THOMPSON HINE

Business Law Update

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Mergers & Acquisitions

Use of Earn-Outs in Private M&A Transactions

By Stuart Welburn & Corby J. Baumann

An earn-out is a form of contingent consideration that is payable to the seller based on the performance of the target business for a period of time after the closing of a merger or acquisition transaction. Earn-outs are typically structured as one or more payments made upon the achievement of certain specified targets (for example, the achievement of a minimum amount of earnings before the deduction of interest, taxes, depreciation and amortization, or EBITDA).

Recently, the American Bar Association released its 2011 Private Target Deal Points Study (ABA Study), which analyzed acquisition agreements for 100 transactions that closed during 2010. The transactions, which ranged from $25 million to $960 million in size, each involved a private target business being acquired by a public company. The ABA Study found that 38 percent of the acquisition agreements included an earn-out provision, reflecting an increase from the ABA's prior study of transactions that closed during 2008, in which 29 percent of the transactions reviewed included such a provision.

An earn-out is one mechanism that can bridge a gap in valuation of the target business in a private M&A transaction. They are often used in situations where there is difficulty in valuing a business or market uncertainty, as the seller and buyer essentially share the risk by making a portion of the payment for the business contingent on its future performance. It is not surprising that the use of earn-outs has increased given the market fluctuations during 2010.

While they can be useful in bridging gaps in valuation, there are several key considerations in structuring earn-outs in private M&A transactions:

- *Earn-out targets*. The targets used to determine whether an earn-out is paid may be financial or operational. For example, typical financial targets include specified thresholds based on revenues, net income or EBITDA. Operational targets may include the launch of a particular product or an increase in customers. In

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addition, an earn-out may be structured to include both financial and operational targets. According to the ABA Study, the earn-out target consisted of a revenue threshold in 37 percent of the agreements and an earnings or EBITDA threshold in 32 percent of the agreements (in each case, the percentages refer to the subset of acquisition agreements that contained earn-out provisions).

- *Earn-out period.* As earn-outs relate to the post-closing operation of the target business, careful consideration should be given to the length of the earn-out period. In particular, if there are post-closing covenants that impact the buyer's operation of the business during the earn-out period, the buyer will likely negotiate for a shorter earn-out period. Earn-out periods typically range from 12 to 36 months, with one payment made at the end for earn-outs of shorter duration and multiple payments made at the end of each year for multi-year earn-out periods. According to the ABA Study, 24 percent of the agreements containing earn-outs included an earn-out period of 36 months, 9 percent included an earn-out period of 24 to 36 months, 12 percent included an earn-out period of 24 months, 18 percent included an earn-out period of 12 to 24 months and 18 percent included an earn-out period of 12 months. In addition, the ABA Study noted that 6 percent of the agreements contained earn-out periods of 36 to 60 months and 6 percent contained earn-out periods of greater than 60 months, while 9 percent of the agreements contained earn-out periods of less than 12 months.

Given the implications that post-closing covenants have on the buyer's ability to operate the business, the buyer may seek to negotiate for no post-closing covenants or to limit its obligations related to operating the business under the post-closing covenants.

- *Payment terms*. The payment to be received by the seller upon achievement of the earn-out target is generally structured as (i) a flat fee, (ii) a multiple of the amount by which the business exceeds the earn-out target or (iii) a percentage of the earn-out target. For example, if the overall purchase price for the business was determined based on a specific multiple of the business's EBITDA, then it may be appropriate to tie the earn-out to EBITDA and the payment to be a multiple of the overall amount by which the business exceeded the specified target. Parties often specify a maximum amount payable, or a cap, in the event that the business far exceeds the earn-out target.

- *Covenants*. The seller will often seek to require the buyer to operate the target business in accordance with certain post-closing covenants in order to facilitate the business reaching the earn-out targets. Post-closing covenants may require (i) that the buyer maintain separate books and records for the business (and give the seller the right to inspect the books and records from time to time), (ii) that the buyer dedicate a certain minimum level of working capital to maintaining the business, (iii) that the buyer not engage in any change of control or sale transaction involving the business or (iv) that the buyer maintain a certain level of effort in operating the business (such as commercially reasonable efforts) in order to reach the earn-out targets. Given the implications that post-closing covenants have on the buyer's ability to operate the business, the buyer may seek to negotiate for no post-closing covenants or to limit its obligations related to operating the business under the post-closing covenants.

- *Dispute resolution*. While earn-outs provide a mechanism for bridging a gap in valuation, they also have the potential to lead to post-closing disputes. In negotiating an earn-out, the parties need to determine which party will prepare the initial financial statements and calculations relating to the earn-

out as well as the accounting principles to be used to prepare these calculations. The parties also need to establish the time periods for review of the calculations and how disputes will ultimately be resolved (for example, which independent accounting firm will be engaged and the time period and procedures for the accounting firm to deliver its calculations). In an effort to avoid disputes, the parties should be as specific as possible in describing the accounting principles to be used in determining the earn-out calculations, including the treatment of post-closing acquisitions, shared costs and expenses, and any extraordinary or non-recurring items.

