# THE INITIAL PUBLIC OFFERING

## A Guidebook for Executives and Boards of Directors

**Third Edition**

Patrick J. Schultheis
Robert G. Day
J. Randall Lewis
Shawn J. Lindquist
Robert G. O'Connor

Wilson Sonsini Goodrich & Rosati, Professional Corporation

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**THIRD EDITION**

Bowne & Co., Inc.
55 Water Street
New York, New York 10041

Phone: (212) 924-5500
email: SecuritiesConnect@Bowne.com

**www.SecuritiesConnect.com**

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# About the Authors

**WILSON SONSINI GOODRICH & ROSATI, PROFESSIONAL CORPORATION**, is the premier provider of legal services to technology, life sciences and growth enterprises worldwide, as well as the investment banks and venture capital firms that finance them. Since 1998 the firm has represented issuers and underwriters in over 300 initial public offerings, more than any other U.S. law firm. Over the past four decades, Wilson Sonsini Goodrich & Rosati has established its reputation by having unmatched knowledge of its clients' industries, as well as deep and long-standing contacts throughout the technology sector. The firm's legal expertise serves clients at all stages of growth, from venture-backed start-up companies to multibillion-dollar global enterprises. Clients include some of the most recognized names in the technology, retail, life sciences, venture capital and finance sectors. The firm's broad range of services and legal disciplines are focused on serving the principal challenges faced by the management and boards of directors of business enterprises. Wilson Sonsini Goodrich & Rosati is nationally recognized as a leader in corporate governance and finance, mergers and acquisitions, securities class action litigation, employment law, intellectual property, and antitrust, among many other areas of law. With well-established roots in Silicon Valley, Wilson Sonsini Goodrich & Rosati has offices in Austin, New York City, Palo Alto, San Diego, San Francisco, Seattle, Shanghai and Washington, D.C. For more information about Wilson Sonsini Goodrich & Rosati, please visit the firm's web site at www.wsgr.com.

**PATRICK J. SCHULTHEIS** is a Partner at Wilson Sonsini Goodrich & Rosati. Mr. Schultheis joined the firm in 1989, is the Chairman of the firm's underwriter representation practice and the Managing Partner of the firm's Seattle office. Mr. Schultheis's practice focuses on the representation of technology, life sciences, healthcare, and other growth companies. In addition, Mr. Schultheis regularly represents underwriters in transactions throughout the world. Mr. Schultheis is active in numerous civic and professional organizations, and is a frequent speaker on topics relating to securities laws and corporate governance. Mr. Schultheis received his A.B. in History (with distinction and departmental honors) from Stanford University and his J.D. from the University of Chicago.

**ROBERT G. DAY** is a Partner at Wilson Sonsini Goodrich & Rosati. Mr. Day works with public and private technology companies through all stages of their growth, as well as with investment banks, private equity firms and venture capital firms. Mr. Day specializes in areas of corporate and securities law, including general corporate representation, public offerings, private placements, and mergers and acquisitions. He also has considerable experience in counseling publicly held companies on disclosure matters, complex securities laws issues, corporate governance and defensive measures. Mr. Day frequently represents investment banks in their technology underwriting transactions across the country. He is a frequent speaker on topics related to public offering issues and corporate governance and disclosure matters. Mr. Day received his A.B. in History and Economics from Stanford University and his J.D. from the Stanford Law School.

**J. RANDALL LEWIS** is a Partner at Wilson Sonsini Goodrich & Rosati. Mr. Lewis represents both public and private companies in all stages of development. Mr. Lewis's practice focuses on corporate and securities law, including general corporate representation, venture capital and private equity financings, public offerings and mergers and acquisitions. Mr. Lewis also has considerable experience in counseling publicly held companies regarding complex securities laws issues and corporate governance matters. Mr. Lewis also has significant experience representing venture capital and private equity firms in complex financing transactions. Mr. Lewis is a leader of the firm's Cleantech and Renewable Energy practice based in San Francisco and is a frequent speaker on matters relating to private equity, venture capital and public capital markets. Mr. Lewis received his B.S. from Boston University and his J.D. from the University of Chicago.

**SHAWN J. LINDQUIST** is the Chief Legal Officer of Omniture, Inc., a leading provider of online business optimization software, which its customers use to manage and enhance online, offline and multi-channel business initiatives. Prior to joining Omniture, Mr. Lindquist was a corporate and securities attorney with Wilson Sonsini Goodrich & Rosati (WSGR). He began his career in WSGR's Palo Alto, California office, and later helped to establish two other WSGR offices. He has also served as vice president and general counsel of a privately held, venture-backed company and as an attorney in the legal department of Novell, Inc., and he has served as an Adjunct Professor of Law at The J. Reuben Clark Law School at Brigham Young University (BYU). Mr. Lindquist received his B.S. in Business Management-Finance from BYU. He also participated in the NCAA Men's Basketball Tournament while at BYU. He received his J.D. from The J. Reuben Clark Law School at BYU.

**ROBERT G. O'CONNOR** is a Partner at Wilson Sonsini Goodrich & Rosati. Mr. O'Connor's practice focuses on advising technology and emerging growth companies in organizing and capitalizing businesses, raising capital through private and public debt and equity financings, and buying and selling companies and technologies. Mr. O'Connor is a leader of the firm's Cleantech and Renewable Energy practice based in San Francisco. Mr. O'Connor has extensive transactional experience in representing companies and underwriters in public offerings, mergers and acquisitions and private financings. Mr. O'Connor also advises companies in connection with the development and financing of renewable energy and biofuels projects. Mr. O'Connor is a regular speaker on capital raising strategies. Mr. O'Connor received his B.A. in economics and history from the University of California at Los Angeles and his J.D. from Loyola Law School.

## In Memoriam

### CHRISTIAN E. MONTEGUT

**(1966-2006)**

Christian E. Montegut, a co-author of the second edition of this book, died tragically in June 2006. The authors of this third edition owe a debt of gratitude to Chris, whose hard work and determination contributed mightily to the second edition. Chris was our colleague and our friend, and we miss him. This third edition is dedicated to his memory.

# Acknowledgements

There are numerous current and former partners, associates and other colleagues who contributed to this edition of *The Initial Public Offering*, by contributing to our collective education as to how to conduct a successful initial public offering, by reviewing and contributing to the text of this edition, or a combination of both. While the individuals who fall within those categories are too numerous to mention, we would specifically like to thank the following: current colleagues Steven J. Bernard, Andrew T. Braff, Douglas J. Clark, Michael S. Herring, Joshua G. James, Justin Judd, Elizabeth J. Kane, Jeana S. Kim, Michael A. Occhiolini, David J. Pashman, Rezwan D. Pavri, Wade W. Sherman and our former colleague Priya Cherian Huskins (particularly with respect to Chapter 4). We also wish to acknowledge the dozens of attorneys who contributed hundreds of hours to the WSGR Knowledge Management library, which was invaluable in connection with the preparation of this edition of *The Initial Public Offering*.

Our former colleagues, Gail Clayton Husick and J. Michael Arrington, wrote the first edition of this guidebook, which was published in 1998. We acknowledge and thank Gail and Michael for establishing the basic framework of this guidebook, as well as for setting a high standard of excellence.

We wish to specifically acknowledge IPOVitalSigns.com from Wolters Kluwer Law & Business and thank them for providing valuable data and other information included in this edition.

Finally, we thank our families, who certainly felt the effect of the days, nights and weekends we spent writing this third edition.

Since the first edition of this guidebook was published in 1998, there have been numerous changes to the securities laws and the listing standards of the New York Stock Exchange and The NASDAQ Stock Market, as well as changes in the U.S. equity markets, affecting the initial public offering process and the post-offering requirements of a public company. Further, there have been significant changes to the rules of the SEC that govern the conduct of public offerings. In the face of these changes, our goal with this third edition has been to present the current state of rulemaking from the SEC, the NYSE, FINRA and NASDAQ and, where appropriate, anticipate and present proposed rules. We do expect that rulemaking will continue and we will seek to update this guidebook regularly.

In addition, since the second edition of this guidebook was published in 2004, there has been a marked increase in the number of companies worldwide that elect to "go public" in jurisdictions outside of the U.S. Notably, the AIM Market of the London Stock Exchange experienced a well-published surge in public offering activity, and more broadly stock exchanges from Hong Kong to Oslo have increasingly attracted non-U.S. companies primarily to go public in jurisdictions closer to home. Nevertheless, the authors have not sought to expand the scope of this guidebook to address the process of conducting initial public offerings outside of the U.S. Rather, this guidebook remains focused on the process of going public in the U.S.

PLEASE READ THIS DISCLAIMER: This book is intended to provide a general, informational overview to non-lawyers and is not intended to provide legal advice as to any particular situation. The laws, regulations and other rules applicable to publicly traded companies and to the initial public offering process in the United States are complex and subject to frequent change. Experienced securities counsel should be involved in the planning, preparation and execution of any public offering of securities. The views expressed in this book are those of the authors only and do not necessarily reflect the views of Wilson Sonsini Goodrich & Rosati, Professional Corporation or Omniture, Inc.

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# Chapter 1

# Deciding to Go Public

What does it really mean to "go public?" Quite simply, "going public" in the U.S. refers to the process of registering shares of a company's stock with the U.S. Securities and Exchange Commission, or SEC, listing the stock on an exchange (typically NASDAQ or the NYSE) and offering the stock for sale to the public for the first time. This is called the initial public offering, or IPO. The process of going public and the consequences of being public, however, are anything but simple.

## Brief Overview of the Legal Framework Governing the IPO Process

### *The Securities Act of 1933*

#### *In General*

The offer and sale of securities in the U.S. is governed at the federal level by the Securities Act of 1933. The Securities Act has two basic objectives:

- require delivery to investors of financial and other significant information concerning securities being offered for public sale; and
- prohibit deceit, misrepresentations and other fraud in the sale of securities.

A primary means of accomplishing these objectives is requiring issuers of securities to disclose important and accurate business and financial information through the registration of securities offerings.

#### *Registration Requirements of Section 5*

Section 5 of the Securities Act requires an issuer to use the registration process for all offers and sales of its securities unless it can find an exemption under Section 3 or Section 4 of the Act. The registration process requires an issuer to file a registration statement (generally on Form S-1) covering the securities to be sold in the transaction before any offers are made. The SEC must declare the registration statement effective before any sales by the issuer can be made.

#### *The Registration Process: The Pre-Filing, Waiting and Post-Effective Periods*

The registration process is basically divided into three periods: (1) the pre-filing period; (2) the waiting period; and (3) the post-effective period. The three registration periods are discussed in greater detail in Chapter 5.

Exactly when the pre-filing period begins is not always clear; however, an issuer should consider itself as being in registration once it has reached an understanding with the investment banking firm that is to act as managing underwriter. SEC rules provide a safe harbor that allows an issuer to communicate freely more than 30 days prior to the filing of a registration statement, so long as the issuer's communication does not refer to the public offering. The issuer must take reasonable steps to prevent republication of the information during the 30 days prior to the filing of the registration statement. A common misconception is that this period begins with the IPO organizational meeting. In general, during the pre-filing period, no "offers" may be made, prospective purchasers cannot be contacted and underwriters may not be publicly disclosed. Chapter 5 provides greater detail with respect to what constitutes an "offer" for purposes of the Securities Act. The pre-filing period ends when the issuer files a registration statement with the SEC.

The waiting period begins when the issuer files a registration statement with the SEC and ends when the SEC declares the registration effective. During this period, offers are permitted so long as they are made orally or by using a preliminary prospectus (commonly referred to as the "red herring") or, in limited circumstances, a free-writing prospectus. Indications of interest are allowed, but sales are prohibited. In addition, the issuer must be careful that nothing in writing (including press releases and content posted on the issuer's web site) is construed as an illegal prospectus.

The post-effective period begins when the registration statement is declared effective and ends when broker-dealers are no longer required to deliver a prospectus by the Securities Act. During this period, sales are permitted and certain communications, such as sales material or literature (commonly referred to as "free-writing"), are allowed and not deemed an illegal prospectus *if* accompanied or preceded by a final prospectus.

### *The Securities and Exchange Commission and its role in the IPO process*

The U.S. Congress established the SEC to administer and enforce the federal securities laws. The SEC is empowered to interpret and enforce the federal securities laws and to propose and amend rules and regulations to address changing market conditions.

The SEC's role in the IPO process is to ensure that the company provides investors with the information considered necessary to enable investors to make informed decisions about whether to purchase the company's securities.

Public offerings of securities must be made pursuant to an effective registration statement. All companies, both domestic and foreign, must file their registration statements electronically via the SEC's EDGAR system. The company's registration statement is then subject to examination by the SEC's Division of Corporation Finance, which reviews it for compliance with disclosure requirements. To meet the SEC's requirements for disclosure, a company issuing securities must make available all information, whether that information reflects positively or negatively on the company, that might be deemed material and relevant to an investor's decision to buy, sell or hold the security. The registration process is discussed in greater detail in Chapter 8.

***State securities regulation***

The offer and sale of securities in the U.S. is also regulated at the state level by each state's securities laws, which are commonly referred to as "Blue Sky" laws. State Blue Sky administrators typically assess not only the sufficiency of disclosure but also the fairness of the offering. However, the U.S. Congress enacted the National Securities Markets Improvement Act of 1996 (NSMIA) to specifically preclude the various states from requiring the registration of certain "covered securities," which include nationally traded securities, or securities listed or authorized for listing on the New York Stock Exchange (NYSE), the American Stock Exchange (Amex), or the NASDAQ Stock Market LLC (NASDAQ). In other words, the Blue Sky requirements generally will be relevant only with respect to those companies whose securities will not be listed on those stock exchanges.

***Self-Regulatory Organizations (SROs) and their role in the IPO process***

A company and its underwriters must also comply with applicable rules and regulations of certain self-regulatory organizations (referred to as SROs), which include the NYSE, Financial Industry Regulatory Authority, Inc. (FINRA) (the successor to the National Association of Securities Dealers, Inc.), NASDAQ and Amex, among others. The SROs require that certain listing requirements be met before listing is approved on the exchange.

Not every company is a candidate to list on the NYSE or NASDAQ. The NYSE and NASDAQ, in particular, maintain stringent quantitative and qualitative standards for their listed companies. If a company is unable to comply with these standards, it will not qualify to list. If a listed company falls below these standards, it is delisted. The listing requirements for the NYSE, the NASDAQ Global Market , and the NASDAQ Global Select Market are set forth on ***Appendix A.***

## Benefits

There are several benefits to going public in the U.S., which include the following:

### *Cash*

A successful IPO can generate significant proceeds for a company, and the infusion of cash offers a company an opportunity to accelerate growth by hiring more people, building more infrastructure, conducting more research and development and delivering more products and services. And unlike debt, there are no payments of interest or principal that must be made.

Public offerings can range from $10 million or less to $1 billion or more. Of the 1,011 IPOs completed from the beginning of 2001 through the end of 2007, the average deal size was approximately $214 million and the median size was approximately $105 million.*

### *Liquidity for employees*

Many companies, particularly technology and life sciences companies, provide incentives to employees through the use of stock options and other equity incentive awards. Underlying this benefit is the hope that someday the company will go public (or experience some other liquidity event, such as a sale of the company) that will enable the employees to realize the appreciation in the value of the underlying stock. Liquidity for employees generally will not be simultaneous with effectiveness of the IPO because the company's underwriters will insist that employees observe a "lock-up," typically for 180 days, with the possibility of an extension in certain limited circumstances, following the company's IPO. After the lock-up is removed, additional restrictions under the securities laws and under the company's insider trading policy may continue to limit the opportunities for employees, and particularly executive officers, to sell shares of the company's stock. Nevertheless, one of the significant benefits of an IPO is the fact that it creates a public market for the company's stock that eventually will result in liquidity for the company's

* Source: IPOVitalSigns.com

employees. The company can use its stock option and employee stock purchase plans to increase employee commitment and recruiting power.

Companies that are considering going public, however, should be aware that the landscape for the use of stock options and other forms of equity compensation for executives and employees has undergone significant change in recent years. This sentiment is reflected not only in increased rulemaking by the SEC, the NYSE, NASDAQ and FINRA, but also through stockholder advocacy groups, such as Institutional Shareholder Services, which are actively recommending to their institutional clients "no" votes with respect to equity compensation plans which they determine to be too generous to executives and too dilutive to existing stockholders. Moreover, the Financial Accounting Standards Board (FASB) has recently adopted FAS 123R which requires the value of employee stock options and other equity incentive awards to be reflected as expenses in a company's income statement. Companies should consult with legal counsel well in advance of the IPO process to understand the recent developments affecting equity compensation policies and practices and how those developments have impacted not only the terms on which companies will be able to compensate their employees through equity incentives but also how board of directors should go about analyzing and determining their equity compensation policies and practices once they are public.

### *Liquidity for investors*

Many investors in private companies invest with a view to earning a sizable return upon a liquidity event. An IPO is one such event. A public market for a company's stock provides an opportunity for investors to realize appreciation in the value of their investment that is typically much more difficult to monetize while a company is private. For example, even if a private company's stock may be sold, the illiquid nature of private company stock generally results in a discount on its valuation. Thus, the IPO allows the investors to realize more of the accrued appreciation than they otherwise would.

The exact timing of this liquidity depends upon a variety of factors. If an investor has contractual registration rights entitling the investor to include its shares in the IPO, or is otherwise permitted to participate in the IPO as a selling stockholder, liquidity can be immediate. If an investor's shares are not included in the offering, and are subject to a lock-up restriction or are subject to holding period requirements under the federal securities laws, liquidity may be delayed. Moreover, selling stock into a liquid trading market is subject to the liability provisions under the federal securities laws and, for insiders, may require compliance with black-out periods under company insider trader policies. Nevertheless, a public company's stock is generally more liquid than that of a private company.

### *Creation of a currency that can be used for acquisitions*

Once a liquid market exists for a company's stock, the stock may be nearly as valuable as cash for acquiring other businesses. In fact, it may be better. Under certain circumstances, a stock-for-stock acquisition is eligible for favorable tax treatment that is unavailable in the case of a cash acquisition. Also, stock provides an acquisition currency that enables the target company stockholders to participate in the anticipated upside of the combined company (and share in the risks related to those anticipated future results), without having to monetize future potential benefits at the time of closing the acquisition. Shares issued by a company in connection with an acquisition are not automatically freely tradable just because the company is public. If the specific shares issued in the acquisition are not registered with the SEC, the shares will be restricted stock under the securities laws, and the resale will need to be registered or benefit from a specific exemption from registration.

### *Access to the public market for future financings*

A company that has completed its initial public offering may return to the public market to raise additional cash in follow-on offerings. A follow-on offering often can be completed in a significantly shorter time frame than an initial public offering. This is due in part to the fact that a company that is already public has relationships with underwriters who are familiar with its business, an established valuation, and a following among analysts and investors who understand the company's business and market.

A registration statement on Form S-1 is generally used for an IPO. A company that has been public for at least 12 months and that meets certain other requirements is eligible to register shares for a follow-on offering on an abbreviated form of registration statement, known as Form S-3. The Form S-3 allows the company to incorporate large amounts of information by reference from documents previously filed with the SEC, such as the company's recent Form 10-K and Form 10-Q filings. Using this abbreviated form significantly reduces the burden and cost of the drafting process for a follow-on offering as compared to the drafting process for an IPO (unless the company and the underwriters choose to include IPO-level disclosure for marketing reasons). Even if the short-form registration statement may not be used (*e.g.*, if the IPO was within 12 months prior to the follow-on offering), significant efficiencies can be obtained by being able to leverage the drafting in the IPO prospectus and subsequent public reporting filings. Form S-1 also permits incorporation by reference of certain information, although on a more limited basis than permitted by Form S-3.

While the SEC reviews and comments on IPO registration statements almost without exception, it sometimes chooses not to review and comment on a registration statement for a follow-on offering, and generally does not if it has recently reviewed another filing of the same company. Whether or not the SEC reviews the registration statement used by a company for a follow-on public offering is entirely within the SEC's discretion.

Recent changes to SEC rules have streamlined the shelf registration process for "well-known seasoned issuers," or WKSIs. A WKSI is a company that has timely filed for at least the prior year all required annual, quarterly and current reports, and either has at least $700 million in market capitalization (including only common stock held by nonaffiliates) or has issued $1 billion in debt securities in registered offerings for cash over the prior three years. WKSIs are permitted to file registration statements that will become automatically effective without SEC review, allowing the WKSI to offer securities immediately after filing the registration statement. The WKSI can file the automatic shelf registration statement to cover an unspecified amount of securities and the filing fee can be paid as securities are pulled down from the shelf. As a result, these new rules greatly simplify and provide greater predictability to accessing the public capital markets for larger public companies.

Public companies are also in a better position to consider debt financing. The transparency that comes from the public reporting requirements applicable to public companies makes them more attractive candidates for lending, all other things being equal. Also, the cash proceeds of an IPO make for a stronger balance sheet, which can make debt financing easier to obtain on more favorable terms. Convertible debt financing transactions are made possible by having liquid common stock with a readily ascertainable market value into which the convertible bonds can convert.

### *Enhancement of the company's stature, perceived stability and competitive position*

An important consideration for many companies contemplating an IPO is the effect that being public will have on the company's stature, perceived stability and competitive position. Private companies often face sales resistance from potential customers who have doubts about the company's staying power. For some companies, an IPO's effect on credibility with customers is even more important than the cash generated by the offering. Suppliers and lenders may perceive a company to be a better credit risk after its IPO, and therefore may be more inclined to extend favorable terms to the company. In addition, the public offering process itself may generate publicity that raises the company's profile with potential customers. For example, newspapers and magazines may be more likely to cover public companies than private ones. The perceived stature and stability that accrues to public companies may also be an advantage in attracting top tier management talent to the organization.

### *Enhancement of the company's market value*

While a company is private, investors typically apply a significant liquidity discount in determining the price they are willing to pay for the company's stock. A successful public offering will eliminate this penalty for illiquidity. A successful public offering also will expose the company to a broad base of investors who might otherwise be unaware of the company or not suited for an investment in a private company, thereby increasing demand for the company's stock.

## Burdens

Going public has its disadvantages, too. Some of the burdens of the public offering process and of being a public company include the following:

### *Distraction of management from the operations of the company*

One of the greatest frustrations expressed by executives of companies going through the offering process is that they "just cannot seem to get anything else done." The offering process typically takes three to six months and consists of many time-consuming tasks that cannot be delegated. Investment bankers must be selected. Due diligence presentations must be made. Drafting sessions, which can range from a few hours to multi-day marathons, must be prepared for and attended. SEC comments regarding disclosure and other items in the registration statement must be addressed and resolved. The offering process culminates with a road show, which typically consists of a multi-week, round-the-clock, national (and oftentimes international) investor presentation tour for the CEO and CFO.

***Restrictions on publicity and other marketing activities***

The federal securities laws restrict the manner in which stock can be offered to the public, and any publicity that could be construed as hyping or conditioning the market for a company's stock could cause the company to delay its offering or require the company and the underwriters to take securities law liability with respect to any such publicity. These restrictions are discussed in greater detail in Chapter 5. Although recent changes in federal securities laws have sought to provide companies with greater lattitude and predictability with respect to publicity during the offering process, companies often must make difficult decisions about curtailing certain marketing and public relations activities during the offering process.

Additionally, following the IPO, all publicity must be monitored with an eye toward securities law requirements and potential liability. Public statements made by company officials regarding the company's business may result in securities fraud liability. For example, prior to an IPO, a CEO may have few concerns about making public statements regarding the future financial performance of the company, but as a public company all such statements carry potential risk. There are also SEC rules relating to selective disclosure, and SEC, NASDAQ and NYSE rules requiring public disclosure of certain events, as well as other disclosure requirements and restrictions. These rules are discussed in greater detail in Chapter 10. A new public company should work closely with its counsel to determine what the rules are, and put in place appropriate control structures to ensure that inadvertent violations do not occur.

***Compliance with SEC disclosure and reporting requirements***

Once a company goes public, it becomes subject to a host of SEC rules and regulations, including the SEC's periodic reporting requirements and Regulation FD (which is discussed in Chapter 10). For example, public companies are required to file quarterly reports on Form 10-Q, annual reports on Form 10-K, current reports on Form 8-K to announce certain events, and proxy statements in connection with their meetings of stockholders. Preparation of these documents will consume a significant amount of time of company personnel, particularly the CFO and his or her staff. In addition, company insiders and large stockholders will become subject to the reporting requirements of Section 13 or Section 16 of the Exchange Act and will require the assistance of counsel in order to comply with these requirements.

Public companies are subject to rules and listing standards issued by SEC, the NYSE, NASDAQ and FINRA, and these rules affect and the manner in which public companies govern themselves and make disclosures to their stockholders and the investment community at large. These rules, among a variety of other matters, address the composition and responsibilities of a company's board of directors and board committees; impose stringent standards of independence on directors and auditors; require disclosures regarding a company's director nominating committee and nomination process; require detailed descriptions of the company's compensation philosophies and arrangements, particularly with respect to its directors and executive officers, and descriptions of stock option practices; require the company to maintain formal disclosure controls and procedures; and mandate CEO and CFO certifications as to the accuracy of financial statements filed with the SEC. A public company's ability to comply with these new rules and regulations, as well as the periodic reporting requirements and the other public company burdens, will come at a cost – both in time and money. Accordingly, a company should plan on spending more to beef up in-house accounting and compliance staffs, more on non-employee directors' fees, more for directors and officers liability insurance and more for fees of counsel, auditors, compensation consultants and financial printers.

***Reduced flexibility in corporate affairs***

While a company is private and relatively closely held, many aspects of corporate governance are conducted informally. "Annual" stockholders' meetings may or may not actually be held on an annual basis. Board and stockholder actions frequently are taken by written consent on short notice. Stockholder communications may consist of nothing more than an occasional letter from the president and periodic financial statements, which may or may not be audited. Individual executive compensation arrangements need not be disclosed to the company's stockholders or other employees. Arrangements between the company and its customers or strategic business partners can be kept secret. Company management may discuss the company's prospects with selected stockholders and others without restriction. Perhaps most importantly, company management can make long-term strategic decisions without worrying about short-term effects on stock price.

Once a company goes public, it becomes subject to extensive new regulations and important strategic decisions are made under intense public scrutiny. Periodic reports containing specified financial information, along with certifications made by the company's CEO and CFO regarding the accuracy and completeness of such information, must be publicly filed by legally imposed deadlines. Independent directors must approve director nominations and executive officer compensation. Stockholders' meetings must be held annually, and solicitations of stockholder proxies may be made only by means of proxy statements that contain specified information and that are filed with the SEC. In general stockholder approval may be required to adopt or materially amend employee stock option or purchase plans and in connection with transactions (other than public offerings) involving the sale, issuance or potential issuance of 20% of more of the company's common stock. Compensation arrangements for top management must be approved by independent directors and be publicly disclosed in detail. Certain management employment agreements must be publicly filed as exhibits to SEC filings. Transactions in the company's stock by company insiders must be publicly disclosed and may trigger insider trading liability claims. Important contracts with customers and others may be required to be publicly filed with the SEC for all the world, including the company's competitors, to see (with limited confidential treatment for sensitive financial or trade secret terms). Casual comments by company officials may lead to claims of selective disclosure and insider trading. Strategic decisions which have a negative effect on short-term financial results may be disfavored by investors and depress the company's stock price.

**Practical Tip: Consider Timing and Disclosure Impact of Potential Acquisitions**

A privately held company generally has no obligation to publicly disclose plans that it may have to acquire another business. However, if a company is engaged in material acquisition discussions at the same time that it is engaged in the public offering registration process, the SEC may require the company to provide detailed disclosure about the proposed transaction in the prospectus, and may even require the inclusion of extensive pro forma financial information to be included in the prospectus. As a result, the company may be forced to choose between premature disclosure of sensitive acquisition negotiations and delay of its public offering. Company counsel should be consulted as early as possible if the company is considering any acquisition activities near the time of its IPO.

Depending on the size of the acquisition, financial statements of the target may be required to be included in the prospectus for the acquirer's IPO. Preparation of these financial statements may require significant time, expense and effort, and could impact the timing of the IPO process. Also, the acquisition agreement may need to be publicly filed as an exhibit to the IPO registration statement. If this is the case, care should be taken to ensure that sensitive confidential information is not included in the agreement. Care should also be taken to evaluate with the underwriters how the accounting for the acquisition will impact the acquirer's operating results in the first few quarters following the IPO, and how that is likely to be perceived by Wall Street and reflected in the company's stock price.

### *Exposure to class action securities litigation*

Public companies also face increased exposure to lawsuits for securities fraud. Typically, these suits arise when a company has made a major announcement that surprises the market (*e.g.*, financial results that fall significantly short of expectations or the loss of a major contract) and the stock price drops. Certain law firms specialize in bringing these suits on behalf of the entire class of investors who traded in the company's stock during the period leading up to the announcement of bad news. Any recent public offering of stock by the company or sale of the company's stock by insiders will be used as evidence that the company and its insiders knew of the bad news in advance and benefited from such information at the expense of unsuspecting public investors. Class action securities litigation can take years to resolve, can be tremendously distracting for a company' management team and can result in multimillion dollar judgments or settlements. Chapter 4 discusses D&O liability insurance in greater detail.

***Loss of control to public stockholders***

One consequence of an IPO is that the founders (or other members of senior management) of the company will lose a significant amount of the control over the company that they exercise prior to the offering. The public disclosure obligations, the scrutiny of the public capital markets, the threat of potential securities litigation and the restrictive influence of active institutional investors all serve to significantly temper the power and flexibility that a company's senior management has prior to going public. The senior management team must be prepared for this change in its freedom to operate, and still be able to execute on the business plan.

As the percentage of shares owned by the public increases, so does the corporate control held by parties other than management and the initial stockholders. In recent years, institutional investors have increasingly exercised the control that they have, particularly in cases where the company is underperforming. The manner in which stockholders attempt to exercise their rights vary based on the specific circumstances, but can include activities such as proxy contests to replace one or more directors and public campaigns to pressure the board of directors of a company to take certain actions to enhance stockholder value.

Stockholder rights activists such as Institutional Stockholder Services (ISS) regularly review the corporate governance of companies and offer stockholders a recommendation as to whether to vote for or against matters that are put to a vote of stockholders. These recommendations can be influential: if ISS recommends a "no" vote against an action because ISS dislikes certain aspects of a company's corporate governance structure, it can be quite difficult to get a favorable vote for that action.

***Vulnerability to a hostile takeover***

On the one hand, raising capital through an IPO may provide a company with the financial resources that it needs to remain independent. On the other hand, going public may increase the company's vulnerability to a hostile takeover, particularly if insiders no longer hold a significant percentage of the company. There are a number of defensive mechanisms that a company can put in place to give the company's board of directors more control in a takeover situation, some of which are discussed in more detail in Chapter 3. This issue should be addressed with the company's counsel and investment bankers at the beginning of the offering process, because many defensive measures are more easily implemented while a company is still private.

### *Effect on employee compensation*

The promise of liquidity and the desire for a high valuation can drive employee performance in the years and months leading up to the IPO. However, once the event has occurred, potential new hires may feel that the opportunity for the "big score" has passed, and they may therefore be more difficult, or more expensive, to recruit. Further, a large and sudden increase in the net worth of existing employees may result in attrition following the IPO, especially among employees who are fully vested in their stock options. The board of directors of a company contemplating an IPO should consider whether key employees have the proper incentives to continue contributing to the company's success following the offering. The company should review its option plans with legal counsel and consider the adoption of additional benefit plans that are appropriate for public companies, such as employee stock purchase plans.

### *Expense*

The public offering process is expensive, and the costs of going public and being public have dramatically increased in recent years, in large part as a result of recent corporate governance reforms.

**Expenses of an Initial Public Offering**

| | **2007** | |
|---|---|---|
| | ***Average*** | ***Median*** |
| *Legal* | $1,318,787 | $ 975,000 |
| *Auditor* | 892,078 | 600,000 |
| *Printing* | 205,000 | 294,852 |
| *Transfer Agent* | 19,830 | 12,000 |
| *Total Expenses* | $3,030,877 | $2,300,000 |

Source: IPOVitalSigns.com

## Expenses of an Initial Public Offering (continued)

The following additional expenses are based on the size of the offering (as of July 1, 2008):

| | |
|---|---|
| *Underwriters' discount and commission* | Typically 7.0% of the aggregate offering proceeds. |
| *SEC filing fee** | $34.30 per $1 million of aggregate offering amount. |
| *FINRA fee* | $500, plus .01% of the proposed maximum aggregate offering amount. The maximum fee is $75,500. |
| *The following are exchange listing fees for domestic issuers:* | |
| *NASDAQ Global Select Market & NASDAQ Global Market* | $5,000 non-refundable application fee, plus an increasing entry fee that is based on the number of shares listed (up to a maximum fee of $150,000). The maximum total fee is $155,000. |
| *NYSE* | $37,500, plus a decreasing marginal fee per million shares listed ($4,800 to $1,900 per million shares). The minimum total fee is $150,000 and the maximum total fee is $250,000. |
| *Amex* | $5,000 non-refundable application processing fee, plus an increasing fee based on the number of shares listed (up to a maximum fee of $65,000). The maximum total fee is $70,000. |

* The filing fee is subject to periodic adjustment. The SEC issues a "Fee Rate Advisory" each time such fees change and posts the advisory on the its web site located at http://www.sec.-gov. For example, on April 30, 2008 the SEC announced that effective October 1, 2008 of five days after the SEC receives its fiscal year 2009 regular appropriation, whichever date comes later, the filing fee will be increased to $33.80 per $1 million aggregate offering amount.

For example, a domestic company applying to be listed on the NASDAQ Global Market selling $50 million of common stock to the public, with 20 million shares outstanding after the offering, would pay $3.5 million in underwriting fees, incur an SEC filing fee of $1,965, a FINRA fee of $5,500, and NASDAQ listing fees of $105,000.

The direct costs of an offering generally are netted against the gross proceeds for accounting purposes and therefore do not have a negative impact on the company's operating results. However, the ongoing expenses of being a public company will have a direct effect on the company's bottom line.

In addition to the costs of the public offering itself, there are a host of additional expenses that come with being a public company. These include the costs of preparing periodic reports to be filed with the SEC, the costs of soliciting proxies prior to each annual stockholders' meeting, the additional cost for directors and officers liability insurance, the costs of putting into place and maintaining the corporate governance structures and control procedures that are required of public companies and the costs of dealing with the disclosure and other securities laws issues that public companies face on a regular basis. These costs can be quite significant.

## New World of Internal Controls

Section 404 of SOX requires publicly traded companies to include in each annual report an assessment of their internal controls over financial reporting. This means that management must evaluate, test, and report on its internal controls on an annual basis. Section 404 also requires that a company's registered public accounting firm attest to, and report on, management's assessment of internal controls. Newly public companies, however, are not required to comply with Section 404 of SOX until their second annual report after becoming a public company.

### *SOX 404 Costs in 2004 and 2005*

The costs incurred by companies in complying with SOX 404 have been significant and substantially in excess of the SEC's initial estimate of $91,000. The following tables summarize the direct financial costs incurred by companies related to SOX 404 compliance during the first two years of its implementation:

The following tables summarize certain of the costs incurred by companies related to SOX 404 compliance during the first two years of its implementation:

**Smaller Company Cost Summary**

| | Year 1 | Year 2 | % Change |
|---|---|---|---|
| **404 Cost Summary:** | in 000s($) | in 000s($) | |
| Internal Issuer 404 Costs | 355 | 301 | (15.2)% |
| Third-Party Costs for 404 | 463 | 223 | (51.8)% |
| **Total 404 Issuer Costs** | **818** | **524** | (36.0)% |
| 404 Audit Fees | 423 | 336 | (20.6)% |
| **Total 404 Costs** | **1,241** | **860** | **(30.7)%** |
| **Proxy Audit Fee Component Summary:** | | | |
| 404 Audit Fees | 423 | 336 | (20.6)% |
| Other (non-404) Audit Fees | 423 | 447 | 12.8% |
| **Total Proxy Audit Fees** | **846** | **813** | **(3.9)%** |

**Larger Company Cost Summary**

| | Year 1 | Year 2 | % Change |
|---|---|---|---|
| **404 Cost Summary:** | in 000s($) | in 000s($) | |
| Internal Issuer 404 Costs | 4,260 | 2,200 | (47.9)% |
| Third-Party Costs for 404 | 2,230 | 980 | (56.1)% |
| **Total 404 Issuer Costs** | **6,490** | **3,200** | **(50.7)%** |
| 404 Audit Fees | 2,020 | 1,570 | (22.3)% |
| **Total 404 Costs** | **8,510** | **4,770** | **(43.9)%** |
| **Proxy Audit Fee Component Summary:** | | | |
| 404 Audit Fees | 2,020 | 1,570 | (22.3)% |
| Other (non-404) Audit Fees | 3,080 | 3,540 | 19.9% |
| **Total Proxy Audit Fees** | **5,100** | **5,110** | **0.2%** |

Source: Sarbanes-Oxley 404 Costs and Implementation Issues:
Spring 2006 Survey Update, prepared by CRA International, April 17, 2006.*

Companies with annual revenues less than $700 million are referred to as "Smaller Companies" and companies with annual revenues in excess of $700 million are referred to as "Larger Companies."

## Is the Company Ready?

After a company takes into account the direct expenses of an offering, the ongoing expenses that it will incur once it becomes a public company, and some of the more intangible burdens of being a public company, it may decide that an IPO is not the most desirable way to raise capital. However, if it appears that the benefits will likely outweigh the burdens, the company's board of directors and management team should consider the following:

### *Does the company have the "right stuff"?*

Answering this question requires a combination of soul-searching on the part of the company and candid advice on the part of the investment bankers. The "right stuff" may vary from company to company or industry to industry, but generally includes such things as a disciplined and experienced management team, strong internal financial controls, reasonable visibility as to future financial results, a large target market, a sustainable and scalable business model and a defensible competitive position.

### *Does the company meet the criteria of underwriters and the market?*

The criteria for going public vary from industry to industry over time, and the characteristics of IPOs have changed substantially over the past several years. During the Internet boom of the late 1990s, many investors were willing to buy "concept" stories, growth and market share gains at any expense, complex or unproven business models, sector plays and early stage Internet companies. However, the equity markets and investors seem to have returned to a more traditional (and, as many observers would say, more balanced) approach in valuing companies and determining whether they make promising investment opportunities. Investors are now focusing on companies that are profitable (or have a short, visible path to profitability), driven by experienced and credible senior managers, have proven business models and differentiated products or technologies that present strong barriers to entry for real or potential competitors and have large, rapidly growing market opportunities.

The criteria used by the various underwriters will differ, with the larger underwriting banks generally requiring a stronger financial profile. The criteria may also differ based on the industry sector in which the company competes (*e.g.*, the financial profiles of biotech and alternative energy companies going public will differ from those of software companies). Of course, exceptions to these rules of thumb abound. Thus, a company with an unusually innovative product, an exceptionally accomplished management team or large market opportunity may be able to attract underwriters and investors even if it falls short on certain other criteria. Also, for many technology companies, projected revenue and income growth have been far more important factors than current profitability. It is also important to keep in mind that many fund managers are restricted by certain mandated breakpoints in terms of the size of company in which the managers can invest. In sum, the market's appetite for particular types of companies varies over time, and a company contemplating an IPO should discuss current market criteria with prospective underwriters.

### *Is a liquid trading market for the company's stock likely to develop after the IPO?*

It is in the interest of all parties for a liquid trading market for the company's stock to develop following the IPO. Whether that market develops will depend on a number of factors, including the number of shares available to be traded, the value of the shares, the presence (or absence) of market makers for the shares, the publication of research reports by analysts covering the company and the company's financial (or other operating) performance following the IPO. Companies considering an IPO should carefully consider, after consultation with potential underwriters, whether it is likely that a liquid trading market will develop.

### *Is the company's business and financial model realistic?*

Predictability of results is essential for maintaining credibility with analysts and investors, as well as for reducing stock price volatility and the likelihood of a lawsuit. Before embarking on an IPO, company management must be justifiably confident in the company's ability to execute on its plan. The public capital markets are unforgiving with companies that fail to meet Wall Street financial performance expectations, especially shortly after an IPO before the company has established a history of credible public company results.

***Would the company's offering benefit from the achievement of additional milestones?***

If a company's financial situation permits, the company may benefit from delaying its IPO until it achieves a certain milestone, such as the introduction of a new product line or a significant increase in revenue. The timing of an offering is a complex matter, and deteriorating market conditions could offset the benefits of delay. The company should discuss the trade-offs with its investment bankers.

***Can company management participate in the offering process without jeopardizing the company's business operations?***

A company will be severely penalized by the market if it loses momentum because management was too distracted to properly run the business during the offering process. Falling short of projections during the first few quarters following the IPO can virtually guarantee securities litigation.

***Is the company prepared to operate under strict publicity guidelines during the offering process?***

If the proposed timing of the IPO conflicts with significant opportunities to promote the company, such as speaking at analyst conferences or giving interviews to important publications, the company should consult with its counsel and investment bankers. Managed carefully, certain types of marketing and publicity are permissible during the registration process. However, if it is determined that the proposed activities would jeopardize the timing of the offering, then the company must decide whether the offering or the publicity is the higher priority.

***Is the company prepared to make the level of disclosure required in connection with a registration of its stock?***

If sensitive negotiations, contractual restrictions, competitive factors or other issues would prevent the company from making the level of disclosure required by the securities laws about material aspects of the company's business, financial condition or risks, the company should re-evaluate the proposed timing for its initial public offering. The company should discuss sensitive disclosure issues with its counsel in the early stages of planning for an IPO.

***Is the company prepared to meet the ongoing obligations of being a public company?***

Chapter 10 addresses the reporting obligations of a public company. It is common for companies to increase staffing in the finance and administration departments in contemplation of becoming subject to these requirements.

***Are the company's insiders willing to relinquish control and answer to its new public stockholders?***

Depending on the amount of stock sold in the offering, insiders may lose voting control immediately or may lose it over time as the company issues additional stock through employee stock plans, follow-on offerings and acquisitions. Even if insiders retain a majority of the outstanding voting stock following the IPO, the company's directors and officers will have fiduciary duties to the company's minority, public stockholders. These fiduciary duties will limit the insiders' ability to declare dividends to meet their personal financial needs, to grant themselves perquisites that may be considered by public investors to be excessive, to cause the company to enter into business dealings with themselves or businesses controlled by them or to engage in other self-dealing activities.

***Can the company meet stock exchange listing requirements?***

The company should discuss with its investment bankers the appropriate place to list the company's stock. The listing requirements of the NYSE and the NASDAQ Global Market are set forth in ***Appendix A***.

***Is an IPO the best route to achieving the company's objectives?***

In weighing the benefits and burdens of going public, the company should also evaluate other alternatives to achieving its capital raising, liquidity or other objectives, as there are a number of other paths a company can follow. If raising a limited amount of cash is a company's primary objective, a private financing, bank loan, lease financing arrangement or joint venture may be a faster, cheaper and less burdensome solution.

## Now or Later?

The valuation that a company receives in connection with its IPO is a function of market conditions as well as a function of the company's current condition and future prospects. Many companies attempt to time their offerings to coincide with periods when the market is especially receptive to new issues. These periods are often cyclical. For example, a particular industry may be perceived as “hot” and companies in that industry will race to complete their offerings while the market window is open. In subsequent quarters, some of those companies will falter. Investors may then become more cautious about new issues and the market window will begin to close, even for relatively strong companies that easily could have sold stock at the beginning of the cycle.

Catching the market at its peak has the obvious advantage of a higher valuation. However, the temptation to go public before the company is ready can result in frustration for management and disappointment for stockholders if the company’s performance is not sufficient to keep the stock price up after the market cools off.

Market windows can also be seasonal. According to conventional wisdom, it is difficult to bring new deals to the market during the second half of August when many professionals are enjoying the last days of summer with their families before the school-year begins and many European countries are essentially closed for business. The Thanksgiving and Christmas holiday seasons have been historically difficult times to bring new offerings. Market conditions can change between the time that a company decides to undertake its IPO and the effectiveness of the IPO.

