult to implement. Is it workable?

It will be interesting to see how it plays out. We worked on it extensively while I was there and we got a comment letter from AFSCME, which recommended that the SEC allow statistical sampling. The hard part is that the Dodd-Frank Act tells the SEC that it has to require this ratio and the pay has to be computed according to very specific requirements in regulations.

The question is how to do it in a cost-effective fashion. The idea of statistical sampling seemed like a way to save money. When I was still at the SEC, some companies said that because of the way pay works in different parts of the company around the world and the absence of integrated payroll systems, maybe statistical sampling will save some money, but not that much.

I think the provision in the proposal that seems like it really could save more money is the part that would allow companies to find the median employee using whatever method of calculating pay they want to, as long as it is done consistently across the company. That is getting away from the requirement to use a multipage pay calculation in the SEC rules to find the median employee.

If you are a U.S.-only company and you can use W-2 forms, it seems this would not be hard. I give the SEC credit for trying very hard to find a way to make it less expensive to find the median employee. If the corporate community has to spend too much money on finding the median employee and otherwise complying with this requirement, the huge burden would be very controversial, even if it is required by the Dodd Frank Act.

Has the JOBS Act helped IPOs?

Everybody wanted to point to someone else about why the IPO market has shrunk. One answer could be that really tiny IPOs are just not an economical way to raise capital. With the JOBS Act, these emerging growth companies — assuming they do not yet have $1 billion in revenues — get up to five years of a pass on internal controls audits and reductions of some reporting obligations.

The JOBS Act also makes the private markets a lot more attractive because you can use general solicitations to raise money for private offerings. Also, the number triggering Exchange Act registration and reporting got raised to 2,000 record holders of stock, up from 500 — so companies can stay private longer. Some people say the incentives are conflicting with each other in the JOBS Act, in that it includes ways to make it easier to be public, but they also have ways to make it easier to stay private.

I like that approach because the company should choose based on what is best for itself.

Critics of a new rule allowing hedge funds and small companies to advertise when they seek to raise capital privately say they are nervous about a vague provision requiring companies to take "reasonable steps" to verify that their investors qualify as high-net-worth accredited investors. Is it a problem?

Congress added the reasonable steps to verify, which made it more complex. That is a difficult thing to make workable so I'm spending a lot of time right now talking to clients about what is required to satisfy the reasonable steps to verify requirement.

I do think it will work out over time. I keep reminding people that it is a facts and circumstances test. For example, if you already know the investor and have had them in multiple deals in the past, you probably don't need to do much.

If you don't know the investor, and you are just finding them online and they just check a box saying they qualify as a high-net-worth accredited investor, the SEC was pretty clear in saying that is not enough. I think people are mixing and matching the concern as it relates to verifying the accredited investor sta-

tus for strangers online vs. the classic venture capital deal where the company knows the community, in which case you probably would not need to get tax returns.

In some circumstances, the issuer has to take certain steps. That can include getting certification from certain people such as your broker-dealer. That broker dealer would be in a good position to verify that their client is an accredited investor.

Overall, my view is that it is definitely complicated in an online world where you are dealing with strangers, but that it will eventually become more workable across the board.

When the SEC adopted the general solicitation of private offerings rule it also introduced a controversial proposal opposed by Republicans that would beef up the so-called Form D, which would among other things require companies that raise money privately to fill out a form with some information about their businesses before the securities were made available. Opponents say that with this proposal still outstanding they are confused about what they can and can't do.

This proposal would require companies seeking private placement investors to file a Form D in advance of their offering, which gives state securities regulators a chance to investigate them and identify if they are above board before making the offering.

Originally, the Form D was just a notice of filing, so the SEC would know what deals were done so the agency could collect data. Over time, people such as state securities regulators have found more and more important uses for it. State securities regulators are pre-empted from regulating these deals on a pre-offering basis, so they would like to see these deals in advance hoping to ferret out more fraud. The SEC is not in a position to do anything with these forms in advance. There are too many of them.

I also think it is a red herring to believe that this Form D proposal has any impact on the rule that was adopted. In practice I'm not thinking about what was in that rule proposal as I advise clients about what they can do under the new general solicitation of private offerings rule. I believe that people are making their plans for how to do deals on that basis.

Will general solicitation of private offerings be successful?

I think it is going to be successful. But I also think the SEC will have to go after some bad actors who advertise or do cold calls to nursing homes — including things that are terrible and aimed at senior citizens or those who have big 401Ks that they are living on.