- *Acceleration; buy-out option*. In structuring an earn-out, the seller and buyer need to agree on whether any actions will result in the acceleration of all or any portion of the earn-out. For example, the sale of the target business during the earn-out period or the termination of key executive officers may result in all or some portion of the remaining earn-out payments becoming immediately due and payable. Acceleration gives the seller some assurance that the buyer may not take certain specified actions that could adversely impact the performance of the business and/or the ability to make the earn-out payments when they are due. According to the ABA Study, 35 percent of the agreements that contained earn-out provisions expressly contained provisions accelerating the payment of the earn-out upon a change of control. Alternatively, the buyer may request a buy-out option allowing the payment of a specified amount to satisfy any remaining requirements under the earn-out and releasing the buyer from its ongoing obligations relating to the earn-out and any post-closing covenants applicable to the business.

- *Other considerations.* The parties should ensure that payment of the earn-out is permitted by the financing documents of the target business. In addition, parties considering use of an earn-out should consult their financial advisers to discuss the implications of the accounting treatment of the earn-out. It may also be appropriate in certain transactions to seek a guarantee or other form of security for the buyer's potential payment obligations under the earn-out.

An earn-out may be an attractive option to address differences in opinion regarding the value of the target business in a private M&A transaction. In particular, consider using an earn-out to bridge a gap in valuation in situations where the target business has limited operating history but potential for significant growth (for example, new service offerings, products or technology) or when the target business has experienced a recent decline in earnings.

For more information about earn-outs, please contact Stuart Welburn or Corby J. Baumann.

Private Equity

Taxation of Carried Interest – The Great Debate

By Douglas D. Roberts

If you have been living under a rock for the past several years (and especially the past few months during the race for the Republican presidential nomination), you might not be aware of the great debate surrounding the taxation of carried interest. At issue: Is carried interest an investment that should continue to receive preferential capital gains, instead of ordinary income, tax treatment?

Based on the extensive press coverage of this issue, I realized that most of the analysts incorrectly assume everybody already knows what carried interest is and how it is created. Some detail as to how private equity and venture capital funds are structured would be helpful and lead to a better understanding of what carried interest really is. Then everyone can form their own informed opinions about how it should be taxed.

The devil in the detail. Private equity and venture capital funds typically are structured as limited partnerships with a lifespan of 10 to 14 years. The general partner (e.g., Bain Capital) finds limited partners that will invest capital in a fund to be used to make private equity and venture capital investments in operating companies around the world. The general partner typically invests a bit of its own money as well, usually 1 percent of the total invested by the limited partners. Then the general partner does all of the work, while the limited partners sit back and hope for a great return on their investments.

The general partner gets compensated for its efforts in two ways: a management fee and carried interest. Paid annually, the management fee is usually set at 2 percent or 2.5 percent of the capital invested in the fund by the partners. So, no matter how well (or poorly) the fund's investments perform, the general partner will receive the management fee. Just to show my math, for an average-sized fund of $500 million with a 2 percent management fee, $10 million gets paid to the general partner every year as its management fee. Of course, for the largest of funds, which are reaching $10 billion in size, that management fee would be up to $200 million per year.

Over the life of the private equity or venture capital fund, the amount of capital invested in it will decrease as certain investments are cashed out and repaid to the limited partners. Those annual $10 million (or $200 million) payments to the general partner will be reduced proportionately. In addition to that decrease, some general partners will have agreed to lower their management fee to 1 percent or 1.5 percent after the first six or seven years once they are no longer actively searching for and investing in portfolio companies; instead, they will be preparing the companies to be sold during the second half of the fund's life so that the proceeds can be returned to the partners.

Which brings us to the carried interest. Even if a general partner invests 1 percent of whatever amount the limited partners invested, the carried interest gives the general partner extra credit – as if it had invested 20 percent of the total size of the fund. The general partners of some very large funds receive a carried interest of 25 percent or even 33 percent. And, like the management fee, the amount of carried interest may be negotiable when the private equity or venture capital fund is being formed, especially if certain large limited partners have enough bargaining power to refuse to invest in the fund unless the general partner reduces its compensation structure.

It comes down to this: The limited partners invested 99 percent of the money used by the fund to make its investments in operating companies, but they receive only 80 percent (or less) of any profit generated by the fund when it sells those portfolio companies. In contrast, the general partner has invested 1 percent of the money but receives 20 percent (or more) of the

profit generated by the fund. But all of the partners receive the same reduced capital gains taxation treatment on income they receive from the fund.