Over the past several years, an increasing number of companies have been considering alternatives paths to provide liquidity to their stockholders while concurrently undertaking preparations for an IPO. Often, the most attractive alternative is a sale of the company. Engaging in a dual-track process whereby a company prepares for a IPO and a sale of the company at the same time can have several benefits, including allowing a company to assess the best exit opportunity for its investors and perhaps secure a better valuation. Further, if the company eventually decides to consummate a sale rather than an IPO, the company would also be able to avoid the expense and potential liability associated with conducting an IPO and being a public company.

However, there are also significant drawbacks to pursuing a dual-track strategy. As noted previously in this chapter, the IPO process is time consuming, and often distracts management from the operations of the company. Combining the IPO process with a sale process would serve to further distract management, and may cause the company to miss its operating targets at a time when proper execution of the company’s business plan is critical to its valuation discussions with its investment bankers or a potential acquirer. Moreover, during discussions with a potential acquirer, the company would likely be required to reveal sensitive business information, and, if negotiations fail to result in a sale, such information may be used by the potential acquirer to compete with the company in the future. Failed negotiations with a potential acquirer would also cause the company to be viewed as “damaged goods,” and could negatively impact the company’s valuation if it eventually chooses to pursue an IPO. In addition, if the company is successful in consummating a sale, the company’s management would likely lose significant operational control.

In deciding whether and when to go public, and the manner in which to conduct the offering process, a company must take into account its own readiness and financial needs, and seek the advice of experienced investment bankers and legal counsel.

# Chapter 2
# Assembling Your IPO Team

Once a company has decided to go public, the next step is to assemble an experienced team to guide the company through the rigorous process that lies ahead. The company's success will depend to a large extent on a coordinated team effort among the members of the working group, which is comprised of the company's management team and board of directors, the company's legal counsel, the managing underwriters and their legal counsel, the company's independent auditors, and in cases where needed, special experts. The primary goal of the working group is to complete a successful offering that complies with applicable laws and regulations. One of the principal tasks of the working group is drafting the registration statement, including the prospectus, that will be used to (1) satisfy legal disclosure requirements, (2) market the company's stock to investors and (3) protect the company and the members of the working group from liability with respect to their participation in the IPO.

## The Company's Management Team

The most important working group members are the company's management team, led by the Chief Executive Officer (CEO), the Chief Financial Officer (CFO) and the Chief Legal Officer (CLO). The management team acts as a liaison between the working group and the company's board of directors and plays a critical role in all aspects of the offering process. The market responds favorably to complete and experienced management teams, especially those that have worked together for some time, and may penalize a company for an inexperienced or incomplete team.

Additionally, the company's management team, and in particular the CEO and CFO, will be the critical points of contact between the company and the public capital markets. They will be communicating directly with the public capital markets in the road show during the IPO process, in the company's quarterly earnings conference calls after the IPO, and in other public settings. How effective these management team members are at conveying information effectively to the market, and how they respond to questions from analysts and investors under pressure, could impact how the company's business is perceived by the market, and could impact the company's stock price. How the information is communicated can often be as important as the content of the information itself. A premium is placed on executives that can instill trust and confidence in the capital markets. These principles are especially true in the world of relatively volatile technology company stocks. A company that is exploring a public offering would be well served to ensure that the executive team includes individuals that have experience communicating with the public capital markets, and working within the complicated and changing framework of securities and corporate governance regulation.

The company should discuss any management gaps or anticipated turn-over with its investment bankers and counsel early in the offering process.

### *Role of the company's management team*

*Making structural and timing recommendations to the board.* The management team must make a number of structural and timing recommendations to the board of directors that are relevant to the IPO, including recommendations regarding the size of the offering, the inclusion of selling stockholders, the drafting schedule, and the timing and extent of the road show. While experienced investment bankers and legal counsel can provide valuable advice on many issues, most key decisions in the offering process are ultimately made by the management team under the guidance of the board of directors.

*Preparing the registration statement and responding to SEC comments.* The CEO, CFO, CLO and, depending on the nature of the business, key engineering, sales and marketing, manufacturing and other employees will be the most important resources to the working group as it prepares the registration statement and prospectus for the offering. The drafting process is a group effort, and company management and key employees will actively participate in the drafting, reviewing and editing of key portions of the registration statement. The management team will be the critical source of information about the company's business and operations that will enable the working group to accurately describe the company in the prospectus. While one or two members of the management team may become the primary liaisons to the working group, the availability of the entire executive staff is crucial to ensuring the accuracy of the registration statement. When SEC comments on the registration statement are received, company management will be integral to the preparation of responses.

The drafting process is a labor-intensive process. Different members of the management team may be required to spend significant periods of time participating in drafting and reviewing the registration statement. In particular, the CEO, CFO, CLO, head of marketing and head of sales will play critical roles. The CFO and CLO are usually the primary managers of the public offering process for the company, with a controller-level person carrying the laboring oar with respect to collecting and disseminating information as part of the due diligence and drafting processes. The CFO will also play a key role in helping other team members understand the company's financial position and results of operations, and describe these in the financial disclosures portions of the registration statement. The CEO and the marketing and sales executives will be invaluable in helping the working group to quickly understand and describe the company's business. A company should be prepared for this demand on the time and attention of its key executives, and plan accordingly. Inadequate time and attention from these critical players can degrade the efficiency of the offering preparation process, and can contribute to inadequate disclosure in the offering documents.

**Practical Tip: Carefully Plan for Availability of Management Team Members to Avoid Slowing Down the Process**

One of the key challenges a company embarking upon the IPO process will face is reconciling the competing realities that the management team is critical to the IPO process and also critical to the successful operation of the company's business on a daily basis. The IPO process will demand significant time from management team members, but, of course, they cannot neglect their duties in managing the business. If management team members are not sufficiently available to the working group, it can affect the timing of the IPO process.

In order to ensure that management team members can adequately participate in the process, the working group should carefully plan the working group's drafting schedule for the entire process and ensure that this schedule is consistent with the availability of the management team members. For example, if a company's business has a seasonal characteristic so that one part of the year is disproportionately busy or critical to the business, the company should carefully consider how that reality will be reconciled with the demands of the IPO process if the IPO process would overlap with the busy period.

*Making road show presentations.* After the registration statement is drafted and a red herring, or preliminary prospectus, is printed by the financial printer, the management team and managing underwriters will conduct a road show to market the offering to investors. The road show is the primary opportunity for the company to tell its story, showcase its business and ultimately sell the offering to investors. While the managing underwriters will handle the logistics of the road show and assist company management in preparing for their presentations, it is company management, not the underwriters, that investors are interested in meeting. During the road show, the CEO and CFO of the company are presenting to investors, and the credibility of the CEO and CFO and the effectiveness of their presentations will be critically important to the success of the offering. Underwriters sometimes suggest that companies work with outside consultants to polish the road show presentations.

## The Company's Board of Directors

The company's board of directors must be involved throughout the IPO process, from the initial decision to undertake a public offering to the final decision to proceed with the offering. The non-employee directors typically are not involved in the working group due diligence sessions and drafting sessions, but they must be provided with interim drafts of the registration statement and kept informed as to the status of the process as the deal progresses. In addition to approving the offering itself, the board will be responsible for reviewing and authorizing any necessary corporate housekeeping matters, reviewing and authorizing the filing of the registration statement and forming a pricing committee comprised of directors who will have the authority to negotiate with the managing underwriters to establish the terms and conditions of the offering (including pricing terms). SEC rules require a majority of the board to sign the registration statement; as such, board members will be liable for material misstatements and omissions unless they can establish a due diligence defense, as discussed in Chapter 7. Directors should be active and diligent in reviewing the registration statement for accuracy and in asking questions of management and the company's counsel with respect to the registration statement and the offering process to ensure that they benefit from the due diligence defense discussed in greater detail in Chapter 7.

SEC, NYSE and NASDAQ rules and regulations impose requirements relating to the composition of the boards of directors, and certain committees of the board of directors, of public companies. These requirements mandate that public company boards of directors be composed of a majority of independent directors and that audit committee members meet certain financial literacy requirements, and confer authority over certain board functions to the independent directors.

The NYSE and NASDAQ rules, as well as SEC rules, will require public company boards of directors to comply with the following requirements:

- *Majority independent directors.* Both NASDAQ and NYSE rules require that boards of directors be composed of at least a majority of independent directors.
- *Executive sessions of independent directors.* Both NASDAQ and NYSE rules require that independent directors hold regularly scheduled meetings at which only those directors are present. The NYSE rules require that non-management directors meet regularly, and also recommends that, if there are non-management directors who are not independent (within the meaning of the rules), the independent directors should additionally meet at least once a year.
- *Independent audit committee.* NASDAQ and NYSE rules and securities laws require that listed companies must have an audit committee composed of at least three directors, all of whom are independent and meet basic financial literacy requirements.
- *Audit committee required to include one financially sophisticated member:* NASDAQ and NYSE rules and securities laws require that least one member of the audit committee must meet more stringent financial sophistication requirements, including prior experience in finance, accounting or otherwise in preparing or overseeing the preparation of financial statements.
- *Board nominations by independent directors:* NASDAQ rules require that board nominations must be determined by, or recommended to the board of directors by, either a majority of the independent directors or a nominating committee composed solely of independent directors. The NYSE rules require that board nominations must be determined by a nominating committee composed solely of independent directors.
- *Independent compensation committee:* NASDAQ rules require that executive compensation must be determined by, or recommended to the board of directors by, either a majority of the independent directors or a compensation committee composed solely of independent directors. The NYSE rules require that listed companies establish a compensation committee composed solely of

independent directors charged with making recommendations to the board of directors regarding compensation.

The rules for determining independence are detailed and fact-specific. The company should work closely with its counsel in determining whether its directors meet the independence requirements, especially in questionable cases.

Depending on the composition of a company's board of directors prior to embarking on the public offering process, these requirements may require the company to significantly alter the structure of its board of directors. It takes a substantial amount of time and effort to identify and install qualified independent directors, particularly directors who are qualified to serve as audit committee members and financial experts. In the past, companies were often able to enlist new directors on the eve of the IPO. However, many director candidates tend to be more cautious because of heightened concern over the potential personal liability that arises in connection with the offering. An IPO-bound company can expect new directors to conduct a thorough review of the company's indemnification measures (*e.g.,* D&O insurance and indemnification agreements) to ensure adequate protection is in place and to make all inquiries necessary in connection with the IPO process to avail themselves of the due diligence defense. The combined effects of recent corporate governance reforms making the requirements for some board positions more stringent and increasing the amount of work required by directors promise to make for a tight market in qualified candidates for public company directorships. As a result, it is important to begin this process early.

Public companies will also need to have charters for their board committees. It is important for a company contemplating an IPO to work closely with counsel to ensure that the committee charters will comply with the applicable exchange and securities laws.

In recognition of these timing issues, the NYSE, NASDAQ and SEC provide newly public companies with phase-in periods for compliance with certain independent director requirements. Companies may initially be allowed to have only one independent director at the time of listing, a majority of independent members within 90 days following listing, and fully independent committees within 1 year. Notwithstanding the grace periods for newly public companies, companies may wish to consider, as a corporate governance best practice, complying with all (or as many as are reasonably practicable) of the requirements as of the date of the company's IPO (or, if possible, as of the initial filing of the registration statement).

Institutional investors may expect to see newly traded companies follow best practices with regard to corporate governance matters. As a result, it is conceivable that a company that is not compliant at the time of the IPO may be penalized in the marketing of its offering for its failure to follow best practices in corporate governance. Companies that anticipate taking advantage of the phase-in provisions for newly public companies should confer with their legal counsel and their underwriting team regarding the potential impact that not accelerating compliance with these requirements before the IPO could have on the offering. A company taking advantage of the phase in provisions will also be required to disclose that fact in the IPO prospectus.

As it prepares for its IPO, a company should review its board composition with its legal counsel and investment bankers, with particular thought given to the SEC and applicable exchange rules as well as marketing bringing on additional outside and independent directors with relevant industry or public company experience, as discussed in Chapter 3.

## The Managing Underwriters

Most IPOs are made with the assistance of investment banking firms that act as firm commitment underwriters. In a firm commitment underwriting, the company sells the IPO shares to the underwriters at a discount from the price at which the shares will be sold to the public. The underwriters then sell that stock, either directly or through a selling group, to investors who have subscribed to the offering.

### *Structure of the underwriting group*

The company typically chooses two or three investment banks to act as managing underwriters, although the number may be smaller or larger in any particular case, depending on factors such as the size of the offering and the level of interest among underwriters. In most IPOs there will be more than one manager. If more than one managing underwriter is selected by the company, one of the managers will be designated as the "lead" manager (also sometimes called the "book runner") with the other managing underwriters referred to as "co-managers." In certain cases, there may be two lead managers, who are typically referred to as "joint book runners." The lead manager plays the dominant role with respect to the structure, allocation, timing and pricing of the offering, the preparation of the registration statement and the organization of the road show. If there are joint book runners, there is typically an agreed allocation of authority and responsibility among the joint book runners. In addition to establishing the roles in managing the IPO process, the designation as a lead manager or co-manager impacts the allocation of the underwriting fees and discounts. The lead manager is listed on the bottom, left side of the cover of the prospectus, and the other managing underwriters are listed below and to the right of the lead manager. The lead manager and co-managers are the members of the underwriting syndicate that will actually be involved in the IPO preparation process, attending drafting sessions and the road show meetings.

It is up to the company to determine which bank will be the lead manager and which bank or banks will be the co-managers. Investment banking firms' relationships with one another can be competitive or cooperative, and usually are a bit of both. There is a definite hierarchy of firm prominence in the investment banking world, and it would not be unheard of for a bank that is not selected as the lead manager to refuse to act as a co-manager to the bank that is chosen, if the selected bank is the less prominent of the two. The concept of joint book runners has only developed in recent years and is still evolving. There are potential advantages and disadvantages to engaging joint book runners, and companies should consult closely with legal counsel and other experienced advisors as to whether joint book runners may be approriate in a particular circumstance and how best to manage the relationships with the joint book runners. The decision regarding the lead manager, whether to have joint book runners and the ordering of the co-managers should be made prior to the organizational meeting to ensure that the underwriters spend their time working together toward the success of the offering.

The managing underwriters may organize a larger group of investment banks to help distribute the stock and bear the risk of the offering. The entire group of investment banks is referred to as the "underwriting syndicate." The underwriting syndicate may, in turn, sell part of the offering through a selling group consisting of even more investment banks and broker/dealers. It is not necessary for the company to participate in the selection of the syndicate or selling group members, although the managing underwriters will often take into account any preferences expressed by the company. The syndicate and selling group members other than the managing underwriters do not participate in the due diligence, drafting or road show processes.

### *The role of the managing underwriters*

The managing underwriters coordinate many aspects of the IPO process, conduct due diligence on behalf of all of the underwriters, advise the company on IPO structural issues, assist in drafting the registration statement, arrange the road show, market the offering to potential investors and provide after-market support and analyst coverage for the company.

### *Selection criteria*

The selection of underwriters for an IPO is a critical step in the process. When choosing managing underwriters, a company should consider the factors listed below. If two or more managing underwriters are to be used, the company may wish to base its decision, in part, on whether the banks have complementary strengths. For example, if a company desires to sell both to institutional and retail investors, it may wish to select one bank that is particularly strong in the institutional arena and one that is equally strong in the retail channel.

*Analyst coverage.* Analyst coverage is essential to maintaining investor interest in a company's stock following its IPO. Without it, the market for the company's stock may be relatively illiquid, volatility of the stock may be heightened and follow-on offerings may be difficult to place. This type of analyst is known as a "sell-side" analyst, and is typically an employee of the underwriting firm (though there are independent analysts that are not part of firms that underwrite equity offerings). The role of the sell-side analyst is to research a particular industry and the companies in that industry, and to report on the results of that research and make predictions about the anticipated performance of the industry, the companies and their securities. The sell-side analyst's reporting is outward facing, intended for the potential purchasers of securities who are brokerage customers (or potential brokerage customers) of the securities firm for which the analyst works. Sell-side analysts are to be contrasted with buy-side analysts, who typically do similar investigatory work, but whose reporting is internally facing, intended for the financial institution employing them in buying decisions on behalf of the institution itself. The buy-side analysts figure into the IPO process as well by attending road show presentations to glean information about the company to determine whether the analyst's institutional employer should purchase the IPO securities.

The fact that an investment bank currently provides significant analyst coverage of a particular industry is generally a sign that the investment bank is committed to that industry and will be likely to hire additional analyst talent if the current analyst jumps ship. A good analyst will help position the company properly and may help reduce volatility in a company's stock by setting realistic expectations for the company's performance. The company should read recent research reports issued by analysts at each of the prospective underwriting firms and investigate the analysts' experience and published industry ratings. The company should then determine whether the reports reflect an understanding of the company's industry and its future, and the company's position in that industry, that is consistent with the company's understanding.

The role of analysts in the IPO process, as well as after the IPO, has undergone intense scrutiny in recent years as a result of the analysts' high profile in the late 1990s, their increasing power to influence stock prices and the widespread perception that analysts were tainted by a raft of conflicting interests. These conflicts included perceived entanglement of research analysts with the investment banking/underwriting side of the analysts' firms' business and perceived entanglement between the analysts and the companies on which they report. The result was a serious undermining of investor confidence in analysts' recommendations, and a backlash of regulatory action. These actions included the promulgation of Regulation FD, which restricts non-public communications between public companies and investment professionals (Regulation FD is discussed in greater detail in Chapter 10), the enactment of the Sarbanes-Oxley Act, which required SROs to adopt rules relating to analyst conflicts, the promulgation by the NYSE and NASDAQ of rules relating to analyst conflicts of interest, and a series of regulatory enforcement actions against securities firms and analysts for past transgressions relating to analyst research. Many of the enforcement actions were settled in a global settlement that resulted in several leading investment banks agreeing to structural and operational restrictions designed to eliminate the analyst conflicts of interest. The result of the regulations is that research analysts will be much less involved in the investment banking aspects of the IPO process, and there may be some duplication of efforts as the analysts and bankers have to essentially operate entirely separately during the process. These analyst conflicts, the regulatory responses and the impact on the analysts' role in the IPO process are discussed in more detail later in this chapter and in Chapter 9.

*Level of interest in the company.* The company should try to gauge how important its offering will be to the underwriter. During particularly frenzied market periods, an investment bank simply may not have the resources to staff all of its deals adequately. Even during normal market periods, a small deal simply may not meet the criteria of bulge- or majorbracket investment banks, in which case the company may wish to consider regional or boutique firms. When interviewing a prospective underwriter, a company should try to get a sense of what priority that investment bank will place on the company's deal by, for example, making inquiries of the bank's interest in the company and its industry, which individuals from the bank will be actively engaged in the IPO process, and whether competing transactions will enable the bank to devote sufficient attention to optimize the success of the road show.

*Track record with similar IPOs.* Does the prospective underwriter have experience marketing the stock of companies of a similar size, stage of development and industry as the company. Underwriters that have successfully placed the stock of similar companies may be more likely to have relationships with investors that would be interested in purchasing the company's stock. Relationships with customers, suppliers and competitors of the company may indicate a deeper understanding of the company's industry and a real commitment to providing analyst coverage in that area. However, this must be weighed against the possibility of conflicting loyalties, problems in handling the company's confidential information and an inability to provide evenhanded advice in certain acquisition situations.

*Reputation.* Some investment banks are more respected than others, either in general or for their expertise in particular market segments. For investors whose first introduction to the company is through the IPO, the reputation of the managing underwriters may have a significant influence on the perceived quality of the investment and, in turn, may even influence valuation.

*Distribution capabilities and focus.* Among the most critical aspects of choosing an underwriting team is ensuring that the company has underwriters who are going to be able to complete the distribution, and are going to be able to get the company's shares into the hands of the right investors. Companies should ascertain the bank's distribution capabilities and objectives, its key institutional accounts, whether the bank will be able to build a quality syndicate to achieve optimum distribution, liquidity and visibility for the company's offering.

Some investment banks sell primarily to institutions, which tend to be more sophisticated and capable of understanding a complex business model. However, institutions tend to take a more activist approach to corporate governance and are less likely than individual investors to accede without a compelling rationale to management recommendations on items such as increases in stock option pools, mergers and acquisitions and anti-takeover measures. Retail investors tend to provide greater liquidity for a company's stock because they contribute to the public float and the actions of a single investor can rarely influence the prevailing market price. Theories abound for whether it is better to be more heavily weighted toward institutional or retail investors. The company's management team should ensure that its prospective lead managers explain their approach and support it with empirical evidence from recently completed transactions. Most companies prefer a mix of institutional and retail stockholders. If a company has a particular international distribution objective, it should discuss that also with prospective underwriters.

Underwriters differ based on many other characteristics as well. Different underwriters may have different strengths in terms of types of technologies. They may also differ as to the regional strengths of their institutional investor relationships. For example, some firms may have stronger connections with East Coast institutional investors. So, if a company chooses a West Coast based lead managing underwriter for some reason, and yet wants to make sure that East Coast institutional investors take positions in the company, the company would be well served to ensure that one of the co-managers (or, at a minimum, one of the other syndicate members) is an underwriter with strong connections to East Coast institutional accounts. Strategizing the makeup of the underwriting team with a view to leveraging their various strengths in terms of reach to investors is a matter on which the company should work closely with the lead managing underwriter and the company's other advisors.

*Aftermarket support.* While sales execution is critical to a successful IPO, post-offering market support can be just as important. In order for the trading price of the stock to accurately reflect the underlying business fundamentals and not be distorted by liquidity concerns, there must be a fluid and efficient market in the company's stock. This requires a few strongly capitalized firms that act as market makers, and stand ready to buy and sell the company's stock at the market prices, so that trading can continue efficiently at all times. Aftermarket support also includes the ability to help the company get other analysts interested in covering the company, and attracting large institutional investors to the company's stock after the IPO. In determining a prospective investment bank's aftermarket support capabilities, a company should request that the bank provide its track record in terms of aftermarket performance of other IPOs it has managed.

Experience in follow-on offerings, debt offerings, mergers and acquisitions, anti-takeover measures and other investment banking functions. A company will realize greater benefits from its investment bankers if it maintains long-term relationships that allow the bankers to develop an intimate understanding of the company's business, objectives and management team. Ideally, a company's investment bankers will keep the company abreast of market developments, make creative financing suggestions, bring desirable acquisition opportunities to the company's attention and assist the company in implementing appropriate anti-takeover measures. A company should look ahead and consider whether the banks that it chooses to manage its IPO will be able to meet the company's expanding needs.

*References.* The company should ask each prospective managing underwriter that it is seriously considering to provide a list of the several most recent IPOs for which it was selected as a managing underwriter. If possible, this request should be refined to the most recent offerings in the company's industry or a related field in which the analyst or corporate finance team that will be working on the company's IPO participated. Company management should then contact the CEO or CFO of those companies to determine whether, with the benefit of hindsight, they were satisfied with their choice.

The company may also wish to ask each prospective managing underwriter for a list of more mature companies with which it has maintained a long-term investment banking relationship. Company management should then contact the CEO or CFO of each of those companies and ask many of the same questions that it asks of the more recently public companies. Company management should also inquire as to whether the reference company did or did not use that investment bank for all follow-on offerings or acquisitions which it has undertaken since its IPO, and why. Has the investment bank stayed in close contact with the company, or does it only show up when a commission is involved? Are the individual bankers familiar with the company's developments, or are they spread too thinly or lost contact due to turnover in the team?

Finally, the company should take into account the opinions of its board members, legal counsel and others who may have first-hand experience with the various investment banking firms under consideration.

*Chemistry.* When company management selects an investment banking firm, it must be comfortable with the people from that firm who will be responsible for providing service to the company. A successful IPO requires teamwork, the ability to read each other's signals and, quite frankly, the ability to spend day after day together in drafting sessions and road show activities. A successful post-IPO investment banking relationship will be far more fruitful if the bankers are enthusiastic about the relationship, understand the company's long-term goals and have management's trust. In considering chemistry, management should try to distinguish between bankers that tell the company what it wants to hear from those that are willing to provide candid advice. The company should make sure it gets to know the broader investment banking team, not just the deal team that pitched the business. The company's senior executives should make a point of meeting the capital markets leads and the institutional sales leads.

*Offering price and underwriting discount.* Generally speaking, price is one of the least important criteria in selecting a managing underwriter. The final offering price will ultimately be determined by factors such as the company's performance, market conditions prevailing at the time of pricing and the level of interest generated during the road show. While investment banks will discuss a ballpark valuation with the company at the beginning of the offering process, no bank can realistically promise a particular price in advance. Company management should be wary of any bank whose valuation of the company is significantly out of line with the consensus of the other prospective underwriters. Because most investment banks (and their customers) use similar valuation techniques and will use a similar group of comparable companies for determining the applicable earnings or revenue multiple, a valuation that is substantially different from others may mean that the prospective underwriter does not grasp the company's business model, does not understand the company's industry, or is playing games in hopes of winning the company's business.

The underwriting discount for a firm commitment IPO listed on NASDAQ or NYSE is typically 7%, and generally does not vary across major investment banks.

## The Company's Legal Counsel

The company's outside counsel will play an instrumental role throughout the IPO process. In particular, they will work closely with company management to quarterback the drafting process, provide critical advice to the company throughout the process and serve as the primary liaison between the company and the SEC. In selecting outside counsel for its IPO, the company should choose a firm that is experienced in securities law matters generally, and the IPO process in particular, and that has sufficient resources to perform all of the tasks required in the time frame set by the company and the managing underwriters.

### *Role of company counsel*

The company's lawyers will have numerous responsibilities throughout the IPO process, including:

- Assisting the company with its pre-IPO corporate housekeeping and IPO preparations;
- Helping the company to anticipate potential or likely issues in the SEC review process, and to formulate strategies and solutions for those issues;
- Helping the company to coordinate the due diligence process;
- Taking the lead in drafting the registration statement;
- Advising the company with respect to the registration statement's compliance as to form with the requirements of the securities laws;
- Filing the registration statement with the SEC;
- Coordinating, drafting and filing responses to SEC comments on the registration statement;
- Negotiating with the SEC regarding contentious issues;
- Preparing the confidential treatment request and negotiating it with the SEC, when applicable;
- Preparing and submitting the exchange listing application and drafting responses to comments from the stock exchange;
- Negotiating the underwriting agreement on behalf of the company;
- Advising the company with respect to directed shares program issues;
- Coordinating the selling stockholder process, when applicable;
- Advising the company on publicity restrictions during the registration process;
- Helping the company formulate its insider trading policy, analyst and investor relations policies and other public company policies;
- Advising the company with respect to employee benefits matters for public companies;
- Educating the company about the many legal restrictions and reporting and other requirements faced by public companies;

- Assisting the company in implementing corporate governance structures applicable to public companies;
- Advising the company regarding anti-takeover measures;
- Advising the company on an ongoing basis after its IPO on securities-related matters;
- Advising the board of directors regarding their duties in the IPO process, including with respect to their due diligence defense; and
- Representing the company in the event of securities litigation.

***Selection criteria***

A company that already has experienced legal counsel meeting the criteria discussed below will have a head start on the offering process. Many companies approaching an IPO, however, discover that they have outgrown their current legal counsel's ability to meet their evolving legal needs or decide to engage legal counsel with more extensive IPO and public company experience. If a company is considering retaining new securities legal counsel in anticipation of an IPO, it should do so sooner rather than later so that the new lawyers will have time to familiarize themselves with the company and to perform the many pre-IPO tasks described in Chapter 3.

*Experience, experience and experience.* An IPO is a highly technical, time-sensitive, high-stakes event, and the company's legal counsel is directly responsible for the execution of the entire registration process. Counsel's experience with the IPO process and the practices of the SEC will be invaluable in ensuring an efficient, timely and successful offering. Only law firms with extensive corporate and securities law experience should be considered. A law firm that regularly represents companies going through the IPO process will be much more effective in leading the working group and performing the many tasks described above. A firm with an active IPO practice also will be better equipped to anticipate problem areas and respond to difficult SEC comments. Many of the issues that arise in the IPO process are as much lore as law, and the knowledge and expertise to efficiently deal with the issues can generally only be adequately obtained though extensive first hand experience with the process.

Timing the effectiveness of the registration statement to coincide with the culmination of the road show is important to the success of any offering, and the company will want to have legal counsel capable of offering timely, creative solutions to outstanding issues as the desired effective date draws near. A law firm that has experience representing underwriters, as well as companies, will have more credibility in negotiating the underwriting agreement and resolving due diligence and disclosure issues with the underwriters. Finally, a law firm with a large, public-company client base should be able to steer the company around many of the pitfalls common to newly public companies following the IPO, and help position the company to be well prepared to meet its public company legal obligations.

An experienced securities law firm will also likely have partners involved in various policymaking groups and task forces that work with the regulatory bodies to evaluate current laws, identify timely issues and propose improvements to the system. That institutional perspective on the process can be helpful in anticipating and addressing particular issues that arise in the IPO process.

**IPO LEGAL REPRESENTATION**
**(IPO Transactions 1998 through 2007)**

| | AS ISSUER AND UNDERWRITER COUNSEL | | | |
|---|---|---|---|---|
| | Number of IPOs | % of Total IPOs | Aggregate Offering Amount | % of Total Aggregate Offering Amount |
| **Wilson Sonsini Goodrich & Rosati** | 303 | 11.40% | $28,809,068,809 | 5.60% |
| **Latham & Watkins** | 220 | 8.30% | $43,510,819,653 | 8.50% |
| **Skadden, Arps, Slate, Meagher & Flom** | 203 | 7.70% | $86,086,180,834 | 16.70% |
| **Davis Polk & Wardwell** | 186 | 7.00% | $92,417,887,611 | 18.00% |
| **Shearman & Sterling** | 186 | 7.00% | $63,342,279,865 | 12.30% |
| **Simpson Thacher & Bartlett** | 162 | 6.10% | $70,104,651,919 | 13.60% |
| **Brobeck, Phleger & Harrison** | 148 | 5.60% | $10,422,274,009 | 2.00% |
| **Cooley Godward Kronish** | 144 | 5.40% | $10,226,862,565 | 2.00% |
| **Cravath, Swaine & Moore** | 141 | 5.30% | $49,858,209,490 | 9.70% |
| **Wilmer Cutler Pickering Hale and Dorr** | 126 | 4.80% | $15,567,201,571 | 3.00% |

Source: IPOVitalSigns.com

*Full-service capabilities.* A company's legal needs will change significantly following its initial public offering. Forming a long-term relationship with a full-service law firm will lead to higher quality and more efficient service. The corporate and securities lawyers from the IPO team will be able to spot issues early, introduce the company to lawyers within the firm who have relevant expertise, and quickly bring those lawyers up to speed on the company's background and current situation. Therefore, when selecting IPO counsel, the company should consider whether a firm can serve its needs in areas such as general corporate and securities counseling, securities litigation, employee benefits and compensation, antitrust counseling and litigation, tax and intellectual property law.

*Interest in the company.* Because company counsel plays such a critical role on the IPO team, company counsel must be motivated to help the company jump-start the IPO process and drive it to completion. In addition to legal abilities and business judgment, selection criteria should include enthusiasm and responsiveness. Company counsel should be willing to roll up his or her sleeves and do whatever it takes to help the company make the transition from a privately held company to a public company. Company counsel also will need to be a quick study on the company's industry, operations, risks and financial condition, and be able to explain these concepts to investors and the SEC in a prospectus.

*References.* Company management should ask prospective counsel to provide contact information for chief executive officers, chief financial officers, and chief legal officers of clients which have recently gone public, as well as clients which have been public for at least a few years.

In checking references with newly public companies, management should ask whether counsel adequately prepared the company for the challenges of the IPO process. Was counsel organized or erratic? Did counsel help the company get a running start on the numerous pre-IPO items listed in Chapter 3? Did counsel drive the process through to the end, or fizzle out and require pushing from the other team members? Did counsel demonstrate good judgment on sensitive disclosure issues, negotiations with the underwriters and dealings with the SEC? Did counsel take the time to thoroughly understand the company's business and financial situation? How much did counsel contribute during the drafting process, particularly in the "MD&A" and "Risk Factors" sections of the registration statement? What has counsel done to help the company transition to life as a public company? Has it helped the company map out its first year of reporting and annual meeting activities? Has it coached the company on dealing with securities analysts and minimizing the risks of a stockholder lawsuit?

In checking references with more seasoned public companies, management should ask how long the company has worked together with the prospective counsel. Does the company value counsel's business judgment and include counsel in major strategic decisions? Has counsel provided responsive and efficient service? Has the law firm been able to satisfy the company's growing needs? How has counsel responded in times of crisis?

*Chemistry.* Company management must not only be confident in the capabilities of the *firm* it has selected, but must also trust the experience and judgment of the *individual lawyers* who will be responsible for guiding the company through the IPO process and beyond. Are the CEO and CFO interested in counsel's opinion on issues of strategic importance to the company? Would their rapport with counsel allow them to successfully wrestle with difficult judgment calls together? Are they comfortable sharing the company's dirtiest laundry with counsel and asking for recommendations? Do they feel that counsel is interested in having this sort of working relationship with them?

*Fees.* A company's focus should be on value for the dollar rather than on absolute fees. In assessing value, there are several factors that a company should take into account. A firm that is experienced in the IPO process may be more efficient in the long run, even if its hourly rates are higher than those of other firms. (Company management should be sure to ask each firm it is considering what its rates are. Companies are often surprised to find that the rates of experienced securities counsel are not significantly higher than those of less experienced firms.) Interest on the proceeds of an average offering can exceed $10,000 *per day* and market windows are often unpredictable. Counsel that can effectively drive the registration process and run the gauntlet of SEC comments may save the company tens of thousands to millions of dollars just by keeping the process on schedule. Additionally, experienced counsel that can advise the company wisely on disclosure issues and policies regarding insider trading and dealing with analysts may help save the company millions of dollars in litigation exposure.

## The Underwriters' Legal Counsel

### *Role of underwriters' counsel*

The underwriters' counsel is responsible for:

- Assisting the underwriters in satisfying their due diligence obligations, including document review, factual back up of statements made in the prospectus and negotiation of the comfort letter from the auditors;
- Participating in the drafting process;
- Satisfying applicable state securities laws and regulations;
- Obtaining FINRA clearance of the underwriting arrangements;
- Drafting the underwriting agreement and negotiating it with the company's counsel;

- Coordinating the mechanics of the underwriting syndicate with the lead manager's capital markets department; and
- Coordinating the closing with company counsel.

### *Selection criteria*

The underwriters' counsel should have extensive public offering experience. Many of the same criteria discussed above for company counsel are equally applicable to the role of underwriters' counsel. Underwriters' counsel generally is chosen by the lead managing underwriter at times, with some degree of input from the company.

## The Company's Auditors

### *Role of the company's auditors*

The company's auditors ensure that the financial information included in the registration statement satisfies SEC financial information disclosure requirements, which are different and in some cases more extensive than GAAP.

In addition, the auditors are the primary liaison between the IPO working group and the SEC's accounting staff, and generally take the lead in drafting responses to the SEC's comments relating to accounting matters.

The auditors will also be responsible for delivering a comfort letter to the underwriters and the company's board of directors confirming that the financial statements contained in the registration statement comply with accounting requirements, and tying the tables, statistics and other financial information included in the registration statement to the financial statements and other financial records of the company.

Following the IPO, the auditors will assist the company in its ongoing financial reporting obligations.

### *Selection criteria*

Almost by definition, a company's auditors must become intimately familiar with the company's financial situation and accounting practices. Therefore, if a company is considering changing auditors in anticipation of its IPO, it should make the decision as early as possible.

*Registration with the public company accounting oversight board.* Under the Sarbanes-Oxley Act of 2002, audit firms preparing or issuing audit reports with respect to publicly reporting issuers must be registered with the Public Company Accounting Oversight Board. Accordingly, issuers should take care to ensure that their auditors are appropriately registered with the Public Company Accounting Oversight Board.

*Reputation and general IPO experience.* The company's auditors should be well regarded and have extensive IPO experience. Most public companies use one of the Big Four accounting firms. In addition, issuers should evaluate the relevant experience of the key audit partners and the partners expected to replace them under the SEC's audit partner rotation requirements. If the issuer has or expects to have operations in foreign countries, the auditor should have offices or experience in those countries.

*Specific industry experience.* The company's auditors should have extensive and ongoing experience with other clients in the company's industry. The SEC almost always raises issues about the company's accounting practices during the SEC's review of the registration statement. As a result, it is essential that the company's auditors be current on accounting developments specifically applicable to the company's industry and be able to effectively justify the company's position with the SEC.

*Track record.* The company's audit committee should consider the audit firm's recent record with respect to restatements and disciplinary proceedings before the SEC.

*Suitability for post-IPO matters.* Following the IPO, the company will rely on its auditors to audit its annual financial statements, as well as to provide advice regarding complex issues such as tax planning or the accounting impact of mergers and acquisitions or new business initiatives.

*References.* As with the company's other service providers, the company (under the direction of its audit committee) should carefully check references, inquiring as to experience, judgment, responsiveness and efficiency.

*Consequences of terminating audit relationship.* Once an auditor has been hired, it is difficult to terminate the relationship. Any resignation or dismissal of the company's auditors must be disclosed on SEC Form 8-K when it occurs, as well as in the company's periodic SEC reports for two fiscal years following the change, along with the reasons for the resignation or dismissal. While changes in accounting firms that occur prior to the IPO are easily explained, changes once the company is public may be viewed by the market as a sign of trouble at the company. Therefore, the company should give careful thought to its choice of auditors well in advance of its IPO.

## The Company's Financial Printer

The company's outside counsel generally will maintain early drafts of the registration statement on its word processing system. A few weeks prior to the initial filing of the registration statement, the company counsel will transfer the draft to the financial printer's document management system. The financial printer will then host and coordinate the remaining drafting sessions. They will manage and circulate new drafts of the registration statement to the working group members, and are integral in the time management and distribution of the drafts as the working group strives for the initial filing. Throughout the process the financial printer can provide research tools and resources as well as word processing and other administrative support. Once the draft is finalized and ready to be filed with the SEC, the financial printer will EDGARize and transmit the registration statement via EDGAR to the SEC. Finally, the financial printer will print prospectuses and promptly distribute them to the underwriting syndicate.

In selecting a financial printer, the company should consider the importance of developing a strong, long-term relationship in light of the future needs that the new public company will have following its IPO. An experienced, strategic financial printer can be a valuable, but oftentimes overlooked, strategic partner.

### *Role of the financial printer*

The company's financial printer is responsible for document management throughout the registration process, including:

- Typesetting/conversion of word-processing documents into the registration statement, including the prospectus, in the appropriate underwriter's style;
- Hosting working group sessions at the financial printer's facilities, utilizing conference rooms, telephone, facsimile and Internet capabilities, administrative support and food services;
- Document management, including author alterations and proof distribution of the registration statement throughout the IPO process;

- EDGARization of the registration statement, including all exhibits, for filing with the SEC;
- Electronic transmission via EDGAR to the SEC of each filing, including correspondence with the SEC staff;
- Printing of the prospectus and distribution of it to the selected underwriters' syndicate and working group;
- Electronic conversion of the prospectus to HTML/PDF formatted files for distribution by the underwriters and electronic posting of the document to the company's web site; and
- Translation and editing of the prospectus into foreign languages as required.
- Established conference facilities and locations in major cities worldwide to accommodate the company and all members of the working group. This is instrumental in meeting distribution deadlines.

Following the company's IPO, the financial printer will assist the company with its ongoing printing and filing responsibilities as a public company, including:

- SEC filing requirements, such as the company's filings on Forms 10-K, 10-Q and 8-K, Section 16 filings and the filing and printing of the company's annual report and proxy statement;
- Other filing needs, including filings made in connection with future follow-on public equity or debt offerings and merger and acquisition transactions;
- Certain ancillary services, including translation services, localization/globalization services, digital and print services; and
- Online document management and distribution systems, including a virtual data room, collaborative workspace, and automated filing services.

***Selection criteria***

Company management is responsible for selecting the financial printer, and should do so relatively early in the IPO process. Criteria that should be used in selecting a financial printer include the following:

*Experience.* The Financial Printer should have an in depth understanding of the IPO process. No two IPOs are the same, and a long history of handling a large share of financial transactions will inform the process and best practices maintained by the financial printer.

*Level of service.* Time will be of the essence as the initial registration statement nears completion and the underwriters and management team gear up for the road show. Rapid and accurate service from the financial printer can reduce the time between receiving SEC comments and filing an amendment to the registration statement. Around-the-clock, professional work by the financial printer will be essential to keeping the offering on schedule.

*Location and facilities.* The location of the financial printer's office, as well as a large national network, and global presence for cross-border deals, the availability of conference rooms, private telephone rooms, and Internet connections and other amenities are factors worth considering for the convenience of the working group.

*Strategic Development of Technologies.* The financial printer should be able to offer clients a set of robust technology based services in conjunction with traditional document management and distribution methods. Web based tools can streamline the document management process and offer transactions new efficiencies.

*Cost.* Cost is a factor, and the multiple variables that affect the IPO process can add to the time and expense of the transaction. A company should consider these costs in relation to the value of the printing services received; the quality of service will affect the time commitment and cost of other service providers during the transaction. An experienced financial printer will consult with the company to ensure they receive a comprehensive, accurate and competitive proposal, which will include pricing of the variable aspects of the transaction.

*References.* The financial printer should provide references for companies recently involved in the IPO process as well as long-time public company clients. These references will establish the financial printer's credentials and provide vital feedback on the quality of their long-term service. The company may also wish to solicit the opinion of company counsel and the underwriters, who likely will have dealt on numerous transactions with all the major financial printers.

## Special Experts

Most working groups do not include special experts. Where the nature of the company's business requires an understanding of highly technical information, however, it may be appropriate to involve a special expert in the registration process. For example, if patented technology is central to the company's business, special patent counsel may be needed to explain the status of a patent application, the strength of the company's patent portfolio or claims of patent infringement. If a company operates in a heavily regulated field, such as medical devices or telecommunications, special regulatory counsel may be helpful to the working group.

The extent of a special expert's involvement in the public offering process can vary widely depending on the working group's requirements. A special expert's involvement may consist of a brief telephonic due diligence interview with the underwriters, an informal review and edit of relevant sections of the registration statement, the rendering of a legal opinion on matters of particular concern, or actual "expertizing" of a portion of the registration statement. In most general terms, Section 11 of the Securities Act describes an expert as one whose profession gives authority to his or her statements. Section 11 of the Securities Act describes an expertized portion of the registration statement as one that is prepared or certified by an expert who, with his or her consent, is named in the registration statement as having prepared or certified a part of the registration statement, or report or valuation that is used in connection with the registration statement. The level of special expert participation should be decided by the company and the underwriters, with the advice of their respective counsel, early in the IPO process. The expected extent and purpose of an expert's role should be made clear to the expert, who may not have much familiarity with the IPO process.

## Others

Numerous other parties will be tangentially involved in the IPO process as well. For example:

- The company will need to select a banknote company to print stock certificates and a transfer agent and registrar to administer stock issuances and transfers.

- The company may also wish to retain a design firm to assist with graphics and artwork to be used in the prospectus, and a professional to help the CEO and CFO refine their public speaking and presentation skills for the road show.
- The board may also wish to engage a compensation consultant to assist it in designating public company-appropriate compensation practices, particularly for the company's executive officers.
- The board may also wish to engage a valuation firm in advance of, and during, the registration process to assist the board in determining the fair market value of its stock for purposes of establishing the exercise price of stock options during the period leading up to the pricing of the IPO.
- The company may also wish to consider retaining a knowledgeable insurance broker to assist it in purchasing D&O insurance for its new life as a public company.

Company counsel generally can assist the company in offering recommendations on the basis of prior experience and reputation and assisting the company in making these arrangements. The underwriters generally can put the company in touch with people experienced in providing these services in the public offering context.

# Chapter 3
# Gearing Up

A company will need to undertake a number of corporate housekeeping and administrative tasks to prepare itself for the IPO process and the transition to becoming a public company. The extent and expense of the work required will vary from company to company and will depend on a number of factors, including the length of the company's operating history and the quality and accuracy of the company's corporate records. In addition to the corporate clean-up items that should be performed, the company should address with its legal counsel and underwriters (and their counsel) any desired structural changes such as a reincorporation, a stock split, various defensive mechanisms and new equity compensation plans.