The SEC is required in 2014 to review the so-called accredited investor category identifying who can invest in these hedge fund private deals. Investors who now have a net worth excluding their home of $1 million or more or income of $200,000 or more for at least two years can qualify. How do you think this will play out?

Aside from removing the house from the net worth test, this definition has essentially been unchanged since the early 1980s. Is $200,000 the right amount of income for an investor to not need the protections of the Securities Act? That's not clear. If I were writing a rule in this space, I would change it to an investments test. This would focus only on how much an individual has invested rather than their net income or net worth.

The idea is that you invest so much that you are qualified to do it without a prospectus. The big questions will involve what is permissible to include as an investment and what is the right minimum investment number.

The difficulty will be determining what is the right minimum investment number to identify someone who is experienced enough at investing to not need the protection of the Securities Act. Is $500,000 of money invested in securities enough? If you said they need $1 million in securities that probably would knock out more investors from the potential universe of investors than the business community will feel comfortable knocking out.

The SEC is moving toward a pilot program that would allow small public companies to widen their current one-penny increment that is used to price securities. Boutique banks that back the initiative are hoping that a pilot program set up by the SEC would kick some life into the lackluster IPO market by giving small boutique investment banks the incentive to trade them more and invest in hiring stock salesmen and analysts who would shine a spotlight on otherwise ignored small public companies. Is it a good idea? How long should it be? A year?

The question about tick sizes is included in a big group of questions around what is needed to restart smaller IPOs. Perhaps tick sizes would help. It is where profits can be made for some of the smaller investment banks and I'm not sure investors are harmed by it. It is logical that you need a longer pilot program to get banks to invest in the analysts and sales people involved. A year is awfully short.

Suggesting that investors are being inundated with "information overload," SEC chief Mary Jo White is seeking to revamp the entire corporate disclosure regime.

I tried to do this the whole time I was at the SEC. It was called the "core disclosure project." I had big teams working on it before the Dodd-Frank Act was enacted and we got 30 or so rules we had to write under the statute so we couldn't really work on the disclosure effort. So having said that, yes, I think it is a great idea. There will be a lot of difficulty getting it done because it is not an emergency requirement.

The disclosure system isn't so broken that people can't find the information they want. Another issue to keep in mind: Whenever you talk about taking away a required disclosure someone gets upset. And yes, there will be difficulty around liability if they go this way because companies will want safe harbors from different kinds of lawsuits related to disclosures.

You've said that many SEC disclosures don't really have a lot in common with what is talked about on earnings calls.

I asked the staff to listen to the earnings calls when they were doing the reviews of the filings and if it didn't seem to be the same company, they should issue a comment along the following lines: "We note on the earnings call that these are the trends you talked about being important. Your document doesn't talk about those trends as being important. Please explain."

The change to provide more informative, useful, communicative disclosure in SEC filings needs to happen eventually.

A lot of it is happening voluntarily. For example, to get the vote on say-on-pay, companies are presenting the information in a more user-friendly presentation. There is already a movement to have companies write their annual reports in a more user-friendly manner as well.

The overall question is whether the information that the SEC mandates through its disclosure system is resulting in a compliance document that is not that relevant. Currently, there is way too much information in these filings. Too much repetition. The financial statement footnotes repeat what is in MD&A. Congress keeps adding things for companies to disclose, such as information about the use of conflict minerals, and these docs just get bigger and bigger. The investor community can't possibly be reviewing it. Analysts review it for investors, but do they need all of it — what do they need?

White suggested that disclosure of high and low historical share prices is something that can be eliminated because people can go on the Internet and get that information.

That is something that can clearly be eliminated. Another one is that you generally have to disclose and list all your properties. It isn't important. How many companies, other than real estate companies, do you buy based on what properties they own? There are a whole lot of strange requirements that you can certainly see eliminating. You also could reduce burdens for companies for their annual proxy statement by letting a lot of the information that is currently required in a proxy statement just be available on the company's Edgar webpage so, for example, you wouldn't have to repeat your basic corporate governance information every year.

Do you think Congress could enact a JOBS Act 2.0, in light of the bipartisan JOBS Act?

I wouldn't be surprised. If they can find things that they think can help small business without adversely affecting investors, and they don't have the patience to wait for the SEC to do it, I can see them doing it. They got the JOBS Act through so quickly.

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