General partners argue that they deserve this preferential treatment on the 20-percent "extra credit" carried interest because they put in the time, energy and expertise to grow the portfolio companies in which the fund invested. Of course, the general partners are still receiving their management fees. And not every investment ends up being a success story for the investors or the portfolio companies as a whole.

Impact. If the tax code is revised so that carried interest is taxed as ordinary income instead of capital gains, what impact will that have on the private equity and venture capital markets? Will general partners walk away from the opportunity to invest in new portfolio companies and, as a result, cause a slowing in the creation and growth of businesses? Or, similar to a banking industry searching for new fees and other sources of revenue, will general partners simply pass their increased costs on to their customers by increasing their management fees and/or percentage of carried interest, or by lowering their pre-money valuations of the portfolio companies so that the projected returns on investment will remain the same? (Hint: Many recently formed private equity and venture capital limited partnership agreements already include a new provision that anticipates any changes to the tax code and protects the general partner so that it will still receive the same economic benefit as if the carried interest had continued to be taxed at the lower capital gains rate.)

While these questions may appear to be a separate debate for another day, "answers" to them are influencing the debate right now.

For more information about carried interest, please contact Douglas D. Roberts.

Public Companies

Regulation D – Private Offerings & Public Solicitations

By Michael J. Hagan

In November 2011, the U.S. House of Representatives passed H.R. 2940, the Access to Capital for Job Creators Act (House Bill), which has been forwarded to the Senate for consideration. The bill addresses Section 4(2) of the Securities Act of 1933, as amended (Securities Act), which provides that the registration requirements of the Securities Act will not apply to transactions by an issuer not involving any public offering. It also addresses Rule 502(c) under Regulation D (Reg D), which prohibits any general solicitation or general advertising in a private placement that is made in reliance upon Reg D. The House Bill seeks to amend Section 4(2) by inserting at the end of the section the phrase "whether or not such transactions involve general solicitation or general advertising." In addition, the bill directs the Securities and Exchange Commission (SEC) to amend its rules on private placements made under Rule 506 (the principal rule relied upon by issuers in Reg D private placements) to provide that the prohibition against general solicitation or general advertising (which is contained in Rule 502(c)) shall not apply to Rule 506 private placements made to only "accredited investors."[1]

Over the last 30 years, there have been periodic efforts to loosen the solicitation and advertising prohibitions. With the explosive growth of the hedge fund industry in recent years, new pressures have been mounted to permit some solicitation and advertising to limited, well-defined audiences.

Since it was promulgated in 1982, Reg D has been the centerpiece for unregistered capital formation via private placements. In addition to its restrictions on offerees,[2] a core aspect of private placements under Reg D has been the prohibition on general

[1] "Accredited investors" is defined in Rule 501 of Reg D to include banks, insurance companies, registered broker-dealers, many employee benefit plans, corporations and other business entities (not formed for the specific purpose of acquiring the securities being offered) with assets in excess of $5 million, and individuals with a net worth in excess of $1 million or whose individual income, or joint spousal income, in each of the last two years was $200,000 or $300,000, respectively, and who has a reasonable expectation of reaching the same income level in the current year.

[2] Rule 506 permits sales to an unlimited number of accredited investors and up to 35 unaccredited investors. In practice, many issuers restrict their offerings to only accredited investors.

advertising or general solicitation, a key distinguishing factor between Reg D private placements and registered and widely marketed public offerings. Over the last 30 years, there have been periodic efforts to loosen the solicitation and advertising prohibitions. With the explosive growth of the hedge fund industry in recent years, new pressures have been mounted to permit some solicitation and advertising to limited, well-defined audiences.

On January 9, 2012, the Managed Funds Association (MFA)[3] submitted a petition for rulemaking to the SEC, requesting that it amend Rule 502(c) to eliminate the prohibition on offers or sales of securities by general solicitation or general advertising with respect to private funds. The MFA petition is crafted more narrowly than the House Bill in that the petition seeks relief from the general solicitation/general advertising ban only with respect to sales to "qualified purchasers" or "qualified clients" in the case of sales of securities by funds that are registered investment advisers.[4] The policy arguments advanced by the MFA include the resulting increased transparency of hedge funds, lifting the veil of secrecy sometimes associated with them, and elimination of the current uncertainty regarding media and industry conference communications by fund managers. The MFA further argues that investor protection would not be compromised because retail, and potentially unsophisticated, investors would be excluded from the universe of potential offerees.