Among the issues that a company should consider in anticipation of its IPO are the following:

### *Structure of entity*

Most entities that go public in the U.S. are domestic C corporations. If the business proposing to go public is a limited liability company (LLC), a partnership, an S corporation, a foreign corporation or other form of entity, legal and tax counsel should be consulted as to the desirability, timing and consequences of converting into a domestic C corporation.

### *State of incorporation*

A fundamental organizational issue that a company should address at the early stages of the IPO process is the state in which it is incorporated and whether the company should reincorporate in another state. Benefits that are often sought in connection with a reincorporation include extensive legal precedent (and therefore predictability) in matters of corporate governance and a judiciary experienced with corporate affairs and a history of upholding stockholder rights plans, or poison pills, and other defensive measures. The primary disadvantages are the effort and costs, which include legal fees and additional annual franchise taxes.

Many legal practitioners recommend that companies reincorporate in the State of Delaware prior to an IPO. More than 500,000 business entities have their legal home in Delaware, including more than 50% of all U.S. public companies and 60% of the Fortune 500. There are a number of reasons why companies choose Delaware, including the following:

- The Delaware General Corporation Law is one of the most advanced and flexible corporations statutes in the nation;

- Delaware's highly respected Court of Chancery dates back to 1792 and is widely recognized for its expertise in corporation law matters;
- The Delaware legislature, which gives high priority to corporation law matters and utilizes the sophistication of experienced practitioners of the Delaware Bar Association (plus, each year, the Delaware Governor and General Assembly work with their Courts and the Delaware State Bar Association to ensure that Delaware's legal system is the most modern, flexible and responsive in the nation); and
- The highly developed body of case law created by the Court of Chancery and the Delaware Supreme Court, with which lawyers and judges in every state are familiar and which provides a wealth of precedent for corporate executives and directors to utilize in making decisions.

A reincorporation is generally accomplished by creating a new subsidiary in the state in which the company wishes to reincorporate, and then merging the company into the newly formed subsidiary. Additional effort and expense will be associated with assigning contracts, patents, trademarks and copyrights from the original entity to the reincorporated entity, and obtaining new qualifications for the reincorporated entity to do business in various states. There is some debate among legal experts as to whether the benefits of reincorporating outweigh the effort and expense, and the company should discuss the matter with its legal counsel before making a decision.

***Capital structure***

Some changes to the company's capital structure may be necessary to complete the IPO. Often, a company needs to authorize additional shares of common stock to have enough shares to complete the IPO and for future needs. In addition, with the advice of its investment bankers, the company may choose to effect a forward or reverse stock split in order to achieve a proposed offering price in a particular target range. As a general rule, the offering price of an IPO is likely to be in the range of $10 to $20 per share. Pricing a stock too high may make the purchase of round lots of shares too expensive, limiting the number of potential investors, and pricing the stock too low may make the stock more susceptible to extreme fluctuations in price and price manipulation, and may increase the risk of falling below the listing requirements of the applicable exchange after the offering. Due to market fluctuations, most companies choose to wait up to the point that they commence marketing the offering before effecting a stock split.

Because stockholder approval is required for most changes to a company's capital structure, any reasonably foreseeable changes should be made while the company is private and the procedure for obtaining stockholder approval is still relatively simple. For example, the company may wish to authorize even more common stock than is necessary to complete the IPO in order to provide flexibility for future public (or private) offerings, certain acquisitions or the addition of shares to stock option pools. The company may also wish to authorize undesignated preferred stock that can later be used for future financings or in connection with the implementation of a stockholder rights plan, as discussed in greater detail in Chapter 2.

***The board of directors and committees of the board***

A company should consider whether changes in the composition of its board of directors should be made prior to or in connection with the IPO. Does the current board have sufficient depth and experience? Would adding one or more independent directors with relevant industry experience provide additional insight and make the company more attractive to investors? Also, does the company's board composition comply with applicable exchange listing requirements and SEC rules? For example, the NYSE and NASDAQ require that a majority of the board of directors of a listed company be composed of directors who satisfy their respective independence standards. Does the company need to add one or more independent directors? Also, are there any directors who may resign in anticipation of the IPO?

In addition, a company should consider whether to organize additional board committees. The board of directors of a public company must have a standing audit committee that is directly responsible for the appointment, compensation, retention and oversight of the company's auditors. Audit committee members must meet stringent standards of independence, and public companies are required to disclose whether they have at least one "financial expert" serving on their audit committees. For example, pursuant to SEC Rule 10A-3, an audit committee member may not, other than in his or her capacity as a member of the board of directors or a committee of the board, accept any payments for services as an officer, employee or consultant of the company. Also, SEC Rule 10A-3 requires national securities exchanges and associations to prohibit the initial listing of any security of a company that is not in compliance with the rule. The SEC has provided certain limited exemptions from its independence standards, including exemptions for the newly public company such that all but one member of the audit committee may be exempt from the standards for 90 days from the effective date of the company's registration statement and a minority of the members of the audit committee may be exempt from the standards for up to 1 year from the effective date of the company's registration statement.

In addition, the NYSE and NASDAQ have requirements with respect to board and board committee composition. The NYSE and NASDAQ require that a listed company have an audit committee of at least three directors and composed entirely of independent directors (pursuant to their respective standards of independence), among other requirements, including certain financial literacy requirements. The NYSE also requires that a listed company have a compensation committee and a nominating/corporate governance committee composed entirely of independent directors. NASDAQ does not mandate that its listed companies have compensation or nominations committees. However, NASDAQ does require that the compensation of a listed company's CEO and other executive officers must be determined, or recommended to the board of directors, either by a majority of the independent directors or a compensation committee composed solely of independent directors. Also, NASDAQ requires that director nominees be selected, or recommended for the board's selection, either by a majority of the independent directors or a committee composed solely of independent directors. The NYSE and NASDAQ have provided exemptions to new public companies from their respective governance rules for a limited transition period.

If a company cannot meet the independence or other corporate governance standards of the SEC and applicable exchange listing requirements prior to its IPO, the company should begin implementing an appropriate process to become compliant within the permitted transition periods. As discussed in Chapter 2, the process of identifying qualified, independent directors, particularly directors who are qualified to serve as audit committee members and financial experts, takes time and diligence. Many companies engage recruiting firms to assist in the process. Regardless, this is an area of corporate housekeeping that requires attention early in the IPO process.

*Indemnification of directors and officers*

The company should review, with the assistance of its legal counsel, the adequacy of the indemnification provisions contained in its charter documents. The company should also make sure that its form of officer and director indemnification agreement reflects the current state of the law, has been approved by the stockholders (to the extent necessary to ensure its enforceability), and has actually been entered into with each officer and director. In addition, the company should purchase appropriate director and officer liability insurance, as discussed in greater detail in Chapter 4.

***Capitalization records***

The company should make sure that its capitalization records accurately reflect all stock issuances, transfers and cancellations; all option and warrant issuances, exercises and terminations; all convertible debt issuances, transfers, conversions and cancellations; all anti-dilution adjustments; and details of any other securities transactions. In order to determine holding periods under Rule 144, the date of payment should also be recorded. Ideally, the date of board authorization, the blue sky exemption relied upon, and any special rights or restrictions (such as rights of first refusal, registration rights, voting agreements or lock-up restrictions) will also be noted in the capitalization records.

**Practical Tip: Avoiding Lost Stock Certificate Charges**

While a company is private, company counsel often acts as the company's transfer agent and lost stock certificates are relatively easily replaced. Prior to the effectiveness of the IPO, the transfer agent function passes to the professional transfer agent selected by the company. Professional transfer agents typically require a fee in connection with the issuance of a replacement certificate. The fee represents a premium for a bond to indemnify the company and the transfer agent in the event that the "lost" certificate resurfaces and is traded in error. The bond premium fee is often calculated as a percentage of the value of the certificate being replaced, and therefore can be quite expensive. As part of its pre-IPO preparation, a company may wish to remind its employee-stockholders and investors to locate their certificates or promptly request replacements.

Company counsel will need to trace the company's capitalization history to ensure that the prospectus accurately discloses the company's current capital structure, the dilution to new investors, and the shares that will be eligible for sale by existing investors following the IPO. Underwriters' counsel will review these records carefully during the due diligence process. If the company's outstanding securities were not issued in compliance with applicable federal or state securities laws, a time-consuming rescission offer may be required. In extreme circumstances, historical transactions that were improperly authorized or executed may need to be unwound and effected again. The company's new transfer agent will also require accurate records.

**True Story: Due Diligence Uncovers Potential Violations**

During the IPO due diligence investigation of one technology company, attorneys discovered that certain stock issuances and stock option grants by the company to its employees and consultants were not made in compliance with federal and state securities laws. This discovery was made just prior to the filing of the company's registration statement. The company and the IPO working group were forced to consider two alternatives — either delay the IPO for several months while the company made an offer to stockholders and optionholders to rescind the earlier stock transactions or proceed with the IPO and hope to be able to convince the SEC to allow the company to conduct the rescission offer after the IPO.

Fortunately for this company, the SEC permitted the company to move forward with its IPO. However, the company was required to register the rescission offer after the IPO as a public offering on a Form S-1 registration statement. The company's IPO was successful, but the company spent well in excess of $100,000 in legal, accounting and other fees to remedy the problem.

***"Lock-up" situation***

The number of shares sold in an IPO is typically only a fraction of the company's total outstanding stock. If all of the company's existing investors tried to sell their stock in the open market at the same time or shortly after the IPO while the underwriters were trying to establish a market for the company's stock, the market price would be severely depressed. Most underwriters would refuse to accept the risk of bringing the offering to the market under such circumstances. Underwriters therefore require that a company's existing stockholders enter into contractual agreements with the underwriters to refrain from selling their stock during a specified time following the IPO, typically 180 days, with the possibility of an extension in certain limited circumstances.

Often, lock-up restrictions will be included in existing contracts with stockholders, such as stock purchase agreements, registration rights agreements or option plans. Underwriters are usually not willing to rely on these provisions and require each existing stockholder to enter into a lock-up agreement with the underwriter on its standard form. The company should analyze which of its stockholders are already bound by lock-up agreements with the company and have this information available for the underwriters early in the registration process. Underwriters typically require that all or a large percentage of the company's outstanding shares are locked-up before the preliminary prospectus is printed. Accordingly, it is important for the company to get an early start on obtaining lock-up agreements from its stockholders.

In addition, rules of FINRA and the NYSE generally prohibit managing and co-managing underwriters of an offering from publishing or otherwise distributing a research report on the company within 15 days prior to or after the expiration, waiver or termination of an IPO lock-up agreement that the underwriter has entered into with the issuer or its stockholders. In the past, favorable research reports issued at the time of lock-up expiration were commonly referred to as "booster shot" reports. Accordingly, the new rules are meant to eliminate such "booster shots." The term "research report" is broadly defined as a written or electronic communication that includes an analysis of individual companies or industries, and provides information reasonably sufficient upon which to base an investment decision, and there is no requirement that the report include an analyst's actual recommendation regarding the company.

In response to the black-out restrictions now imposed by NYSE and FINRA rules, most IPO underwriters have now begun requiring lock-ups with periods longer or potentially longer than 180 days. The extended lock-up approach enables an analyst from the managing or co-managing underwriter to publish a research report (or make a public appearance) concerning the company that is within the 15-day period before or after the expiration of the customary 180-day lock-up period. Otherwise, if the company were to issue, for example, an earnings release within the black-out period mandated by the NYSE and FINRA rules, the analyst would be required to wait for 15 days to publish his or her report. Ongoing research coverage is particularly critical for a newly public company when the only available coverage often comes from the investment banking firms involved in the IPO, especially in today's environment in which research analysts are expected to cover more industries and companies. Any lapse in analyst coverage could reduce investor interest and be damaging to the market for the company's stock. This kind of delay could be disastrous for a company that issues a mixed earnings announcement at or near the time of the 180-day lock-up expiration. Investors could have trouble understanding the real impact of the news and at a time when a large number of shares are being sold into the market, and the analysts would not be able to issue a report explaining their analysis of the news. Accordingly, these extended lock-up provisions can be beneficial to both the company and the analysts who are covering the company's stock.

Unless obtained well in advance, it can be extremely difficult for an issuer to obtain a customary 180-day lock-up agreement from all of its stockholders in connection with an IPO. It is certainly not uncommon for one or two shareholders to refuse to sign the underwriter's form of lock-up agreement in connection with the issuer's IPO, regardless of the potential risk that the underwriters may be unwilling to market the offering without obtaining a sufficient percentage of signed lock-up agreements. For this reason, among others, securities counsel have been advising their clients for years to include lock-up (also commonly referred to as "market standoff") provisions in securities purchase or other stockholder agreements (*e.g.*, stock purchase agreements, investor rights agreements, registration rights agreements, option agreements, convertible promissory notes, warrants and the like). During the last decade, many privately held companies have heeded such advice. However, the typical lock-up provision contains language limiting the maximum length of time of the lock-up period to 180 days.

Further, contractual privity is between the company and the stockholder — not between a future underwriter and such holder. Some companies creatively make a future underwriter, albeit unknown at the time of the agreement, an intended third-party beneficiary with the right to enforce the lock-up agreement between the company and the holder of securities. Regardless of whether a company uses this type of approach, a managing underwriter generally requires stockholders to enter into the underwriter's particular form of lock-up agreement, which is sometimes more extensive and places the underwriter, not the issuer, in control of any future modification, waiver or early termination of the lock-up period.

If pursued, the new lock-up approach discussed above creates some potential challenges for issuers and underwriters in part because many lock-ups still only contain the old form of lock-up period (*i.e.*, 180 days). The issuer will not only be required to obtain an underwriter lock-up agreement from each stockholder in connection with the IPO (or amend existing agreements), but also a form of agreement that contains a lock-up period that is longer or potentially longer than the one to which they had originally agreed. This may be particularly difficult in a situation where the issuer has a large number of shareholders that are not otherwise affiliated with the company and are not inclined to sign up to the underwriter's new lock-up term.

A company should seriously consider requiring a lock-up provision in its securities purchase and other stockholder agreements, including stock option agreements, that would provide for more flexibility to address the NYSE and FINRA rules. For example, require stockholders to agree to enter into the underwriter's form of lock-up agreement at the time of a public offering, which may include for the possibility of an extension of the lock-up period). Also, in connection with subsequent rounds of financing, a company could consider incorporating amendment provisions in investor rights contracts that provide for a simple majority consent to amend lock-up and other provisions so that the company would not be required to obtain the consent of every stockholder should a different lock-up be required by the company's underwriters in an IPO.

### *Analysis of registration rights*

The company may have granted some of its stockholders the right to include their shares in a public offering of the company's stock. The company, together with its counsel, should analyze these rights, including the number of shares subject to them, whether the rights apply in the case of the company's IPO, whether the underwriters can reduce or eliminate the number of such shares to be sold if marketing considerations so require, the order of priority among registration rights holders in the event of a cutback, the steps required to obtain an amendment or waiver of the registration rights and applicable notice periods. The company should have this information available for the underwriters early in the registration process.

### *"Overhang" analysis*

Closely related to an analysis of the company's capitalization records, lock-up situation and registration rights is the "overhang" analysis. This analysis, which will be summarized in the section of the prospectus entitled "Shares Eligible for Future Sale," reflects the interplay of required holding periods under the securities laws, lock-up restrictions and registration rights. The analysis shows the maximum number of shares held by existing securityholders that may be sold at various intervals after the effective date of the IPO. Due to the SEC's amendments to Rule 144, it is likely that, in most cases, the substantial majority of an issuer's shares will be freely tradable in the public markets following the expiration of the underwriter lock-up agreements.

### *Analysis of other rights*

During the company's financing history, it may have granted various rights to certain investors, including the right to receive advance notice of certain events, such as an IPO, or rights of first refusal to purchase stock in new rounds of financing. The documents containing these rights should be reviewed carefully to ensure that, to the extent that such rights apply to an IPO, they are satisfied or properly waived, and to analyze whether it is appropriate to seek to terminate these rights upon effectiveness of the IPO.

### *Minute books*

The company should make sure that its minute books contain final minutes of all board, board committee and stockholder meetings, as well as actions of the board or stockholders taken by written consent. Not only is this good corporate practice, but both company counsel and underwriters' counsel will insist upon reviewing a complete set of all minutes and consents as part of the due diligence process.

### *Due diligence materials*

The company can begin assembling the many documents that the underwriters and their counsel will want to review in the course of their due diligence. This includes capitalization records, minute books, material contracts and many other documents. Once underwriters have been selected, the company can obtain due diligence checklists from them and their counsel. The company can obtain a sample due diligence checklist from its legal counsel or use the one in ***Appendix B*** to begin collecting materials in anticipation of the underwriters' request. As this process can be time consuming and will require the attention of many of the members of a company's management team who will also be involved in the remainder of the offering process, companies can improve the quality of the offering process by starting to assemble the due diligence materials early and by completing as much of this process as possible prior to the formal kick-off of the offering process. In addition, it has become a common practice for these due diligence materials to be posted to an electronic data room, which enables the underwriters and their counsel more efficient and cost-effective access to the due diligence materials. An electronic data room also better facilitates a dual-track process. This topic is discussed in greater detail in Chapter 7.

### *Stock plans*

The company will need to review its existing stock plans with its counsel. Once the company is public, certain provisions of the federal securities laws will become applicable to the company's stock plans, while certain provisions of state securities laws may no longer apply. As a result, the company's existing plans may be inadequate or inappropriate for a public company. Many companies also use the IPO preparation process as an opportunity to add shares to the pool of options available for future grant. The company should authorize a sufficient number of shares for its anticipated needs for the foreseeable future. Finally, new types of plans which were not practical prior to the company's stock becoming publicly traded, such as employee stock purchase plans (ESPPs), will become available following the IPO. Because most of these plans require board and stockholder approval and must be described in the prospectus, it is advisable to finalize them as early in the IPO process as possible.

### *Audit and review of material accounting issues*

The prospectus must contain audited statements of operations, cash flows and changes in stockholders' equity for the three most recently completed fiscal years and audited balance sheets as of the end of the two most recently completed fiscal years. While there is no requirement that the period since the end of the prior fiscal year be audited, some underwriters will request an audit of such interim period, particularly where the company's financial situation has changed rapidly and the offering will go effective late in the current fiscal year. The company should keep its auditors apprised of its IPO plans to give them sufficient time to complete their audit work. The company should also discuss with its underwriters, auditors and counsel any accounting practices that may deviate from the industry norm, which involve unusual facts or which may otherwise cause concern or confusion for the SEC or investors. Common problem areas historically include revenue recognition, deferred charges, accounting for business combinations, goodwill amortization periods, capitalization policies for intangible assets, reserves, related-party transactions and stock-based compensation. The company will also need to be prepared to comply with new SEC rules relating to the use of non-GAAP financial measures, critical accounting policies and off-balance sheet arrangements, as well as have a roadmap for compliance with rules relating to management reports on internal controls (and required auditor attestation), disclosure controls and procedures, certifications regarding the accuracy of financial statements and periodic reports filed with the SEC following the IPO. It will be particularly important for the company to ensure that it has the right internal accounting and control team and that its systems have been designed to ensure the company can satisfy its disclosure requirements as a public company.

### *Executive compensation*

The period of time leading up to an IPO represents an opportunity for companies to ensure that senior executives and key employees are appropriately compensated and financially motivated as the company makes debut in the public capital markets. Often, as a private company readies itself for life as a public company, it may find that the compensation arrangements with its executives and other key employees are no longer appropriate for a variety of reasons, including the increased responsibilities and demands that come from managing a U.S. public company. Boards of Directors may find that compensation practices that were good enough for life as a private company are not appropriate, in one or more respects, for a public company, whether those practices relate to salary levels, cash bonus programs, equity awards or change of control policies.

As a result, Boards of Directors should carefully evaluate their executive compensation policies and practices, consulting with outside counsel and compensation consultants as appropriate. Legal counsel, and to a greater extent, compensation consultants, can assist in developing tools, such as tally sheets as well as historical and current company compensation data, to help the company evaluate its executive compensation policies.

### *"Cheap stock" analysis*

One issue that emerging growth companies have long encountered in the IPO process is "cheap stock." The cheap stock issue revolves around the accounting treatment of equity compensation awards (primarily stock option grants) made during the 12 to 18-month period leading up to the filing of the registration statement for the IPO or, later, if the estimated price of the IPO is not determined at the time of filing. This issue has been prevalent for emerging growth companies because they often rely to a significant extent on equity compensation (stock options in particular) to provide incentives to their employees and consultants.

The cheap stock issue arises when option grants are made with exercise prices that are less than the fair value of the underlying stock at the time of grant of the option, in which case the company is required to record compensation expense on its income statement in the aggregate amount of that differential over the vesting period of the option. This compensation expense can be significant, often in the millions of dollars (or tens of millions in extreme situations), and can therefore materially affect the company's results of operations for the historical periods reflected in the financial statements included in the registration statement, as well as in future periods as stock options continue to vest. However, the added expense is not a cash expense, so it does not negatively impact the company's capital resources. Also, it is debatable whether the non-cash expense negatively impacts the market price of the company's stock, because institutional public market investors often evaluate companies on a "non-GAAP" basis that excludes the effects of the stock-based compensation expenses.

Fundamentally, the cheap stock conundrum stems from the fact that private companies, by definition, do not have a liquid market for their stock that can efficiently determine the fair value of the company's stock based on third-party, arm's-length transactions. In the absence of a liquid trading market for their company securities, boards of directors, in determining a fair value of their stock for purposes of establishing an exercise price for stock option grants, have generally been required to exercise their own judgment based on a patchwork of valuation criteria for which, until recently, there was relatively little guidance aside from informal guidance that could be drawn with the benefit of hindsight from the SEC's position in the context of an IPO. Boards of directors historically have been, and sometimes still are, too lax in the methodologies they employ in making these determinations, often relying on "rule of thumb" approaches instead of approaches that employ more robust valuation techniques or that take into account specific developments in the company's business or prospects. As a result, as these companies' IPOs neared, they would find themselves in the unenviable position of having to defend or explain their option pricing practices to the SEC staff during the comment process and, more often than not, would be required to retroactively record significant, unanticipated compensation charges in response to SEC comments.

However, recently adopted Section 409A of the Internal Revenue Code (Section 409A), and the recently published AICPA Practice Aid entitled "Valuation of Privately-Held-Company Equity Securities Issued in Other Than a Business Combination — An Overview" (the AICPA Practice Aid) provide guidelines for boards of directors to follow in establishing the exercise price of stock options. Under Section 409A, stock options that are issued with an exercise price less than the fair market value of the underlying stock on the grant date are considered nonqualified deferred compensation and are subject to potentially onerous taxation. Regulations promulgated under Section 409A provide detailed guidance as to acceptable methods for determining the fair value of private company stock for Section 409A purposes, and represent a significant change for the better in most companies' processes for determining fair market value of private company stock. Although Section 409A states that any reasonable valuation method is acceptable, it lays out in detail the factors that must be considered and provides that, for an illiquid start-up corporation, a rebuttable presumption is created in favor of the fair market value if its is based on a valuation prepared by an independent appraisal or if it is made in good faith, evidenced by a written report, and performed by persons with significant knowledge and experience or training in performing similar valuations. At the same time, the AICPA Practice Aid has gained prevalence among accounting and legal practitioners in establishing "best practices" in valuation of private company securities. The AICPA Practice Aid establishes a hierarchy of valuation methodologies, with a fair value determined in a contemporaneous (as opposed to retrospective) valuation by an unrelated valuation specialist being viewed as the most reliable valuation method. The AICPA Practice Aid also enumerates a list of factors to be considered in performing a valuation, irrespective of the valuation approaches selected, as discussed below.

As a result of the guidance provided to boards by Section 409A and the AICPA Practice Aid, private companies generally are entering the IPO process better prepared for the SEC's cheap stock position. In fact, in recent SEC comment letters, the preponderance of SEC comments revolve around providing detailed disclosure in the "MD&A" section of the registration statement regarding the valuation methodologies and corresponding assumptions employed for option grants during the most recent fiscal year and any interim period, as opposed to the comments that draw into question the fair values themselves.

However, companies are not entirely out of the woods yet. That is, it is important to note that a valuation methodology that comes within the Section 409A safe harbor does not necessarily mean that it will be safe from SEC scrutiny in view of the SEC's long-held view that the fair value of a company's common stock should close the gap with the company's IPO price in the months leading up to the IPO, a position that is made more difficult to navigate with market volatility and a trend among underwriters not to recommend a price range well into the IPO process. Suffice it to say that the interplay of Section 409A and the SEC staff's guidance with respect to option pricing is not easily navigable, and companies should consult with their accounting and legal advisors regarding their option pricing strategy well in advance of the IPO to minimize adverse accounting charges, unintended tax consequences or delays in their IPO process.

***Deemed dividends; discount on sale of equity to strategic partners***

In recent years, the SEC has extended the cheap stock concept to sales by the company to outside investors. Under this type of analysis, the SEC takes the position that sales of stock during the time preceding an IPO (usually within six months of filing the registration statement) were made at a price less than the fair value of the stock and requires the company to record a one-time "deemed dividend" charge — in essence, saying that the company paid a dividend to the investors in an amount equal to the difference between the price paid and the deemed fair market value.

The SEC looks most closely at rounds of financing led by existing investors in the company under the theory that the transaction may not have been at arm's length and that the investors may have used their position to buy stock at a discounted price. However, the SEC has required a deemed dividend charge even with respect to some transactions in which a company has no discernible incentive to sell its stock to investors at a reduced price. For example, one company recorded a charge of over $65 million in connection with its first registration statement filing. The charge related to the sale of preferred stock three months before the filing to a group led by outside financial investors. Unfortunately, for both the investors and the company, the eventual IPO price was significantly less than the price paid by these investors, but the charge remained on the books.

The SEC also closely scrutinizes sales to investors who also have a commercial relationship with the company (*e.g.,* customers and suppliers). The assumption is that the negotiated price does not represent the true fair value of the stock because the strategic partner is otherwise transferring value to the company in exchange for a reduced purchase price. If the relationship with the strategic partner yields revenue for the company, the SEC may require the company to reduce revenue in an amount equal to the deemed discount. In other cases, the charge will increase the cost of revenue or an operating expense line item. The charge is usually amortized over the life of the contract.

***Defensive measures***

Once a company's stock becomes publicly traded, the company can be vulnerable to unwanted takeover attempts. Some of the lessons to be learned from hostile transactions (or attempted transactions) during recent years include: size alone is no defense; stock may be used in hostile takeover attempts; aggressive agitators can become catalysts for stockholder action and can provoke corporate change; foreign companies are a threat; and cross-border issues will not deter a buyer coveting a strategic asset at a compelling value. The goal of defensive measures is to enable the company to control the timing and process of unsolicited takeover bids and to encourage bidders to negotiate with the company's board of directors. A defensive measure is not intended to, and will not, preclude all unsolicited takeover bids.

There are numerous defensive measures that can give the company procedural advantages in ensuring that the stockholders are not subject to abusive takeover tactics and that make a hostile takeover more difficult and costly to complete. These measures include undesignated preferred stock, stockholder rights plans (also known as "poison pills"), certain charter and bylaw amendments, option acceleration provisions, golden parachutes, elimination of cumulative voting, a classified board of directors, a dual class stock structure (with one class of stock, which is not publicly traded, having super-voting rights) and many others. Several of these measures are discussed below.

*Classify the board of directors.* A corporation can divide its board of directors into two or three classes of directors, with the term of office (in years) for directors equal to the number of classes, and the election of each class to occur in staggered years (*e.g.*, the term of directors in the first class to expire at the next annual meeting following the adoption of the classified board, the second class one year thereafter and the third class two years thereafter). By so dividing the board into classes, only the members of one class of the directors are up for re-election in any given year. In connection with the classified board, the company may also provide in its charter documents that directors may only be removed by stockholders for cause (in some states, this automatically results from opting for a classified board). Classifying the company's board of directors may increase continuity of board membership, make it harder for a stockholder to acquire control of the board in one election, give time for a long-term strategic plan to be implemented, and prevent some types of unfriendly creeping acquisitions or partial bids for control or other abusive takeover tactics. Critics of classified boards argue that it is more difficult to hold directors accountable for their actions when they are up for election only every two or three years.

*Board Size and Vacancies.* A company may amend its charter documents to vest solely in the board the power to change the size of the board of directors and to fill any vacancies (other than following removal by a vote of stockholders). These provisions, together with supermajority requirements to amend such provisions in the charter documents (discussed below), protect against expansion of the board by a simple majority stockholder vote and allow the board to control who fills all vacancies other than those created by a stockholder vote.

*Eliminate cumulative voting.* Where cumulative voting by stockholders is required or permitted in the election of directors, a stockholder can cast a number of votes equal to the product of the number of directors to be elected multiplied by the number of votes to which the stockholder's shares are entitled, and allocate those votes all to a single candidate or distribute the votes among as many candidates as the stockholder thinks fit (not to exceed the number of board seats up for election). This type of voting can allow a minority stockholder to gain board representation. A company should consider the benefits of eliminating cumulative voting, if possible.

*Eliminate ability of stockholders to act by written consent.* A company may provide in its charter documents that stockholders may not act by written consent. As a result, stockholders of the company would only be able to act at a meeting duly called and held in accordance with the company's charter documents, the applicable state corporation law and the proxy rules under the federal securities laws. These amendments help to prevent a small number of investors that hold a majority of the outstanding shares of the company from acting quickly to take corporate action that may or may not be in the best interests of the company or the minority stockholders. In addition, these amendments ensure that all stockholders are entitled to consider and vote upon a stockholder proposal.

*Eliminate right of stockholders to call special meetings.* A company's charter documents can eliminate the ability of the stockholders to call special meetings. This would mean that a stockholder would have to wait until an annual meeting or a special meeting called by the board of directors to bring a proposal for stockholder approval. This is likely to prevent a majority stockholder or proxy contestant from forcing stockholder consideration of a proposal before the board has had an opportunity to review the proposal.

*Require specific advance notice for director nominations and stockholder proposals.* A lengthy advance notice provision for director nominations and stockholder proposals for consideration at stockholder meetings allows a company and its board of directors an adequate amount of time to prepare before these nominations or proposals come before the other stockholders.

*Create a class of undesignated preferred stock.* A company may authorize in its certificate of incorporation a class of undesignated preferred stock (often referred to as "blank check preferred"). This class of undesignated preferred stock enables the board of directors, without any action by the stockholders, to create one or more series of preferred stock, to establish the terms of each such series and to issue (or reserve for issuance) the shares of each such series. This gives the company a high degree of flexibility to rapidly issue securities with terms different than those of common stock. This flexibility can be important in acquisitions, in financing transactions and in other strategic transactions where a company wishes to issue securities to one or more parties.

Blank check preferred also enables the board of directors to implement a stockholder rights plan (often referred to as a "poison pill") without stockholder approval. The primary goal of a stockholder rights plan is to encourage potential bidders to come to a company's board of directors with an acquisition proposal and negotiate, rather than going directly to stockholders with a tender offer. The existence of a stockholder rights plan helps to discourage inadequate bids, and gives the board the opportunity to adequately evaluate an acquisition overture and take steps to maximize stockholder value. A rights plan can have this effect because of its potential to make it financially unattractive for someone to acquire the company without approval of the board of directors. A stockholder rights plan is usually implemented through the issuance of a pro rata dividend of rights to acquire a newly designated series of preferred stock of the company or, under certain circumstances, another company involved in a business combination with the target at a designated price.

*Supermajority vote for certain amendments to the company's certificate of incorporation and bylaws.* Most of the defensive measures discussed above are implemented through the company's charter documents. The certificate of incorporation and bylaws generally can be amended with a vote of stockholders holding a majority of a company's outstanding stock. To provide the company with additional protection, the company may amend its charter documents to include a supermajority (often 66⅔% or some other percentage in excess of a simple majority) vote requirement for any proposed future amendments to the sections of the charter documents that implement the defensive measures discussed above. The absence of super-majority voting provisions could make it easier for a hostile third-party to eliminate defensive protections.

*Statutory anti-takeover measures.* In addition to the protections discussed above, depending on a company's state of incorporation, the company may be subject to the protection of a state anti-takeover statute. These provisions generally prohibit mergers, sales of material assets and certain other specified transactions between the company and a holder of a threshold percentage of the company's outstanding voting stock for a number of years following the date on which the stockholder became a holder of the significant percentage of the outstanding stock, subject to certain qualifications. The ban typically does not apply if (1) the proposed transaction by which the stockholder became a significant stockholder is approved by the company's board of directors prior to the date on which the stockholder became a significant stockholder, (2) the transaction involves a business combination approved by the board of directors of the company or by holders of the outstanding voting stock not owned by the significant stockholder, or (3) the company elects under certain circumstances to exclude itself from the coverage of the anti-takeover statute. These statutes vary from state to state, and companies should consult with counsel about whether the company's state of incorporation has an anti-takeover statute and how it works.

Most defensive measures can be implemented at any time, provided the company can obtain the required corporate approvals. However, adopting them while the company is private has certain advantages. Any necessary stockholder approval can often be obtained more easily before the company becomes public, has institutional stockholders and is required to comply with the proxy solicitation rules applicable to public companies. Many institutional investors vote against the implementation of additional defensive measures because they believe such measures may deprive them of a change in control premium for their shares. In addition, a court is more likely to enforce a mechanism that is implemented following careful and orderly consideration by the board, rather than one that is hastily adopted in the face of a particular threat.

The existence of, or absence of, defensive measures could in theory affect on the success of an IPO. After all, the institutional investors who typically vote against the implementation of defensive measures are often the same institutional investors to which the company's underwriters may be attempting to sell shares in the IPO. However, as a general rule the existence of most typical, middle-of-the-road defensive measures such as a classified board and blank check preferred at the time of an IPO will not have an adverse effect on the marketing of the IPO. An exception to this rule is the stockholder rights plan; conventional wisdom has been that the existence of a stockholder rights plan at the time of an IPO generally does have an adverse effect on the marketing of the IPO. Companies should note that stockholder activism has increased in recent years. Stockholder rights activists and institutional investors have actively opposed classified boards of directors and poison pills, and have introduced stockholders proposals at many public companies seeking to roll back defensive measures.

Each of the defensive measures mentioned above are highly specialized topics, and the formulation of an effective package of defensive measures should be discussed in detail with the company's counsel and investment bankers. Additionally, the implementation of defensive measures requires analysis of and advice regarding the fiduciary duties of the company's board of directors.

***Review and amendment of charter and bylaws***

The company's certificate of incorporation and bylaws may have been adopted many years prior to the IPO and may contain a number of artifacts from early rounds of financing or other provisions that are obsolete and no longer appropriate for a public company. The company and its counsel should review these charter documents and amend them as necessary as part of its pre-IPO corporate housekeeping.

***Third-party consents***

The company may have lines of credit with banks or other agreements with third parties that require consent to certain actions contemplated in connection with the IPO. For example, even if the IPO itself does not require any third-party consents, a reincorporation might require approval under certain bank covenants, or naming a customer in the prospectus might require the customer's approval. Also, a company is often required to file its customer, strategic partner, distributor and other agreements with the SEC because of their materiality to the company. These agreements often contain confidentiality provisions that require the consent of the other party. The company will also need to obtain consents from customers to include their logos or case studies in the company's prospectus. If the company decides to include statements and statistical data from market research firms, it will need consents from those parties as well. In seeking such consents, the company should request that the third parties keep the company's IPO plans confidential.

**Practical Tip: Securing Certain Third-party Consents**

Companies will often include in their prospectuses information contained in third-party market analyses and industry reports to substantiate assertions made in the prospectus, among other things. When such third-party data or information cited in the prospectus is not publicly available for no charge or nominal charge, the SEC has increasingly required companies to (1) either obtain the consent of the third-party source of the information and file that consent with the registration statement, or (2) adopt the information or data as the company's own and thereby assume the risk of any inaccuracies of this data or information. Accordingly, as a practical point, it is advisable that the company identify early on in the IPO planning and prospectus drafting process which third-party information or data will be cited in the registration so as to allow sufficient time to obtain the appropriate consents without jeopardizing the timing of the offering.

Additionally, if the company states in the prospectus that a valuation firm performed valuation services on behalf of the company in connection with the company's equity grant practices or tax compliance matters, the SEC is increasingly requiring the company to identify the valuation firm in the prospectus. In addition, the SEC has required companies to obtain the consent of these valuation firms regarding their identification in the prospectus and file these consents with the registration statement. As a result, many such valuation firms are increasing their fees for providing valuation services.

***Settlement of claims***

If a company has outstanding disputes, it should consider how the IPO might change its negotiating position and what steps can be taken to resolve the disputes before the company's IPO plans become known. Litigants may be less likely to settle for a reasonable amount once the company has large cash reserves. Disputes regarding ownership of stock, intellectual property or other significant rights may create marketing problems for a company in the IPO, lowering its valuation or making a successful IPO impossible. Material unresolved disputes generally must be disclosed in the prospectus.

### *Qualifications to do business*

The company should confirm that it and all of its material subsidiaries are qualified to do business and are in good standing in all jurisdictions where their respective activities require that they be so qualified. Although this is primarily an administrative task, getting everything in order can take a significant amount of time, especially if foreign country jurisdictions are involved, and may involve the payment of back-taxes or late fees in the event required qualifications were neglected. The underwriters generally will expect certificates of good standing from each applicable jurisdiction to be delivered at the closing of the IPO.

### *Income and sales tax*

Another corporate housekeeping item that may require some lead time is confirming that the company is current in the payment of all of its income and sales taxes.

### *Draft of the registration statement*

Having a good first draft of the registration statement available for the working group early in the registration process can shave many days, and sometimes weeks, off of the drafting timetable. Although the final version may bear little resemblance to the initial draft, the information contained in a good first draft will give the group something to react to and will make subsequent due diligence meetings and drafting sessions more productive. Sections that are particularly useful to have available early in the process are the financial statements and "Business," "Risk Factors" and "Management's Discussion and Analysis of Financial Condition and Results of Operations."

### *Confidential treatment*

The company may be required to file with the SEC certain of its contracts as exhibits to its registration statement. SEC rules require a company to file all contracts "not made in the ordinary course of business which are material to the company and are to be performed in whole or in part at or after the filing of the registration statement or was entered into not more than two years before such filing." If the contract is such as ordinarily accompanies the kind of business conducted by the company, it will be deemed to have been made in the ordinary course and need not be filed with the SEC *unless* it falls within one of the following categories, in which case it must be filed except where immaterial in amount or significance to the company:

- any contract to which directors, officers, the underwriters, stockholders named in the registration statement and certain others are parties, subject to certain exceptions;
- any contract upon which the company's business is substantially dependent (*e.g.,* continuing contracts to sell the major part of the company's products or services or to purchase the major part of the company's goods, services or raw materials or any license agreement to use a patent, trade secret or other intellectual property right upon which the company's business depends to a material extent);
- any contract calling for the acquisition or sale of any property, plant or equipment for a consideration exceeding 15% of the fixed assets of the company (on a consolidated basis); or
- any material lease under which a part of the property described in the registration statement is held by the company.

Regardless, any management contract or any compensatory plan, contract or arrangement in which any director, the CEO or any of the other four most highly compensated executive officers of the company participates is deemed material and must be filed. Other such management contracts or compensatory plans must be filed unless immaterial in amount or significance to the company.

Once the company files a contract with the SEC, the contract is publicly available on the SEC's EDGAR web site. However, the company may request confidential treatment for certain portions of exhibits, particularly financial and technical details, so long as the disclosure of the information would be harmful to the company and is not necessary for the protection of investors. The process of obtaining confidential treatment can be time consuming and should be started as early as possible to ensure that the initial request can accompany the initial filing of the registration statement (or shortly thereafter). This process is discussed in greater detail in Chapter 8.

***Mezzanine and other financing considerations affected by an IPO***

Some companies raise additional equity capital as they are nearing the IPO, either to bolster the balance sheet or to bring in strategic investors. During the late 1990s, some companies had to raise capital before filing their registration statements to avoid a qualification in the audit of their financial statements as to the company's ability to finance its future operations, and obviously it is important that the company make a determination regarding its capital (or strategic financing) needs early on in the process and ensure that it conducts any such fund-raising activities carefully so as to avoid violation of SEC rules.

*The SEC's integration doctrine.* In general, a company may only offer and sell securities either (1) pursuant to an effective registration statement filed with the SEC or (2) pursuant to a valid exemption from the registration requirements (typically, a private placement exemption). In determining whether a private placement of securities has a valid exemption from registration, the SEC will review not only the private placement at issue but also any offering of securities that occurs within six months before and after the private placement. In the event of multiple offerings occurring within six months of each other, the SEC may view the offerings to be integrated. In other words, the SEC may consider the offerings as one, single offering for purposes of determining securities law compliance. The SEC has proposed to shorter this time period from six months to 90 days.

The integration of multiple offerings can have the effect of destroying the availability of a valid exemption for the current transaction but also of retroactively invalidating the exemption upon which the earlier offering relied. This issue took on increased importance for companies caught in the IPO market slowdown that began in late 2000. Some of these companies, after beginning the IPO process, find themselves needing to raise money from private sources.

The integration question arises most often in three public offering contexts: (1) where the company wishes to make a private offering contemporaneously (or nearly contemporaneously) with the IPO; (2) where the company wishes to make a private offering after it has abandoned its IPO; and (3) where the company wishes to proceed with its IPO after it has abandoned a private offering.

*Private offerings completed before registration statement is filed.* Companies that complete a private financing prior to filing their registration statements can benefit from the safe harbor protection from integration offered by Rule 152 of the Securities Act. Consistent with Rule 152, the SEC has confirmed that in its review of registration statements, it will not take the view that a completed private placement that was exempt from registration under the Securities Act should be integrated with a public offering of securities that is registered on a subsequently filed registration statement. Additionally, the SEC has confirmed that an issuer's contemplation of filing a Securities Act registration statement for a public offering at the same time that is conducting a private placement would not cause the exemption to be unavailable for that private placement.

*Contemporaneous private and public offerings – Black Box.* Absent a six-month interval (or 90-days if the SEC's proposal to shorten the six-month interval is approved) the question of whether two offerings should be integrated is generally a fact-based analysis using five factors outlined by the SEC in 1962. These five factors are whether: (1) the offerings are part of a single plan of financing; (2) the offerings involve the issuance of the same class of security; (3) the offerings are made at or about the same time; (4) the same type of consideration is being received; and (5) the offerings are made for the same general purpose. Rule 152 of the Securities Act provides a safe harbor from the subjective application of these five factors relating to the potential integration of certain completed private placements with a company's subsequent IPO, even though the offerings may be nearly contemporaneous in time.

Most private offerings to investors while a company is in registration to go public would fail a straightforward application of the five-factor test. However, the SEC provided significant relief to companies with the issuance of the *Black Box* and *Squadron, Ellenoff* line of no-action letters. Among other important guidance given, the SEC in *Black Box* expanded the safe harbor for private offerings completed prior to the initiation of an IPO by stating that a private offering will be deemed completed (even if not closed) if the only closing conditions that remain are ones beyond the control of the investors.

The *Black Box* no-action letter, as supplemented by *Squadron, Ellenoff*, also provides a means of effecting a contemporaneous private placement transaction (which can be initiated and closed during any part of the registration process) to "qualified institutional buyers" (QIBs) and no more than three "large institutional accredited investors." Therefore, companies have relied on the *Black Box* approach to issue securities to up to three strategic partners who represent that they are QIBs or institutional accredited investors either during the registration process or concurrently with the closing of the IPO.

*SEC's Recent Guidance Regarding Contemporaneous Private and Public Offerings.* Citing the importance of an issuer's ability to raise capital around the time of an IPO to ensure sufficient liquidity to allow the issuer to operate its business during the IPO process, the SEC proposed a new rule in Release No. 33-8828, and announced a more liberal view regarding the integration of contemporaneous public and private offerings. Specifically, The SEC stated that the filing of a registration statement does not, in and of itself, eliminate a company's ability to conduct a private placement. The SEC further stated that such a determination should be based on a consideration of whether the investors in the private placement were solicited by the registration statement or through some other means that would otherwise not foreclose the availability of an exemption.

*Private offering following an abandoned IPO.* Once the IPO market began to deteriorate in late 2000, and valuations of numerous companies fell, many companies that were in the process of going public were forced to postpone those plans indefinitely and withdraw their registration statements. Many of those companies still needed to raise money but faced significant integration concerns. Companies were required to wait for up to six months before initiating a private offering following an abandoned public offering. In response, the SEC adopted Rule 155, which allows a company to pursue certain types of private offerings following an abandoned public offering without fear of integration with the abandoned public offering so long as certain specific conditions set forth in the rule are met. The intent behind these conditions is to ensure that investors in the private offering fully understand that the abandoned public offering was separate and distinct from the private offering and that the protections of Section 11 of the Securities Act that would have been available to them in the abandoned public offering will not be available to them in the private offering.

*Abandoned private offering followed by an IPO.* Rule 155 also provides integration relief for companies wishing to begin the public offering process after abandoning a private offering. A private offering will not be integrated with a public offering in this situation so long as certain specific conditions set forth in the rule are met. The intent behind these conditions is to ensure that investors in the public offering fully understand that any offers to sell securities in the abandoned private offering are withdrawn and are distinct from the offer to sell stock in the public offering. Rule 155 permits most companies to commence their IPOs immediately following the abandoned private offering subject to satisfying the conditions of the rule.

# Chapter 4†

# D&O Liability Insurance

Directors and officers of companies face the possibility that — even if they diligently discharge their duties to their stockholders — their stockholders may still sue them. During the period leading up to an IPO, directors and officers may be particularly concerned about their personal liability because the chance that they will be sued by their stockholders substantially increases once the company's shares are publicly traded. Recognizing that the risk of personal liability makes being a director or officer of a public company unattractive, most companies purchase director and officer liability insurance, or "D&O insurance", to protect their directors and officers. This insurance can in turn help companies recruit and retain good directors and officers.

## The Need for D&O Liability Insurance

D&O liability insurance is best understood as a type of professional liability insurance for errors and omissions that a company carries to protect its directors and officers if they are sued. It is D&O insurance that responds when directors and officers are accused in civil or criminal court of acting in a way that violates their duties to the stockholders or the law, especially federal securities law. From a dollars perspective, the largest threat that public company directors and officers face is the threat of a federal securities class action suit that alleges violations of the federal securities laws. This type of suit is most likely to occur when there is a precipitous decline in a company's stock price. Since the passage of the Securities Litigation Reform Act in 1995, the average stock price drop suffered by companies with resulting federal shareholder class action lawsuits has been 39%.

These lawsuits are of great concern for directors and officers because the trend in average cash settlements has been upward. The average cash settlement in 2007 was $27.9 million, compared to only $8.3 million in 1997. Moreover, the directors and officers of companies that are sued shortly after a company goes public are at particular risk because these lawsuits generally include allegations of having violated Section 11 of the Securities Act. Such cases are relatively easier for plaintiffs to pursue because the pleading standards under Section 11 are easier for plaintiffs to satisfy as compared to other civil liability provisions of the federal securities laws. (Section 11 is

† The authors wish to thank Priya Cherian Huskins for preparing this chapter. Priya was an associate at Wilson Sonsini Goodrich & Rosati from 1997 to 2003. Priya is a Partner and Senior Vice President of Woodruff-Sawyer & Co., a commercial insurance brokerage. Priya specializes in D&O liability risk and its mitigation, including D&O insurance. The authors also wish to thank Woodruff-Sawyer & Co. for making their database available for use in preparing this chapter.

discussed in greater detail in Chapter 7.) Another reason these lawsuits are of great concern to directors and officers is that they often take years to settle, resulting in legal defense fees in the millions of dollars.

Beyond securities class action lawsuits, directors and officers should be concerned about suits that allege that they breached their fiduciary duties to a corporation. These suits can either be brought directly or derivatively. Derivative suits are of particular concern because, in some circumstances, a company cannot indemnify its directors and officers to settle these suits, leaving insurance as the only payment source available to a director and officer other than his or her own checkbook. In these suits, the stockholder alleges that the officers and directors who are the subject of the suit have breached a fiduciary duty owed to the company and its stockholders and must pay damages or make restitution to the company. In recent years, more than 50% of all securities class action law suits have been accompanied by "tag along" derivative suits that were premised on the same alleged wrongdoings recited in the securities class action complaint. Moreover, there is reason to be concerned that the plaintiffs' bar has increasingly used derivative suits in bringing claims. For example, in 2006 derivative suits — and not securities class action suits — were the primary vehicle stockholders and plaintiffs' firms chose for pursuing claims related to stock-option backdating. Like federal securities class action lawsuits, these suits can be extremely expensive for a company to defend.

In most cases, companies have an obligation to indemnify their directors and officers for suits brought against them. This obligation can arise pursuant to personal indemnification agreements as well as provisions found in a company's charter documents, and sometimes pursuant to state law. Nevertheless, directors and officers usually require the company to purchase D&O insurance as a form of balance sheet protection for this indemnification obligation and to protect themselves if, during the midst of a long-running lawsuit, their company becomes financially or legally unable to indemnify them.

## Outline of a D&O Insurance Policy

Although a D&O policy can be described in broad terms for heuristic purposes, it bears mentioning that a particular company's D&O insurance program is typically comprised of several highly negotiated financial instruments. Most public companies purchase their overall limits of insurance from multiple insurance carriers in layers. Each of these layers represents coverage provided by a particular insurance carrier for typically at least $5 million in limits and often much more. The terms of each of these layers of insurance is set by the insurance policy issued by the insurance carrier providing that particular layer of insurance. Each of these layers must be separately negotiated by a company's insurance broker. This process generally includes negotiating multiple endorsements, *i.e.* amendments, to an insurance carriers' basic policy form.

*Typical D&O Insurance Policy.* A typical D&O insurance policy is divided into three parts, all of which share the same single policy limit put up by the insurance carrier. "Side A" is that part of a D&O insurance policy that responds when a company is unable to indemnify its directors and officers. The most common example of such a situation is when a company becomes insolvent. Properly constructed, this part of the insurance policy should pay on a first-dollar basis, *i.e.* there should be no self-insured retention or deductible. Side A coverage is often referred to as the "personal protection" part of a D&O insurance contract.

"Side B" is that part of a D&O policy that reimburses a company for its indemnification obligation to its directors and officers. This is typically the case with the vast majority of civil claims brought against directors and officers. This part of the insurance policy is generally subject to a self-insured retention or deductible.

"Side C" – also known as "Entity Coverage"– is that part of a D&O policy that responds to securities claims made against the company. Side C exists because in a typical federal securities class action lawsuit, the company is a named defendant along with the directors and officers. If an insurance policy does not have Side C coverage, the insurance carrier and the company must negotiate the portion of the total defense costs and the settlement of a securities claim that is to be allocated to the uninsured company and the portion that is to be allocated to the insured directors and officers. This will be a contentious negotiation because any portion of the suit that is allocated to a company without Side C coverage is a portion the insurance carrier does not have to pay. Purchasing Side C coverage eliminates this area of dispute. Like Side B, Side C is typically subject to a self-insured retention or deductible. Side B and Side C coverage together are often referred to as "balance sheet protection" for a company.

*Side A Difference in Condition D&O Policy.* A Side A "Difference-in-Condition" or "DIC" policy is a D&O policy that only provides Side A coverage. Such a policy does not include Side B and Side C coverage. Many companies will structure their insurance program to include a combination of regular ABC insurance policies and Side A-only insurance policies. One of the main drivers of this type of insurance program structure is the concern that directors and officers with only a full ABC policy may find themselves without any insurance coverage if their company ends up in bankruptcy, which is, of course, precisely the moment that the company can no longer indemnify its directors and officers. This concern arises because there is some risk that if a company goes into bankruptcy with a D&O policy that includes Side C coverage and perhaps Side B coverage, a bankruptcy trustee may attempt to seize the insurance policy proceeds for the bankruptcy estate. Such a seizure would leave the directors and officers without coverage unless they had a separate, Side A policy on which they could rely. While many courts have declined the invitation to appropriate D&O policy proceeds to the bankruptcy estate, legal experts agree that there is a higher probability that that a bankruptcy judge would allow a bankruptcy trustee to seize all the proceeds of an insurance policy if the policy includes balance sheet protection. The bankruptcy trustee's argument is that the now-bankrupt company paid for the insurance policy and is the intended beneficiary of the policy by virtue of being an insured party under the policy. Therefore, the insurance policy may be viewed by the bankruptcy court as an asset of the now-bankrupt company and not exclusively as an asset of the directors and officers. A bankruptcy trustee would not have this same argument to seize the proceeds of a Side A policy since the company is not an intended beneficiary of a Side A policy; the only intended beneficiaries of a Side A policy are the company's individual directors and officers.

Typically, bankruptcy is not a concern for a company that is about to embark upon an IPO. Thus, most companies planning to undertake an IPO will purchase an insurance policy with Side A Coverage, Side B Coverage and Side C Coverage. Some companies going public also decide to purchase at least a small amount of stand-alone Side A coverage in addition to a regular ABC insurance policy because (1) they are being cautious about bankruptcy concerns, (2) they find purchasing a Side A DIC policy is attractive because it is often subject to fewer exclusions than a the Side A portion of a regular D&O policy, and (3) the Side A-only policy can drop-down and respond on a first dollar basis in some circumstances, including if a company wrongfully refuses to indemnify a director or officer. This third reason is particularly attractive because in most cases if a company refuses to indemnify a director or officer for an indemnifiable claim, that director or officer must pay the Side B self-insured retention before the insurance would start to respond. This self-insured retention can be hundreds of thousands or even millions of dollars. As an aside, it is worth mentioning that some very large public companies elect to purchase only

Side A coverage in order to save money on the overall cost of the insurance program by forgoing any balance sheet protection.

*Limiting the Insureds Under a Policy.* It is possible to limit the insureds under a D&O insurance policy to a subset of all the directors and officers of a company. This is done when there is a desire to limit the number of insureds who are allowed to share the limits of a particular D&O policy. If a company is going to purchase a restricted-insured insurance policy, the insureds are generally limited to all the non-officer, independent directors. This type of policy is typically referred to as an "Independent Director Liability" or "IDL" policy. When the insureds under a policy are restricted to one individual, usually an independent director, the policy is typically referred to as a "Personal Director Liability" or "PDL" policy. PDL policies can also be modified so that they provide insurance coverage for one independent director who sits on the board of multiple companies. Only a very small minority of individuals typically purchase this type of D&O policy.

*Policy Definitions.* One of the key areas that is in play in a D&O policy are the policy's definitions. For example, whether informal SEC investigations are covered by the policy generally turns on the definition of a "claim," and the answer to this subtle question can mean the difference between being reimbursed for millions of dollars in legal expenses or not.

Another critical definition in a D&O policy is the definition of "loss." In particular, it is important that an IPO company's D&O policy have a "Section 11 Endorsement." Such an endorsement can affirmatively clarify that the insurance carrier intends to include settlements of Section 11 cases in the definition of loss. Without this clarification to the definition of loss, recent case law suggests that a carrier might attempt to take the position that a settlement of a section 11 claim falls outside the ambit of the policy because it does not meet the definition of covered loss under the policy. A sophisticated D&O insurance broker will be able to provide guidance on the types of definition modifications that are available from each insurance carrier.

*Policy Exclusions.* Like all insurance policies, D&O policies will not pay for a claim if a relevant exclusion removes the claim from the scope of the policy's coverage. As is typical with most components of a D&O insurance policy, the contours of these exclusions are negotiable. For example, one exclusion that will appear on all D&O insurance policies is an exclusion for fraudulent or dishonest conduct. This exclusion exists as a matter of public policy, so no insurance carrier can insure for these items. The critical item that can be negotiated, however, is the point at which such conduct becomes excluded. For example, if the conduct can only be excluded after a final adjudication of fraudulent or dishonest conduct, then clearly all defense costs will be advanced by an insurance carrier until the final adjudication is made. Most companies and their directors and officers consider this to be a superior result, but a minority may instead prefer that an insurance carrier have the ability to stop spending policy limits on persons the carrier considers to be bad actors so as to preserve the limits for good actors. A skilled broker will identify issues of this type for a company, make a recommendation based on the particular company's risk profile, and then negotiate with the insurance carriers to obtain the desired result. Other typical exclusions found in D&O policies concern areas of exposure for which other types of insurance can be purchased. Examples of these are ERISA claims, many types of employment practices claims, and pollution claims.

*Rescindablity and Severability.* When a claim hits that has particularly egregious facts, insurance carriers may consider rescinding a policy. This would involve an insurance carrier's taking the position that the insureds misled the insurance carrier at the time the contract between the company and its insurance carrier was formed. As a result, the carrier would assert, it should be allowed to rescind the insurance policy. One way of handling this concern is to negotiate for a non-rescindable policy, at least in part. Side A is the part of the insurance policy that is most easily obtained on a non-rescindable basis. Another way to address the concern that the bad acts of one insured could result in the loss of insurance coverage for innocent parties is to put provisions in the insurance contract that sever bad actors out of a policy, leaving the policy proceeds available for good actors. Referred to as "severability provisions" these provisions can enhance a company's ability to preserve insurance coverage for good actors in the face of unfortunate fact patterns. Obtaining solid rescission and severability provisions is fundamental to the protective strength of a D&O policy.

*Claims-Made Policy.* One final note on the structure of a D&O insurance policy: D&O insurance policies are typically "claims-made" policies, as opposed to "occurrence" policies. When a policy is a claims-made policy, the policy that responds to a claim is the policy that is in effect at the time the claim is made. By contrast, with occurrence policies the policy that responds to a claim is the policy that was in effect at the time the bad occurrence, the one that is later the subject of a claim, took place. A further complication, however, is that notwithstanding being claims-made policies, D&O insurance policies may have a "past acts" date. When a D&O insurance policy has a past acts date, the policy will not respond to a claim made during the policy period if that claim relates to a wrongful act (occurrence) that took place before the past acts date. It is critically important to a company's insurance coverage that this past acts date be completely eliminated or negotiated as far back in the past as possible.

**Practical Tip: Past Acts Date**

A mistake that can be made in obtaining D&O insurance coverage for a company undertaking an IPO is to have a past acts date that is the effective date of the IPO registration statement. While such a past acts date ought to result in a lower premium, the result of such a past acts date would be to exclude from coverage anything relating to the preparation of the IPO prospectus. This is because the prospectus was prepared before the past acts date. Given the vulnerability of IPO companies to litigation related to the prospectus, excluding the process of preparing the prospectus from coverage would be ill-advised.

## Selecting the Right Broker

Securing a D&O insurance policy is easy and can even be relatively inexpensive; securing D&O insurance that will actually pay a claim that hits a company and its directors and officers is much more difficult. It is all too easy for a company to purchase a D&O policy that, by its contractual terms, is unlikely to pay for any claims. Counter-intuitively, even purchasing insurance from a reputable carrier is no guarantee that a good policy will be issued to the buyer. The pricing, terms and conditions of an insurance policy are almost entirely driven by the knowledge and skill of the broker placing the insurance contract. For this reason, a company should hire a broker that specializes in this particular type of insurance and places it regularly. Indeed, it is common for companies to have their D&O insurance placed by a specialist and to have a different brokerage place the company's other important but less complex lines of insurance.

A good D&O insurance broker will be able to give a company specific recommendations for limits of liability that are based on historical data and not just peer data benchmarking. The broker should also be able to understand and provide guidance on the important terms and conditions in a D&O insurance policy contract. The broker should be able to help a company address the issues that arise from a company's having foreign subsidiaries, including, in some cases, the need for locally-admitted insurance policies, as well as the need in some cases for changes to be made to the master D&O insurance program to accommodate non-US legal issues. A company's D&O insurance broker should be able to provide a company with information and advice on alternative vehicles to D&O insurance that can help control cost. It is useful if a company's D&O insurance broker can offer loss control and risk management consulting that can drive down a company's overall D&O insurance premium. The broker should also be able to convey effectively to the insurance marketplace specifics both about the company's risk as well as its insurance requirements. Finally, a D&O insurance broker should be able to supply the company with information about each potential insurance carrier's claims history, financial stability and rescission history. A good place to start for recommendations for D&O insurance brokers is the company's legal counsel.

**Practical Tip: Avoid Sending Multiple D&O Insurance Brokers Into the Insurance Market**

A company will obtain the best possible terms, conditions and pricing for its D&O insurance if it chooses one broker to speak to all insurance carriers. A less effective strategy that some companies attempt to employ is the strategy of asking multiple D&O insurance brokers to place the D&O insurance on the theory that the company will choose the broker that presents the best program. This is called "dividing the market."

The problem with the multiple broker approach is that insurance carriers will only give quotations for a specific company to a single broker. The greater the number of interested insurance carriers (that is, the more competition for the company's D&O risk), the more a skilled broker can use market competition to lower the premium and improve the terms and conditions of an insurance policy for a company. Dividing the market, on the other hand, has the net effect of limiting the number of insurance carriers that are competing against each other for the same D&O risk. Less competition almost always means a result that is suboptimal compared to the result that could have been obtained if the full insurance market were competing for the same D&O risk.

## The Insurance Process

A company will ideally select its D&O insurance broker at least a couple of months prior to the initial filing of the registration statement for the IPO. During the time leading up to the IPO, the broker will work with the company and its counsel to develop an appropriate D&O insurance program for the company. This work includes providing the company with guidance on items of corporate governance about which D&O insurance carrier underwriters are particularly sensitive, such as corporate communications policies and insider trading policies. Also during this time, the D&O insurance broker, in conjunction with the company's management team, should give a company's board of directors a presentation on the company's plans for its D&O insurance. The majority of the insurance work taking place during this time, however, is done behind the scenes by the D&O broker. A company's D&O broker should be working to build a company's insurance program, usually with multiple insurance companies. For example, a company that seeks to obtain $40 million in liability limits might put together its insurance program with as many as four to six different insurance companies.

It is during this time that management and its board of directors should consider the optimal D&O insurance program structure for the company, including alternatives to traditional D&O liability insurance such as Side A DIC policies and independent director policies. It is also during this time that companies should consider the amount of D&O insurance limits they would like to purchase.

Other items that should be considered during this time are concepts such as coinsurance and setting high self-insured retentions. Coinsurance refers to a company's sharing a portion of all losses with the insurance carrier. Self-insured retentions, like deductibles, are dollar thresholds under which an insurance policy would not pay. Having coinsurance and a high self-insured retention are two things that can bring down the cost of D&O insurance. As with most D&O insurance options, however, co-insurance and high retentions pose issues. For example, the premium savings resulting from a high retention may be of little comfort when a claim is made and the company has to go out of pocket for defense costs for a prolonged period, instead of being reimbursed by a carrier for these costs.

Part of the process of building the final the insurance program often involves having members of a company's senior management team speak directly with insurance underwriters. These telephone calls or in-person meetings, which are all conducted under strict non-disclosure agreements, allow insurance underwriters to get a better feel for management as well as to obtain detailed information that may not be available in the IPO prospectus. These telephone calls and meetings also give management the opportunity to explain to insurance underwriters why the company is a good risk for the insurance carrier.

The entire insurance program should be completed — except for the actual binding of policies – before the CEO and the CFO leave for the investor roadshow. This work includes the completion of any required insurance applications, which can be long and time consuming.

The D&O liability insurance application for a company about to go public often contains a number of representations and warranties that are the basis of the insurance carrier's decision to issue the insurance contract at the agreed-to premium. Misrepresentations or omissions in the application can lead to the rescission of an insurance contract and could therefore, in the worst case, leave all directors and officers without insurance coverage. The application process must thus be taken seriously. Companies often poll members of the senior management team, the entire legal and finance departments, and all the members of the board of directors in advance of completing the application to make sure that the application is as complete and thorough as possible. In addition, between the date on which the application is signed and the date of the IPO, the company has a duty to update its insurance carriers on any changes to the application, such as any new litigation against the company.

The final order to bind a company's D&O insurance program will be placed the night before the company's first trading day. This timing ensures that there is D&O insurance coverage from the moment a company's directors and officers have public company liability exposure, but also that the company is not paying for D&O liability insurance before it is needed. Once the insurance binds, however, the insurance premiums are due and payable. Most insurance contracts allow insurance carriers to cancel the policy for non-payment of premiums after a certain period of time, so it is prudent for a newly public company to pay for its D&O insurance promptly.

# Chapter 5

# Managing Publicity During the Offering Process

The federal securities laws are designed to ensure that a public offering is made only by means of a prospectus that contains disclosure required by SEC rules and that is subject to review by the SEC. When a company engages in other publicity near the time of its public offering, there is a concern that the company may be using other means to draw attention to itself and to encourage the sale of its stock. The boundaries of what is permissible vary according to the stage of the offering.

## The Pre-Filing Period; Gun Jumping Concerns

*Overview*

Prior to the time that a company has filed a registration statement with the SEC in connection with a public offering of its stock, any offer to sell or solicitation of an offer to buy the company's stock is forbidden (with narrow exceptions for offers such as grants of employee stock options). The Securities Act definition of "offer" is broad, is not intended to be exclusive, and includes "every attempt to offer to dispose of, or solicitation of an offer to buy, a security or interest in a security, for value." In addition, the SEC has further broadened the definition by including activities that condition the market for the securities to be sold in the offering. Therefore, publicity that may increase public interest in an offering of the company's stock is forbidden during the pre-filing period.

Exactly when the pre-filing period begins is not always clear. At the latest, a company should consider itself as being in registration and subject to the SEC's pre-offering publicity rules when the company has selected the managing underwriters and has reached an understanding with them to proceed with the IPO; this may be well in advance of the organizational meeting. As soon as a company begins to seriously contemplate its initial public offering, it should meet with its counsel to establish appropriate publicity guidelines, because press releases, presentations, advertising and interviews can all lead to potential problems discussed in greater detail below.

The SEC has long been concerned about companies conditioning the market prior to a public offering by generating publicity about the company or its financial prospects. Impermissible public announcements or disclosures during the registration process (referred to as "gun jumping") are considered illegal "offers" in violation of the securities laws. As a practical matter, statements made in the early stages of the offering process may have little impact by the time the company is ready for its registration statement to be declared effective. Nevertheless, a company should be careful about its publicity activities during all stages of the offering process. Fortunately, as part of its securities offering reform in 2005 intended to modernize the securities offering and communication processes while maintaining protection of investors under the Securities Act of 1933, the SEC adopted new rules in this area which have added more clarity to the gun jumping rules.

***Exceptions to the definition of "offer"***

The central issue in the pre-filing period is whether activities or communications constitute an "offer." There are four generally applicable exceptions to the definition of offer: (1) preliminary negotiations with underwriters; (2) certain notices of proposed offerings registered with the SEC; (3) certain communications made more than 30 days before a registration statement is filed with the SEC; and (4) certain communications of regularly released factual business information. The latter two are relatively new exceptions, or safe harbors, both of which were adopted in 2005 by the SEC as part of its securities offering reform.

*Preliminary Negotiations with Underwriters.* The first exception applies to preliminary negotiations and agreements between an issuer and underwriters, which are expressly excluded from the definition of offer contained in Section 2(a)(3) of the Securities Act of 1933.

*Rule 135 – Notice of Proposed Registered Offering.* The second exception is found in SEC Rule 135, which permits the company to announce its proposed IPO so long as it contains only the information permitted by the rule. However, there is no legal requirement for a company to make a pre-filing announcement of its intent to make a public offering. In fact, such an announcement is rarely made unless it becomes necessary to end inquiries and conjecture. If a pre-filing announcement of a proposed offering is made, Rule 135 requires that the announcement state that the offering will be made only by means of a prospectus; it must not contain anything more than the specific items of information enumerated in the rule; and it must not identify the underwriters or describe the company's business. Any such announcement should be prepared with the assistance of counsel to ensure compliance with the rule.

*Rule 163A – "Bright-line" Exception for Certain Communications Made More than 30 Days before a Registration Statement is Filed.* SEC Rule 163A excludes from the definition of offer any communication made by a company more than 30 days before the date of the filing of its registration statement, so long as the communication does not reference an offering that is or will be the subject of a registration statement, is made by or on behalf of the company (as opposed to by an underwriter or dealer), and the company takes reasonable steps within its control to prevent further distribution or publication during the 30-day period prior to filing of the registration statement. The SEC has provided little guidance as to when a company will be considered to have taken "reasonable steps within its control to prevent further dissemination of the communication." However, the SEC made clear that companies that give interviews prior to the 30-day period that are published during the 30-day period are not necessarily entitled to make use of the Rule 163A exception. Thus, when giving press interviews in advance of an IPO, to avoid the potential gun jump the company should have an explicit agreement with the press regarding the timing of the publication of the interview.

*Rule 169 – Exception for Certain Communications of Regularly Released Factual Business Information.* Rule 169 permits a company to release or disseminate factual information about the company, its business or financial developments, or other aspects of its business and advertisements of, or information about, its products or services. However, the following conditions must be satisfied by the company:

- the company has previously released or disseminated similar types of information in the ordinary course of its business;
- the timing, manner, and form in which the information is released or disseminated is consistent in material respects with similar past releases or disseminations; and
- the information is released or disseminated for intended use by persons, such as customers and suppliers, other than in their capacities as investors or potential investors in the company's securities, by the company's employees or agents who historically have provided such information.

The first and third points noted above are relatively easy to follow. The second point involves subjective determinations. Companies occasionally attempt to time their offerings to coincide with major corporate events, such as the launch of a new product by the company or one of its largest customers. There is nothing wrong with a company delaying its offering until it has achieved a new milestone and can take advantage of a corresponding increase in its valuation. However, timing an offering to take advantage of publicity surrounding a highly visible event may prove to be a risky strategy if the SEC determines that the publicity was actually an attempt to generate interest in the company's IPO. It is important to note that the safe harbor provide by Rule 169 does not extend to forward-looking information regarding the company.

It is also important to note that Rule 169 does not permit any communication containing information about the company's IPO or released or disseminated as part of the company's offering activities in the IPO.

**Practical Tip: Avoiding Publicity Foul-Ups During the IPO**

Executives do not always find the securities laws' restrictions on publicity to be intuitively obvious. A company will likely run afoul of the rules unless affirmative steps are taken to control publicity during the offering process and guidelines are communicated to all employees. To avoid inadvertent foul-ups:

- As soon as the company has decided to proceed with a public offering, the company should have its counsel visit the company and make a presentation explaining the restrictions on publicity;
- Executive officers should attend this tutorial, as should all other personnel or outside consultants responsible for public relations or marketing activities;
- The company should designate one person, usually the CLO, to pre-approve all press releases, speaking engagements, interviews and major public relations and marketing activities occurring at any time during the offering process;
- Generally, all interviews with newspapers and business or financial magazines, and all speeches to groups covering the company's business or financial condition or outlook, should be prohibited after the decision to proceed with the IPO is made and prior to the effective date of the company's registration statement;

**Practical Tip: Avoiding Publicity Foul-Ups During the IPO (continued)**

- The company should purge its web site of any information (including information on third-party web sites to which the company hyperlinks) that is inconsistent with its publicity policy and the company should also designate a person, usually the CLO, to pre-approve all new content prior to its posting on the web site (all web site communications should be reviewed regularly, dated, evaluated for continued accuracy and relevance, and removed as they become stale or irrelevant); and
- When the company announces to its employees that a public offering is being undertaken, it should also announce that all non-routine inquiries, including any inquiries from reporters, analysts or brokers, must be referred immediately to the designated publicity clearance person.

***Internet web sites***

The company is responsible for the accuracy of its statements that reasonably can be expected to reach investors or the securities markets regardless of the medium through which the statements are made, including the Internet. For example, information posted on a company's web site is deemed published in the same way as information contained in a press release, and the information will be considered continually republished so long as it stays posted on the web site. In other words, the federal securities laws apply in the same manner to the content of the company's web site as to any other statements made by or attributable to the company while in registration, including information on a third-party web site to which the company has established a hyperlink. The SEC staff has indicated that a company may archive old information, such as press releases, on its web site so long as the company indicates clearly that the information is historical and that the company will not refer to such information as part of the offering activities. Whether third-party information will be attributable to the company depends upon whether the company has involved itself in the preparation of the information or explicitly or implicitly endorsed or approved the information. Ideally, the companies in registration would not link to any site where it has no control over the content, but most companies would find this advice impractical.

The SEC staff scrutinizes a company's web site carefully to determine whether or not it may contain information which conditions the market for the company's proposed IPO. To ensure compliance with the federal securities laws, the company must be vigilant in regards to the content on its web site, including hyperlinks to third-party web sites and information. The company and its counsel should carefully review the company's web site and any information on third-party web sites to which the company hyperlinks to ensure not only that there are no gun jumping concerns, but also that the information is consistent with the disclosure contained in the registration statement. For hyperlinks that are retained on the web site, the company should add a clear and noticeable disclaimer indicating that the user is leaving the company's site. The company may also want to consider displaying hyperlink addresses as inactive text (rather than as "hot" links) or adding a "pop-up" window notifying the user that he is leaving the company's web site.

### *Consequences of a gun jumping violation*

The consequences of a gun jumping violation can be severe. It is likely that the SEC will require the company to include the gun jumping statements made in the registration statement, which subjects the company to strict liability for its accuracy. In other cases, the SEC has disciplined companies by imposing a cooling off period. In other words, the SEC may delay the date of effectiveness of the company's registration statement until the impact of the premature publicity has faded. This type of discipline can destabilize the entire marketing effort of a company and its underwriters and can result in a company missing an IPO window. In still other cases, the company has been forced to include a risk factor in its prospectus stating that the company may have violated securities laws and describing the risk of recission (that is, a purchaser of shares in the IPO may have the right to rescind his or her purchase or be entitled to damages if he or she no longer owns the securities). Pre-filing publicity can also result in heightened SEC scrutiny of the entire transaction. If an underwriter is involved in a violation, the SEC may require that the underwriter be excluded from the deal. In egregious cases, the SEC may bring formal enforcement action, and may seek an injunction as well as other sanctions.

**True Story: Teddy Bears and the SEC**

A toy company that was conducting a public offering was contacted by the SEC concerning hundreds of newspaper and magazine articles that had appeared in the months leading up to the offering. The company explained to the SEC that most of the articles were about the company's top-selling product, a talking teddy bear, that had been the hit of the Christmas season. The company argued that the publicity had nothing to do with conditioning the market for its stock. The company was able to establish that as soon as the decision to proceed with the offering had been made, the company had instructed its public relations firm to halt all publicity activities and the company's officers had declined all requests for interviews. In the end, the SEC permitted the offering to proceed without imposing a cooling off period.

Is the moral of this story that a company won't get into trouble if it can establish legitimate business reasons for extensive publicity while it is in registration?

*Maybe.* More likely, the lesson to be learned is that even if a company follows the rules, high-profile publicity will attract SEC attention and may jeopardize the timing of the company's offering while the SEC evaluates the situation.

## The Waiting Period

### *Overview*

The "waiting period" is the period between the filing of the registration statement with the SEC and the time that the SEC declares the registration statement effective. The purpose of the waiting period is to give investors time to become acquainted with the information in the prospectus and arrive at an informed investment decision, as well as to allow the SEC time to review and comment on the registration statement.

During the waiting period, offers (but not sales) of the company's securities are permitted. However, the methods for making offers during the waiting period are highly regulated. With a few exceptions, publicity relating to the company's offering is limited to oral offers and written offers made by means of either the preliminary prospectus or a free-writing prospectus. The SEC defines a written communication as any form of communication other than an oral communication. Thus, such methods of communications as e-mail, Internet web sites, CD-ROMs and audiotapes are considered written communication. The term "prospectus" is broadly defined and includes any written offer (including offers made via television, radio or the Internet) or a confirmation of a sale. Any written communication (*e.g.*, press releases and articles quoting the company or its officers) that conditions the market for the company's securities will be construed by the SEC as an offer. Accordingly, the pre-filing guidelines for determining whether an announcement is legitimate business news or impermissible hype are also applicable during the waiting period.

After a company files a registration statement with a price range the company and other offering participants may make written offers outside of the statutory prospectus, such written offers are referred to as "free-writing prospectuses" (FWPs). FWPs can take any form and are not required to meet the informational requirements otherwise applicable to prospectuses.

The use of an FWP after filing of a registration statement is conditioned on meeting certain conditions, including the placement of a specified legend on the FWP and generally on filing of an FWP with the SEC. The use of an FWP is further conditioned on the FWP being preceded or accompanied by a prospectus with the price range. Thus, the use of broadly disseminated FWPs may not be feasible unless the FWPs are in electronic form and contain a hyperlink to the prospectus.

Because oral offers are permitted during the waiting period, the company and the underwriters can commence the selling effort and conduct the road show during this period. However, the distinction between an oral offer and a written offer is not always intuitive, and, given the broad definition of written communication, issuers must recognize a number of limitations on their activities during the waiting period, including:

- Offers by means of radio or television broadcasts or by audio or video recordings are not permissible during the waiting period;
- Misleading statements, whether written or oral, are never permissible; and
- Written materials other than the preliminary prospectus, such as copies of slide presentations which accompany an oral presentation, may only be distributed during the waiting period if they are provided simultaneously with a roadshow in a manner designed to

make the communication available only as part of the roadshow and not separately.

The company must be careful to avoid making statements or projections during the road show or in interviews that could be deemed to be factually inaccurate or misleading or to speak of material items or developments that are outside the scope of the prospectus. The best method for avoiding these pitfalls is to limit the content of statements during the road show or in interviews to only the information contained in the prospectus.

The customary form of roadshow, which is conducted live, in person and to a limited institutional audience, is considered oral communication and is not required to be filed with the SEC as a free writing prospectus. Despite the general rule that electronic transmissions are required to be filed, a live, in real-time roadshow to a live audience does not need to be filed as a free-writing prospectus. A roadshow that does not originate live, in real-time to a live audience would typically need to be filed as a free writing-prospectus. However, in the context of an IPO, if a company makes at least one version of a bona fide electronic roadshow readily available without restriction electronically to any potential investor then the roadshow does not need to be filed.

E-mails are considered writings, and any e-mail communication during the offering process could be considered a written offer. During the waiting period, telephone calls should not be supplemented by e-mail. The company should hold telephonic conference calls or in-person meetings to keep employees or other constituencies informed of the progress of an offering rather than using e-mail.

***Rule 134 press release***

A public announcement is allowed during the waiting period so long as the press release contains only the limited amount of information permitted by SEC Rule 134 and states from whom a prospectus can be obtained. Although there is no requirement that such a post-filing announcement be made, most companies issue such a press release shortly after the registration statement is filed with the SEC. The contents of such a press release are limited by SEC rules, and any such press release should be reviewed in advance of its publication by counsel.

***Directed shares program***

The company may consider requesting that the underwriters set aside a certain number of IPO shares to be sold to individuals specifically designated by the company. Depending on the number of the IPO shares to be reserved for this purpose, a formal program may need to be implemented, with corresponding disclosure in the company's registration statement. These programs are referred to as "directed shares" or "friends and family" programs, and they are a fairly common feature of IPOs. Most underwriters offer some type of directed shares programs. A majority of the IPOs completed since 2001 involved some form of directed shares program, and in most of those deals, 5% or less of the IPO shares were reserved for the program. However, in the wake of the Vonage Holding Corp. IPO in 2006, the percentage of IPOs including a directed share program appears to be declining. Fewer than half of the IPOs completed since 2006 involved a directed shares program.

Generally, shares purchased in an IPO are freely tradable once the company's stock begins trading on the market, and they are not subject to the underwriters' lock-up agreement. As a result, directed shares can prove quite valuable in IPOs in which the price rises quickly after trading in the stock commences. However, in recent years, many investment banks have required participants in a directed share program to agree that they will not re-sell the shares purchased in the program for a period of time following the IPO, typically 90 or 180 days, with the possibility of an extension in certain limited circumstances. The effect of this lock-up agreement is to reduce the attractiveness of participation in the directed share program.

There are a number of burdens to a company associated with a directed share program. For example, after announcing IPO plans, many companies find that they have more "friends" than they ever realized, and the demands for directed shares can become overwhelming. The company's CEO and CFO (and sometimes other officers) must then deal with the distraction of numerous telephone calls from participants or would-be participants. Participants do not get a discount to the price that is offered to the public; they pay the same offering price as other IPO investors. As a result, if the company's stock price drops after trading in the stock commences, participants quickly forget the benefits of participation and the CEO and CFO soon find themselves dealing with disgruntled friends and family; in fact, in some situations, participants have attempted to refuse settlement of the purchase price, which can create severe tension among the underwriters, the company, and the participants. Also, if directors and officers of the company decide to participate in the program, they must be careful that they do not violate the Section 16 short-swing trading liability provisions discussed in Chapter 10.

Administering a directed shares program necessarily involves communicating with the participants prior to the effectiveness of the company's registration statement. Such communications are likely to be considered offers subject to the securities laws. Please note, however, that amendments to SEC Rule 134 provide issuers with increased clarity regarding the types of communications used in connection with directed share programs that will not constitute offers under the federal securities laws. The SEC closely scrutinizes these types of programs. If the company is contemplating a directed shares program in connection with its IPO, it should carefully weigh the potential advantages and disadvantages before moving forward. If the company decides to conduct such a program, it should work closely with its counsel and the underwriters to ensure compliance with applicable securities law requirements in the administration of the program.

## True Story: Directed Shares Programs Can Be Dangerous

Caution should be used in administering directed shares programs, as potential violations of the securities laws have led to undesirable consequences for some companies and underwriters. In certain offerings in which the SEC believed that the company or its underwriters may have violated securities laws, the SEC required the company to include a risk factor in its prospectus informing investors of a potential violation of securities laws and describing the resulting potential liability for recission. The following risk factor from one such company's IPO prospectus illustrates this unpleasant result:

> *Some shares in this offering may have been offered or sold in violation of the Securities Act of 1933*
>
> Prior to the effectiveness of the registration statement covering the shares of common stock being sold in this offering... an underwriter of this offering provided written materials to approximately 80 employees that we had designated as potential purchasers of up to 300,000 shares of common stock in this offering through a directed share program. These materials may constitute a prospectus that does not meet the requirements of the Securities Act of 1933. No employee who received these written materials should rely upon them in any manner in making a decision whether to purchase shares of common stock in this offering.
>
> If the distribution of these materials by the underwriter did constitute a violation of the Securities Act of 1933, the recipients of these materials who purchased common stock in this offering would have the right, for a period of one year from the date of their purchase of common stock, to obtain recovery of the consideration paid in connection with their purchase of common stock or, if they had already sold the stock, sue us for damages resulting from their purchase of common stock. These damages could total up to approximately $4.5 million plus interest, based on the initial public offering price of $15.00 per share, if these investors seek recovery or damages after an entire loss of their investment. If this occurs, our business, results of operations and financial condition would be harmed.

Other companies have had to make similar disclosures in their IPO prospectuses. For example, a risk factor in one prospectus disclosed risks of potential securities laws violations related to the fact that certain information regarding its directed shares program had been posted on an internal bulletin board and that certain executive officers had sent e-mails to potential participants in the program.

**True Story: The Vonage IPO Directed Shares Program**

In the wake of the Vonage Holding Corp. IPO in May 2006, there has been much controversy surrounding its directed share program. In connection with its IPO, Vonage requested that its underwriters reserve 15% of the offered shares for sale at the IPO price in a directed share program, of which 13.5% of the shares were reserved specifically for sale to customers.

The Vonage common stock closed at nearly 13% lower than the $17.00 IPO price on the first day of trading and nearly 50% lower by the time it reached its second month as a publicly traded stock, and it has not yet recovered, reaching a low of $0.96 per share in late 2007.

In the weeks following the IPO, certain participants in the directed share program who had been allocated shares in the offering failed to pay for and accept delivery of the shares. As a result of this failure and as part of the indemnification obligations owed to its underwriters set forth in the underwriting agreement concerning the offering, Vonage was forced to acquire the shares from the underwriters or their affiliates and reimburse the underwriters for the price of the unpaid shares.

In addition, during June 2006 and July 2006, Vonage, several of its officers and directors, and the firms who served as the underwriters in the IPO were named as defendants in several similar purported class action lawsuits. The complaints assert claims under the federal securities laws on behalf of a professed class consisting of all those who were allegedly damaged as a result of acquiring Vonage common stock in connection with the IPO. The complaints allege, among other things, that Vonage omitted or misstated certain facts concerning its directed share program, and that Vonage violated federal securities laws when it informed customers of the directed share program via e-mail and voicemail.

Regardless of the outcome of the lawsuits, the Vonage scenario provides some valuable insight into the potential disadvantages involved in employing an directed share program in one's IPO.

### *Consequences of violations*

The consequences for violations during the waiting period are the same as those for violations during the pre-filing period and include delay in effectiveness, expulsion of offending underwriters from the syndicate and injunctions. Because the desired effective date is closer at hand, the effect of an SEC-imposed cooling off period at this stage can be more detrimental to the proposed timing of the offering. For the offending parties, it can also be embarrassing.

**True Story: The SEC Goes Online Grocery Shopping**

In October 1999, the SEC required Webvan Group, Inc. to take a three-week cooling off period and to include in Webvan's registration statement certain statements that were reportedly made to prospective investors during the company's road show that had not been included in its prospectus and comments reportedly made by Webvan's CEO during an interview with *Forbes* magazine. As one commentator put it, the SEC put Webvan's IPO in the frozen-foods section.

Ironically, the Webvan controversy generated only more media attention regarding the company and its offering, which several observers claimed only helped to push the offering price of the stock to $15 (much higher than the $11 to $13 range initially projected) and the aggregate offering proceeds from $300 million to $375 million. Regardless, the SEC could have imposed more severe penalties.

It is difficult for a company to remain quiet during such an exciting time, especially when employees, journalists and investors are seldom satisfied to learn the details of the company's offering from its registration statement filed with the SEC. Had the use of free writing prospectuses been available to Webvan at the time of its IPO, Webvan could have potentially avoided the SEC-imposed sanctions by filing the statements and the interview in a free-writing prospectus. Nonetheless, the important lesson in the Webvan IPO case is that a company in registration should err on the side of caution rather than try to test the boundaries of the rules. The company should approach the IPO process with the assumption that the SEC will find any statement that is published, either on its own or with the aid of the internet or interested parties, including competitors.

## The Post-Effective Period

The post-effective period begins when the SEC declares the company's registration statement effective and it continues until the distribution of the company's securities is completed (a 25-day period in the case of an IPO conducted on an exchange).

Once the registration statement has been declared effective, offers and sales of securities are permitted. A final prospectus must precede or accompany any delivery of the security. During this period, a communication (*e.g.*, sales material or literature) is not deemed a prospectus so long as it is preceded or accompanied by the final prospectus. These types of communications are commonly referred to as "free writing."

Following the pricing of the IPO, the company will typically issue a press release announcing the pricing of the deal. The content of the press release is governed by SEC Rule 134 discussed above. As a result, most pricing press releases look similar – they include the number of shares offered, the price, the names of the managing underwriters, a short description of the company's business and instructions as to how to contact the managing underwriters to obtain a final prospectus.

While the rules for publicity during the post-effective period are substantially less restrictive than the rules applicable to the waiting period and the pre-filing period, caution is still advisable. Statements made during the post-effective period are subject to general antifraud rules and may serve as the basis for liability.

After the 40th day following the pricing of the IPO, research analysts who are employed by managing or co-managing underwriters in the IPO can publish research reports regarding the company. Analysts employed by underwriters or dealers other than the manager or co-managers can publish research reports regarding the company after the 25th day following the pricing of the IPO. Additionally, as discussed in greater detail in Chapter 3, research analysts who are employed by managing or co-managing underwriters are subject to certain restrictions regarding research reports published 15 days prior to and after the expiration, waiver or termination of any lock-up agreement. It is for these reasons that underwriters often require an extended lock-up period provision in the IPO lock-up agreement, which extends the lock-up to permit the analyst to publish research if the 180-day lock-up period expires at or near the time of an earnings announcement of the company.