On February 7, 2012, the Investment Company Institute (ICI)[5] submitted to the SEC a position paper expressing its opposition to the MFA petition. The ICI argues that it opposes any rule that would, in its view, weaken the fundamental statutory requirement that a private fund not engage in a public offering of its securities. The ICI contends that the real motivation behind the MFA petition is marketing and product promotion and not greater transparency for the hedge fund industry. In addition, the ICI claims that the elimination of the Rule 502(c) general solicitation/general advertising ban would collapse the regulatory distinctions between public and private securities offerings. The ICI also asserts that the explosive growth of the hedge fund industry, to the point that hedge funds are now estimated to have approximately $2.01 trillion in assets under management, belies any suggestion that hedge funds are not able to reach potential investors under current regulations.

To date, the SEC has not expressed publicly a definitive position on the House Bill, the MFA petition or the ICI response, nor has the Senate acted on the version of the House Bill before it. We continue to monitor material developments on this important subject with its wide-reaching ramifications.

For more information on Regulation D, please contact Michael J. Hagan.

[3] The MFA describes itself as the voice of the alternative investment industry, with a membership that includes the vast majority of the world's largest hedge fund groups.

[4] The more rigorous test of "qualified purchasers" would restrict sales only to individuals with at least $5 million in investments and institutions with at least $25 million in investments.

[5] The ICI is a lobbying and advocacy group acting primarily on behalf of registered investment companies.

OTCQX International and the SEC

By Michael J. Hagan

Non-U.S. companies are often eager to gain access to U.S. public markets to trade their securities and enhance both their liquidity and the company's profile. At the same time, a number remain cautious and have concerns regarding the rigors of the registration process with the U.S. Securities and Exchange Commission (SEC) and the possible burdens and exposure associated with the ongoing reporting requirements of U.S. securities laws. Increasingly, non-U.S. companies that are traded on a qualified non-U.S. exchange have found OTCQX International to provide a desirable route for accessing U.S. trading markets.

This article provides a brief overview of the key steps for qualified non-U.S. companies to "list" their securities for trading with U.S. investors.[1] It is widely understood that a non-U.S. company undertaking a public offering of securities in the United States or listing its shares on a U.S. exchange will be subject to the periodic reporting requirements under the Securities Exchange Act of 1934 (Exchange Act). A private placement of securities may be exempt from these registration and reporting requirements; however, even in the case of a Rule 144A offering, there will be limited liquidity in a circumscribed trading market for the securities. Therefore, an increasingly popular and efficient mechanism for non-U.S. issuers to establish trading for their shares in the United States, and thereby access the most liquid global market, is through a listing with OTCQX International.[2]

OTCQX, run by OTC Markets Group (OTC Markets) is a fully electronic interdealer quotation system that provides investors and broker-dealers access for trading through online and full service brokerage firms in the United States. It has two international tiers: OTCQX International and OTCQX International Premier (collectively, OTCQX International). Trades on OTCQX International are settled and cleared in U.S. time and in U.S. currency. OTCQX International has been described as the preeminent over-the-counter (OTC) securities marketplace for blue chip, non-U.S. companies. Many non-U.S. companies have joined the marketplace seeking to develop or maintain an active U.S. investor base without necessarily incurring the burden and expense of the disclosure and compliance obligations imposed by U.S. market listing rules and the Exchange Act, including the Sarbanes-Oxley Act of 2002 (Sarbanes-Oxley). OTCQX International is designed to be used by non-U.S. companies that satisfy the listing requirements of qualified international stock exchanges and comply with local disclosure and reporting obligations in their home countries.

As of March 1, 2012, there were 309 non-U.S. private issuers listed on OTCQX International. Since January 1, 2012, more than 30 companies, including significant Australian and Canadian mining and natural resource companies as well as Chinese and Israeli issuers, have listed on OTCQX International. In order to list its securities on OTCQX International, a non-U.S. company must have either a Level 1 American Depositary Receipt facility (ADR Facility) or ordinary or common shares of capital stock eligible for Depositary Trust Company (DTC)[3] treatment.

Non-U.S. companies have reportedly found OTCQX International to be a convenient and inexpensive way to tap into the vast U.S. retail market while often creating more liquidity. With more than 200 market makers providing liquidity during U.S. market hours and connectivity to primary market trading, OTCQX International facilitates trading by eliminating the burdens of complex cross-border trading, currency conversions and international clearing imposed on investors.[4]

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[1] This article does not constitute formal legal advice and does not discuss all of the legal questions that a company must address to qualify its securities for trading on OTCQX International. Readers are advised to consult with their legal advisers. This note follows the convention of referring to quotation on OTCQX as a listing, even though the SEC does not consider OTCQX to constitute a securities exchange.

[2] The OTC market for domestic issuers, referred to as the "Pink Sheets" market, tends to attract a different category of issuer, and has different criteria for listing, than OTCQX International, which is directed at non-U.S. issuers that are listed on a qualified non-U.S. exchange.