# Chapter 6
# Hosting the Organizational Meeting and Management Presentations

## Purpose

The registration process formally commences with the organizational meeting, which is usually held at the offices of the company, or sometimes at the offices of company counsel. The purposes of the organizational meeting are to allow the working group members an opportunity to meet each other and to consider the IPO issues at a high level. This portion of the organizational meeting typically lasts for a few hours. Management due diligence presentations are often combined with the organizational meeting, although they may be held separately. If management presentations are included, the organizational meeting will be a full-day event.

## Agenda for the Organizational Meeting

### *Review the working group list*

The managing underwriters will distribute a draft working group list that contains office and home address, telephone and other contact information about each member of the working group. The list should be reviewed and any changes should be noted and returned to the managing underwriters.

### *Review the proposed time schedule*

The working group will outline a proposed schedule at the organizational meeting. The schedule will cover drafting sessions, the SEC review process and the road show. Time should be allowed for any necessary corporate housekeeping, stockholders meetings or financial audits. ***Appendix C*** is a sample IPO timetable.

Actual or contemplated acquisitions by the company during the offering process could significantly affect the timing of the offering due to the related disclosure requirements. Any proposed acquisitions should be discussed with company counsel prior to the organizational meeting.

### *Structure of the offering*

Topics to be discussed at the organizational meeting are listed below. While all of these issues are typically discussed at the organizational meeting, most of them are not finally resolved until later in the offering process.

*Size of the offering*. The size of the offering will be determined by the company and the underwriters, taking into account the amount of proceeds the company is interested in raising, the level of dilution the company is willing to accept, the amount of shares (or float) needed to ensure a liquid trading market after the offering and the appetite of the market.

*Price of the offering.* Although the price will not be determined until after the road show is complete, the company should advise the underwriters of any price-related parameters, such as price thresholds for the automatic conversion of preferred stock into common stock.

*Participation of selling stockholders.* Often, the IPO will not only include shares issued and sold by the company but also shares sold by existing stockholders of the company. Who is allowed to participate as a selling stockholder and how much they are allowed to sell in the offering will be influenced by several factors. Contractual registration rights must be considered, although these are often amended or waived in connection with an IPO. If the company intends to sell a large amount of stock for its own account, there may be little room for selling stockholders. If there is a large stockholder which could flood the market with stock after the lock-up is released (or worse yet, which is not subject to a lock-up), the company and the underwriters may wish to include that stockholder's shares in the IPO in order to reduce this unpredictable overhang. The underwriters will advise the company as to the marketing implications of a particular stockholder's participation in the offering. For example, potential investors may be alarmed if the company's CEO sells most of his or her stock in the IPO, but may be understanding of an early investor's desire to achieve liquidity.

*Over-allotment option.* The over-allotment option, also known as the "green shoe," virtually always consists of an additional 15% of the stock being offered and can be exercised by the underwriters within 30 days of the initial closing to cover over-allotments of the company's stock. The company and the underwriters should discuss whether the over-allotment shares will come from the company, selling stockholders or a combination of the two.

*Desirability of a directed shares program.* The company may request that the underwriters set aside a certain number of IPO shares to be sold in a directed shares program. To ensure compliance with applicable securities law requirements, the company should closely coordinate any directed shares program with the underwriters and company counsel. This topic is discussed in greater detail in Chapter 5.

*Overhang analysis and lock-up situation.* The trading price of a company's stock following its IPO is a function of supply and demand. The post-IPO performance of the stock can be adversely affected if large quantities of stock flood onto the market. At the organizational meeting, the underwriters will want to discuss the number of the company's outstanding shares that can be sold in the public market following the IPO in reliance on Rule 701, Rule 144 or otherwise, and the dates that these shares will become eligible for sale.

In order to reduce downward pressure on the stock, the underwriters will likely insist that most, if not all, of the stock outstanding prior to the IPO be subjected to contractual lock-up restrictions prohibiting the sale of the stock for a specified period following the IPO, typically 180 days, with the possibility of an extension in certain limited circumstances. The company should alert the underwriters if it expects to have difficulty obtaining a lock-up with respect to any significant block of shares.

*Distribution objectives.* The company and the underwriters will briefly review the proposed allocation between retail and institutional investors, as well as any international distribution objectives.

*Listing on NASDAQ, the NYSE or another exchange.* Company counsel should be prepared to discuss the applicable listing requirements and any concerns about the company's ability to satisfy them. The working group may also briefly discuss proposed ticker symbols.

### *Use of proceeds*

The company's intended use of the IPO proceeds must be disclosed in the prospectus, as must the fact that management will have broad discretion over the use of the proceeds if no definitive use is contemplated at the time of the IPO. If the proceeds are to be used for the repayment of existing debt or specific acquisitions of other businesses, extensive disclosure, including pro forma financial statements, may be required in the prospectus. The underwriters will need to understand the intended use of proceeds in order to understand its effect on the company's future business and financial projections.

### *Legal issues*

Company counsel will review the important legal issues and concerns relating to the offering. Although the working group members will not expect an extensive report, they will expect a brief summary of the status of most of the items addressed in Chapter 3. Company counsel should identify and the working group should discuss any issues that will have a significant impact on disclosure or timing.

### *Accounting issues*

The timing of the offering may be significantly dependent upon the ability to quickly close the company's books, prepare financial statements and complete an audit. Therefore, the working group members should use this opportunity to clarify any accounting-related timing issues. When will the audit for the most recently completed fiscal year be completed? Will financial statements for the company's most recent quarter be required for the initial filing? When will they be available? Will financial statements for the following quarter need to be included in an amendment to the registration statement? When will these financial statements be prepared? Will financial statements for the stub period since the last annual audit need to be audited?

**Practical Tip: Identify Need For Special Accounting Work As Early As Possible**

If the company has a significant "stub" period for financial statements (6 or 9 months) the underwriters may want the stub period financials to be audited. Often this will occur if the issuer company does not have a long history of operations, and the stub period represents a significant part of the positive financial results trend in which investors will be investing. Because the trend is not preceded by a significant history of audited financial results that is consistent with the trend, the underwriters may want the audit as a matter of due diligence. This audit could require a significant amount of time to complete and could prove to be a rate-limiting step in the IPO process. It is important to highlight this issue as soon as possible in the process so the audit can be started, and the entire working group can properly factor its timing into the overall timing for the IPO. Even if the underwriters do not require the company to audit stub periods, the company and the underwriters may wish to include financial statements for those stub periods in the prospectus (whether or not SEC rules require inclusion). In addition, the underwriters may advise the company to include in the prospectus summary quarterly financial information for some number of quarters (typically at least 4 but not more than 10) prior to the time of the IPO, even though the Securities Act does not require such quarterly information. It is typical in these circumstances for the underwriters, as part of their due diligence, to require the company's auditors to perform a limited review of the quarterly financial statements. While the procedures performed by the auditors when reviewing interim financial information (typically a SAS 100 review) is more limited than the procedures performed in an audit, it is important to highlight this issue early in the process so that the review can be started and any issues associated with the review can be identified.

The CFO and the company's auditors should identify for the working group any significant accounting issues, such as controversial revenue recognition or other accounting methods used by the company, unusual reserves, the need for restatement of financials, or anticipated cheap stock problems.

Finally, the auditors and the underwriters' counsel may briefly discuss the auditors' comfort letter and any potential points of contention that may arise. The underwriters' counsel will want to discuss with the auditors the level of review that has been or will be conducted by the auditors with respect to each annual and quarterly period included in the registration statement, and will want appropriate comfort on such periods. In addition, if the company has had a change of auditors within the five years prior to the offering, there is a possibility that a comfort letter would be required or requested from the prior auditor. Discussions between the underwriters' counsel and the auditors should begin early in the process in order to ensure that there are no unforeseen surprises or complications at critical points in the offering.

### *Due diligence*

If the working group members have not already done so, they can begin exchanging due diligence requests and materials with the company. The company should alert the working group if there have been any major recent developments.

### *Publicity policy*

At the organizational meeting, the underwriters will want to confirm that the company has its pre-offering publicity policy in place. If the company is aware of any upcoming product announcements, press releases, third-party research reports, media articles or other publications involving the company, or if the company intends to participate in any conferences or seminars, it should alert the IPO team at the organizational meeting.

### *Additional issues*

The working group may also briefly discuss the status of the company's decisions regarding the financial printer, the registrar and transfer agent, the bank note company and the custodian for the selling stockholders, if any.

## Management Presentations

Management presentations are essential for the group that will be conducting due diligence, drafting the registration statement and marketing the company's stock. In preparing presentations, the company should bear in mind that the audience members may vary widely in their understanding of the company and its industry. The investment bankers may already be quite familiar with the company and may ask fairly sophisticated questions. For other members of the team, such as the underwriters' counsel, the organizational meeting may be the first introduction to the company.

Each executive officer of the company typically speaks for one-half to a full hour, although more or less time may be appropriate depending on the scope of the officer's responsibilities. Follow-up meetings may be requested by the IPO team at a later date.

*The CEO.* The CEO typically begins by discussing the history of the company and giving a general overview of the company's industry, overall operations, culture and organizational structure, including board composition. The CEO will also discuss the company's short-term and long-term goals and plans for achieving those goals. Any foreseeable roadblocks to the company's success should also be discussed at this time.

*Other executive officers.* The working group typically expects to hear from the head of each principal function/division, such as sales and marketing, operations, engineering, manufacturing and customer service, as applicable. Each executive officer should describe his or her professional background, the activities and personnel for which he or she is responsible, and significant factors influencing his or her area of responsibility. The vice president of sales may discuss the company's sales and distribution strategies and programs, sales channel, customers and strategic relationships, sales force and compensation policies, product sales trends, market share and competitive pressures on sales and pricing, pricing and selling terms, and forecasting methodology. The head of engineering or chief technology officer may discuss product development activities and strategy, technology and skills, and intellectual property position. The head of manufacturing may discuss the company's current manufacturing operations, capacity for growth, sole source components and relationships with suppliers.

*The CFO.* The CFO is responsible for presenting historical financial information as well as projections. Because the working group members often have a limited ability to absorb new information by the end of a full day of management presentations, the CFO often limits his or her initial presentation to a brief overview of the company's financial status, projections, accounting controls and financing requirements. A more in-depth review of the company's financial situation and projections is then given in a separately scheduled financial due diligence session. Prior to the organizational meeting, the CFO should discuss with the underwriters their preference for the timing and format of a detailed financial presentation.

**Practical Tip: Effective Management Presentations**

The task of coordinating the management presentations typically falls to the CEO or CFO. To ensure an effective meeting, the coordinator should consult with experienced legal counsel and consider taking the following steps:

- Schedule the date of the presentations far enough in advance to ensure that each presenter will be available;
- Ensure that each presenter understands the purpose of, and audience for, the presentation;
- Ensure that each presenter is prepared;
- Find out how many people will be attending and make sure the conference room is large enough for the entire group;
- Have a writing surface available for all attendees;
- Make sure all audio-visual equipment is set up properly;
- At the meeting, distribute hard copies of any slides BEFORE the presentation so that the attendees can focus on what the presenter is saying rather than trying to transcribe all the information from the slides;
- Mark all slides and hand-outs "CONFIDENTIAL";
- Allow time for questions;
- Schedule regular breaks and re-convene on schedule;
- Try to stay on schedule and arrange for follow-up meetings as necessary; and
- Have food and beverages available at the beginning of the meeting and at appropriate intervals.

# Chapter 7

# Potential Liability and the Role of Due Diligence

By the end of the initial public offering process, most executives would rather hear underwriters' counsel drag their fingernails over a chalkboard than ask another due diligence question. Still, due diligence is an essential part of the offering process. Due diligence is a small price to pay for the liability protection that it provides, and in most due diligence matters the interests of all of the working group members will be aligned.

## Potential Liability for Violations of Federal Securities Laws

It has become an unfortunate fact that a sharp drop in a public company's stock price is often closely followed by a securities class action lawsuit. This results from a variety of factors including the structure of the securities laws and the financial incentives for the plaintiffs and their counsel (especially shortly following a public offering when there are underwriters and other potential defendants who have substantial financial resources).

The federal securities laws impose special disclosure obligations (and concomitant liabilities) on a company and others involved in the IPO process when the company avails itself of the securities markets. There are three principal securities law provisions that create potential civil liability in connection with a company's IPO: Section 11 and Section 12 of the Securities Act, Section 10(b) of the Exchange Act and SEC Rule 10b-5.

### *Section 11 of the Securities Act*

Section 11 of the Securities Act creates an obligation of candor in the context of a public offering – specifically relating to the contents of the registration statement. It provides securities purchasers with an express right of action for damages if any part of the company's registration statement (when it is declared effective by the SEC) contains "an untrue statement of a material fact or omit[s] to state a material fact required to be stated therein or necessary to make the statements therein not misleading."

Section 11 of the Securities Act does not define the meaning of "material" in this context. However, well-established case law has held that information is material if there is a substantial likelihood that a reasonable investor would consider it important in making an investment decision, or the information would be viewed as having significantly altered the total mix of information available in the market. Section 11 does not require a plaintiff to establish a culpable state of mind in the defendant as a requirement of recovery, nor does it require a showing of reliance by the plaintiff on misstatements in the registration statement.

The parties who can be sued pursuant to Section 11 are limited. Section 11 gives the plaintiff the right to sue:

- every person who signed the company's registration statement (SEC rules require the registration statement to be signed by the company's principal executive officer, principal financial officer, principal accounting officer and a majority of the directors of the company);
- every person who was a director of the company at the time of the filing of the registration statement;
- every expert (*e.g.*, auditor, engineers, appraisers) whose profession gives authority to a statement made by such person, who is named as having prepared or certified any part of the registration statement, or as having prepared or certified any report or valuation used in connection with the registration statement, with respect to the statement in such registration statement, report, or valuation, which purports to have been prepared or certified by such person; and
- every underwriter in the offering.

Section 11 also provides a plaintiff with three alternative methods for computing damages. A successful plaintiff may recover the difference between the amount paid for the securities (not to exceed the IPO offering price) and (1) the value at the time of the lawsuit, (2) the price at which the plaintiff sold the securities prior to the lawsuit, or (3) the price at which the securities were sold by the plaintiff after the lawsuit was brought but before judgment so long as the damages computed under this third alternative would be less than those based on the difference between the price paid for the security (not to exceed the IPO offering price).

The company is strictly liable for material misstatements or omissions contained in its registration statement. However, Section 11 provides each potentially liable party other than the company a due diligence defense to avoid liability. The due diligence defense is discussed in greater detail later in this chapter, but it is worth noting that an officer or employee director who signs a registration statement containing a material misstatement will find it difficult to prove that he or she had reasonable grounds to believe the statement was true. The closer the involvement of a defendant in the IPO process (or in the company's business and operations generally) and the higher his or her position within the company, the more a court will expect of the defendant and the more difficult it will be for him or her to establish the due diligence defense.

### *Section 12 of the Securities Act*

Section 12(a)(2) of the Securities Act supplements liability pursuant to Section 11 by providing securities purchasers with an express remedy for material misstatements or omissions in connection with the offer or sale of the company's securities by means of a prospectus or oral communication. Unlike Section 11, Section 12(a)(2) is not limited in scope to the statements made in the company's registration statement but extends to oral statements (*e.g.,* statements made during the company's road show and other meetings with potential investors). Also, liability pursuant to Section 12(a)(2) extends beyond the persons enumerated in Section 11 (*e.g.*, it is possible that directors or stockholders who actively participate in the IPO process may be deemed "sellers" for purposes of Section 12(a)(2)). However, Section 12 liability is narrower than Section 11 liability in regards to privity: the plaintiff must have purchased the securities directly from the defendant. Similar to Section 11, a plaintiff is not required to establish a culpable state of mind in the defendant as a requirement of recovery, nor does it require a showing of reliance by the plaintiff on misstatements.

A successful Section 12(a)(2) plaintiff is entitled to rescission – to recover the purchase price paid for the company's securities plus interest, less any income received on the securities, upon tender of the securities to the company – or to damages if the plaintiff no longer owns the securities. However, if a defendant proves that any or all of the amount otherwise recoverable by the plaintiff pursuant to Section 12(a)(2) arose from something other than the misstatement or omission, then such amount is not recoverable.

Section 12(a)(2) expressly provides that a defendant is not liable if he or she did not know, and in the exercise of reasonable care could not have known, of the misstatements or omissions. Accordingly, a proper due diligence investigation in connection with the preparation of the company's registration statement can be effective in minimizing potential liability.

Historically, Section 12(a)(2) liability with respect to a "prospectus" was premised on information included in the final prospectus delivered to investors several days after an offering was priced and the securities sold to such investors. Typically, prior to the sale of a security, investors, particularly investors that participated in "road show" presentation with a company's management, would receive a preliminary prospectus relating to the offering. This preliminary prospectus would often be prepared at least one to two weeks prior to the sale of the securities to investors, and would be used as a marketing and disclosure document for the transaction. As such, the preliminary prospectus would include only an estimated range of the price and size of the offering, and would not contain any information that about events that transpired or changes that occurred with respect to the company, its industry or otherwise between the time of the printing of the preliminary prospectus and the time that sales were made to investors. In certain situations, where a company, its underwriters and each of their respective counsels concluded that the information in the preliminary prospectus had become substantially and materially deficient, the company and the underwriters would "recirculate" a revised preliminary prospectus to investors prior to confirming sales. Otherwise, absent such deficiencies in the preliminary prospectus, the parties participating an offering typically assumed that any shortcomings in the preliminary prospectus could be "fixed in the final prospectus," and that such changes would be sufficient to prevent liability for misstatements or omissions of material information in the prospectus under Section 12(a)(2). As noted previously, the prospectus is not typically delivered to investors until several days after they have made the decision to purchase a company's securities, and, as such, this assumption often meant that arguably material information may not have been in the possession of investors at the time they made their investment decision.

In 2005 the SEC adopted Rule 159, which interpreted Section 12(a)(2), such that for the purposes of determining liability under Section 12(a)(2), any information "conveyed" to a purchaser after the "time of sale" will not be taken into account. The principal effect of this new rule is that it excludes any information delivered to an investor after such investor has already agreed to buy a security, including any information contained in a final prospectus that was not included in a preliminary prospectus or otherwise delivered to the investor prior to the "time of sale." The adoption of Rule 159 has increased the need for companies, underwriters and their respective counsels to remain in contact throughout the offering process and to remain focused on follow-up due diligence, particularly during the road show, to ensure that all material information is conveyed to investors prior to the time of sale.

### *Section 15 of the Securities Act – liability of controlling persons*

In addition, Section 15 of Securities Act provides that any person who controls a person liable pursuant to Section 11 and Section 12 will be liable jointly and severally with and to the same extent as the controlled person. It is important to note that the term "controls" is broadly defined for purposes of Section 15 and the concept of control in this context can include directors, officers and principal stockholders, depending on the specific facts and circumstances. There is one exception to Section 15 liability: the controlling person will not be held liable if such person can prove that he or she had no knowledge of or reasonable ground to believe in the existence of the facts by reason of which the liability of the controlled person is alleged to exist.

### *Section 10(b) of the Exchange Act and SEC Rule 10b-5*

Section 10(b) of the Exchange Act makes it unlawful "to use or employ...in connection with the purchase or sale of any security...any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the SEC may prescribe as necessary or appropriate in the public interest or for the protection of investors." Based on the authority granted to it by Section 10(b), the SEC adopted Rule 10b-5 to prohibit fraudulent devices and schemes, material misstatements and omissions of material facts, and acts and practices that operate as a fraud or deceit upon any person in connection with the purchase or sale of a security. Unlike Section 11 and Section 12 of the Securities Act, neither Section 10(b) nor Rule 10b-5 provides an express private right of action to securities purchasers injured by a violation. However, an implied private right of action has developed over time in the federal courts based on basic common law principles used in fraud cases.

Unlike Section 11 and Section 12 claims, a plaintiff in a private damages action brought under Section 10(b) and Rule 10b-5 must demonstrate that the defendant had a culpable mental state with respect to the misstatement or omission (*e.g.,* that the defendant made a misrepresentation with the intent to deceive). The courts have interpreted Section 10(b) and Rule 10b-5 to extend liability to defendants who were reckless with respect to the statements (*e.g.,* where the defendant had reasonable grounds to believe material facts existed that were misstated or omitted, but nonetheless failed to obtain and disclose such facts). Stated differently, a completely innocent misstatement may not result in Rule 10b-5 liability, but if the company's registration statement is drafted with a reckless disregard for its accuracy there will likely be liability exposure.

Presumably if the working group takes reasonable steps to ensure the accuracy of the registration statement, liability under Section 10(b) and Rule 10b-5 can be avoided. Accordingly, one reason why due diligence is important in the IPO process is that a thorough due diligence effort will go a long way to undermining any claim that there was recklessness if it turns out that the registration statement contains a material misstatement or omission. The diligence effort will also reduce the risk that the registration statement will contain a misstatement or omission in the first instance.

In a Section 10(b) case, the plaintiff ultimately must show actual damages caused by the misstatement or omission. In most of these cases, an appropriate measure is the out-of-pocket loss caused by such statement or omission. However, the courts have not always agreed on what constitutes an appropriate measure of damages in these cases.

The IPO process exposes the company and certain other participants in the process to potential liability. However, there are a number of things that the working group can do to mitigate the risk of liability. This is why due diligence takes on enormous importance for the participants in the IPO preparation process.

## What is Due Diligence?

Due diligence is the process of ensuring that the information in the registration statement is accurate, that the registration statement does not omit any required information, and that the registration statement does not omit any information necessary to prevent the statements in the registration statement, taken as a whole, from being misleading. Due diligence is an iterative, fact-finding investigation.

## What is the "Due Diligence Defense"?

Section 11 and Section 12 of the Securities Act provides a special defense against liability for certain participants in the IPO process, and it is commonly referred to as the "due diligence defense." The term "due diligence defense" does not appear anywhere in the federal securities laws, but it is generally understood to refer to the "reasonable investigation" defense against civil liability contained in Section 11 of the Securities Act, or to the "reasonable care" defense contained in Section 12 of the Securities Act. If the due diligence defense is established by a defendant, it will effectively shield the defendant from Section 11 and Section 12 liability.

In general, in order to establish a due diligence defense and avoid liability for a misleading registration statement, a working group member must prove that:

- the working group member made a reasonable investigation regarding the contents of the registration statement; and
- the working group member had reasonable grounds to believe, and did believe, at the time the registration statement became effective, that the statements in the registration statement were true, that there was no omission to state a material fact required to be stated in the registration statement, and that there was no omission to state a material fact necessary to prevent the statements in the registration statement from being misleading.

The due diligence defense is available to working group members but not to the company itself.

The due diligence activities that create the defense pursuant to Section 11 with respect to a registration statement are also useful in mitigating potential liability pursuant to Section 12 and Rule 10b-5.

## Why is Due Diligence Important to the Company, the Board of Directors and Management?

As noted above, the company does not have the benefit of a due diligence defense to claims regarding the contents of the registration statement. As a result, a company's only real defense against a lawsuit brought in connection with a public offering of its stock is to avoid the misstatement or omission that causes a lawsuit. Specifically, the company must ensure that the registration statement was materially accurate and that the registration statement did not omit any material information required to be contained in the registration statement or necessary to prevent the registration statement from being misleading to a potential investor. A material inaccuracy or omission, regardless of how innocent, will give rise to potential liability. Accordingly, the most important reason for due diligence is that it significantly decreases the likelihood that the registration statement will be deficient.

The second reason that due diligence is important to the company is that the company's officers and directors do have a due diligence defense. Under the federal securities laws, directors of the company and officers of the company who sign the registration statement may be personally liable to a purchaser of the company's stock if the registration statement is materially defective. However, the federal securities laws provide that if a director or officer can establish that he or she conducted a reasonable due diligence investigation, such person can avoid personal liability even if the registration statement is materially misleading.

## Why is Due Diligence Important to the Underwriters?

Underwriters also have a due diligence defense. Of course, underwriters would rather avoid the need to rely on the due diligence defense by simply making sure that the registration statement is accurate. Regardless of whether a court determines that the managing underwriters made a reasonable investigation in connection with the offering, a managing underwriter's reputation in the financial community may be tarnished if it appears that the underwriter failed to uncover a critical issue in connection with the company's business. In other words, the underwriters have a business motive, as well as a legal motive, to conduct thorough due diligence. In today's environment, underwriters and their counsel will do all that they can to perform a careful and conscientious diligence investigation.

In addition to the underwriters' general diligence investigation relating to the registration statement, underwriters and their counsel will interview the company's auditors and the company's audit committee regarding their respective roles in auditing and reviewing the financial statements and disclosure in the registration statement. The underwriters will likely insist on holding these meeting without management being present, although many auditors refuse to participate in such interviews without the company's chief financial officer present. The underwriters and their counsel will focus on the company's critical accounting policies, accounting controls and systems (and whether such controls and systems will be adequate to enable the company to meet its disclosure requirements as a public company following the IPO) any recommendations by the Company's auditors to improve such controls and systems and the trends in the company's business.

The underwriters will conduct due diligence regarding the company's officers and directors. Underwriter's counsel will review resumes and responses to detailed directors' and officers' questionnaires. The form of questionnaire is generally prepared by the company's counsel, and the responses enable the company to make certain required disclosures in the registration statement and to FINRA and to provide an efficient way for the underwriters to formalize a part of their due diligence investigation.

In recent years, underwriters have paid enormous sums of money to discharge settlements or judgments against them which resulted from alleged shortcomings in their due diligence investigations in connection with securities offerings. The most visible example of the consequences to underwriters of failing to perform adequate due diligence is provided by the litigation related to the SEC-registered bond offerings conducted by WorldCom in 2000 and 2001. WorldCom was a telecommunications company that rose quickly from obscurity to international prominence, and then imploded as a result of a massive accounting scandal. From the 1990s until its bankruptcy in July 2002, WorldCom had undertaken a number of SEC-registered offerings, including a bond offering in 2000 in the amount of $5 billion, and another bond offering in 2001 in the amount of $11.9 billion. At the time, the 2001 bond offering was reported to be the largest public debt offering in U.S. history. Members of the underwriting syndicates that participated in the 2000 and 2001 offerings received approximately $85 million in underwriting discounts and commissions. Eventually, these same underwriters paid nearly $5 billion to settle civil litigation claims relating to the 2000 and 2001 offerings that resulted from material misstatements in, and material omissions from, WorldCom's registration statements and prospectuses related to such offerings. The WorldCom litigation is discussed in greater detail below, and helps put into context the reasons why underwriters and their counsel spend so much time on their due diligence review.

**True Story: It's OUR Prospectus**

In a drafting session for a telecommunications equipment company's public offering, the CFO and one of the representatives of the managing underwriter were arguing over some proposed language for the "Risk Factors" section of the prospectus. The conversation went something like this:

*CFO:* I do not want to discuss this risk in the prospectus. It's ridiculous. It's just going to scare people off. I hired you to sell my stock, not to tell people why they shouldn't buy it.

*Underwriter:* It's not ridiculous. Our due diligence investigation revealed that this risk has been a real problem for the company in the past and there's a real probability that these problems could crop up again. If it does scare people off, then by definition it's material and we're all going to get sued if something blows up and we didn't disclose it.

*CFO:* This is MY prospectus and I'm not letting YOU people tell me how to write it.

*Underwriter:* The prospectus has our fingerprints on it too.

The underwriter was right. Underwriters, as well as the company, have liability if the prospectus is false (unless, of course, the underwriters can establish their due diligence defense).

In this case, the CFO begrudgingly allowed the risk factor language into the document and the offering passed without incident. Unfortunately, the company's fundamental disregard for public disclosure didn't change, and a few years later the company's auditors abruptly resigned, the SEC commenced an investigation of the company, and a criminal investigation was commenced against members of the management team.

## What's the Standard?

Under the federal securities laws, the standard for reasonable investigation and reasonable ground for belief is defined as "that required of a prudent man in the management of his own property." This is a negligence standard – as long as the members of the working group are not negligent in their efforts to confirm the material accuracy and completeness of the registration statement, the due diligence defense should be available to working group members other than the company. So, the investigation need not be perfect, just reasonable under the circumstances.

## Examples of Bad Due Diligence

Understanding what constitutes a reasonable investigation and a reasonable ground for belief lies partly in understanding what does not constitute adequate due diligence.

*Escott v. BarChris Construction Corporation,* decided in 1968, is the landmark case on this topic. To make a long story short, BarChris failed to disclose certain unusual accounting policies, related-party transactions, accounts receivable collection problems and an assortment of other financial irregularities in its public offering prospectus.

Shortly following the public offering, BarChris's precarious financial position collapsed and BarChris was forced to file for bankruptcy. A stockholder lawsuit was filed against the company, the underwriters, the principal officers, the non-employee directors and the auditors (that is, most of the working group). The case involved over 60 plaintiffs and 10 law firms, and took nearly 5-1/2 years to reach a final decision.

BarChris was found liable because the prospectus was materially misleading; as discussed above, as the issuer of the securities in the offering, the due diligence defense was not available to it. Most of the other working group members asserted that they had satisfied the due diligence standard. The court, however, ruled in favor of the plaintiffs. The BarChris case is illustrative of the types of behavior that will not satisfy the due diligence obligation of IPO working group participants. The court made the following points regarding the due diligence standard:

- An officer will not be held to a lower standard just because it is the officer's first time to be involved in a public offering;
- An officer may not rely exclusively on its attorneys and auditors to determine what the prospectus should contain, especially if the officer is aware of factual misstatements and omissions in the prospectus;
- An officer will not be excused of his or her due diligence obligations due to a lack of formal education, or a lack of understanding of the issues. An officer should make an effort to investigate matters which he or she does not understand;

- An officer may not rely on its auditors to expertize sections of the prospectus when the officer knows or has reason to believe that those sections are partially untrue;
- An officer may not rely on other members of the management team to ensure that the disclosure in the prospectus is accurate;
- A director cannot satisfy his or her due diligence obligations by briefly glancing at a preliminary draft of the prospectus in a board meeting. A director may not rely exclusively on management's general assurances that everything is "all right" to ensure that the prospectus is accurate and not misleading;
- A director may not satisfy his or her due diligence obligations by relying on general inquiries about the company that are not specifically related to the contents of the prospectus;
- A director will not be excused of his or her due diligence obligations just because he or she joined the company's board shortly before the offering;
- A director should not be satisfied with a prospectus that is a "scissors and paste-pot job" from a prospectus used by the same company in connection with an earlier offering where the company's business has changed significantly between the two offerings;
- A director should insist that minutes of executive committee meetings that he or she did not attend be written up and made available for the director's review prior to the filing of the registration statement;
- It may be appropriate for a director to have a discussion with the company's auditors if the director is aware that the company has from time to time in the past entered into unusual financial arrangements with the company's officers;
- When a prospectus takes many months to prepare, a director should investigate whether statements in an early draft are still accurate or need to be updated before the preliminary prospectus is distributed to potential investors;
- The underwriters may not be able to establish their due diligence defense if they fail to thoroughly follow up on potential problems and missing records identified by their counsel;

- The underwriters may not be able to establish their due diligence defense if neither they nor their counsel review copies of the company's material contracts, especially where such documents are necessary to substantiate important figures such as backlog;
- The underwriters may not rely solely on assurances from the company's officers that the prospectus is accurate;
- If the underwriters delegate due diligence tasks to their counsel and their counsel performs those tasks inadequately, the underwriters will suffer the consequences of their counsel's failure;
- A failure to follow-up on facts that would cause a reasonable person to engage in further inquiry or merely accepting a general indication that there is no problem without a reasonable attempt to verify the answer, may be evidence of a lack of due diligence;
- A director who is actively involved in the preparation of the registration statement may be required to do more to satisfy the due diligence defense than a director who is not so involved; and
- The failure to make a check of easily verifiable matters is evidence of a lack of due diligence.

Of course, these are only examples from one particular case. The due diligence review necessary in connection with any particular offering will be fact-specific and will vary depending on the unique facts and circumstances surrounding the particular company that is going public.

Another important lesson to take from *BarChris* is that it is important to create a record of diligence. Those members of the working group who are entitled to rely on a due diligence defense must bear the burden of proving that they in fact satisfied that duty of care. This is a sensitive area though, that must be reconciled with the document retention policies of the company and the underwriters. Officers and directors should work closely with their counsel in determining how to create a reasonable and effective record of diligence.

## Examples of Good Due Diligence

For years, *BarChris* was the leading authority on due diligence (or the lack thereof), leaving working groups to wonder just what sort of investigation would meet the standard necessary to establish a due diligence defense. In two important cases, *In re Software Toolworks, Inc. Securities Litigation* (decided in 1992) and *In re International Rectifier Securities*

*Litigation* (decided in 1997), the court went to great lengths to describe good due diligence. In both cases, the underwriters asserted that they were entitled to rely on the due diligence defense. In both cases, the court agreed. The following actions were helpful to the underwriters in establishing their due diligence defense:

- Interviewing company officials, exploring all aspects of the company's business;
- Reviewing trade journals and other industry-related publications to ascertain industry trends, market trends and competitive information;
- Contacting major customers to verify management's representations;
- Contacting major distributors to verify management's representations;
- Contacting major developers and licensees to verify management's representations;
- Contacting major customers of the company's OEM partners;
- Contacting an industry organization regarding the health of the company's market;
- Inspecting the factory in which the company's product was being manufactured;
- Subjecting the company's annual budget to line-by-line scrutiny;
- Reviewing the company's financial statements with the company's auditors;
- Reviewing the company's internal financial model with the company's management;
- Obtaining a comfort letter from the company's auditors;
- Obtaining written representations from the company that the prospectus was accurate;
- Obtaining written representations from the selling stockholders that the prospectus was accurate;
- Confirming with customers the company's return policy;

- Surveying retailers to confirm that no price cutting on the company's products was occurring;
- Contacting officials at an industry organization in order to follow up on negative information about the health of the company's market appearing in an article in a financial magazine;
- Following up on information discovered during the due diligence process that appeared to contradict the disclosure in the prospectus;
- Repeatedly asking the company about the current quarter's expected financial results;
- Discussing the current quarter's preliminary financial results with the company's auditors;
- Relying on financial statements expertized by the company's auditors;
- Confirming the company's OEM revenue recognition policy with other accounting firms;
- Reviewing confirmations and reconfirmations from each OEM;
- Questioning company personnel about the development and scheduled availability of products;
- Employing an analyst who is knowledgeable about the issuer company's industry;
- Interviewing consultants and other service providers to the company;
- Interviewing outside counsel on specialized matters such as patents and environmental issues;
- Having underwriters' counsel review the company's contracts, board minutes and similar documents;
- Confirming the company's backlog figures by reviewing purchase orders or company summaries of such;
- Having entire working group review the prospectus line by line; and
- Maintaining involvement by the company's management throughout the drafting process.

Other examples of good due diligence techniques can be derived from the securities regulators' occasional forays into proposing formal due diligence requirements upon underwriters. While these rule proposals have not been adopted, they serve as a good suggestion of diligence processes to consider. In 1973, the SEC requested that the NASD (the predecessor to FINRA) consider establishing appropriate standards of underwriter due diligence, as a result of SEC findings that there was significant difference among underwriters relating to due diligence practices (including disagreement as to which parts of the prospectus must be verified, the extent to which verification should be carried and the methods of such verification). As a result, the NASD (the predecessor to FINRA) proposed requiring the following minimum diligence standards for underwriters of public offerings:

- Review by underwriters' counsel of the issuer's corporate charter, bylaws, and corporate minutes;
- Examination of the audited and unaudited financial statements of the issuer, including footnotes, for the preceding 10-year period or for the entire period of the issuer's existence if less than 10 years;
- Review of all changes in auditors by the issuer within the preceding 10-year period, if applicable, and the reasons therefor;
- Review, with the issuer's auditors, of the financial statements that will appear in the prospectus;
- Review of the issuer's budgets, budgeting procedures and order/backlog figures;
- Review of internal projects of the issuer, including the intended use of the proceedings of the offering;
- Review of all pertinent marketing, scientific or engineering studies or reports concerning the issuer or its products during the previous 10-year period or for the term of the issuer's existence, if less than 10 years;
- Consideration as to the necessity of third-party review of appropriate portions of the inquiry if the issuer is a promotional organization or engaged in marketing high technology or previously unmarketed products;
- Investigation of the issuer's current and past relationships with banks, creditors, suppliers, competitors and trade associations;

- Communication with key company officials and appropriate marketing and operating personnel regarding the nature of the issuer's business and the role of each of the above individuals in the business operation;
- Inspection of the issuer's property, plant and equipment;
- Examination of business protection devices and related data such as trademarks, patents, copyrights and production obsolescence, among others;
- Review of available information with respect to the issuer's position within its industry;
- Review of pertinent management techniques, organization of management and the background of the management personnel of the issuer; and
- Preparation and maintenance of memoranda pertaining to all meetings or conversations regarding the issuer held during the member's performance by it of its obligation of adequate inquiry.

In addition to the lessons of recent cases and the NASD (the predecessor to FINRA) proposal, there are many other due diligence investigation steps that underwriters and their counsel will typically follow. These include (in part) the following:

- Review communications between the company and its stockholders;
- Confirm the capitalization of the company (tying it to the board authorizations, as well as to the paper records of the stock ledger and agreements relating to the issuance of stock);
- Confirm that securities issuances complied with applicable securities laws;
- Confirm contractual rights relating to securities (including voting agreements, participation rights and registration rights);
- Perform analysis of outstanding shares which were issued pursuant to exemptions from the registration requirements of applicable securities laws, including the ability of the holders to re-sell those shares;
- Review of material contracts and standard forms of contracts;

- Review of registered intellectual property of the company and other intellectual property protection strategies;
- Analyze outstanding litigation matters;
- Understand the company's principal sales channels and the structure of agreements relating to those channels;
- Review benefit plans for employees, including all equity compensation plans, agreements and arrangements;
- Circulate comprehensive directors' and officers' questionnaire;
- Review the company's web site and recent publicity regarding the company;
- Investigate the company's relationships with its material suppliers (identify limited source suppliers; identify actual or potential problems regarding suppliers);
- Examine management letters issued by the company's auditors;
- Conduct interviews with the company's auditors;
- Discuss with auditors the type of "comfort" that will be provided in the comfort letter;
- Discuss with the auditors any areas related to the financial statements that require further investigation or review;
- Review any recent appraisals or valuation reports;
- Review disclosure documents of comparable companies;
- Review the effect of the transaction on the company's financial statements;
- Review the company's corporate governance, including, in particular, the quality, independence and engagement of the company's audit committee;
- Conduct interviews with members of the company's audit committee, or chairman;
- Review industry sector reports for the company's industry; and
- Obtain report of recorded liens.

The foregoing is not a comprehensive list. Rather, it is representative of the types of inquiries that underwriters and their counsel will typically pursue in the IPO process.

## Different Diligence Standards for Different Participants

It is important to note that all of the foregoing procedures are not required. The investigation does not have to be perfect. However, the process must be reasonable. Notwithstanding the cases discussed above, members of the working group are not prohibited from relying on statements made by the company's management. On the contrary, reliance on management representations is acceptable, as long as it is reasonable. The reasonableness will depend on the facts and circumstances, including the materiality of the information, the difficulty of verifying the information and the absence or presence of information that calls into question the accuracy of the management representations.

Is the same level of due diligence required of every member of the working group? No. The due diligence required of the different working group members will vary according to their situations. As noted by the court in *Feit v. Leasco Data Processing Equipment Corporation* in 1971: "[w]hat constitutes a 'reasonable investigation' and a 'reasonable ground to believe' will vary with the degree of involvement of the individual, his expertise, and his access to pertinent information and data...[and] [w]hat is reasonable for one director may not be reasonable for another by virtue of their differing positions." The *Leasco* court indicated that underwriters might be held to a higher duty than some other members of the working group. The court noted that, since underwriters are expected to assume an opposing posture with respect to that of the issuer's management in an offering, the courts "must be particularly scrupulous in examining the conduct of underwriters." The court further noted that the adverse posture of the underwriters requires that they must be alert to exaggerations and rosy outlooks put forth by management and must play the role of devil's advocate in the transaction. On the other hand, in *Weinberger v. Jackson*, a non-employee director was able to defeat a lawsuit by demonstrating that, after reviewing six drafts of the registration statement and discussing certain aspects of the registration statement with management, he saw nothing suspicious or inconsistent with the knowledge he had acquired as a director. In *BarChris*, the court made it clear that the chief financial officer of a company cannot rely on the report of the company's auditors to the same degree as other members of the working group who are not as intimately familiar with the financial records, processes and performance of the company. In *Software Toolworks*, the court noted that underwriters cannot be held to have the same intimate knowledge of a company's affairs that inside directors have, and so the underwriters' duty must be considered in light of this more limited access.

It is an important part of the role of both company and underwriters' counsel in the IPO process to educate the working group on the potential liabilities from the transaction for their respective clients, and the steps that they may take to satisfy their due diligence duty obligations.

**Practical Tip: Helping the Outside Directors Build a Due Diligence Defense**

Outside directors (non-employee directors) typically do not have the same opportunities as the other working group members to participate in the due diligence and drafting processes. To assist the outside directors in building a due diligence defense, the company should include the outside directors on the distribution list for drafts of the registration statement, copies of SEC comments, responses to SEC comments and amendments to the registration statement. Shortly before the initial filing of the registration statement is made with the SEC, the board should hold a meeting at which it reviews the registration statement in detail with the company's officers, counsel and auditors.

## The *WorldCom* Case and the Due Diligence Defense

In general, there is relatively little case law or other guidance regarding the legal standards for establishing a "due diligence defense," and much of the relevant case law and guidance is several decades old. However, one of the most recent judicial pronouncements on the due diligence defense has provided a stark reminder of why it is important for participants in an SEC-registered public offering to conduct a thorough due diligence review. As noted above, WorldCom had undertaken many SEC-registered offerings, including bond offerings in 2000 and 2001. On July 21, 2002, only one year after the second of these bond offerings, WorldCom filed for bankruptcy protection, shortly after it announced a massive restatement of its financial statements. Class action securities litigation commenced against WorldCom, its officers and directors, its auditors, and the underwriters that had participated in the 2000 and 2001 bond offerings. Among the various claims against the underwriters, the plaintiffs alleged that the underwriters had violated Section 11 and Section 12(a)(2) of the Securities Act.

The plaintiffs alleged that the financial statements of WorldCom that were a part of the registration statements and prospectuses for the bond offerings contained misstatements and omissions of material facts. The fraud which caused such misstatements and omissions was eventually uncovered by an internal audit conducted by WorldCom in 2002, and WorldCom subsequently restated its financial statements. The underwriters argued that, among other things, both they and WorldCom's auditors were misled by WorldCom's management, and that it was not unreasonable for them to rely on both audited and unaudited financial statements reviewed by the auditors, which were considered experts under the Securities Act.

In an extensive opinion, the federal judge overseeing the case refused to grant summary judgment in favor of the underwriters with respect to alleged misstatements and omissions in the audited financial statements and the unaudited financial statements contained in the registration statements. The court also questioned whether the underwriters' due diligence effort was sufficient to satisfy the "reasonable investigation" standard set forth in Section 11 of the Securities Act.

The underwriters argued that under Section 11, they were entitled to rely on clean audit opinions from WorldCom's auditors relating to financial statements included in the registration statements. While the court recognized that reliance on such opinions and audited financial statements from auditors is reasonable, it also noted that such reliance may not be blind. If "red flags" emerge regarding the reliability of the audited financial statements or the audit opinions, the mere reliance on an audit will not be sufficient to avoid liability. The court noted that "red flags" may be those facts which come to the underwriter's attention that would place a reasonable party in the underwriter's position on notice that the audited company was engaged in wrongdoing to the detriment of its investors. They may also be those facts or circumstances that would suggest to an investor of ordinary intelligence the probability that he has been defrauded. Essentially, the court concluded that any information that strips an underwriter of its confidence in the accuracy of those portions of a registration statement premised on audited financial statements is a red flag, whether or not it relates to accounting fraud or an audit failure. In the WorldCom situation, the court agreed with the plaintiffs that there was sufficient information available to the underwriters to conclude that "red flags" existed with respect to the audited financial statements, and, accordingly, the court determined that the underwriters had not done enough to demonstrate that their reliance on the audited financial statements was reasonable.

With respect to the unaudited financial statements contained in the registration statements, the underwriters argued that they were entitled to rely on comfort letters from the WorldCom's auditors. However, because the court held that comfort letters are not considered statements "purporting to be made on the authority of an expert" under Section 11 of the Securities Act, the underwriters were required to demonstrate affirmatively that, after conducting a reasonable investigation, they had reasonable ground to believe, and did believe, that the unaudited financial statements were true. This decision by the court meant that unaudited financial statements that are included in a registration statement are not "expertized," and, therefore, underwriters must conduct a reasonable investigation in order to avail themselves of the due diligence defense. In the *WorldCom* case, the court found that the underwriters, in their summary judgment motion, did not show that they had conducted a reasonable investigation, and so could not show that they had reasonable grounds to believe that the unaudited financial statements were accurate. Their reliance on the auditors' comfort letters, without more, was simply not enough to satisfy the requirements of the due diligence defense.

The court noted that the word "investigation" connotes a "thorough" or "searching inquiry" both today and in 1933 when the Securities Act was passed. The court also cited past cases in which courts have noted that because the underwriter is the only participant in the registration process who, as to matters not certified by the accountant, is able to make the kind of investigation that will protect the purchasing public, the underwriter must not merely rely on representations by the management of the company, but rather, must play devil's advocate.

The underwriters in the *WorldCom* case argued that no amount of due diligence would have uncovered the accounting fraud. The court pointed out, however, that to rely on the due diligence defense, the underwriters must establish that they did perform a reasonable investigation, even if it would not have revealed the existence of fraudulent conduct.

After this opinion was handed down, the underwriters settled the lawsuit, and the total amount of the settlements between the underwriters and the plaintiffs in the *WorldCom* case came to nearly $5 billion.

As the court noted in the *WorldCom* case, underwriters cannot merely rely on representations of the issuer's management or assume the accuracy of the information provided by management. Underwriters, and, by extrapolation, all other participants in securities offering, must make an investigation reasonably calculated to reveal all of those facts which would be of interest to a reasonably prudent investor.

Although what constitutes a reasonable investigation may vary from case to case, some common practices in cases where offering participants have successfully relied on the due diligence defense have been discussed elsewhere in this chapter.

Moreover, the *WorldCom* case also indicates that, when any red flags emerge from the investigation, offering participants must investigate further and discuss them with the appropriate persons in order to arrive at their own informed conclusions and opinions about the information. With respect to the "expertized" portions of a registration statement (*e.g.*, audited financial statements), offering participants are not expected to conduct their own audits, but they must not have any reasonable belief that the information is false. If they do have such belief, then it is a red flag that must be investigated thoroughly.

## The Use of Experts

Section 11 of the Securities Act describes an "expert" as every accountant, engineer, or appraiser or any person whose profession gives authority to a statement made by such person, who has, with such person's consent, been named as having prepared or certified any part of the registration statement, or as having prepared or certified any part of the registration statement or report or valuation used in connection with the registration statement. An expertized portion of the registration statement is one that is prepared or certified by such an expert who, with such person's consent, is named in the registration statement as having prepared or certified a part of the registration statement, or report or valuation that is used in connection with the registration statement. The most common example of an expertized section of a registration statement is the report of the company's auditors and the accompanying audited financial statements. Other examples of expertization include opinions of special counsel, reports of engineers and reports of appraisers.

Courts take a narrow view in determining whether a portion of a registration statement has been expertized. For example, the involvement of auditors in the preparation of a registration statement will not result in the unaudited figures being expertized. Similarly, the participation of company counsel in preparing the registration statement will not result in expertization, even if company counsel is the primary drafter.

Each potential defendant, other than the issuer, has a due diligence defense to the potential liability imposed by Section 11 of the Securities Act. The burden of proof associated with each due diligence defense varies with the class of the potential defendant (*e.g.*, expert or non-expert) and whether the portion of the registration statement giving rise to the potential liability has been expertized.

- *Non-expert defendant sued for non-expertized portion of registration statement.* To invoke the due diligence defense, a non-expert facing potential liability for statements contained in a non-expertized portion of a registration statement must demonstrate that he or she had, after reasonable investigation, reasonable grounds to believe and did believe, at the time the portion of the registration statement giving rise to the potential liability was declared effective by the SEC, that statements in the portion of the registration statement were true and that there was no omission to state a material fact required to be stated therein or necessary to make the statements therein not misleading.

- *Expert defendant sued for expertized portion of registration statement.* To invoke the due diligence defense, an expert facing potential liability for statements made upon his or her authority as an expert or as a copy or extract from his or her report or valuation as an expert contained in a portion of a registration statement must demonstrate that either (1) he or she had, after reasonable investigation, reasonable ground to believe and did believe, at the time the portion of the registration statement giving rise to the potential liability was declared effective by the SEC, that the statements in such portion of the registration statement were true and that there was no omission to state a material fact required to be stated therein or necessary to make the statements therein not misleading or (2) such portion of the registration statement did not fairly represent such expert's statement as an expert or was not a fair copy of or extract from his or her report or valuation as an expert.

- *Non-expert defendant sued for expertized portion of registration statement.* To invoke the due diligence defense, a non-expert facing potential liability for statements contained in an expertized portion of a registration statement must demonstrate that he or she had no reasonable ground to believe and did not believe, at the time the portion of the registration statement giving rise to the potential liability was declared effective by the SEC, that the statements therein were untrue or that there was an omission to state a material fact required to be stated therein or necessary to make the statements therein not misleading, or that such part of the registration statement did not fairly represent the statement of the expert or was not a fair copy of or extract from the report or valuation of the expert.

**Practical Tip: A Few Ways to Minimize the Disruption Caused by Due Diligence**

Due diligence is inherently a laborious and disruptive process for the company. To keep due diligence running smoothly and in parallel with other aspects of the offering process, keep the following tips in mind:

1. *Anticipate.* Reduce the number of interruptions later in the process by obtaining due diligence checklists from the underwriters and their counsel prior to the organizational meeting. Assemble the requested materials as early as possible (and make a second copy, so that large copying projects are minimized during the busier parts of the process). If the checklist is not yet available, assemble materials based on the list at ***Appendix B*** and then supplement them as necessary. In addition, as factual information is added to the registration statement (*e.g.,* industry size data or industry growth rates) obtain copies of supporting sources.

   Failure to provide the underwriters with backup for statistics or other factual information may result in important marketing or other factual information being pulled from the registration statement on the eve of filing. It is a good practice to create a binder of backup materials that is indexed to the prospectus, so you have an organized source available for easy reference of all of the factual statements in the prospectus.

2. *Control the flow of documents.* Do not allow the due diligence process to get out of control. Designate a single person at the company as the primary contact for due diligence materials. Often the controller or another member of the CFO's staff is well suited for this job. A relatively new employee who is

**Practical Tip: A Few Ways to Minimize the Disruption Caused by Due Diligence (continued)**

unfamiliar with the company's records and history is not a good choice. The company's counsel should similarly designate one person to take primary responsibility for due diligence document matters. Requests for documents such as company contracts, stock option records or minute books should then be made through the designated company and legal contact persons. Obviously, company officers still will need to make themselves available to discuss key aspects of the business. It is also helpful if the company coordinates diligence production through its counsel. This way, the company's counsel can be sure that it is seeing everything that is provided to the underwriters' counsel.

As an alternative to manual or physical organization and production of due diligence materials to the IPO working group members as described above, issuers should consider organizing and managing the due diligence process by use of a virtual data room. With a virtual data room the issuer's due diligence materials are organized and maintained electronically on a secure website which members of the working group can access independently without involvement form the issuer or the issuer's counsel. Often, the use of a virtual data room enables a more efficient and cost-effective due diligence process.

3. *Be cooperative.* While due diligence requests rarely come at a convenient time, everyone benefits from the improved disclosure and liability protection resulting from thorough due diligence. Due diligence responsibilities often fall on the relatively junior members of the team, who are simply doing their jobs when they ask for backup information. Cooperating with these team members will avoid last-minute crises.

4. *Stay organized.* Many companies find it helpful to create a master set of indexed binders containing all requested due diligence materials. Responding to multiple due diligence requests then becomes a simple photocopying exercise. Also, if these materials are indexed based on the diligence request list, it is easy to determine what has, and has not, been provided and it is easy to refer back to previously produced

**Practical Tip: A Few Ways to Minimize the Disruption Caused by Due Diligence (continued)**

materials when the inevitable follow-up questions are asked throughout the process. It is helpful not only to organize the materials in accordance with the diligence list, but also to annotate the list with a brief description of each individual piece of diligence material provided so that it may become a useful guide to the assembled materials. It has also become increasingly common for the diligence materials to be housed in an electronic data room environment (which is often hosted by the company's financial printer or counsel) that permits multiple members of the working group to access the diligence materials at the same time and on an as-needed basis, which reduces some of the need to produce multiple photocopies of the materials and allows for updates to the diligence materials to be reviewed more effectively.

5. *Resolve issues early.* If a due diligence request is unclear or seems unreasonably burdensome or disruptive, the company and its counsel should discuss the issue with the underwriters and their counsel. Often the scope of a request can be clarified or narrowed. Invariably, issues will arise during the due diligence process. The company and its counsel should address these issues as quickly as possible.

# Chapter 8

# Preparing the Registration Statement and Going Effective

## Timeline

From the date of the organizational meeting until the closing, the IPO process takes roughly three to five months. An illustrative timeline is contained in ***Appendix C.***

## The Drafting Process

Drafting a registration statement is a group effort. Active participation without pride of authorship generally leads to the best result.

Company management and counsel should work together to prepare a draft of the registration statement for distribution to the working group several days prior to the first drafting session. The initial draft is primarily intended to get the drafting process started by giving the working group something to react to. Inevitably, the registration statement will go through many revisions before being filed with the SEC.

Preparing the initial draft of the registration statement will be a more productive exercise if done with input from the underwriters as to the general marketing positioning of the company. All members of the working group should review prospectuses (or other SEC filings) for comparable companies, including the company's competitors, that can be used as examples or counterpoints. Business plans, private placement memoranda and marketing brochures previously prepared by the company may provide material for the registration statement, although care should be given to making a balanced presentation.

The most effort and detail initially should go into the "Risk Factors," "Business" and "Management's Discussion and Analysis of Financial Condition and Results of Operations" sections. The financial statement pages also should be made available to the working group as soon as possible. The balance of the prospectus, often referred to as the "back half," contains management biographies, executive compensation data, descriptions of option plans and certain other information and generally can be added to a later draft. However, management should take care to get an early start on back half information, particularly executive compensation-related disclosure, as the SEC recently adopted rules that significantly expand the information required to be disclosed with respect to executive compensation.

Company counsel typically maintains the master draft of the registration statement and is responsible for processing changes from the working group. During the early drafting sessions, comments from the working group are likely to be broad, structural comments, such as “draft a new section to explain,” “rearrange this section to emphasize” or “condense these sections.” Turn-around time will be slow for the first few drafts, but can be improved if other members of the working group help draft or revise certain sections. For example, the CFO and the company’s auditors might make certain requested revisions to the “MD&A section,” while the underwriters might bring their marketing expertise to bear on certain parts of the “Business” section, particularly the “Industry Background” and “Strategy” sections. The ultimate drafting burden, however, tends to fall squarely on company counsel (because it typically has experience drafting registration statements) and the management team (because it has the company-specific knowledge).

**Practical Tip: Drafting Schedule**

An overly ambitious schedule for turning drafts of the registration statement can be counterproductive. Enough days should be allotted between each drafting session to allow company counsel to collect all comments, draft revisions and circulate the new draft. Time also should be allowed for the working group to read the new draft carefully prior to the next drafting session.

As the registration statement takes shape, the working group’s comments should become more focused, and company counsel can make specific changes with the working group during the drafting sessions. At this point, the size of the working group often shrinks to a core of representatives of each working group member. Not only is this cost-effective for the company, but it also makes the drafting process more efficient. The last few drafting sessions typically are held at the financial printer, where pages marked with changes can be submitted for revision as the group continues to work.

## Contents of the Registration Statement

Form S-1 is the registration statement form most commonly used by companies selling securities to the public for the first time. Form F-1 is available for certain non-U.S. issuers, as discussed in more detail in Chapter 11.

The principal SEC regulations affecting the Form S-1 registration statement are Regulation S-K and Regulation S-X. Regulation S-K dictates the content of the registration statement exclusive of the financial statements. Regulation S-X states the requirements applicable to the form and content of financial statements included in the registration statement. There are additional SEC regulations guiding the mechanics of the filing (such as fees and signatures) and the SEC's electronic filing system (EDGAR).

The Form S-1 registration statement consists of two parts. Part I contains most of the information about the company's business and financial condition. The prospectus, which is the portion of the registration statement delivered to investors, is Part I of the registration statement without the Form S-1 cover page. Part II of the registration statement contains supplemental information not required to be included in the prospectus, such as information regarding offering expenses, indemnification of officers and directors of the company, recent sales of unregistered securities, undertakings and exhibits and financial statement schedules. Part II is not required to be delivered to investors, although it is publicly available.

The prospectus portion of the registration statement is typically comprised of the following sections.

***Front and back cover pages***

The front and back cover pages of the prospectus contain certain information required by Regulation S-K, such as the company's name and the number and type of securities being offered. The company may elect to include additional information and color graphics or photos on the back cover page or inside cover pages to increase the marketing appeal of the document. The company should work closely with the financial printer if graphics or photos are to be used, as a certain amount of lead time will be required to prepare them for inclusion on the cover. The content of graphics and photos is subject to SEC review and can serve as the basis of liability. Therefore, graphics and photos included in the cover pages should not make claims or imply information that would be inappropriate to include in the body of the prospectus.

**Practical Tip: Get Artwork Started Early**

Many prospectuses include artwork on the inside cover page. The company should discuss this artwork early in the drafting process to develop a consensus from the working group regarding the artwork. Depending upon the company's internal graphics capabilities, designing the artwork, and the iterative process of review/redesign, can be a time consuming process. The SEC will want to see the artwork (or at least a nearly final draft of it) with the initial registration statement filing, or soon thereafter. If the artwork is delayed, it could slow down the registration statement review process.

### *Summary*

The Summary section, which comprises the first few pages of the prospectus, is the first substantive information about the company that investors will see. The Summary contains a brief description of the company and its business, typically consisting of a few paragraphs. It also sets forth the type and amount of securities being offered, the number of shares that will be outstanding following the offering, the use of proceeds and the proposed listing symbol. Condensed financial statement information is also included, generally consisting of a table showing information for the prior three or five years (or such shorter period as the company has been in existence), as well as information for the current year stub period and the corresponding prior-year period. A summary version of the most recent balance sheet, as well as a corresponding balance sheet adjusted to reflect the receipt and application of the offering proceeds, is also included. Companies also include their mailing address and telephone number, as well as their Internet home page address. Other interesting or useful information may also be included. In recent periods, the SEC has required that the Summary section present a more balanced view of the contents of the registration statement, and therefore summary risk factor disclosure should also be considered for inclusion in the Summary. The Summary section is often one of the last sections to be drafted due to the fact that it is a condensed version of the other portions of the prospectus.

### *Risk Factors*

Material risks faced by the company or factors that may cause investments in the company's stock to be risky should be disclosed in the "Risk Factors" section. To maximize protection from liability, risk factors should be specific and disclose enough information to place the risk in context and enable an investor to assess the magnitude of the risk. Each individual risk must be disclosed under a descriptive heading that clearly and concisely describes the risk and several different (even though related) risks should not be grouped under a single risk factor heading, but rather should be separated into different risk factors.

Risk Factors customarily are listed in the approximate order of importance and likelihood of occurrence. Although SEC regulations do not specify any particular required order, they do require that risk factors be organized logically. The exact order should be decided among the working group members. However, the SEC has provided some guidance with respect to the manner in which the risk factors should be categorized to make that section more readable. The SEC has noted that risk factors generally fall into three broad categories, and the risks should be specifically identified to the applicable category. These three categories are risks faced by companies in the industry, risks that are specific to the company and risks related to investing in the company's securities.

The SEC also indicates that companies should not use boilerplate risk factors copied from the prospectuses of similar companies or companies in the same industry. Rather, a company should provide disclosure that enables readers to understand the specific risks applicable to the company.

**Practical Tip: Risk Factors – A Cheap Form of Insurance**

During the process of drafting the company's registration statement, management will no doubt hear from company counsel or underwriters' counsel that good risk factor disclosure may be the company's "cheapest form of insurance." There are certainly plenty of examples in securities litigation where risk factor disclosure led to the dismissal of multi-million dollar securities class action lawsuits. A company should strive to prepare thorough and thoughtful disclosure of each material risk faced by the company.

***Use of Proceeds***

The registration statement must disclose the proposed use of the net proceeds of the offering or, if the company has no specific plan for the use of the proceeds, a discussion of the principal reasons for the offering. Examples of uses of offering proceeds include capital expenditures, working capital, debt repayment and acquisitions. If debt repayment is a use of proceeds, the company must make specific disclosures regarding the debt to be repaid. If the company identifies acquisitions as a use of proceeds, the SEC will require the company either to represent that it has no current plans, arrangements or intentions concerning specific acquisitions or to include certain detailed information about any proposed acquisition, including pro forma financial information if the acquisition is probable within the meaning of the accounting rules and would meet certain materiality thresholds. Therefore, the company should discuss any thoughts about acquisitions with its counsel as early in the IPO process as possible.

### *Dividend Policy*

This section addresses the company's current and anticipated dividend policy, including the frequency and amount of dividends. If there are any legal, contractual or other restrictions on the ability of the company to pay dividends, such as negative covenants in the company's bank line of credit, the nature of those restrictions should be disclosed.

### *Capitalization*

The company's capitalization information, including short- and long-term liabilities and stockholder equity, is included in tabular format both on an actual basis and on a pro forma basis reflecting the offering.

### *Dilution*

When new investors will be diluted immediately following the offering due to a difference between the IPO price and the net tangible book value per share, the prospectus must disclose (i) the net tangible book value per share before and after the offering, (ii) the increase in net tangible book value resulting from the offering and (iii) the amount of dilution from the public offering price which will be absorbed by the new investors.

### *Selected Financial Data*

In order to highlight trends in the financial condition and results of operations of the company, SEC Regulation S-K requires that selected historical financial data for at least the last five fiscal years (or since incorporation, if the company has not been in existence for five full fiscal years) be included in the registration statement. If financial statements for the interim period since the end of the last fiscal year are included in the registration statement, then the "Selected Financial Data" section should also set forth selected financial data for such period and the corresponding prior-year period. Companies should be mindful that the underwriters will require comfort from the company's auditors on all five years of financial data and if the company used different auditors in earlier periods, it should consider either contacting those auditors early in the process or have its current auditors re-audit the earlier periods.

### *Management's Discussion and Analysis of Financial Condition and Results of Operations (MD&A)*

*Overview and Results of Operations*

The MD&A section of the prospectus analyzes the company's operating results, capital resources and other relevant financial information. MD&A focuses particularly on year-to-year comparisons of the company's prior three fiscal years and a comparison of any subsequent interim period against the corresponding prior-year period. In a number of interpretative releases, most recently in "Commission Guidance Regarding Management's Discussion and Analysis of Financial Condition and Results of Operations" (Release Nos. 33-8350 and 34-48960, dated December 29, 2003), the SEC has stated that the purpose of MD&A is to provide readers with the information necessary for them to understand the company's financial condition and results of operations and should satisfy the following principal objectives:

- provide a narrative explanation of the company's financial statements that enables investors to see the company through the eyes of management;
- enhance the overall financial disclosure and provide context within which financial information should be analyzed; and
- provide information about the quality of, and potential variability of, a company's earnings and cash flow, so that investors can ascertain the likelihood that past performance is indicative of future performance.

Accordingly, a well-drafted MD&A does more than state the obvious about whether a line item has gone up or down. Good MD&A will help investors gain insight into the reasons behind the trends and will identify material events or uncertainties that could affect the company's future operating results or financial condition. Careful thought should be given to signaling anticipated changes from historical trends experienced by the company.

The SEC has suggested that companies provide an introductory section or overview to the MD&A section that facilitates the reader's understanding of the company's financial condition and operating performance. The SEC has cautioned that this overview should include the most important matters on which a company's executives focus in evaluating such matters. The SEC has suggested that a good introduction or overview should:

- include economic or industry-wide factors relevant to the company;
- inform the reader about how the company earns revenues and income and generates cash;
- to the extent necessary or useful to convey this information, discuss the company's lines of business, location or locations of operations, and principal products and services (but an MD&A introduction should not merely duplicate disclosure in the Business section of the prospectus); and
- provide insight into material opportunities, challenges and risks such as those presented by known material trends and uncertainties, on which the company's executives are most focused, both short- and long-term, as well as the actions they are taking to address these opportunities, challenges and risks.

*Liquidity and Capital Resources*

In its MD&A, the company also must assess its liquidity and capital resources. Specifically, MD&A must include an assessment and an analysis of material changes in the company's cash requirements, sources and uses of cash and debt instruments, guarantees and related covenants.

*Critical Accounting Policies*

MD&A must discuss the significant implications of the uncertainties associated with the methods, assumptions and estimates underlying the company's critical accounting measurements. MD&A must disclose the company's accounting measurements if:

- the nature of the estimates or assumptions is material due to the levels of subjectivity and judgment necessary to account for highly uncertain matters or the susceptibility of such matters to change; and

- the impact of the estimates and assumptions on financial condition or operating performance is material.

This disclosure should supplement, not duplicate, the description of accounting policies that must be disclosed in the notes to the company's financial statements.

*Off-Balance Sheet Transactions*

The SEC also requires that MD&A provide the following disclosure with respect to certain off-balance sheet transactions that have, or are reasonably likely to have, a material current or future effect on the company's financial condition, changes in financial condition, revenues or expenses, results of operations, liquidity, capital expenditures or capital resources:

- an identification and critical analysis of the arrangement; and
- an assessment of the likelihood of the occurrence of any known trend, demand, commitment, event or uncertainty that could affect the arrangement.

*Related-Party Transactions*

The SEC has stated that transactions involving related parties will not be presumed to be transactions carried out on a market basis due to the potential lack of arm's-length dealings. Accordingly, the SEC has advised companies that MD&A should discuss material transactions with related parties to the extent necessary for an investor to understand the company's current and prospective financial position and operating results, financial statements and the business purpose and economic substance of such related-party transactions. These disclosures are likely to include:

- the business purpose of the arrangement;
- identification of the related parties;
- a description of how the transaction prices were determined;
- a description of the terms or other transaction arrangements that differ from those which would likely be negotiated with clearly independent parties;
- a description of the methodology for the evaluation, if disclosures represent that the transactions have been evaluated for fairness; and

- a description of any ongoing contractual or other commitments as a result of the arrangement.

**Practical Tip: High-Level Attention to MD&A**

Delegating the primary drafting of the MD&A section to less experienced team members is a mistake. The MD&A, more than any other section of the prospectus, is the company's forum for setting investor expectations and helping financial analysts understand the company's financial model. Although it often lacks the marketing impact of the Summary or Business sections of the prospectus, the MD&A section is important to sophisticated investors. If thoughtfully prepared, the MD&A section can go a long way toward protecting the company in the event of securities litigation.

***Business***

SEC Regulation S-K requires a comprehensive narrative discussion of the company's business during the previous five-year period (or such shorter period as the company has been in existence). Specifically, this section of the prospectus should include a discussion of the company's industry segment, the company's products and services, capital equipment purchases, seasonality of the company's business, intellectual property, foreign operations and export sales, properties, sources and availability of raw materials, inventory practices, customer concentration, backlog, competition, research and development expenditures, regulatory environment, legal proceedings involving the company and number of employees. The Business section has evolved over time into a stylized format incorporating this information. Variations of the following categories are used, roughly in this order: Industry Background, Company Solution, Strategy, Products, Sales and Marketing, Customers, Manufacturing, Competition, Research and Development, Intellectual Property, Employees, Properties and Legal Proceedings. Of course, the exact layout and content of the information to be included is determined according to the company's specific business and the preferences of the working group, particularly the underwriters.

**Practical Tip: Anticipating the Comment Regarding the Customer List**

For obvious marketing reasons, companies and their underwriters often like to include a list of the company's representative customers in the Business section. Care should be taken to ensure that the customers named are truly representative and are not selected simply for their name recognition. The SEC frequently requires companies to justify their selections or revise their lists. The company should be prepared to defend its choices on the basis of revenues generated, units purchased or some other relevant criterion.

### *Management*

In general, the prospectus must state the names, ages, business experience and certain other information for each of the company's directors and executive officers. For the most highly compensated executive officers of the company, extensive compensation data must be presented in the format specified by Regulation S-K, as amended recently by the adoption of the new executive compensation disclosure rules described below. The management section also describes committees of the board of directors, corporate governance policies and practices, employment contracts, the company's stock plans and indemnification of directors and officers.

In August 2006, against a backdrop of investor outcries against excessive executive compensation and option-backdating scandals, the SEC adopted new executive compensation disclosure rules (the "New Compensation Disclosure Rules") with the objective of providing investors with a clearer and more complete picture of compensation to principal executive officers, principal financial officers, and a Company's other highest paid executive officers and directors. The New Compensation Disclosure Rules represent a thorough rethinking on the part of the SEC of the rules in place prior to the amendments, combining a broader-based tabular presentation with more-detailed, plain-English narrative disclosure supplementing the tables. The approach represented by the new rules is intended to promote clarity and completeness of numerical information through an improved tabular presentation, to continue to provide the ability to make comparisons using tables, and calls for material qualitative information regarding the manner and context in which compensation is awarded and earned.

Under the New Compensation Disclosure Rules, compensation disclosure begins with a narrative providing a general overview. Much like the overview that the SEC encourages companies to provide with their MD&A, the new Compensation Discussion and Analysis (CD&A) calls for a principles-based discussion and analysis of the material factors underlying compensation policies and decisions reflected in the data presented in the tables. The CD&A is intended to address in one place these factors with respect to both the separate elements of executive compensation and executive compensation as a whole. The SEC has published helpful guidance to ensure meaningful, non-boilerplate disclosure under the CD&A section, including its observations from the 2007 proxy season disclosure that may be found at http://www.sec.gov.

Following the CD&A, the New Compensation Disclosure Rules require significantly expanded and detailed tabular and narrative disclosure of executive compensation, organized into three broad categories:

- compensation with respect to the last fiscal year (and the two preceding fiscal years), as reflected in an amended Summary Compensation Table that presents compensation paid currently or deferred (including options, restricted stock and similar grants) and compensation consisting of current earnings or awards that are part of a plan, and as supplemented by a table providing back-up information for certain data in the Summary Compensation Table;

- holdings of equity-based compensation, such as stock options and restricted stock awards, that were awarded in prior years and are "at risk," whether or not these interests are in-the-money, as well as recent realization on these interests, such as through vesting of restricted stock or the exercise of options; and

- retirement and other post-employment compensation, including retirement and deferred compensation plans, other retirement benefits and other post-employment benefits, such as those payable in the event of a change in control.

It should also be noted that the New Compensation Disclosure Rules require tabular disclosure of director compensation for each director, together with narrative discussion of all of the elements of director compensation.

**Practical Tip: Avoid Nasty Surprises from the New Compensation Disclosure Rules**

Companies that first consider the requirements of the New Compensation Disclosure Rules during the IPO process may be in for a rude awakening at the penetrating nature of the disclosure requirements. The following are actions that companies can take in advance of the IPO process to avoid negative "surprises" from the far-reaching disclosure requirements of the New Compensation Disclosure Rules:

- *Get educated.* There is simply no better time than the months leading up to the initiation of an IPO process to get educated on the requirements of the New Compensation Disclosure Rules. As discussed below, doing so will enable companies to adopt best practices throughout the organization in advance of the IPO that will avoid pitfalls that may result in delays in the IPO process and that may foster good investor relations as a company enters life as a public company.

- *Do compensation "due diligence."* Nobody, especially not CEOs, CFOs, and CLOs and compensation committees, wants the IPO registration statement to include any nasty surprises, such as those that may arise from disclosure of perquisites or "perks" required under the new rules. Certainly, more sensational "perks" can be picked up in the financial or popular press and can be embarrassing to the executive, strain investor relations and result in harm to employee morale or a company's reputation with customers and partners. To avoid this possible scenario, companies should consider conducting due diligence on their compensation practices. For example, companies may consider preparing a "mock-up" of executive compensation disclosures or a "tally sheet" showing all elements of executive compensation early in the IPO process to show how the disclosures would look or how the numbers stack up under the new rules. Doing so may enable the compensation committee to make changes that will allow it to avoid, or at least mitigate, any nasty surprises.

**Practical Tip: Avoid Nasty Surprises from the New Compensation Disclosure Rules (continued)**

- *Focus on the compensation committee.* It is very important that members of the compensation committee are educated well in advance of the IPO process about the new rules and the disclosures that they will require. For example, compensation committees should review the SEC's list of questions that should be addressed in the CD&A. For many companies, this will mean that the compensation committee needs to review and revisit the overall objectives of the company's compensation program and consider how each specific element addresses the overall stated objectives and fits into the big picture of compensation.
- *Examine disclosure controls and procedures.* The new rules require the calculation of a number of new amounts, both for the tables and the narrative disclosure. Companies should ensure that its systems and disclosure controls and procedures permit it to capture the necessary information for the new disclosures.

***Certain Transactions***

The company must disclose certain transactions in which any director, executive officer or 5% stockholder (or any of their family members) had or will have a direct or indirect interest. Examples include purchases of stock by these individuals, transactions involving the company and another entity in which these individuals have a substantial interest or loans between the company and these individuals. The new Executive Compensation Disclosure Rules broadened the disclosure requirements in this area by employing a more principles-based approach and eliminating some of the bright-line instructions previously contained in the rules.

***Principal and Selling Stockholders***

The prospectus must disclose the total number of the company's securities owned by (1) any person known to the company to be the beneficial owner of more than 5% of the company's stock, (2) the company's named executive officers, (3) all directors (and director nominees), and (4) directors and executive officers of the company as a group, without naming them. The prospectus also must state what percentage of the total number of outstanding securities each such individual owns. If there are selling stockholders, information regarding the number of shares owned and the number of shares being sold by each selling stockholder also must be disclosed. The information presented must reflect not only stock currently held by such persons, but also stock which such persons have the right to acquire within 60 days.

***Description of Capital Stock***

This section provides a description of the important rights and characteristics of the securities being sold in the offering. Where the security being offered is common stock, this section of the prospectus can be fairly simple. Provisions of the company's certificate of incorporation or bylaws that would have the effect of discouraging a takeover attempt also must be described.

***Underwriting Arrangements***

SEC Regulation S-K requires a list of the underwriters involved in the offering and the respective amounts of stock each underwriter is allotted. This section also includes a description of the principal terms of the underwriting arrangements, any material relationship between the company and any underwriter involved in the offering, any conditions to the obligations of the underwriters to sell the securities, an analysis of restrictions on resale of the company's unregistered securities and the factors considered in determining the offering price of the securities. Each investment banking firm typically has its own preferred format for this section.

***Financial Statements***

Generally, the prospectus is required to present (1) audited balance sheets as of the end of the company's two most recent fiscal years, (2) audited statements of operations, statements of cash flows and statements of changes in stockholders' equity and footnotes for each of the company's three most recent fiscal years and (3) depending on the length of time between the end of the prior fiscal year and the date of filing or effectiveness, an unaudited balance sheet as of the end of the interim period and statements of operations, statements of cash flows and statements of changes in stockholders' equity for the interim period and for the corresponding prior-year period.

## A Word about Words: Plain English Disclosure

***Prospectus - disclosure document or protective document?***

One of the central means by which the securities laws protect investors is through rules requiring that a prospectus provide adequate information regarding the issuer and the offering to prospective investors. Key to the protective effect of these disclosure requirements is the clarity and accessibility of the disclosure – the most detailed description of a business is of little value to investors if it is conveyed in impenetrable language or if its presentation discourages investors from reading it in the first place. SEC rules have long required that prospectuses be clear, concise and understandable.

The prospectus, which was conceived as a means of providing information to investors (in part as a selling document and in part to protect investors), gradually came to be viewed by issuers as largely a defensive document. Increasingly, the driving force behind the language in the prospectus was the tenet that an issuer cannot be liable for something it has truthfully told the investors in the prospectus. This notion led to the natural corollary that more is better (that is, that more information, more detail and more repetition equates to more protection from potential liability). Once these defensive doctrines gained control of the drafting process, it became increasingly a legal document – the focus was the protective needs of the issuer more than the informational needs of the investors. The result was that, over the years, quantity supplanted quality, the prospectus became increasingly highly stylized and a great deal of non-specific boilerplate disclosure crept in, resulting in an incredibly dense and repetitive document.

### *The Plain English Disclosure requirements*

In 1997, the SEC adopted the Plain English Disclosure rules in response to these trends in disclosure. The Plain English requirements apply to the cover page and the Summary and Risk Factors sections of the prospectus, and are designed to make these sections more accessible to the average reader. Specifically, these sections must use the following six basic principles:

- Short sentences;
- Definite, concrete, everyday language;
- Active voice;
- Tabular presentation or bullet list presentation of complex information wherever possible;
- No legal or business jargon or highly technical terms; and
- No multiple negatives.

In addition, the rules require the company to design and format the cover page and the Summary and Risk Factors sections to make them easy to read and to highlight important information for investors. The rules permit companies to use pictures, charts, graphics, and other design features to make the prospectus easier to understand.

A copy of the SEC's *Plain English Handbook: How to Create Clear SEC Documents* is available on the SEC's web site at www.sec.gov.

## Filing the Registration Statement with the SEC

Once in its final form, the registration statement will be electronically filed with the SEC. The financial printers routinely provide the service of converting the registration statement into the electronic format required by the SEC, known as "EDGARizing," and transmitting the document to the SEC.

Prior to filing, the company must obtain an EDGAR ID number, deposit an amount sufficient to cover the SEC filing fee in a special SEC bank account established for this purpose, obtain signature pages to the registration statement from the company, its principal executive officer, its principal financial officer, its controller or principal accounting officer and at least a majority of the board of directors, and obtain an executed auditors' report and consent. Although these originally executed signature pages, reports and consents are not filed with the SEC, they must be obtained prior to the EDGAR filing, must be kept on file by the company for at least five years and must be provided to the SEC upon request.

## Filing Exhibits with the SEC and Requesting Confidential Treatment

Regulation S-K requires that certain documents, including the underwriting agreement, the certificate of incorporation, bylaws and other documents affecting the rights of security holders and certain material contracts be filed with the registration statement as exhibits. (*See* Chapter 3 – "Confidential Treatment" for a discussion of the SEC's rules regarding the filing of material contracts.) All exhibits must be filed electronically with the SEC via its EDGAR system, absent a hardship exemption. Preparing the exhibits for filing can require significant lead time, particularly when an electronic version in the proper format to EDGARize does not exist and must be created. (Yes, this means that those lengthy leases, lines of credit and other contracts may need to be scanned or re-typed by hand if electronic versions in the proper format do not exist.)

As discussed earlier in Chapter 3, exhibits filed with the SEC are not included in the prospectus, but they are publicly available when filed. Disclosure of the company's material contracts may be harmful to the company, especially where the contracts contain sensitive technical or financial information that would be useful to the company's competitors or hinder the company's future negotiations with its customers or suppliers. As a result of these hardships, the SEC will consider requests for confidential treatment of limited portions of material contracts.

To request confidential treatment of sensitive information, the company must prepare two versions of its exhibits. One version, which is filed via EDGAR and becomes publicly available, should have the sensitive portions redacted (that is, eliminated and replaced with a placeholder such as *****). The other version, which is submitted to the SEC in paper format only, should have the sensitive portions bracketed. This paper version of the exhibits should be submitted to the SEC with an accompanying letter identifying each item of information for which confidential treatment is sought and explaining in specific detail for each item the company's position as to why such confidential treatment should be granted.

Generally, the SEC will grant confidential treatment only if the request meets the following requirements:

- *Type of information entitled to protection.* The information to be granted confidential treatment must be entitled to protection under an exemption from the disclosure requirements of the Freedom of Information Act. Most confidential treatment requests rely on the exemption covering trade secrets and commercial or financial information.

- *Information not publicly disclosed.* Confidential treatment will not be granted if the information has been publicly disclosed already, either in the prospectus or elsewhere. The SEC will deny confidential treatment of publicly disclosed material, even if the disclosure was inadvertent, such as an erroneous EDGAR filing of unredacted exhibits.

- *Information not necessary for protection of investors.* The SEC must be persuaded that disclosure of the information is not necessary for the protection of investors. The SEC will not grant confidential treatment if withholding the sensitive information would obscure a material risk faced by the company.

- *Narrow request.* The request should be as narrow as possible. A common mistake is to request confidential treatment for an entire sentence or paragraph where only a few words or numbers are truly sensitive. The SEC will require that a request be amended if it is too broad.

- *Duration of request.* The company must state the specific term for which confidential treatment for a specific item is requested, along with an analysis that supports the period requested. The term should be as short as is necessary to protect the company.

- *Consent to release.* The confidential treatment request must contain the company's consent to the release of the information to other governmental agencies, offices or bodies and Congress.

The SEC examiner will review the company's confidential treatment request and respond with a comment letter. The company may respond by giving the examiner additional information to support the company's request, or may file an amendment to the registration statement in which exhibits are re-filed to include those portions of information for which the SEC is unwilling to grant confidential treatment. This process continues until the only redacted items are those for which the SEC has agreed to grant the company's request for confidential treatment.

**Practical Tip: Begin the Confidential Treatment Process Early**

The confidential treatment review process has its own timeline which is separate but parallel to the registration statement review process. In order to prevent the confidential treatment process from delaying the effectiveness of the company's registration statement, the company should submit its initial confidential treatment request as soon as possible after the initial filing of the registration statement.

Confidential treatment requests present a number of logistical challenges. For example, the agreement required to be filed may include confidential information of the company's major customer or strategic partner. Companies often must obtain consent from customer or partner legal departments, which can take weeks in large organizations. Moreover, concessions required by the SEC may require disclosure of confidential information of the company's customer or partner and resolution can require disclosure of information that can be damaging to the relationship. In summary, companies should plan early and strategize with counsel to ensure that the confidential treatment request process does not delay the offering or harm the company's business.

## Exchange Act Registration

While the IPO registration process focuses on preparing and filing a Form S-1 registration statement under the Securities Act, the company also must register its common stock pursuant to the Exchange Act if it plans to be listed on an exchange (including NASDAQ). Even if the company did not plan to initially list on an exchange, the IPO would eventually cause the company to trigger certain numeric thresholds requiring Exchange Act registration under the federal securities laws. Exchange Act registration is accomplished by filing a short registration statement on Form 8-A, which contains basic information about the characteristics of the company's stock (dividend rights, voting rights, etc.) and which identifies anti-takeover provisions in the company's charter documents. The working group generally does not focus on Form 8-A, which is not distributed to investors. Rather, company counsel usually prepares the document, which is reviewed briefly by underwriters' counsel prior to filing.

The Form 8-A is automatically effective 60 days after filing. Accordingly, care should be taken to prevent the Form 8-A from becoming effective pre-maturely if the IPO process is delayed. To do so could cause the company to inadvertently become subject to the public company reporting requirements of the federal securities laws. As a result, it is common to file the Form 8-A in close proximity to the anticipated effective date of the company's Form S-1 registration statement.

## SEC Review

The SEC's purpose in reviewing registration statements is to ensure adequate disclosure, not to determine the merits of the offering. In other words, the SEC's comments and the company's responses to them will focus on whether investors are being provided with sufficient disclosure to make an informed investment decision, not whether investing in the company at the proposed offering price is a good or bad idea.

Once the company's registration statement is filed with the SEC, it will be assigned to the division within the Division of Corporation Finance that has experience with the company's industry. This assignment is based on the company's SIC code, so care should be given to stating it correctly on the cover page of the registration statement.

An SEC staff attorney or analyst, referred to as the "examiner," will be assigned to review all aspects of the registration statement other than the accounting aspects, and a staff accountant will be assigned to review the financial statements and accounting-related issues. The examiner and the staff accountant review their respective portions of the registration statement separately, although they coordinate to discuss areas of concern and prepare comments. The examiner will deliver to the company, typically within 30 days of the initial filing, a letter containing the SEC staff's comments on the registration statement.

When the comment letter is received, it should promptly be circulated to the working group. A conference call or meeting should be scheduled for the working group to discuss the comments, the proposed responses and the timing of the response letter. The working group then will prepare an amendment to the registration statement and a response letter to the SEC. The response letter will address each comment made by the SEC, noting where the company revised the registration statement in response to the comment or the company's reasons for not revising the registration statement in response to the comment. The comment letter may ask that the company supplementally provide information to the SEC staff. The company's response letter will contain such supplemental information or an explanation of why the information is not available or should not be required. Depending on the extent of the revisions to be made in response to the SEC's comments, the working group may or may not convene at the financial printers for a drafting session prior to filing the amendment.

Once the amendment to the registration statement and the letter in response to SEC comments are filed with the SEC, the examiner and staff accountant will review them and provide another comment letter to the company. This process may go through several cycles until the SEC staff is satisfied with the disclosure in the registration statement. The SEC will not declare a registration statement effective until all outstanding comments have been resolved to the satisfaction of the SEC.

A key timing decision is when the company should print and circulate the preliminary prospectus, or "red herring." If a company distributes red herrings to potential investors before all substantive SEC comments are resolved, it runs the risk that the SEC will require amendments to the registration statement that result in disclosure that is materially different from the disclosure contained in the red herring. In that event the company and the underwriters will be required to convey the new disclosure to prospective investors prior to the time they make their investment decisions. This is typically done by means of a free-writing prospectus; however, if the new disclosure is significantly different from the disclosure in the red herring, the underwriters may determine that a complete recirculation of a new red herring is the most effective way to market the IPO.

For disclosure issues that are particularly complex or sensitive, it may be helpful for company counsel to call the examiner to discuss the matter and the proposed response. The company's auditors may become involved in discussions with the SEC staff if the issues are accounting-related. If the company reaches an impasse with an examiner or staff accountant on an important issue, the company may request to have the examiner's or accountant's supervisors within the division get involved. Most issues can be resolved by telephone, and it is often helpful to put the company's thoughts on the matter into a short letter that can be faxed to the SEC staff in advance of the call. Going over the examiner's head is not something to be done lightly or in an adversarial manner, as the company must continue to work with the examiner through the remainder of the transaction. Politely requesting the examiner's assistance in involving more senior members of the SEC staff is generally the best strategy. Protocol generally requires the company to obtain working group consensus before escalating an issue to higher levels within the SEC.

One ancillary challenge of navigating the SEC comment process is that the SEC now makes comment response letters available to the public on its web site no earlier than 45 days following completion of the SEC's review. If the company is concerned about any information provided electronically it must seek confidential treatment of such information when it files its response letter with the SEC. A common mistake to avoid is to simply state in the response letter that the company requests confidential treatment of the contents of the letter under the Freedom of Information Act. The SEC will not accept this kind of blanket response. Rather, the company will be required to redact each specific occurrence of confidential information from the electronic filing and then deliver a paper copy of the full response letter that includes the unredacted information accompanied by a separate, formal letter requesting confidential treatment containing an analysis of the justification for such treatment. Reaching a resolution with the SEC in this regard will require time, which can slow the offering process.

If the company submits information to supplement the comment response, the company generally may submit the information in paper so long as it requests that the information be returned following the SEC's review at the time of the submission. However, if the company submits supplemental information in paper and does not request its return (and request confidential treatment), the information must then be filed with the SEC electronically in full.

The SEC review process will span many weeks. The working group should consider whether the registration statement must be amended before going effective and whether a free-writing prospectus should be distributed to reflect changes that have occurred in the company's business between the initial filing of the registration statement and the desired date of effectiveness. This step should be taken even if SEC comments do not specifically call for it.

## Exchange Listing

Early in the offering process, the company will need to decide where to list its stock. Listing the company's securities on a securities exchange, such as the NYSE or NASDAQ, is the primary method for achieving stockholder liquidity and generally will be required by the underwriters.

Company counsel will assist the company in preparing its listing application and reserving the company's proposed trading symbol. The company should review the requirements of the desired securities market with its counsel and determine the likelihood of its application being approved. Although the specific requirements differ, each market requires that companies meet certain quantitative and corporate governance standards, certain of which are discussed in Chapters 1 and 3. In special cases, a company may petition a securities market for an exemption from certain listing requirements that the company falls short of satisfying.