[3] DTC provides clearing and settlement services by making "book-entry" changes to ownership of securities. More information on eligibility of securities for DTC treatment can be found on the organization's website.

[4] Examples of large companies trading ADRs on OTCQX International Premier and their approximate market capitalizations include Adidas ($13.4 billion), BASF ($57.3 billion), easyJet plc ($2.4 billion), Gazprom Neft ($20.3 billion), Imperial Tobacco Group PLC ($35.3 billion), Peugeot S.A. ($3.8 billion), Roche Holding Ltd. ($102.9 billion), Allianz ($39.1 billion), AXA ($27.1 billion), Wal-Mart De Mexico S.A.B. de C.V. ($43.3 billion), Deutsche Telekom ($50.2 billion), Marks & Spencer Group plc ($226.4 billion), AkzoNobel N.V. ($10.8 billion) and Air France-KLM ($1.6 billion). Among the financial institutions listed on OTCQX International are Grupo

Non-U.S. companies can subject themselves to the requirement of registration under the Exchange Act by listing their securities on a U.S. stock exchange, doing an initial public offering of their securities in the United States, having more than 500 shareholders worldwide (with more than 300 in the United States) and more than $10 million in assets, or having 500 U.S. shareholders regardless of asset size.[5] Under Exchange Act Rule 12g3-2(b), a non-U.S. private issuer will be automatically exempt from registration under the Exchange Act if the issuer is not and does not become a Section 12 company and, therefore, is not required to file or furnish reports under the Exchange Act; currently maintains a listing on a non-U.S. stock exchange that constitutes the primary trading market for the issuer's listed securities; and has published, in English, certain information required to be made public in its home jurisdiction. Fulfilling the 12g3-2(b) exemption is a prerequisite for a non-U.S. company that wishes to have its securities, or ADRs representing its securities, listed on OTCQX International without registering under the Exchange Act.

A concern for many non-U.S. private issuers entering the U.S. marketplace is the degree of legal exposure they may encounter under U.S. securities laws. Overall, there is limited impact on a non-U.S. issuer's exposure associated solely with listing on OTCQX International, assuming it is properly structured and maintained. For instance, the principal liability regime under the Securities Act of 1933, as amended (Securities Act), is only triggered when an offer and sale of securities is involved (this regime is referred to as Section 11 or Section 12 liability). Since listing on OTCQX International does not require an issuer to file a registration statement or issue a prospectus, these Securities Act sections will not apply merely as a result of having securities listed on OTCQX International.[6]

An issuer's risks can be successfully managed with proper disclosure and legal advice… Experienced U.S. counsel can assist a company in preparing the application materials and processing the application through to completion.

All issuers, foreign or domestic, must be mindful of the possible reach of the anti-fraud provisions of U.S. securities laws. A non-U.S. company would not necessarily face increased potential liability under the anti-fraud provisions of the Exchange Act solely as a result of listing on OTCQX International. Under Section 18 of the Exchange Act, issuers are liable for false and misleading disclosures in Exchange Act filings. Since issuers listing on OTCQX International that do not engage in a registered offering will not be subject to Exchange Act registration, and disclosures made available in English under Rule 12g3-2(b) (as discussed more fully below) do not carry Section 18 liability, a non-U.S. company in those circumstances that is compliant with Rule 12g3-2(b) will be unlikely to face Section 18 liability merely by listing on OTCQX International.

Section 10(b) and Rule 10b-5 under the Exchange Act impose liability on any issuer for manipulative and deceptive practices in the U.S. securities markets. These provisions may apply to non-U.S. companies listed on OTCQX International depending on the circumstances of the subject transaction. The question of the scope of liability of non-U.S. issuers under the Exchange Act anti-fraud provisions is

Financiero Banorte, S.A.B. de C.V., a commercial bank from Mexico, with a nearly $7 billion market capitalization; BNP Paribas, the largest bank in France, with a $40.4 billion market capitalization; and Zurich Financial Services Ltd., with a nearly $30 billion market capitalization.

[5] Companies, whether domestic or foreign, that are subject to registration under the Exchange Act are often referred to as "Section 12 companies," which is the section of the act that sets forth periodic reporting obligations for those companies.

[6] We do note that there may be some potential for liability under the Exchange Act for non-U.S. companies listing securities on OTCQX International. Exchange Act Rule 10b-17 may apply even to non-U.S. companies that are not listed on a U.S. securities exchange or registered under the Exchange Act. Rule 10b-17 imposes liability for failure to give appropriate notice of a dividend or other distribution, a stock split or reverse split or a rights or other subscription offering relating to any publicly traded class of securities. However, this type of exposure can be easily managed with proper diligence and timely legal advice.

an area of law that is in flux at present due primarily to developing case law and legislation.[1] Nonetheless, claims based upon the anti-fraud provisions are rare in the overall market and an issuer's risks can be successfully managed with proper disclosure and legal advice.

As noted, companies listed on OTCQX International are divided into two tiers – OTCQX International Premier and OTCQX International. To be listed on OTCQX International, a non-U.S. company, as of the end of its last fiscal year, must have $2 million in total assets and one of the following: $1 million in net tangible assets, $500,000 in net income, $2 million in revenue or a global market capitalization of at least $5 million. Listing on OTCQX International Premier requires a non-U.S. company to meet the financial requirements of the Worldwide Listing Standards of the New York Stock Exchange and, as of the end of its last fiscal year, to have $2 million in total assets and either $100 million in revenues, a global market capitalization of at least $500 million, aggregate cash flows for the last three years of $100 million and a minimum cash flow in each of the two preceding years of $25 million; or $75 million in revenue and a global market capitalization of at least $750 million.

In addition to meeting one of the applicable quantitative tests summarized above, to be listed on OTCQX International, a non-U.S. company must establish an ADR Facility or have ordinary or common shares eligible for DTC treatment. SEC requirements for establishing an ADR Facility are significantly less burdensome than those for a registered offering and there is no requirement that the issuer comply with the corporate governance provisions of Sarbanes-Oxley. To establish the ADR Facility, the non-U.S. company must qualify for the Rule 12g3-2(b) exemption discussed above, enter into a deposit agreement with an ADR depositary (Depositary) in the United States and designate a depositary in the issuer's home jurisdiction to receive the shares underlying the ADRs and have the Depositary issue depositary receipts representing the shares underlying the ADRs to U.S. investors. In addition, the issuer and the Depositary must file a Form F-6 with the SEC.

The issuer also must have a proprietary quote published by a market maker, which is required to make a filing with FINRA's OTC compliance unit before the stock can be quoted on a permanent basis. The review and clearance process can take several weeks.

The issuer must also be listed on a qualifying international stock exchange for a minimum of 40 days,[2] be eligible for the Rule 12g3-2(b) exemption and fully compliant with the rule or have securities registered under the Exchange Act, be included in a recognized securities manual (published by Standard & Poor's (S&P) or Mergent (formerly known as Moody's)) to deal with state securities law compliance[3] and appoint a principal American liaison (PAL) to assist with admission and ongoing compliance.[4]

An important efficiency of an OTCQX International listing is that non-U.S. issuers are not required to prepare and disclose any further materials solely by reason of the listing. In summary, the required disclosure consists of the materials the issuer provides to its home stock market, its shareholders and the public.

Experienced U.S. counsel can assist a company in preparing the application materials and processing the application through to completion. In a number of instances, approval of listing can be obtained in several weeks following the submission of the application materials.

For more information about OTCQX, please contact Michael J. Hagan.

[1] Recent court decisions have severely restricted the circumstances under which non-U.S. companies can be liable under these provisions. In *Morrison v. National Australia Bank*, the U.S. Supreme Court found that these anti-fraud provisions apply "only in connection with the purchase and sale of a security listed on a [U.S.] stock exchange, and the purchase and sale of any other security in the United States." However, the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 did inject an element of uncertainty by codifying the approach taken by courts prior to the *Morrison* decision, the so-called "conduct and effects" test. Under the conduct and effects test, non-U.S. companies could be liable under Section 10(b) and Rule 10b-5 based on their conduct in the United States or the effects of their conduct in the United States. The impact of this legislation on the *Morrison* approach is still uncertain.

[2] See the List of Qualifying Non-U.S. Exchanges on the OTCQX International website.

[3] Each state has its own securities laws and regulations (Blue Sky Laws) that require certain filings and disclosures. Listing in either the S&P or Mergent's Blue Sky manual will ensure compliance with most state law disclosure rules.

[4] An issuer can appoint as its PAL any attorney, investment bank or ADR depositary included on the PAL List published on the OTCQX International website, or as otherwise qualified.

Investment Management

Dodd-Frank's Impact Within Financial Services

By Richard S. Heller

While the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act) has forever changed the landscape of securities offerings and banking in America, it is still largely a bill yet to become a bill. Many agencies have been tasked with writing regulations to supplement the act, and while many rules have been written, some agencies have hardly begun.

For example, the SEC has adopted numerous rules affecting "private funds" that are applicable to both hedge funds and private equity funds.[1] The rules require most private funds to register with the SEC as registered investment advisers (if the fund has assets under management in excess of $150 million) or with the state or states in which the fund is domiciled. The registration deadline was February 22, 2012, giving the SEC sufficient time to complete its review of the Form ADV by March 30.