***Appendix A*** of this guidebook sets forth the listing requirements for the NYSE and the NASDAQ Global and Global Select Markets. In 2004, NASDAQ launched a dual listing program permitting NYSE-listed issuers to dually list their stock on NASDAQ. Initially, six companies whose stock had been listed only on the NYSE elected to be dually listed on both the NYSE and NASDAQ — Apache Corporation, Cadence Design Systems, The Charles Schwab Corporation, Countrywide Financial, Hewlett-Packard Company and Walgreens. Since 2004, two of those original six dual-listed companies have switched their listing solely to NASDAQ after participating in the dual listing program, while two others have gone back to solely listing on the NYSE. As of December 31, 2007, securities of 11 companies were dual listed on NASDAQ and the NYSE. Companies desiring to be dual listed must meet the listing requirements of both NASDAQ and the NYSE. Both the NYSE and NASDAQ maintain that companies should regularly review their listing decision.

In recent years, the exchanges have increasingly subjected companies to a robust review process to ensure that a given company satisfies the exchanges' listing criteria and is otherwise suitable for listing on the applicable exchange.

Specifically, companies that apply for listing on an exchange will receive comment letters from the exchange addressing such topics as corporate governance, board and committee composition and function, and related party transactions, which comments may take several weeks to resolve.

### The NYSE vs. NASDAQ: The Big Board or the Electronic Market

During the height of the Internet boom market (1999-2000), NASDAQ was the clear IPO leader by capturing approximately 85% of the number of IPOs on primary U.S. markets. NASDAQ aggressively pursues new listings from companies undertaking IPOs, and for the past three years it has continued to be the IPO leader securing 59%, 67% and 62% of the IPOs on primary U.S. markets in 2005, 2006 and 2007, respectively, including companies such as Under Armour in November 2005 (which is now listed on the NYSE), Omniture, Inc. in June 2006, and Clearwire in March 2007. Typically, however, the NYSE captures the larger IPOs in terms of deal size (*e.g.*, the largest U.S. IPO in history — the $19.7 billion IPO of Visa in March 2008).

**NYSE**

The New York Stock Exchange, also known as the "Big Board," the largest and oldest stock exchange in the U.S. (and the largest cash equities market in the world), traces its origins back to 1792, when a group of brokers and merchants met under a tree at the tip of Manhattan and signed an agreement to trade securities. Unlike some of the newer exchanges, the NYSE still uses a large trading floor to conduct its transactions. The NYSE operates an auction market in which orders are electronically transmitted for execution, which is known as an "agency auction trading model." Specialists on the trading floor are charged with maintaining fair, orderly and continuous trading markets in specific stocks by bringing buyers and sellers together and, when circumstances warrant, adding liquidity

**The NYSE vs. NASDAQ:
The Big Board or the Electronic Market (continued)**

by buying and selling stocks for their own account. Floor brokers act as agents on the trading floor to facilitate primarily large or complicated orders. According to the NYSE, as of December 31, 2007, the NYSE and its sister exchange — NYSE Arca — were home to approximately 2,805 listed issuers representing a total global market value of approximately $27.1 trillion.

**NASDAQ**

Unlike the NYSE, NASDAQ (once an acronym for the "National Association of Securities Dealers Automated Quotation" system) does not have a physical trading floor that brings together buyers and sellers. Instead, all trading on NASDAQ is done over a network of computers and telephones. NASDAQ began when brokers started informally trading via telephone; the network was later formalized and linked by computer in the early 1970s. In the subsequent decades it has become a serious rival to the NYSE. For example, certain prominent companies, such as, Charles Schwab, Cisco, Google and Microsoft and Starbucks have opted to list on NASDAQ instead of the Big Board. According to NASDAQ, it is the largest electronic equity securities market in the U.S., both in terms of number of listed companies and traded share volume, and as of March 31, 2008, NASDAQ was home to 3,115 listed issuers with a combined market capitalization of approximately $3.9 trillion.

## Going Effective

At least two full trading days before the company and the underwriters intend to price and begin selling the stock, the company and the managing underwriters should submit letters to the SEC requesting that the SEC accelerate the effective date of the registration statement to a specified date and time. The registration statement then will be calendared for review by the Assistant Director of the division reviewing the registration statement. The company should request that its Exchange Act registration statement on Form 8-A be declared effective simultaneously. Before the SEC will declare the company's registration statement effective, FINRA must notify the SEC that it has no objections to the underwriting arrangements (this process is described in more detail in Chapter 9). The company also should notify the exchange where its stock will be listed of the anticipated date and time that trading will commence.

## Post-Effective Matters and the Closing

### *Final prospectus*

The SEC will declare a registration statement effective even though certain information that cannot be determined until immediately prior to the offering is omitted. Specifically, the SEC will not require the version of the registration statement that is declared effective to contain certain information about the offering price, the identity of the participants in the underwriting syndicate or the amount of underwriting discounts and commissions. However, no later than two business days after the earlier of the pricing or initial sale of the shares, the company must file with the SEC a final prospectus, also known as the "424(b) prospectus," filling in the missing information. This final prospectus is then professionally printed and distributed to purchasers of the company's shares.

### *The closing*

The closing is the settlement of the sale of the IPO shares. At its most basic level, the closing is an exchange of the IPO shares for cash. The company authorizes the delivery (typically electronic) of the stock in the names and denominations specified by the underwriters. The underwriters, in turn, deliver a check or wire transfer for the proceeds, net of underwriting discounts and commissions, to the company and selling stockholders.

Various documents are exchanged as called for by the underwriting agreement, including cross receipts, management certificates, legal opinions and an auditor's comfort letter. The closing is largely an administrative task. While representatives of the company and the underwriters may be present, the company's and underwriters' respective counsel essentially run the closing.

The federal securities laws require that the closing occur no later than the third business day following the pricing of the deal, unless the pricing occurs after the close of the market, in which case the closing may occur as late as the fourth business day following the pricing.

**Practical Tip: Don't Disappear until after the Closing**

IPO closings are usually anti-climactic events. Some executives choose to attend them and turn them into a small celebration. Other executives skip them altogether (especially on the West Coast, where closings are typically held early in the morning). Often at the end of the demanding IPO process, the CEO and CFO are anxious to go on vacations and get reacquainted with their families. Before disappearing, these management team members should check in with company counsel and make sure that all closing documents requiring their signatures are in order. Because so many of the closing documents require original signatures, it is preferable for the CEO and CFO to stay in town until the closing has been completed, just in case there are any last-minute changes in the closing documents that would necessitate additional original signatures.

***The underwriters' over-allotment option***

The underwriters of a public offering typically receive an option to purchase up to an additional 15% of the number of shares being sold to cover over-allotments, if any. These over-allotment shares are purchased on the same terms and conditions as the other IPO shares. In the process of marketing the IPO shares during the road show, the managing underwriters will build a list of prospective investors and allocations of IPO shares at given prices. At the closing, market and other factors may lead to excess demand for the IPO shares and the underwriters may elect to exercise all or part of the over-allotment option to satisfy some of this demand. The underwriters generally have up to 30 days following the effective date to exercise the over-allotment option. If this option is exercised at the effective date or shortly thereafter, the closing for the over-allotment shares can be combined with the closing of the initial IPO shares. If not, a second closing must be scheduled to settle the sale of the over-allotment shares.

# Chapter 9

# Underwriting Arrangements and Marketing

Most IPOs are made by means of a firm commitment underwriting, meaning that the underwriters are obligated to purchase all of the offered shares from the company at the offering price, less underwriting discounts and commissions. The underwriters then re-sell the shares to the public at the offering price stated on the cover of the prospectus. As a practical matter, the underwriters reduce their risk by entering into the underwriting agreement only after the road show has been completed, the SEC has declared the registration statement effective, the underwriters have solicited indications of interest from potential investors in the offering and the shares are ready to be traded. The underwriters further reduce their risk by syndicating the deal among a number of investment banking firms, sometimes as many as 10 or more.

## The Underwriting Fee

In a firm commitment underwriting, the underwriters charge a fee, known as the underwriting discount, as compensation for marketing and selling the deal. This fee is calculated as a percentage of the gross proceeds of the offering. For most IPOs , the fee is 7%. There are, however, rare exceptions. For example, in Seagate Technology's IPO, which priced in December 2002, the underwriting discount was 4.25%. In Google's IPO in August 2004, the underwriters' discount was 2.8%, in Clearwire's IPO in March 2007, the underwriting discount was 6% and in Visa's IPO in March 2008, the underwriting discount was 2.8%. The underwriting fee is divided among the managing underwriters and the members of the underwriting syndicate and the selling group, with the managing underwriters getting a larger share of the fee for managing the offering.

## FINRA Review of Underwriting Arrangements

The SEC will not declare a registration statement effective until FINRA has approved the underwriting arrangements. FINRA is a private, self-regulatory organization of the securities industry and operates subject to SEC oversight. FINRA was formed in 2007 through the consolidation of the NASD and the regulation, enforcement and arbitration functions of the NYSE. Prior to the formation of FINRA, all underwriting arrangements in connection with IPOs and certain other public offerings required review by, and approval of the NASD. Virtually every underwriter and broker/dealer in the United States that sells securities to the public is a member of FINRA. SEC rules relating to the acceleration of effectiveness of the registration statement require that the issuer company inform the SEC whether FINRA has reviewed the underwriting arrangements, and whether FINRA has determined that it has no objections to the arrangements. FINRA rules provide that an offering will not commence until FINRA has reviewed the terms of the transaction and has no objections to the proposed underwriting and other terms and arrangements. The required standard is set forth in the "Corporate Financing Rule," which is a part of the FINRA rules.

To facilitate its review, FINRA requires that three copies of the following documents relating to the offering be provided to FINRA for review:

- the registration statement;
- the preliminary and final prospectus (and/or any other document used to offer securities to the public);
- the underwriting agreement;
- the agreement among underwriters;
- the selected dealers agreement;
- any other document which describes the underwriting or other arrangements in connection with or related to the distribution, and the terms and conditions relating thereto; and
- any other information or documents which may be material to or part of such arrangements, terms and conditions and which may have a bearing on FINRA's review.

As these documents are revised or amended, updated drafts must also be provided to FINRA (including a marked copy showing the changes). Documents that are filed with the SEC on its EDGAR electronic filing systems are deemed to be filed with FINRA.

FINRA also requires that certain information regarding the basic underwriting arrangements and any relationships between the company, officers, directors and stockholders, on the one hand, and FINRA members, including the underwriters, on the other hand, be disclosed to FINRA. The proper application of several provisions of FINRA rules requires an understanding of the nature of these relationships. Specifically, FINRA requires information regarding the following:

- an estimate of the maximum public offering price;
- an estimate of the maximum underwriting discount or commission to be paid to the underwriters;

- an estimate of the maximum reimbursement of underwriters' expenses, and underwriters' counsel's fees (except for reimbursement of "blue sky" fees);
- an estimate of the maximum financial consulting and/or advisory fees to the underwriter and related persons;
- an estimate of the maximum finder's fee;
- a statement of any other type and amount of compensation which may accrue to the underwriter and related persons;
- a statement of the association or affiliation with any FINRA member of any officer, director or holder of 5% or more of any class of the issuer's equity securities, and of any beneficial owner of the issuer's unregistered equity securities that were acquired during the 180-day period immediately preceding the required filing date of the IPO;
- a description of factors to be considered in determining whether items of value received by underwriters prior to the offering were in connection with or related to the offering; and
- a description of any agreement entered into with any underwriter within the 180-day period immediately preceding the filing of the offering that provides for an underwriter or any of its related persons to receive items of value, warrants, options or other securities of the issuer.

FINRA will accept disclosure of these matters based on the member's or its counsel's reasonable inquiry into the background of the stockholders of the issuer and any transactions between the issuer and the underwriters and related persons, but will not accept disclosure that is merely based on the knowledge of the issuer. As a result, the underwriters and their counsel must make a reasonable inquiry sufficient to provide statements that FINRA can rely on when reviewing the offering. The procedure typically employed involves circulation of a detailed questionnaire to the company's securityholders, officers and directors. Company counsel and underwriters' counsel should coordinate to ensure that appropriate questionnaires are circulated to these parties to obtain the required information. Underwriters' counsel is responsible for providing the required information to FINRA and responding to any questions that FINRA examiner may have. Underwriters' counsel should keep company counsel informed of the progress of FINRA review so that the entire working group is aware of any timing issues that FINRA review process may create.

### Practical Tip: Send Out FINRA Questionnaires Early

Work early in the process with underwriters' counsel to prepare and distribute questionnaires to the company's directors, officers and stockholders soliciting information required for FINRA's review. It is sometimes a time-consuming process to collect the information, so getting started early will ensure that FINRA review process does not slow the offering. Also, there are additional documents that will be sent to stockholders, and sending the paperwork in a single package can streamline the process and increase chances of getting people to respond in a timely manner.

In reviewing the underwriting arrangements, FINRA considers whether the fees being charged by the underwriters are reasonable. FINRA rules provide that no member or person associated with a member may receive an amount of underwriting compensation in connection with a public offering which is unfair or unreasonable and no member or person associated with a member shall underwrite or participate in a public offering of securities if the underwriting compensation in connection with the public offering is unfair or unreasonable. FINRA does not publish what it considers "reasonable," as this will vary according to the circumstances of the transaction and general trends in the market (though the rules indicate that the amount of compensation that is reasonable, expressed as a percentage of the proceeds of the offering, will be higher if more risk is borne by the underwriters, and will be lower if the size of the offering is larger).

In determining the amount of underwriting compensation, FINRA not only looks at the underwriting discount and commission charged in connection with the IPO, but also looks at all items of value received or to be received by the underwriters and related persons which are deemed to be in connection with or related to the offering. Other items of value might include warrants or other compensation that the underwriters may have received in earlier transactions with the company. These other items of value may be aggregated with the IPO underwriting discounts and commissions for the purpose of determining whether the total underwriters' compensation is reasonable. In making the reasonableness determination, FINRA will review all items of value received by the underwriters and related persons during the 12-month period preceding the filing of the registration statement. Items received prior to such 12-month period are presumed not to be underwriting compensation. Items received during the 6-month period preceding the filing of the registration statement will be presumed to be underwriting compensation received in connection with the offering, unless the underwriters can demonstrate to FINRA that these other items of value were received in connection with a bona fide investment or for bona fide services unconnected to the IPO. FINRA rules provide a number of factors that are considered in determining whether items of value are received in connection with or related to an underwriting.

If the company has had prior transactions with members of the selling group, such as an investment from a venture capital fund affiliated with one of the underwriters, it will be important for underwriters' counsel to begin correspondence with FINRA on these issues early in order to determine whether there will be any difficulty in obtaining FINRA clearance of the underwriting arrangements.

FINRA also reviews the underwriting arrangements for other terms that may be unreasonable, including unreasonable provisions relating to reimbursement of expenses and rights of first refusal to underwrite future offerings. The standard forms of underwriting agreements used by most major investment banks do not contain provisions that would be deemed unreasonable under FINRA's rules.

FINRA also reviews the underwriting arrangements for conflicts of interest. Where the lead underwriter has a large investment stake in the company or certain other conflicts of interest exist, FINRA rules may require that a "qualified independent underwriter" set the offering price. As a practical matter, this means that one of the co-managers that has participated in the entire offering process will lead the pricing of the deal.

## The Underwriting Agreement

The underwriting agreement is the principal written document outlining the rights and obligations of the company, the underwriters and any selling stockholders. Each investment banking firm has its own form of underwriting agreement, and the form of the lead manager is the form that will be used for a given offering. Underwriters' counsel should obtain these forms from the lead manager as soon as the IPO process begins, and is responsible for tailoring this form for the particular offering and negotiating it with the company's counsel. The ability to deviate from the form will vary from underwriter to underwriter. Some underwriters are very protective of their form and want their in-house counsel to review any changes to the form for a particular deal. Others are more accommodating to changes from the form in this regard. In negotiating the terms of the underwriting agreement, the lead manager will typically be very conscious of the fact that changes may be used against it as precedent when negotiating an underwriting agreement in future offerings.

*Obligation to sell and buy the IPO shares*

The underwriting agreement is, in its essence, a stock purchase agreement. The primary purpose of the underwriting agreement is to establish the obligations of the underwriters to buy, and the company and any selling stockholders to sell, the IPO shares at a fixed price (stated in the underwriting agreement as the price per share to the company and any selling stockholders net of the underwriting discount). The underwriting agreement also typically includes provisions relating to an over-allotment option allowing the underwriters to purchase up to an additional 15% of the underwritten shares from the company or selling stockholders for a period of up to 30 days following the date of the offering in order to cover over-allotments of the stock.

*Representations and warranties*

The underwriting agreement contains numerous representations and warranties made by the company to the underwriters as to the accuracy and completeness of the registration statement as of its effectiveness and the prospectus as of the time of sale, and that the registration statement complies with applicable securities laws, and as to certain other aspects of the company's business. If stockholders of the company are selling shares in the IPO, then the underwriters will require the selling stockholders to make certain representations and warranties relating to their ownership and ability to transfer title to their shares, among others. Underwriters will occasionally request that a selling stockholder make representations and warranties similar to those made by the company as to the accuracy and completeness of the prospectus and as to other aspects of the company's business, or confirm that to the selling stockholder's knowledge the company's representations are true. The outcome of this request typically will depend on whether the stockholder is in a position to evaluate the accuracy of the prospectus and whether the stockholder has an economic incentive to bear the risk of making such representations and warranties.

*Indemnification*

This part of the underwriting agreement provides the manner in which risk will be allocated among distribution participants (the company, the underwriters and selling stockholders) in the event that the registration statement or prospectus contains or is alleged to contain a material misstatement or omission. The company will agree to indemnify the underwriters from liability arising from misstatements and omissions in the registration statement and prospectus, except to the extent that the liability arises from information provided by the underwriters specifically for inclusion in the offering documents. The underwriters will agree to indemnify the company from liability arising from misstatements or omissions, but only to the extent that the liability arises from information provided by the underwriters for inclusion in the offering documents. This information provided by the underwriters is typically very limited.

The negotiation of this section is closely related to the representations and warranties and involves many of the same considerations. Common points of negotiation include, among others:

- whether the company and the selling stockholders are jointly and severally liable for each other's representations and warranties, or only for their own;
- whether indemnification obligations of the company, the selling stockholders or the underwriters are capped at the amount of proceeds (or, in the case of underwriters, discounts) received; and
- whether the company will be liable for misstatements or omissions in a preliminary prospectus that have been corrected in a final prospectus when the final prospectus is not delivered as required.

***Covenants***

The underwriting agreement will have a section containing agreements by the company relating to the offering, which agreements are to be performed following the offering. The covenants vary from deal to deal, and from underwriter to underwriter, but there are some common covenants that are typically required. Typical covenants include that the company agrees to inform the underwriters of proposed amendments or supplements to the registration statement and prospectus, to inform the underwriters of the company's communications with the SEC and to promptly make all required amendments or supplements to the prospectus. Additionally, the company will be required to agree to provide copies of the final prospectus, comply with SEC reporting requirements and cause the IPO shares to be listed on the applicable exchange or market. The underwriting agreement will also clearly spell out which costs and expenses in connection with the IPO are to be paid by the company, the selling stockholders and the underwriters, respectively.

One covenant that is typically negotiated is the agreement by the company to refrain from issuing securities for a period of time following the effectiveness of the registration statement (typically 180 days, subject to extension under certain limited circumstances). Often there are exceptions to this restriction (for example, issuances upon exercise of outstanding options and warrants, and issuance under the company's equity compensation plans). The exceptions are typically one of the more heavily negotiated provisions in the underwriting agreement. The negotiation usually centers around issuances that the company contemplates making or reasonably expects it may need to make during the 180-day period following the IPO, and that may not be ordinary course transactions – such as issuances in connection with acquisitions and commercial transactions. Sometimes underwriters will allow an exception for certain acquisitions and other strategic transactions.

### *Closing conditions*

The underwriting agreement will list certain requirements that must be satisfied as conditions to the closing of the purchase and sale of the IPO shares and the closing of the sale of any over-allotment shares that the underwriters elect to purchase. These conditions typically include requirements that the representations and warranties of the company and selling stockholders are true and correct, that the company has performed its covenants that are to be performed prior to closing, that no material adverse event has occurred which impacts the company or the offering, that the opinions of counsel have been delivered, and that an auditor's comfort letter has been delivered.

### *Provisions allowing termination of the offering by the underwriters*

The underwriting agreement will also set forth certain situations in which the underwriters may abort the offering after the underwriting agreement has been signed, but prior to closing. These provisions typically include matters such as:

- the suspension of trading generally on national securities exchanges;
- the suspension of trading in the company's securities;
- the disruption of the securities trading settlement process;
- the declaration of a moratorium on banking activities; and

- the outbreak or escalation of hostilities or the occurrence of other conditions or events which, in the underwriters' discretion, make it impractical or inadvisable to proceed with the offering.

While these seem like remote scenarios, they do in fact become relevant at times. These provisions take on enormous importance to the company because there is potentially a large price to pay if they are invoked. In addition to the loss of the benefits of the offering, a company that has filed a registration statement and fails to complete the offering (especially under unusual circumstances) will have the burden of explaining why the failed offering is not a negative commentary on the company. However, underwriters regularly refuse to negotiate any provision of this section.

**True Story: The Eagle Computer Tragedy**

Eagle Computer Inc., an early microcomputer company based in Silicon Valley, stands out as one of those "what might have happened if. . ." type of stories from the personal computer boom era. On June 8, 1983, just hours after Eagle Computer's initial public offering, Dennis Barnhart, the company's young, energetic president and CEO, after celebrating his dream and newly minted millions by drinking with friends, set out on the road in his red Ferrari with the president of a local yacht company. According to reporters, Barnhart was driving at high speed when he failed to navigate a turn just one block from company headquarters. His Ferrari veered out of control, tearing through 20 feet of guard rail and crashing into a deep ravine, killing Mr. Barnhart and leaving his passenger in critical condition. Word of the accident spread quickly, shattering the jubilant mood in the company's crisp, modern headquarters and throughout the area's sprawling computer plants. The following day, the company's board of directors made the decision to rescind the initial public offering, withdraw the shares from trading and return investors' money. The company was able to complete its stock offering a week later, but at a lower price. However, Eagle Computer never truly recovered from the loss of Barnhart and eventually became another casualty of the IBM clone wars, forced to liquidate just three years later.

***Provisions regarding a default by one or more of the underwriters***

In the event that an underwriter defaults in its obligation to purchase shares, the agreement contains provisions that outline how the offering will proceed, if at all. The underwriting agreement will provide that if the defaulting underwriter is responsible for a relatively small portion of the offering, the other underwriters will be obligated to take responsibility for the defaulting underwriter's share. If the default is for more than the threshold amount, there is a period of time during which the underwriters and the company can make arrangements for the purchase of the defaulting underwriter's allocation of the offering shares, which arrangements are mutually satisfactory to the underwriters and the company. If such arrangements cannot be made in that period of time, the underwriting agreement will terminate. The stated period of time is typically 36 hours.

**Practical Tip: Conditions to Closing Involving Third Parties**

The underwriters' obligation to purchase the IPO stock is conditioned upon a number of documents being delivered at the closing. Many of these documents must be delivered by third parties. Examples include the comfort letter to be delivered by the company's auditors, legal opinions to be delivered by the company's counsel, legal opinions to be delivered by foreign counsel addressing matters related to the company's foreign subsidiaries, legal opinions to be delivered by counsel to the selling stockholders and legal opinions to be delivered by patent, regulatory or other expert counsel. To avoid last minute surprises and failures to satisfy closing conditions, particularly with respect to opinions of foreign counsel where time zone and language issues may present delays, these third parties should be included in the negotiation of the portions of the underwriting agreement describing the documents they are expected to deliver at the closing.

## The Comfort Letter

The comfort letter (also known as a “cold comfort” letter because the letter states only that the auditor is not in disagreement with any statements in the prospectus) is a critical part of the underwriters' due diligence process, and it is one of the key closing items for an IPO. The comfort letter is a letter from the company's independent auditors addressed to the underwriters (and often the company's board of directors, who also have a due diligence defense, as discussed in Chapter 7) that describes the independent auditors' review of the financial statements and other financial information derived from the financial statements contained in the prospectus, and the results of that review. It helps to demonstrate that the underwriters have made a reasonable investigation of the financial information included in the prospectus. Refer to Chapter 7 regarding due diligence for a further discussion of the role and limitations of the comfort letter in the due diligence process. A comfort letter is typically issued as of the date of pricing of the offering, and an update of the letter (the "bring down" comfort letter) is issued as of the closing of the IPO. Because liability attaches to the prospectus at the time of sale, the underwriters will typically request that the comfort letter dated as of pricing address both the preliminary prospectus and the final prospectus.

The form and content of comfort letters is governed by accounting professional standards as set forth in the Statement on Auditing Standards No. 72 – "Letters for Underwriters and Certain Other Requesting Parties," as amended by Statement on Auditing Standards No. 76 and Statement on Auditing Standards No. 86, which are published by the American Institute of Certified Public Accountants. The two primary principles that establish the scope of a comfort letter are:

- Independent auditors may properly comment in their professional capacity only on matters to which their professional expertise is substantially relevant. This effectively limits the accountants' assurances in the comfort letter to information included in the prospectus that is derived from the accounting records of the company and that is subject to the internal control policies and procedures of the company's accounting system. Examples of matters on which accountants cannot provide comfort include square footage of facilities, number of employees, beneficial ownership of securities and (subject to limited exceptions) backlog.

- The limited procedures that precede the issuance of a comfort letter (much more limited than an audit) provide only the basis for negative assurance with respect to the items reviewed. Negative assurance refers to a statement that nothing has, as a result of the procedures, come to the attention of the accountant that causes the accountant to believe that the reviewed items do not meet a specified standard.

Early in the process, the underwriters' counsel should discuss with the accountant expectations regarding the procedures to be conducted by the accountants in connection with the comfort letter and the timing of those procedures.

The accountants and the underwriters' counsel should specifically discuss the comfort letter requirements with respect to acquired entities to determine whether a prior auditor from that acquired entity will be required to deliver a comfort letter and any pro forma financial statements to determine which auditor will be providing comfort on the pro forma adjustments.

- The auditors should, soon thereafter, prepare a draft of the comfort letter, so that the underwriters and the auditors can agree upon basic form;
- As soon as the prospectus develops to a point where it is substantially complete, the underwriters' counsel should provide to the accountants a copy in which the numbers for which comfort is sought are circled; and
- The accountants should review the preliminary comfort letter markup, and discuss with underwriters' counsel any requested comfort that the accountants find problematic so that any issues can be resolved and the prospectus can be revised as necessary before it is filed.

The comfort letter will typically cover the following matters:

- A list of the financial statements included in the prospectus that the accountant has audited;
- A statement regarding the independence of the accountants;
- A statement that the audited financial statements included in the registration statement comply as to form with the accounting requirements of the Securities Act and related rules;
- A statement of the procedures carried out by the accountants with respect to unaudited financial statements for interim periods, when such financial statements are included in the prospectus, or condensed financial information from such financial statements is included in the prospectus;

- A statement that the unaudited interim financial statements comply as to form in all material respects with accounting requirements of the Securities Act and related rules;
- A negative assurances statement regarding the interim financial statements;
- A negative assurances statement regarding the absence of adverse changes in certain financial data (for example, capital stock, long-term debt, stockholders' equity, net sales and net loss) between the date of the latest balance sheet included in the prospectus and the date of the comfort letter;
- A list of procedures used to provide comfort with respect to specific financial data set forth in the prospectus which vary in the degree of comfort they provide; and
- A statement that the accountants offer no assurances that the comfort letter procedures will be sufficient to satisfy the purposes for which the comfort letter was requested.

**Practical Tip: Start Comfort Letter Process as Early as Possible; Establish Expectations**

The comfort letter is an easy matter to defer, particularly given the other priorities of an IPO process. However, the comfort letter negotiation can take a significant amount of time. This is exacerbated by the need for multiple levels of review within the accounting firm, particularly for difficult issues. If the resolution of comfort letter issues causes a delay in the IPO process, the company and the underwriters will typically become frustrated with the company's auditors and underwriters' counsel. In order to reduce the risk of delay, working group members should work together as follows:

- Craft prospectus disclosure with a view toward comfort. Many times, disclosure of a particular financial datum can be made in a variety of ways. If one method of disclosure (for example, expressing the datum as of a recent balance sheet date instead of as of the date of the prospectus) lends itself to an easier degree of comfort without negatively affecting the quality of the disclosure, the working group should consider that method of disclosure. Experienced counsel will guide disclosure in this regard during the drafting process.

**Practical Tip: Start Comfort Letter Process as Early as Possible; Establish Expectations (continued)**

- Discuss important financial disclosure items with the company's auditors early in the process. If the disclosure is important, but the auditors cannot address it in the comfort letter, the underwriters and their counsel will be required to perform due diligence on the disclosure in another manner, which can result in delays.
- Request a draft of the comfort letter from the company's auditors early in the process and ensure that the auditors review the preliminary comfort letter markup as early in the process as possible, to identify any unexpected issues.

## Other Underwriting Documents

The Agreement among Underwriters and the Selected Dealers Agreement are the principal written documents that govern the relationships among the underwriters and between the managing underwriters and the dealers included in the selling group. Each major investment bank has its own forms of these agreements. Investment banks typically sign on to each other's forms as master documents which apply to all future deals in which the banks participate. The primary purpose of the agreements is to grant the managing underwriter the authority to act on behalf of, and as the agent for, each of the other underwriters and dealers. The company is not a party to either of these agreements and, absent unusual circumstances, it is not necessary for the company or the company's counsel to review these documents.

## Selling Stockholder Documents

If selling stockholders are participating in the offering, a number of additional documents will be required. The purpose of these documents is to give the underwriters and the company comfort (prior to the time that they begin the road show) that the selling stockholders will actually participate in the IPO. Because neither the underwriters nor the company are contractually bound to participate in the IPO until the underwriting agreement is signed at the time of pricing, the underwriters and the company work on the basis of trust for the several months of the IPO process prior to pricing. When several selling stockholders are participating in the offering, that level of trust may not develop. Accordingly, the underwriters and the company must have some contractual assurances that, if the company includes the selling stockholders in the prospectus and the company and the underwriters market an IPO of a certain size assuming selling stockholder participation, no selling stockholder will change its mind and decide not to participate.

The documents required of the selling stockholders include a Power of Attorney, which appoints two or three individuals (often the company's CEO, CFO and CLO) as attorneys-in-fact with the power to negotiate and sign the Underwriting Agreement on behalf of the selling stockholders, and a Custody Agreement placing the selling stockholders' shares with a custodian to hold until the consummation or termination of the offering. These documents are often subject to some negotiation. For example, some selling stockholders may refuse to grant a Power of Attorney that enables shares to be sold at any price, and may request a "floor" price below which the attorneys-in-fact cannot sell the shares. It is important that these issues be resolved well in advance of the commencement of the road show.

In many cases, the company's counsel will also act as counsel for the selling stockholders. In other cases, particularly where a selling stockholder is a large institution, a selling stockholder may choose to retain its own separate counsel to negotiate the selling stockholder documents and underwriting agreement on its behalf.

## The Role of Research Analysts in the IPO Process

One of the important roles that financial institutions play in the IPO process involves research coverage of a company's stock. In order for the stock to have a healthy, liquid trading market after the IPO, it is important that respected research analysts track the company's industry and the company's performance and make recommendations to the investing public regarding whether they should buy the stock, sell the stock or hold it in their portfolios. The same institutions that provide investment banking services to the company typically also have a research group that provides research coverage.

### *The conflict problem*

The role of research analysts in the capital markets and the investment banking industry received a great deal of media and regulatory attention in the aftermath of the severe declines in the public equity markets following the late 1990s. Historically, analysts played a somewhat low-profile role in the industry. However, in the late 1990s, some analysts were gaining notoriety for their following among institutional and retail investors and the recommendations they were making, and were receiving substantial, well-publicized compensation packages. At the same time that a relatively small number of analysts was raising the profile of the industry, the role of the analyst in the securities industry was changing, and was resulting in potential conflicts of interest that eventually undermined investor confidence in the capital markets.

The SEC began investigating the role of Wall Street analysts in the securities industry in 1999 as it became apparent that the analysts were playing an increasingly prominent and pivotal role in the industry, and in the capital raising process in particular. The SEC reviewed industry practices and conducted examinations of the largest full-service investment banking firms on Wall Street. The results of the SEC investigation outlined a number of conflicting pressures to which analysts had become exposed, including the following:

- *Analysts were involved in the investment banking group's activities.* Analysts routinely participated in pitches for prospective banking engagements, participated in road shows, initiated analyst coverage on prospective banking clients, developed relationships with prospective banking clients and provided informal consulting to privately held companies.

- *Analyst compensation was tied to the investment banking groups.* Many firms paid their analysts based on the operating performance of the investment banking group. Some firms' investment banking groups were involved in the performance reviews of analysts and in determining analyst compensation. Favorable research reports could result in increased trading (and, hence, increased brokerage commissions) and in future investment banking engagements (and, hence, increased banking fees), which would boost the operating performance of the investment bank, and also the compensation of the analysts. Some firms also directly linked bonus compensation to analysts assisting in generating new banking business.

- *Investment banks and analysts often held equity positions in the companies they covered.* It was not uncommon for investment banks, and even their analysts, to hold stock in the companies for which the investment bank and the analyst provided research coverage. In some cases analysts had purchased shares of private companies in advance of the analyst's firm managing the company's IPO.

- *Inadequate disclosure of conflicts.* The disclosure of stock ownership conflicts was inconsistent across firms. The disclosure of investment banking relationships between covered companies and the analysts' firm was deemed inadequate.
- *Suspicious timing of favorable ratings relative to lock-up release.* There were numerous examples of analysts issuing favorable reports on companies coincident in time with the release of the post-IPO lock-up. These so-called "booster shot" reports had the effect of boosting the stock price at precisely the time that the company management and others subject to lock-up agreements were first able to sell their shares.

***The regulatory response***

A number of regulatory actions were taken to correct these perceived structural problems with the investment banking and research coverage businesses, and to instill confidence and trust in the public capital-raising process.

*Global Analyst Research Settlements.* Several large investment banks, and certain of their analysts, were subject to actions by attorneys general and state securities regulators for their practices involving research analysts. These actions were settled in April 2003. The settlement resulted in a number of major investment banking firms being enjoined from future violations of the rules they were accused of violating. These firms also agreed to make payments totaling $1.4 billion, including $875 million in penalties. The firms that were party to the settlement (which do not include all investment banks with research departments) also agreed to implement the various structural changes to their research organizations.

*New NYSE and NASDAQ Analyst Rules.* In May 2002 and July 2003, the SEC approved new rules for NASDAQ and the NYSE relating to analyst conflicts of interest which are specifically designed to ameliorate the risk of analyst conflicts that undermine the public confidence in analyst recommendations. The rules cover some of the same basic topics that the Global Research Analyst Settlement covered, but also go further. The rules apply to all investment banking firms (whether or not such firms were parties to the global settlement) and cover the following areas:

- *De-coupling research and investment banking.* The rules prohibit analysts from being under the supervision or control of the investment banking group, and require legal and compliance groups to act as intermediaries with respect to communications between research and banking groups regarding the contents of research reports. The rules also prohibit securities firms from directly or indirectly retaliating or punishing an analyst who issues an unfavorable research report or comments unfavorably in a public appearance.

- *Limitations on company review of reports.* The rules limit the extent to which analysts can have subject companies review their reports prior to issuance, and require legal and compliance groups to be copied on portions of reports submitted to subject companies for review.
- *Disclosure of investment banking compensation from companies covered by the bank's research.* The rules require disclosure in research reports if the analyst's investment bank managed or co-managed a public offering of securities of the subject company in the past 12 months or received investment banking compensation from the subject company during the past 12 months. Disclosure is also required for non-investment banking compensation received by affiliates of such banks, subject to certain exceptions.
- *Breaking links between analyst compensation and the investment banking business.* Securities firms are prohibited from paying any compensation to securities analysts that is based upon investment banking transactions, and analysts are required to disclose if their compensation is based in any part upon the operating results of the investment banking group. Analyst compensation must be reviewed and approved by a compensation committee that has no participation from the investment banking group. The committee must base its review in part upon the analyst's report performance and may not consider the analyst's contributions to the investment banking business of the firm.
- *Prominence of disclosures.* The disclosures regarding analyst conflicts must either be set forth on the cover of the research report, or the cover page must include an explicit cross reference to the pages in the report where the disclosure may be found.
- *Prohibition on research report issuance shortly following an IPO.* The rules prohibit securities firms from publishing research reports on, or making public appearances regarding, a company for which the firm acted as a managing underwriter in an IPO for a period of 40 calendar days following the IPO. The blackout period is 25 calendar days for securities firms that participated in the offering as an underwriter or dealer but not as a managing underwriter.

- *Prohibition on research report issuance near time of lock-up expiration.* Analysts are prohibited from publishing research reports or making public appearances for a period of 15 calendar days prior to or after the expiration, waiver or termination of a lock-up agreement restricting the sale of shares following a public offering. See Chapter 3 — *"Lock-up" situation.*

- *Disclosure of stock ownership by an analyst's firm.* An analyst must disclose in a research report or public appearance if the analyst's firm has an ownership position of 1% or more of a company that is a subject of the research report or the public appearance.

- L*imitations on trading by analysts in securities they cover.* Research analysts and members of their households are prohibited from (1) obtaining pre-IPO shares in companies that they cover, (2) trading in the securities of companies they cover for a period beginning 30 days prior to, and ending 5 days following, the issuance of a research report or a modification in the rating or price target for the company and (3) trading contrary to the analyst's recommendation with respect to a security. Legal or compliance personnel are required to approve securities transactions by supervisors of research analysts.

*Regulation AC (Analyst Certification).* SEC Regulation AC requires that underwriters that publish, circulate or provide research reports must clearly and prominently include in the reports:

- A statement by the analyst that the views expressed in the report accurately reflect the analyst's personal views about the companies and securities discussed in the report; and

- A statement as to whether any part of the analyst's compensation was, is or will be directly or indirectly related to the recommendations or reviews contained in the report. If the answer is "yes," the report must also disclose detail regarding the source, amount and purpose of that compensation, and an explicit statement that the compensation may influence the recommendations in the report.

The rule also requires investment banking firms to keep records of public appearances by their research analysts. Within 30 days of the end of any calendar quarter in which an investment bank's research analyst makes a public appearance, the investment bank must create a record that includes statements by the research analyst substantially similar to the statements required in research reports.

## Online Offerings

It has become quite common for a company's public offering to include an online, retail component. Internet-focused underwriters, however, typically play a limited role in the overall deal, with a major portion of the offering still being sold in a traditional institutional manner. The SEC has issued only limited guidance in this area, but a number of practices, supported by various levels of SEC guidance, have surfaced. E-brokers use differing methods for conducting the online portion of their offerings. Accordingly, the company should decide whether to include an online component to its offering early in the IPO process, fully understand the underwriter's procedures and ensure that such procedures have received SEC approval.

## Dutch Auction Offerings

Some underwriters utilize a method of distribution in IPOs that differs somewhat from the method traditionally employed in firm commitment underwritten offerings – the "Dutch auction." In a Dutch auction offering, the public offering price and allocation of shares are determined following an auction process conducted by the underwriters and other securities dealers participating in the offering. All investors, both individuals and institutions alike, have priority to buy shares based on the number that they indicate they are willing to pay (that is, the higher bids receive higher priority). The actual public offering price is then determined based on the "clearing price," which is the highest price at which all shares in the offering can be sold. Accordingly, investors whose bids are accepted will pay the price that is either the same or lower than their bidding price.

**True Story:**
**WR Hambrecht's OpenIPO wins bid in Overstock.com IPO**

In 2002, Overstock.com, Inc. (NASDAQ: OSTK), an online "closeout" retailer that offers discount, brand-name merchandise for sale over the Internet, completed its IPO using the OpenIPO® auction process created by William Hambrecht, Chairman and CEO of WR Hambrecht + Co. Hambrecht's auction process, a system designed by Nobel Prize-winning economist William Vickrey, uses a mathematical model to treat all qualifying bids in an even-handed

**True Story:**
**WR Hambrecht's OpenIPO wins bid in Overstock.com IPO (continued)**

and impartial way (similar to the model used to auction U.S. Treasury bills, notes and bonds).

In an OpenIPO auction, the entire process is private and the highest bidders win. Winning bidders all pay the same price per share – the public offering price. The auction is typically open for bids for three to five weeks prior to the effective date of the offering. Once the bidding concludes, all bids are assembled and, working from highest to lowest, the first bid price that will sell all the offering's shares is determined. This bid sets the "clearing price" or the maximum price at which all of the shares the company seeks to offer will be fully subscribed.

The company may choose to sell shares at the clearing price, or it may offer the shares at a lower offering price, taking a number of economic and business factors into account.

If the number of shares bid above the clearing price exceeds the number of shares in the offering, WR Hambrecht + Co. allocates the shares among the bidders on a pro-rata basis, with allocations rounded to multiples of 100 or 1,000 shares, depending on the size of the bid.

In its IPO, Overstock.com sold 3,101,000 shares of its common stock at a price of $13.00 per share.

## The Road Show

### *Logistics*

Once the preliminary prospectus has been printed and distributed, the management team and managing underwriters conduct the road show. Introduced in the 1970s, road shows today play an integral part of the IPO process. The primary purpose of the road show is to sell the offering shares to institutional investors.

A typical road show will last two to three weeks and will visit ten or more cities in the United States. If the company and managing underwriters have decided to include an international tranche or allocation in the offering, the road show will often include presentations outside the United States, usually in Europe.

The CEO and CFO should expect to make one or two large group presentations in each city, as well as several one-on-one presentations each day. Occasionally, the managing underwriters will have a second road show team with other members of the company's management, doubling the number of possible one-on-one presentations. It is not uncommon for the management team to meet as many as 200 potential investors over the course of a single road show.

The biggest logistical challenge is generally determining the schedule for the road show. As a practical matter, the road show is scheduled only after the company and the underwriters are satisfied that the company has responded sufficiently to the SEC's comments such that no SEC comments that would require a material revision to the prospectus are outstanding. Depending on the subject matter of the SEC comments, this may require one or two rounds of comments and responses before the company and the underwriters are comfortable scheduling the road show. For example, an unresolved comment relating to revenue recognition may warrant delaying scheduling the road show. The risk of beginning the road show before all material SEC comments are resolved is that if new material information is added to the registration statement after the preliminary prospectus is printed for use in the road show, the SEC could require the company to distribute and file a free-writing prospectus.

### *Preparation*

Preparation for the road show generally begins after the initial filing of the registration statement and during the period of time that the company is waiting for SEC comments.

**Practical Tip: Listen to the Underwriters**

Once the company's road show begins, there will be almost no time to make adjustments to the road show presentation. The underwriters have every incentive to ensure a successful road show, and therefore company management should follow the practical suggestions of the underwriters when it comes to preparing for this event. Underwriters often suggest the company retain a professional coach to help management improve its road show presentation skills. Underwriters may also recommend that the company engage a design firm to help create the visual portion of the presentation.

Within a few days prior to the road show, the company will make presentations to the managing underwriters' sales forces. In addition to being an excellent opportunity for the management team members to refine their presentations, these sessions also serve the purpose of educating the sales forces about the company to enable them to call on their retail accounts to solicit interest in the offering.

### *Presentations*

Road show presentations are designed to provide large amounts of high-level information in a very short period of time. As a general rule, the entire presentation should take 30 to 45 minutes and is often shorter. Group presentations are virtually the same format and length as one-on-one presentations, although one-on-ones are generally more conducive to detailed Q&A. As a practical matter, the company should recognize that not all attendees will have studied the prospectus prior to hearing the company's presentation, and should prepare the presentation accordingly.

A representative of the lead underwriter typically introduces the management team and makes a few comments regarding the company and the industry.