To accomplish this aspect of the SEC's rule, it has instructed the Office of Compliance Inspections and Examinations (OCIE) to determine whether investment advisers have adopted appropriate written compliance policies and procedures that deal specifically with a particular fund's business – the days of having generic, off-the-shelf manuals are over. Instead, the OCIE will review a fund's policies and interview its staff and principals to determine if the policies and procedures are reasonably designed to meet the risks identified in the fund's risk assessment and to ensure that the procedures are consistent with the adviser's actual operational practices.

The SEC has also begun to stress the need for a "top-down" culture of compliance within private funds, seeking to ensure that a private fund's chief compliance officer is kept informed about all daily operational issues confronting funds, and that whistle-blowers, addressed with specificity in the Dodd-Frank Act, are protected. In addition, the act revises the "accredited investor" standard (in Rule 501 of Regulation D) to exclude the value of the primary residence of a natural person (including the corresponding value of related debt) from the net worth calculation. Most recently, the SEC adopted amendments to Rule 205-3 under the Investment Advisers Act of 1940, which raise the net worth and assets under management eligibility requirements for "qualified clients" who pay performance fees to investment advisers from $1 million to $2 million.

The Dodd-Frank Act also includes the Volker Rule, which seeks to restrict banks from making certain kinds of speculative investments. Specifically, it prohibits a bank or institution that owns a bank from engaging in proprietary trading and from owning or investing more than a small percentage of its assets in private funds. It should be noted that the Volker Rule and other aspects of the Dodd-Frank Act continue to be criticized (specifically, SIFMA has begun to lobby strongly against it) and numerous issues remain with regard to the rules that have been or will be written pursuant to the Dodd-Frank Act.

The 3,000-page bill impacts banks, thrift institutions, insurance companies and rating agencies. Mortgage loans, derivatives, credit cards, and commercial and consumer loans will all be subject to new rules. It likely will take months, if not years, for the various regulatory agencies mandated to implement these new rules to be able to respond.

For more information on the Dodd-Frank Act, please contact Richard J. Heller.

[1] Venture capital funds are exempt from the Dodd-Frank Act, as are "foreign private advisers" (any investment adviser who has no place of business in the United States, has fewer than 15 clients, has U.S. investors who are invested in "private funds" advised by the investment adviser, has aggregate assets under management in the United States of less than $25 million, and neither holds itself out to the U.S. public as an investment adviser nor advises a business development company or an SEC-registered investment company).

Venture Capital

Review of 2011

By Jonathon H. Vinocur

Venture capital investment is a multivariable equation informed by information so voluminous that management teams often are unable to digest properly the rules of engagement, let alone the state of play. The following article, which summarizes data from more than 3,500 venture capital investments made in 2011, can be useful to companies first considering a venture-style investment in determining how and where the marketplace closed out in 2011, and informative to VC-backed companies wishing to compare and contrast the current climate with that of the period in which their investment transactions were closed.[1]

In 2011, approximately 3,600 transactions resulted in more than $28.4 billion of venture capital invested in the United States. This represented a 4 percent increase in the number of transactions closed, a 22 percent increase in dollars invested and the third highest total in history, with only 2007 and 2008 outpacing 2011. Figure 1 summarizes the amounts invested by industry segment and the change in each from 2010:

FIGURE 1

Industry Segment	2011 Dollars Invested	Δ from 2010
Software	$6,714,359,400	38.3 percent
Biotechnology	$4,733,488,700	22.4 percent
Industrial/Energy	$3,516,767,900	3.7 percent
Medical Devices and Equipment	$2,806,667,600	19.5 percent
IT Services	$2,422,929,100	38.6 percent
Media and Entertainment	$2,316,677,900	53.3 percent
Consumer Products and Services	$1,245,994,800	103.3 percent
Semiconductors	$1,177,055,400	5.9 percent
Electronics/Instrumentation	$691,387,800	52.1 percent
Telecommunications	$677,931,400	-19.1 percent
Financial Services	$390,950,600	-24.1 percent
Networking and Equipment	$375,818,400	-42.6 percent
Computers and Peripherals	$364,886,300	2.7 percent
Retailing/Distribution	$359,560,300	76.5 percent
Healthcare Services	$351,681,000	7.2 percent
Business Products and Services	$234,784,700	-48.2 percent

[1] The MoneyTree™ Report by PricewaterhouseCoopers and the National Venture Capital Association based on data from Thomson Reuters is a quarterly study of cash-for-equity investments by the professional venture capital community in the United States. See https://www.pwcmoneytree.com/MTPublic/ns/index.jsp for study results and definitions of the capitalized terms used in this article.

FIGURE 1	Industry Segment	2011 Dollars Invested	Δ from 2010
	Other	$44,134,100	172.0 percent

While the Software and Biotechnology industries once again led the way in total dollars invested in 2011, significant investment increases were seen in Consumer Products and Services and Retailing/Distribution, rising more than 103 percent and 76 percent, respectively. Those industries seeing the biggest decreases in capital committed were the Business Products and Services and Networking and Equipment sectors, which saw decreases exceeding 48 percent and 42 percent, respectively. Presumably, this decrease in enterprise-related activity and increased focus on the consumer is driven by 2011's social media explosion.

Of the more than $28 billion in 2011 venture capital investment, the amounts allocated to Early Stage and Later Stage companies increased 47 percent and 37 percent, respectively. In contrast, the number of Seed Stage investments stayed relatively flat but resulted in a 48 percent decrease in dollars invested. At the same time, the amount of capital devoted to first-time financings increased by 12 percent from 2010, while the number of first-time financings increased by 11 percent. This could indicate that companies are reaching more mature stages prior to taking on venture capital and, like the seed funds spreading less capital among the same number of recipients, are doing more with less. Figure 2 summarizes the amounts invested by stage of development and the change in each from 2010:

FIGURE 2	Stage of Development	2011 Dollars Invested	Δ from 2010
	Seed Stage	$919,111,100	-47.7 percent
	Early Stage	$8,300,156,500	47.2 percent
	Expansion Stage	$9,711,345,000	8.6 percent
	Later Stage	$9,494,462,800	37.1 percent

While the information that can be gleaned from this study is informative, it is only an indication of where VCs may be concentrating capital in 2012. To discuss what Thompson Hine's lawyers are seeing thus far this year, contact Jonathon H. Vinocur.

Industry Spotlight

Rail Fuel Surcharge Antitrust Litigation

By Sandra L. Brown

Many businesses ship products by railroad all across the nation. Railroads, like other modes of transportation, have started imposing fuel surcharges. However, rather than just collecting the incremental increase in fuel prices, the railroads' fuel surcharge mechanisms were universally put in place and became a profit-making center for the railroads. Companies that use railroad transportation and have paid the freight bills will likely find the ongoing rail fuel surcharge antitrust class action litigation of interest.

In mid-2007, the first of several class action antitrust lawsuits was filed by a few relatively small shippers against the four big Class I railroads, alleging that they conspired to fix fuel surcharges that were a component of the overall rates charged for rail freight transportation services during the period July 1, 2003 until December 31, 2008. These multiple class actions have been consolidated into a lawsuit that is currently pending in the United States District Court for the District of Columbia.

In the class action, the plaintiffs allege that the defendants – BNSF Railway Company (BNSF), Union Pacific Railroad Company (UP), CSX Transportation, Inc. (CSX) and Norfolk Southern Railway Company (NS) – conspired to fix the rates charged for rate-unregulated rail freight transportation services. (Second Consolidated Amended Class Action Complaint (Complaint) ¶ 19.) They allege that the conspiracy is a per se violation of Section 1 of the Sherman Act because it was the means by which defendants "fixed, maintained, and standardized prices for Rail Fuel Surcharges for rail freight transportation handled through private contracts and other means exempt from regulation." (¶ 104.)

To establish a per se violation of Section 1, a plaintiff needs to prove by a preponderance of the evidence an agreement, combination or conspiracy between or among defendants to fix or stabilize prices charged for rail freight transportation services beginning July 1, 2003 or later. In general, to have standing under Section 4 of the Clayton Act (15 U.S.C. § 15) to maintain the action, any plaintiff or class will have to

show that it paid more for rail freight services after July 1, 2003 than it paid before that date, and that the increased charges are a direct result of the conduct of the defendants in violation of Section 1.

A decision on class certification is expected to be issued in the near future. The current definition of the class as proposed by the plaintiffs' lawyers would include the following members of the class as defined below:

> *All entities or persons that at any time from July 1, 2003 until December 31, 2008 (the "Class Period") purchased rate-unregulated rail freight transportation services directly from one or more of the Defendants, as to which Defendants assessed a stand-alone rail freight fuel surcharge applied as a percentage of the base rate for the freight transport (or where some or all of the fuel surcharge was included in the base rate through a method referred to as "rebasing").*

If the court grants the motion for class certification in whole or in part, and barring appeals, then any company will have to decide in a relatively short time period, i.e., 45 to 60 days

after the class notice is published, whether to remain in the class or pursue a different strategy outside the class (opting out of the class). This decision is not one made easily or quickly, and requires an understanding of the discovered record in the lawsuit; the particulars of transportation, pricing and contracts with the Class One railroads; and the challenged conduct's estimated economic impact on a company. If a company waits until the class notice is published to consider this decision, it will likely be difficult to make a full deliberative decision on the best strategy.

For more information on rail fuel surcharges, please contact Sandra L. Brown.