The CEO then speaks. Investors do not expect more than an overview of the company, given that they can review the detailed financial and business information contained in the prospectus to the extent that they are interested. The CEO's presentation should describe the company's history, business, products and services, growth strategy, sales and marketing, customers, competitive situation and other pertinent information about the company.

The CFO typically follows the CEO's presentation with a review of financial and accounting matters. This involves a review of the company's financial statements and general financial status.

The company's road show presentation should not disclose any material information about the company that is not contained in the prospectus. Discussions of projections or other forward-looking information can be particularly dangerous because such discussions cannot be protected by the safe harbor described in Chapter 10. Moreover, information presented in a road show discussion can serve as the basis for a claim under the anti-fraud provisions of the federal securities laws, and, if material, may raise questions about the adequacy of a prospectus that omits the information.

Although the federal securities laws allow oral and audio/visual communications such as the road show presentation during the pre-effective period, no written materials may be handed out to investors, analysts or other spectators except for the preliminary prospectus. Copies of the slide show presentations and other written or recorded materials used in the road show presentations may not be distributed.

### *Electronic Road Shows*

A majority of IPOs now include an Internet-delivered electronic road show in addition to the traditional physical roadshow.

The offering reforms adopted by the SEC in 1995 set forth a number of rules regarding electronic road shows. The initial distinction made by the rules is based on whether the electronic road show is solely a live one-time transmission or is archived and available for viewing (or listening) by a prospective investor at a time other than the time of the live broadcast. If it is only a live transmission, the electronic road show is not considered a free-writing prospectus (though it is still considered an offer subject to Section 12(a)(2) liability). If the electronic road show is archived, it is considered a free-writing prospectus. Since the adoption of the new rules, most electronic road shows in IPOs have been archived (and thus available to investors on demand during the offering), and are considered free-writing prospectuses.

When an electronic road show for an IPO is archived, the company and the underwriters must make a decision whether to limit the prospective investors who can view the electronic road show to a defined group or to make the electronic roadshow available to any potential investor. If the electronic road show is available to any prospective investor, it need not be filed with the SEC. However, if access to the electronic road show is limited based on the identity of the investor, the electronic road show is required to be filed with the SEC as a free-writing prospectus. As a result of these conditions, since the adoption of the new rules most companies and underwriters have made the electronic road show widely available to the general public.

As discussed earlier with respect to online offerings, the company should decide early in the IPO process whether an electronic road show component will benefit its offering, fully understand the underwriters' procedures and confirm with the underwriters that such procedures have received SEC approval.

## Pricing the IPO

### *Incentives*

The incentives of the company and the managing underwriters are mostly, but not entirely, aligned when it comes to pricing the IPO. A higher price raises more money for the company with less dilution and also generates higher fees for the underwriters. An unsustainably high price, however, can harm the company and the underwriters. Disappointing aftermarket performance may cause investors and analysts to lose interest, make a follow-on offering more difficult, and even expose the company to securities litigation. Similarly, poor aftermarket performance can expose the underwriters to potential liability and tarnish the underwriters' credibility with their institutional accounts. The company and managing underwriters therefore have an incentive to establish as high a price as possible while still ensuring some after-market demand that will support the trading price in the days following the IPO. However, the company and the managing underwriters do not always see eye-to-eye on the exact valuation that will accomplish these dual objectives, especially since the underwriters face conflicting pressures to place stock with favored brokerage customers at a favorable price.

### *Valuation analysis*

The underwriters use a number of different financial models to determine company valuations. By the time the deal is priced, the company will be familiar with the valuation approach used by the managing underwriter, which will have presented its approach to the company first during the underwriter selection process and then again prior to recommending a price range to include in the preliminary prospectus for marketing the offering during the road show. If there are comparable companies in the same industry which are already publicly traded, the underwriters generally will use a similar multiple of earnings, revenue or cash flow in valuing the company. Another method of valuation, which is particularly useful in valuing companies with no publicly traded counterparts, is a discounted cash flow, or net present value, method whereby projected cash flow or earnings for some future period are discounted to a current valuation.

Companies should expect some discount to be taken after a valuation of the company is determined. First, this discount reflects the desire to ensure after-market demand as discussed above. Second, it reflects the relatively higher risk of investing in a young, unproven company compared with more established companies with more resources in the same industry segment.

Finally, the managing underwriters will have a good feel for the demand for the company's stock as they near the end of the road show and see the levels of potential orders. During the road show, the underwriters will be tabulating the indications of interest as they come in and should be able to provide the company with visibility as the "book" is built as the road show progresses. In fact, as discussed in greater detail earlier in this chapter and Chapter 2, certain rules proposed by FINRA mandate greater transparency into the IPO pricing process. A particularly strong or weak demand for the company's stock will influence the final valuation, regardless of the preliminary results of the various calculations described above. This bears out in particular because many institutional investors have analysts that develop their own valuation models which may be different, positively or negatively, than the underwriters' model.

### *Final pricing negotiation*

The final pricing negotiation between the company and the underwriters will occur as the registration statement is ready to be declared effective and the underwriters are ready to sign the underwriting agreement and commence sales of the stock. Because events at this stage move rapidly, it usually is not practical for the company's entire board of directors to convene for the purpose of considering and approving the final price. Therefore, boards of directors typically delegate this authority to a "pricing committee" consisting of two or three members, usually including the CEO and one or more outside directors. As discussed earlier in this chapter, the company and the underwriters typically require all selling stockholders to name an attorney-in-fact with the power to negotiate and determine the price on behalf of the selling stockholders.

During the pricing call with the company's pricing committee, the underwriters will present data to support their pricing recommendation. This data may include performance of the equity markets in general, the performance of comparable companies in recent weeks and the corresponding valuation multiples, the book of institutional investor demand and the extent to which the offering is oversubscribed, expected aftermarket interest in the company's stock, price information and aftermarket performance of other recent IPO companies. Based on the data, the underwriters will make a recommendation that will form the basis either of an agreement, further negotiation or a decision to postpone (or cancel) the offering.

# Chapter 10

# Now that You're Public...

Once a company is public, life is noticeably different. Some of the most significant areas of change are discussed below.

## Managing Relations with Wall Street

One of the things that management of a new public company finds most stressful, and for which it often feels inadequately prepared, is dealing with Wall Street research analysts and disclosure issues in general. Managing analyst contacts has been characterized as "fencing on a tightrope." On the one hand, having well-respected analysts publishing reports regarding the company raises the company's visibility with investors and contributes to liquidity in the stock. On the other hand, if managed poorly, contacts with analysts may lead to lawsuits or SEC enforcement actions based on claims of selective disclosure of material, non-public information or insider trading.

Public companies use analyst conference calls (or webcasts on the Internet, or both), in conjunction with press releases issued prior to such calls, as one method of providing new or updated information to the market. Most of these conference calls are held following the end of the company's fiscal quarter to discuss financial results. These calls are preceded by an earnings press release, which is also furnished on Form 8-K with the SEC prior to the call. Companies also use these calls (or webcasts) to discuss unexpected material or irregular news (*e.g.,* corporate reorganizations or acquisitions, including mergers, or other significant developments). Research analysts attend these calls to evaluate the information disclosed by the company and then publish reports to inform investors of their analyses. Each research analyst hopes to build an accurate model of the company's future performance.

### *General Disclosure Obligations*

*General rule*

The securities laws have historically given companies latitude to determine when and how they communicate material information to the public. The courts and the SEC have stated as a general rule that, in the absence of insider trading or previous inaccurate disclosures, a company has no affirmative duty to disclose material information, apart from an obligation to make required disclosures in their periodic and current reports filed pursuant to the Exchange Act (*e.g.,* Form 10-K, Form 10-Q and Form 8-K), as well as annual reports and proxy statements.

However, such a general rule has little practical value in light of the day-to-day circumstances that are widely acknowledged to impose an affirmative obligation of disclosure on a public company. In fact, a more open communications policy is encouraged by constant inquiries from the investment community for current information, internal pressures from employee stockholders and insiders with respect to purchases and sales of the company's stock, and the company's motivations in apprising the investment community of current developments. In addition, as discussed in greater detail below, the NYSE and NASDAQ require listed companies to promptly disclose material information. As a result, most public companies adopt affirmative policies to disclose material information, subject to certain exceptions (*e.g.*, when it is necessary to keep the information confidential or when the company has a legitimate business reason for not disclosing it). As discussed in greater detail below, Regulation FD prohibits public companies from selectively disclosing material information to certain persons, such as securities analysts and stockholders, prior to public disclosure of the information.

*Timing issues*

Once a company concludes that certain information is material, the company must then determine when such information must be disclosed to the public. Materiality determinations are often difficult, and companies should consider various timing issues and concerns, such as whether the company is in a position to adequately and accurately disclose the information. Disclosure is appropriate only when the information to be released by the company is accurate, clear and specific. For example, information that is released prematurely may be susceptible to misinterpretation. As a general matter, the courts concede that the timing of disclosure of material information, outside a company's periodic and current reporting obligations, is a matter of the company's business judgment. However, most companies as a matter of practice follow the rule that unless there is a legitimate business reason for delaying disclosure, a company should promptly disclose material information. Generally, a company has a legitimate business reason for non-disclosure when disclosing information would likely adversely impact the ability to reach agreement on a pending transaction (*e.g.*, a merger or product partnership). However, when price, terms and structure have been agreed upon, courts have ruled the information generally becomes material.

*Exceptions requiring disclosure*

Notwithstanding the general rule discussed above, there are certain specific circumstances in which a public company will have an affirmative disclosure obligation. A company has an immediate duty of disclosure if insiders possessing material, non-public information are trading in the company's stock (except for trading pursuant to Rule 10b5-1 plans discussed later in this chapter), or if the company itself is involved in such trading.

In some circumstances, a company will have a duty to correct existing information in the marketplace that is inaccurate when published. Such a duty may well arise where such previously existing information was published by the company, is attributable to the company through express or tacit endorsement in one form or another, or where such information was generated by a person or institution with whom the company has a special relationship. However, a company generally does not have an obligation to rectify or correct rumors in the marketplace that are not attributable, directly or indirectly, to the company. A company may also have a duty to update existing information that it put in the marketplace that is still material information but subsequently becomes incorrect due to later facts.

Additionally, even if a company is not required to disclose material information under the federal securities laws, the company is subject to NASDAQ rules or other applicable exchange rules. NASDAQ requires listed companies to promptly disclose to the public material corporate information and that such information be provided to the NASDAQ MarketWatch Department by telephone and facsimile at least ten minutes prior to public announcement. Also, the NYSE requires listed companies to promptly disclose to the public material corporate information via press release. The NYSE has stated that it continues to believe that a press release constitutes the single best way to ensure that new material information released during the trading day becomes available to all traders and the investing public as promptly as possible.

***Disclosures of forward-looking information – using the safe harbor***

Historically, a large portion of securities fraud suits were based on projections and other forward-looking statements that companies failed to meet. In 1995, as part of its attempt to reduce the incident of abusive securities litigation, Congress passed the Federal Private Securities Litigation Reform Act, which, under some limited circumstances, provides for a safe harbor for certain forward-looking statements. However, this safe harbor provides immunity for forward-looking statements only if it is used properly.

The safe harbor works differently depending on whether the communication is written or oral. For written statements, such as in press releases and SEC filings, the safe harbor applies where the forward-looking statement is identified as such and is accompanied by meaningful cautionary statements identifying important factors that could cause actual results to differ materially from those projected in the forward-looking statement. To invoke the safe harbor for oral communications, such as conference calls, the company must announce at the beginning of the call that it may give forward-looking information (and, ideally, identify the nature of such information), that actual results could differ materially and that the factors that may cause the difference are explained in the Risk Factors section of the company's SEC filings, identifying the filings (*e.g.*, "our Form 10-K for the fiscal year ended December 31, 2006, filed with the SEC on March 15, 2007"). If the referenced document contains a meaningful description of the risks facing the company, the oral forward-looking statements cannot be the basis of a private securities suit, even if they turn out to be off the mark.

In addition to properly invoking the safe harbor, it is important to understand that the statement must be truly forward-looking (that is, truly a projection of the future) to be protected by the safe harbor. For example, if a company knows present or historical facts that belie the projection, the statement would not qualify as forward-looking and would not be protected by the safe harbor.

A new public company should ensure that all analyst calls, press releases and any other public statements include the disclosure necessary for the company to invoke the protections of the safe harbor. (However, note that the safe harbor does not apply to IPOs and a few other transactions and does not protect a company in an enforcement action brought by the SEC.)

### *Regulation FD (Fair Disclosure)*

#### *Background*

Effective October 23, 2000, the SEC adopted Regulation FD (Fair Disclosure), which introduced new rules intended to improve the transparency and fairness of the dissemination of information and address the SEC's growing concerns regarding the selective disclosure of material information by companies to securities analysts and selected institutional investors. Regulation FD prohibits selective disclosure of material information.

As reflected in well-publicized reports, many companies had been selectively disclosing important non-public information, such as advance warnings of earnings results, to securities analysts or selected institutional investors or both, before making full disclosure of the same information to the general public. These disclosures took the form of limited-access analyst conference calls or one-on-one conversations, during which material information regarding corporate earnings and other key financial and operating metrics were disclosed, directly or indirectly, by giving qualitative feedback on analysts' assumptions and financial models. As a result, those who had the information before public announcement were in a position to make a profit or avoid a loss at the expense of those investors who were kept in the dark. The SEC believed that the practice of selective disclosure was leading to a loss of investor confidence in the integrity of the capital markets. The SEC stated that selective disclosure bore a close resemblance in this regard to tipping and insider trading, which are topics discussed in greater detail later in this chapter. Moreover, many commentators believed that these inefficiencies in the public dissemination of information had contributed to the speculative euphoria that characterized the late 1990s.

Regulation FD was also designed to address another important concern of the SEC – the potential for corporate management to treat material information as a commodity to be used to gain or maintain favor with particular analysts or investors. The SEC believed that in the absence of a prohibition of selective disclosure, analysts may feel pressured to report favorably about a company or otherwise slant their analysis to have continued access to selectively disclosed information. The SEC expressed concern with reports that analysts who published negative views of a company were sometimes excluded by that company from calls and meetings to which other analysts were invited.

Finally, the SEC acknowledged that recent technological developments had made it much easier for companies to disseminate information broadly. Historically, companies may have had to rely on analysts to serve as information intermediaries. In addition to press releases, companies now can use a variety of methods and mediums to communicate directly with the market.

*Regulation FD in a nutshell*

Regulation FD requires that, whenever a public company intends to disclose material information to securities market professionals and stockholders that are likely to use the information in buying and selling securities, it must do so through a public disclosure. In addition, if the company discovers that it has mistakenly made a material selective disclosure to any such person, it must make prompt public disclosure of the information (within 24 hours of learning of such disclosure).

Some of the key elements of Regulation FD are as follows:

- *Material information.* The regulation does not define what is material or non-public information. Instead, it relies on the definitions from case law which hold that information is material if there is a substantial likelihood that a reasonable investor would consider it important in making an investment decision, or the information would be viewed as having significantly altered the total mix of information available in the market. Case law also provides that the materiality of contingent or speculative information or events requires balancing the probability that the event will occur with the anticipated magnitude of the event, in light of the totality of the company activity.

  However, the SEC has provided a non-exclusive list of certain types of information that is likely to be material:

  - earnings data, either historical or projected;
  - acquisitions, joint ventures and dispositions of assets;
  - new products or discoveries or developments regarding key customers or suppliers;
  - changes in control or management;
  - changes in auditors or auditor notification that a company may not rely on an audit report;
  - events regarding the issuer's securities (defaults, redemptions, repurchase plans, splits, changes in dividends, changes in rights, and public and private sales of additional securities); and
  - bankruptcy-type events.

  The SEC has made it clear, however, that by providing such a list it did not mean to imply that each of these items is *per se* material – the information and events on the list still require analysis and judgment.

The SEC Staff Accounting Bulletin No. 99, which addresses financial statement materiality looking at quantitative and qualitative factors, can be useful in making materiality determinations as well. However, the company cannot assume that items are immaterial simply because they fall below a certain percentage threshold, as quantitatively immaterial misstatements may have a material effect on an issuer's financial statements when "all relevant factors" are considered.

Finally, NASDAQ's definition of "material news" may also be helpful in making materiality determinations. NASDAQ defines "material news" as information that would reasonably be expected to affect the value of the company's securities or influence investors' decisions. NASDAQ's list of events that triggers its advance notice requirement is similar to the SEC's list discussed above.

- *Non-public information.* Whether or not material information is "non-public" is a factual question. Information is non-public if it has not been adequately disseminated in a manner making it available to investors generally.
- *Required public disclosure.* Regulation FD requires that whenever an issuer discloses material information" it shall make public disclosure of that information." A variety of methods can satisfy this requirement. These include making a public filing with the SEC on Form 8-K, the issuance of a press release on a wire or news service and holding press conferences or conference calls at which members of the public may either attend or listen via telephone or the Internet, so long as the company discloses that it intends to have such a conference call.
- *Disclosures to members of the financial community.* Although Regulation FD is broad at first glance, it does not apply to all of a company's communications with the outside world. The regulation applies only to communications with (a) market professionals including broker-dealers, analysts, investment advisors, institutional investment managers, registered investment companies and unregistered private investment companies (such as some venture capital funds or hedge funds), and their associated persons, and (b) security holders, under circumstances in which it is reasonably foreseeable that securityholders will trade on the basis

of the information. Regulation FD does not apply to communications with advisors who owe a duty of trust or confidence to the company (*e.g.*, lawyers, accountants, investment bankers) or to communications with the press, rating agencies, and business communications with customers. In addition, the SEC carved out communications made to persons who expressly agrees to maintain the disclosed information in confidence (*e.g.*, pursuant to a non-disclosure agreement entered into prior to the disclosure that prohibits trading on the information).

- *Disclosures by persons acting on behalf of the public company.* Regulation FD does not govern the conduct of all employees. Rather, it applies only to communications made by senior management, investor relations professionals, and others who regularly communicate with the market and investors. Mid-level management or junior employees do not speak for a company – unless the disclosure is made at the direction of a senior official. Statements made in connection with most registered securities offerings will be exempt from Regulation FD.
- *Timing of disclosure.* Intentional disclosures covered by the regulation (which includes disclosure with respect to which the issuer is reckless) must be made public simultaneously with the covered disclosure to a member of the financial community. If an issuer discovers that it has mistakenly made a material selective disclosure to a covered person, it must make a prompt public disclosure, within 24 hours, of the covered disclosure.

Regulation FD does not create a private right of action for violations. Thus, a stockholder cannot file a suit for a company's violation of Regulation FD. However, the SEC may bring an enforcement action against the company and the individual, which could be in the form of an administrative proceeding seeking a cease-and-desist order, or a civil proceeding seeking injunctive relief or money damages or both. The SEC has indicated that it will seek to punish (a) intentional or reckless selective disclosure, (b) persons subverting Regulation FD by "speaking in code," and (c) repeat offenders.

**Practical Tip: Managing Contacts with Analysts and Investors**

Prior to the effective date of its IPO, a company should work together with its counsel to adopt an analyst policy and an investor relations policy. Managing relations with analysts and investors is not always intuitive, and guidance from someone who regularly defends companies in stockholder lawsuits can be invaluable. Among other things, the company should heed the following:

- Make sure that the policies are realistic. Having a policy that is not practical, and therefore not followed, may put the company at a disadvantage in defending a stockholder lawsuit.
- Designate company spokespersons who are authorized to talk to the financial community. Require employees to refer all analyst, investor and financial press inquiries to one of the designated spokespersons. Get a tutorial from the company's counsel and make sure that each of the company's designated spokespersons attends.
- Prepare scripts and anticipate Q&As for analyst calls; pre-clear scripts and material press releases with counsel, and ensure that the appropriate safe harbor language is included in every communication.
- Do not distribute analysts' reports or otherwise endorse them.
- Do not be pressured into disclosing information; it is often appropriate to say, "We are not commenting on that." Consider imposing an analyst blackout period during which no calls from analysts will be accepted (*e.g.*, during the last two weeks of each quarter), to avoid inadvertent violations of Regulation FD.
- Review analyst and investor relations policies periodically as the company's situation changes.

**True Story: The Schering-Plough Enforcement Action and Settlement**

In September 2003, the SEC announced its first settlement of a Regulation FD enforcement case. The settlement with Schering-Plough Corporation and its former Chairman and CEO illustrates the SEC's views on enforcement of Regulation FD and highlights the important of strict adherence to the rules.

The SEC's complaint against Schering-Plough alleged that the company's Chairman and CEO and its Senior Vice President of Investor Relations met privately with analysts and portfolio managers. During these meetings, the company allegedly disclosed, through a combination of spoken language, tone, emphasis and demeanor, material and adverse non-public information regarding the company's earnings prospects, including the fact that analysts' estimates for third quarter 2002 earnings were too high and that earnings would significantly decline in 2003.

Immediately after the meetings, analysts at two of these firms downgraded their ratings on the company, and portfolio managers at three of the firms heavily sold the company's stock. The price of the company's stock declined over the next several days by more than 17% on approximately four times normal volume.

The SEC charged the company with violations of Section 13(a) of the Exchange Act and Regulation FD. Schering-Plough paid a $1 million fine, and the Chairman and CEO paid a $50,000 fine.

## Periodic Reporting and the Disclosure Obligations of a Public Company and its Stockholders

### *Quarterly reports on Form 10-Q and annual reports on Form 10-K*

The IPO registration statement is only the first SEC disclosure filing that a public company will make. Companies must file quarterly reports on Form 10-Q within 40 days (if the company is a large accelerated filer or an accelerated filer) or within 45 days (if the company is a non-accelerated filer) of the end of each of the first three quarters of their fiscal years and annual reports on Form 10-K within 60 days (if the company is a large accelerated filer), within 75 days (if the company is an accelerated filer) and within 90 days (if the company is a non-accelerated filer of the end of the last quarter of their fiscal years). Failure to make timely filings may result in the company's ineligibility to use Registration Statement on Form S-3 or to incorporate by reference into Form S-1 for follow-on public offerings and Rule 144 being unavailable for certain resales of restricted shares of the company's stock. As a general matter, public companies simply do not miss filing deadlines, and any delinquency in a required filing can be interpreted by analysts and investors as a sign that the company does not have its house in order.

### *Proxy solicitation materials and annual reports*

Once the company has registered its securities under the Exchange Act, it will be required to comply with the SEC proxy rules. The company will be required to file with the SEC proxy statements that comply with Schedule 14A relating to annual and special meetings of stockholders. Definitive proxy solicitation materials relating to an annual meeting at which the only agenda items are the election of directors, amendments to stock plans, certain stockholder-sponsored proposals, and ratification of the independent registered public accounting firm selected by the Audit Committee of the board of directors are required to be filed with the SEC concurrent with mailing to stockholders.

However, proxy solicitation materials containing agenda items other than these items may not be distributed to stockholders until the materials have first been filed with the SEC for its review. Such preliminary proxy solicitation materials must be submitted to the SEC at least 10 days prior to the date definitive copies are first sent to stockholders. Because the SEC may review these preliminary proxy materials in detail, it is often advisable to submit the preliminary materials earlier than 10 days before the scheduled mailing date, so that any changes requested by the SEC can be accommodated without disrupting the mailing schedule.

Most public companies solicit proxies for their stockholder meetings. If the company elects not to solicit proxies from stockholders, the stockholders must nevertheless be furnished with an information statement containing information substantially equivalent to that required in a proxy statement.

In addition, the SEC proxy rules require that, where the solicitation is made on behalf of management of the company and relates to an annual meeting of stockholders at which directors are to be elected, the proxy statement must be accompanied or preceded by an annual report to stockholders. This annual report must contain, among other things, audited financial statements, MD&A, a brief description of the business done during the most recent fiscal year, and information regarding each of the company's directors and executive officers. The annual report gives the company a chance to tell its story not only to its stockholders but also to the financial community and investing public at large. As a result, the annual report is often a lengthy document prepared with great concern for literary content and visual form. If this will be the company's practice, it should recognize that the preparation of the report will involve a great deal of lead time, especially with respect to graphics and color printing, and the company should therefore begin early enough so that it will be completed in time for mailing not later than the date the notice of annual meeting and proxy statement are mailed to stockholders. The annual report and proxy materials, as is the case with all public disclosures by the company, should be carefully prepared, as they could give rise to liability for material misstatements or omissions.

In January 2007, the SEC adopted new rules related to the electronic delivery of proxy solicitation materials. These new rules provide that companies are permitted to use a "notice and access" model for the Internet delivery of proxy solicitation materials rather than the traditional method of soliciting proxies (including the proxy statement and annual report to stockholders) to stockholders although companies may elect to continue to mail a full set of proxy materials with only minor modifications to account for the notice and access rules if they wish. The notice must be sent at least 40 days prior to the meeting. The notice must be written in plain English and contain: a prominent legend that advises stockholders of the date, time, and location of the meeting; the availability of the proxy materials at a specified web site address; a toll-free phone number, e-mail address and a web site that stockholders may use to request copies of the proxy materials; and a clear and impartial description of the matters to be considered at the meeting. A proxy card may not accompany the notice. However, a company may send a paper proxy card accompanied by another copy of the notice 10 days or more after sending the initial notice. Any shareholder may request that copies of the solicitation materials be delivered to them in paper (by mail) or in electronic form (by e-mail), which the company must provide within three days. Stockholders may also make permanent elections to receive materials in paper or by e-mail.

Soliciting persons other than the company may also use the notice and access model, and may choose to only solicit persons who have not requested paper or e-mail copies in the past. However, if any shareholder to whom they send a notice requests such a copy, they must provide it. Non-company soliciting persons must send out their notice by the later of 40 days prior to the meeting or ten days after the company files its proxy materials.

## Executive Compensation, Compensation Discussion and Analysis and Related Party Transactions

In July 2006, as amended in December 2006, the SEC adopted rules overhauling the disclosure requirements for executive and director compensation and related-party transactions. The executive and director compensation matters that public companies are required to disclose include the following:

- Compensation Discussion and Analysis. Requires an overview of the compensation objectives and policies for certain of the company's executive officers. The CD&A should be a principles-based discussion of the goals and objectives behind executive compensation and an analysis of each element of compensation.
- Tabular Disclosure of Various Compensation Arrangements. Requires tabular and narrative disclosure of various elements of executive compensation, including disclosure of the fair value of equity compensation awards.
- Post-employment Compensation. Requires both tabular and narrative disclosure of severance arrangements and benefits, benefits triggered upon a change of control, deferred compensation contributions and earnings on such contributions.
- Stock Option Timing and Pricing Practices. Requires tabular and narrative disclosure regarding the details of the company's stock option grant and pricing policies and practices.

The SEC has also made significant revisions to its disclosure requirements related to certain relationships and related party transactions. Under the SEC's current approach, a publicly reporting company will have a greater responsibility to determine whether particular transactions rise to the level of related party transactions requiring disclosure. However, the SEC increased the transaction value threshold for required disclosure from $60,000 to $120,000.

### *Current reports on Form 8-K*

Certain significant events that occur between periodic filings must be reported on Form 8-K. A public company may also use Form 8-K to report on other events which are not specifically required to be disclosed, but which the company wishes to include promptly in its formal SEC disclosure documents.

The SEC adopted amendments to Form 8-K, effective August 23, 2004, that expanded the types of events required to be disclosed on Form 8-K and accelerated the Form 8-K deadlines with a new four business day deadline.

These amendments were responsive to the current disclosure goals of the Sarbanes-Oxley Act by requiring public companies to disclose, on a "rapid and current basis," material information regarding changes in a company's financial condition or operations as the SEC, by rule, determines to be necessary or useful for the protection of investors and in the public interest. The requirements of Form 8-K were then amended again in connection with the amendments to disclosure requirements with respect to executive compensation and related party transactions discussed above.

Following these amendments, the current Form 8-K disclosure items include:

- entry into a material agreement outside of the ordinary course of business;
- termination of a material agreement outside of the ordinary course of business;
- completion of a material acquisition or disposition of assets;
- creation of a material direct financial obligation or a material obligation under an off-balance sheet arrangement;
- triggering events that accelerate or increase a material direct financial obligation or a material obligation under an off-balance sheet arrangement;
- material costs associated with exit or disposal activities;
- material impairments;
- notice of delisting or failure to satisfy a continued listing rule or standard; transfer of listing; unregistered sales of equity securities;
- material modification to rights of security holders;
- changes in the company's certifying accountant;
- non-reliance on previously issued financial statements or a related audit report or completed interim review (restatements);
- changes in control of the company;

- departure of directors or principal officers, election of directors or appointment of principal officers or compensatory arrangements of certain officers;
- amendments to charter or bylaws and change in fiscal year;
- temporary suspension of trading under company's employee benefit plans;
- amendments to the company's code of ethics, or waiver of a provision of the code of ethics;
- regulation FD disclosure;
- other events the company may choose to report; and
- financial statements and exhibits.

The disclosure documents referred to above are not simply forms to be filled in. They are substantive disclosure documents which are relied upon by analysts and investors, and which, if carefully prepared, may protect the company from liability. For these reasons, they should not be left until the last minute or delegated to administrative personnel. Rather, they should be prepared by, or under the close supervision of, the CFO or other senior personnel who have perspective on the company's business, results of operations, risks and prospects. Like the company's IPO prospectus, Forms 10-Q, 10-K and 8-K, and Schedule 14A are based on Regulation S-K. A well-drafted IPO prospectus will serve as a good starting point for a public company's first periodic reports.

**Practical Tip: Make a 12-Month Compliance Calendar**

Shortly after the effective date of a company's IPO, the CFO and the company's counsel should create a list of SEC reporting deadlines, annual meeting events and similar compliance items covering a full annual cycle. Toward the end of the year covered by the calendar, a new calendar for the following year can be created, and so on.

## Resales of Restricted Stock

### *Overview*

Just because a company has gone public does not mean that all of its shares, however or whenever acquired, may be publicly traded. The company's registration statement on Form S-1 registers only those shares to be offered and sold to the public in the IPO. Similarly, the company's registration statement on Form S-8 applies only to those employee benefit plan shares specifically registered. Shares that were acquired while the company was private remain unregistered and may be publicly resold only if they are included in an effective registration statement or if an exemption from registration is available. These unregistered shares are referred to as "restricted stock."

One of the goals of an IPO is to provide liquidity for the company's employees and private investors. Newly public companies are often surprised by the level of activity that this new liquidity generates, especially when the lock-up period expires. In order to adequately respond to inquiries of employees and investors, the company should have some familiarity with the basic rules governing resales of restricted stock as it embarks on the new path of being a publicly traded company.

Stockholders of the company who propose to sell restricted stock into the public market following the IPO must comply with the applicable provisions of Rule 144 or Rule 701 under the Securities Act. These rules apply to both restricted securities and control securities. Control securities are any securities held by an "affiliate" of the company. An executive officer, director, or large stockholder, who, directly or indirectly, controls the management or policies of the company is deemed an affiliate for purposes of the rule.

### *Rule 144*

Generally, under Rule 144 of the Securities Act, unregistered stock of a company may be publicly resold by non-affiliates if:

- The shares have been beneficially held for at least six months; and
- The company has been subject to the reporting requirements of the Exchange Act for at least 90 days and has filed all required reports under the Exchange Act.

Sales of unregistered securities by a non-affiliate of a reporting company who has held the shares for at least one year may be made without restriction.

Unregistered stock of a reporting company may be publicly resold by affiliates if:

- The shares have been beneficially held for at least 6 months;
- The company has filed all required reports under the Exchange Act

- The amount of stock sold by the seller, together with certain sales made by the seller within the preceding three months, does not exceed the greater of one percent of the outstanding shares of the company or the average weekly reported volume of trading in the company's stock during the preceding four calendar weeks;
- The shares are sold in a brokers' transaction or directly with a market maker; and
- A notice on Form 144 is filed with the SEC and the principal exchange on which the company's shares are traded.

The foregoing restrictions applicable to affiliates apply to all sales of unregistered stock by affiliates, regardless of the length of time the shares have been held.

***Rule 701***

Rule 701 provides even more relief for employees, consultants, directors and certain others who hold unregistered shares of a company's stock that they obtained pursuant to a written compensatory benefit plan (such as a stock option plan) or a written contract relating to compensation (such as an employment agreement) prior to the IPO. This stock will be considered "701 stock" so long as the company complied with the limitations on offers and sales under Rule 701. Ninety days after a company becomes subject to the reporting requirements of the Exchange Act (that is 90 days following the effective date of the company's IPO), non-affiliates may sell 701 stock without compliance with the current public information, holding period, volume limitation or Form 144 filing requirements of Rule 144, and affiliates may sell 701 stock without compliance with the holding period requirement of Rule 144.

***Application of Rule 144 and Rule 701***

The application of Rule 144 and Rule 701 to particular fact patterns can be complex. Issues often arise regarding the determination of affiliate status, the permissibility of tacking the holding period of one holder to that of a subsequent holder, and the aggregation of sales of related or affiliated parties for purposes of computing compliance with volume limitations. The company need not attempt to master these rules in this level of detail, as the company's counsel generally will provide advice regarding these issues.

Stock certificates issued prior to the IPO generally bear a restrictive legend referring to the Securities Act, indicating that the shares represented by the certificate are unregistered and may not be transferred unless subsequently registered or unless an exemption from registration is available. The company's transfer agent will not transfer a stock certificate bearing a restrictive legend unless the transfer agent receives instructions from the company or its counsel that the legend may be removed and the shares may be transferred in compliance with the provisions of the Securities Act. For this reason, when a broker receives "legended stock" that a holder wishes to sell, the broker typically will send a legend removal request directly to the company's counsel. Much of the analysis necessary for determining the Rule 144 or Rule 701 status of unregistered securities will have already been conducted in preparation of the "overhang analysis" included in the IPO prospectus. However, company counsel may require additional detail from the company when preparing a legend removal instruction letter. Sellers usually are impatient to have their trades cleared, and the company can facilitate the delivery of the legend removal instruction letter by promptly responding to its counsel's requests for information.

## Section 16 and Insider Trading

### *Section 16 reporting and short-swing liability*

Each of the directors, officers and beneficial owners of more than 10% of any class of the company's equity securities registered under Section 12 of the Exchange Act are subject to Section 16 of the Exchange Act. The three sections of Section 16 that concern Section 16 insiders are: Section 16(a) requiring disclosure and reporting; Section 16(b) imposing liability for short swing trading; and Section 16(c) prohibiting short sales.

#### *Determining Beneficial Ownership under Section 16*

The issue of beneficial ownership arises in two contexts under Section 16: (1) determining who is a 10% stockholder; and (2) determining beneficial ownership for purposes of reporting and short-swing profit. Beneficial ownership in the first context (that is, 10% stockholder determinations) is determined by reference to Rule 13d-3. Rule 13d-3 provides that a person is the beneficial owner of a security if the person has or shares the power to vote, or direct the voting of, or the power to dispose, or direct the disposition of, that security. In addition, a person is the beneficial owner of securities where such power can be obtained within 60 days through the exercise or conversion of derivative securities.

For all Section 16 purposes other than determining who is a 10% stockholder, beneficial ownership means a direct or indirect pecuniary interest in the subject securities through any contract, arrangement, understanding, relationship or otherwise. “Pecuniary interest” means the opportunity, directly or indirectly, to profit or share in any profit derived from a transaction in the subject securities.

*Section 16(a) – Reporting Obligations*

*Section 16(a)* imposes the reporting obligations on Section 16 insiders. It provides that Section 16 insiders (1) must file an initial report on Form 3 with the SEC of their beneficial ownership of equity securities of the company (including derivative securities, such as options, warrants and stock appreciation rights) and (2) must report subsequent changes in their beneficial ownership of those securities on Forms 4 and 5.

SEC rules require most changes in beneficial ownership to be reported by Section 16 insiders to the SEC within two business days after the change occurs. Examples of the many transactions by a Section 16 insider involving the company’s securities that will require filing within two business days include: stock and option grants, regrants, repricings and cancellations, stock option exercises, open market purchases, discretionary transfers to or from a company stock fund in a 401(K) plan, and transactions under non-qualified deferred compensation plans. Certain other transactions may be filed on Form 5 within 45 days after the end of the company’s fiscal year.

In the event that a Section 16 insider fails to timely file any required report under Section 16(a), the company must report such failure in its subsequent proxy statement, information statements and annual report on Form 10-K under a section entitled “Section 16(a) Beneficial Ownership Reporting Compliance.” The company must identify by name its Section 16 insiders who, during the prior fiscal year, reported transactions late or failed to file required reports, and must disclose the number of delinquent filings and the number of transactions that were reported late for each such insider.

Although the company is not obligated to prepare or file reports under Section 16(a) for its Section 16 insiders, many companies assist their reporting persons or submit reports on their behalf to facilitate accurate and timely filing. The two-business day filing requirement will most likely present an administrative challenge to the newly public company and advance planning will be necessary to ensure compliance. In addition, Section 16(a) requires public companies to post Section 16 reports filed by its Section 16 insiders on its public web site by the end of the business day after the filing.

*Section 16(b) – Short-Swing Liability*

Section 16(b) is a liability provision, and it provides that Section 16 insiders are liable to the company for any profits made from purchases of the company's stock within six months of a sale of the company's stock. To violate Section 16(b), there must be a purchase and sale (or a sale and purchase) within a period of less than six months. The prohibition on short-swing trades applies regardless of whether the purchase or the sale occurs first. The purpose of Section 16(b) is to prevent the unfair use of information about the company that may have been obtained by Section 16 insiders by virtue of their position.

Section 16(b) is applied strictly, and liability is not dependent on a proven or actual use of the material, non-public information and may be imposed regardless of good faith. In other words, the Section 16 insider's actual intentions and actual awareness or possession of inside information at the time of the trade are irrelevant. If a Section 16 insider makes a short-swing trade, he or she is required to disgorge the profits from the trade to the company. If the company fails to bring a suit against the Section 16 insider for recovery of the profits within 60 days after demand by a stockholder to do so (or fails to prosecute the suit diligently), a suit may be brought on behalf of the company by the stockholder. Certain attorneys specialize in discovering short-swing trading violations, and the company can expect to receive letters from such attorneys from time to time seeking information regarding Section 16 insiders' trading activities. These attorneys actively review computerized databases of all Forms 3, 4 and 5 filed by Section 16 insiders in the hope of matching transactions that will result in Section 16(b) liability.

*Section 16(c) – Prohibition of Short Sales*

Section 16(c) prohibits Section 16 insiders from engaging in both traditional short sales of the company's securities and certain other transactions that are economically or functionally equivalent to a short sale.

## Practical Tip: Ensuring Section 16 Compliance

Given the administrative demands of the Section 16 filing requirements, companies should consider implementing the following procedures to help ensure compliance:

- Annually review the status of the company's Section 16 insiders and determine whether the designations are still appropriate;
- Require all Section 16 insiders to pre-clear all transactions in the company's securities and all Rule 10b5-1 trading plans with an internal compliance officer (*e.g.*, the CFO or CLO);
- Consider requiring that all Section 16 insiders' brokers (1) confirm with the company all proposed trades (other than trades made pursuant to a pre-cleared and compliant Rule 10b5-1 plan) and Rule 10b5-1 plans have been pre-cleared by the compliance officer, and (2) promptly report the details of all trades (including trades made pursuant to Rule 10b5-1 plans);
- Establish a specific e-mail address for Section 16 notification purposes so that if the compliance person is on vacation or unavailable, someone can still easily check for broker notifications;
- Circulate proposed option grant lists to the compliance officer before the board meeting at which approval for such grants is being sought;
- Meet in person with each Section 16 insider to explain the rules and procedures, including pre-clearance procedures;
- Confirm that the company has a power of attorney from each Section 16 insider that authorizes specified members of the company's management team to sign and file Section 16 reports on behalf of the Section 16 insiders;
- Ensure that the company's insider trading policy includes the mandatory pre-clearance and notification procedures;
- Send periodic reminders to Section 16 insiders of reporting requirements and deadlines; and
- Obtain EDGAR filing codes for each Section 16 insider.

***Insider trading; insider trading compliance programs; pension fund blackouts***

*Insider Trading*

The securities laws broadly prohibit fraudulent activities of any kind in connection with the offer, purchase or sale of securities. A person may be subject to criminal and civil fines and penalties, as well as imprisonment, for engaging in transactions in the company's securities at a time when such person was aware of material, non-public information about the security or the company as well as for disclosing the information ("tipping") to others who then trade on such information. This is known as "insider trading." The person who is aware of material, non-public information about the company or its securities is often referred to as an "insider," even though the person may not be an executive officer or director of the company.

*Insider Trading Compliance Program*

There may often be occasions when material, non-public information regarding a public company should not, for legitimate business reasons, be publicly disclosed at a particular time (*e.g.*, prior to the announcement of the execution of a merger or acquisition agreement). The implementation of an insider trading compliance program is important to protect the company and its insiders from liability under Rule 10b-5 and the other insider trading laws.

A good insider trading compliance program will include a strong, but thoughtful, policy regarding the unauthorized disclosure of non-public information acquired in the workplace in general and the misuse of material, non-public information in securities trading.

The policy should also establish periods of time during which certain insiders are not permitted to engage in transactions in the company's securities. For example, many public companies have a regular quarterly trading blackout period that begins two to four weeks prior to the end of their fiscal quarters and ends one or two trading days after the public announcement of financial results for the quarter. The length of time of the quarterly blackout period varies from company to company in light of its revenue and earnings cycles and other factors. If a material event occurs outside a regular quarterly blackout period, companies should consider imposing a special blackout until the event or information has been publicly disclosed. In any event, a good policy should always prohibit a person who is aware of material, non-public information from trading. As an added measure of precaution, many companies have mandatory pre-clearance procedures for their insiders, executive officers and directors, which apply regardless of whether a trading blackout period is in place, and designate one or more corporate officers as "compliance officers" to oversee such procedures. A good compliance program should also include a training component, which begins with new hires and involves regular periodic training for directors, officers and other employees.

*Prohibition against Trading during Pension Fund Blackout Periods*

The Sarbanes-Oxley Act of 2002 contains a prohibition against trading by directors and executive officers of a company during a pension fund blackout period. The SEC has also adopted a new regulation – Regulation Blackout Trading Restriction, or BTR – to clarify the scope and operation of that provision of the Sarbanes-Oxley Act. The purpose of these new rules is to equalize the treatment of corporate executives and rank-and-file employees with respect to their ability to trade in company stock during pension fund blackout periods.

Regulation BTR provides that during a pension fund blackout period, directors and executive officers of a public company are prohibited from purchasing, selling or otherwise acquiring or transferring a security acquired in connection with service as a director or officer. For purposes of these rules, a "blackout period" means any period of more than three consecutive business days during which pension plan participants (or beneficiaries) are temporarily suspended from trading in company securities held in their individual accounts but only if the suspension applies to at least 50% of the pension plan participants. The penalty for violations is disgorgement of any profits. There are a number of transactions that are exempt from these rules. For example, purchases and sales made under a Rule 10b5-1 trading plan are exempt. The rules also require the company to provide advance notice of a pension fund blackout period to directors and executive officers and to file such notice on Form 8-K.

***Rule 10b5-1 trading plans***

Legal and company policy constraints (*e.g.,* SEC insider trading rules, and company-imposed blackout periods) frequently prevent executive officers and directors from selling company stock. Individually, and in combination, these constraints and other factors can effectively prevent insiders from selling stock for extended periods of time. Even when trading windows are open and other constraints lifted, insiders who decide to engage in market transactions risk being second-guessed by regulators, prosecutors and private securities class action plaintiffs.

In October 2000, the SEC adopted Rule 10b5-1 to provide an affirmative defense for certain trading arrangements that are designed to cover situations in which a person can demonstrate that the material, non-public information was not a factor in the trading decision. However, a trading plan only merits the affirmative defense if it is in writing, was adopted in good faith by the person before he or she became aware of any material, non-public information and the plan:

- specified the amount of, the price at, and the date of the purchases or sales;
- included a formula or algorithm, or computer program, for determining the amount of, the price at, and the date of the purchases or sales to be made; or
- did not permit the person to exercise any subsequent influence over how, when, or whether to effect purchases or sales (so long as the actual person who did exercise such influence) (*e.g.,* the broker, was not aware of the material, non-public information).

Any person can adopt a trading plan, including the company or a stockholder otherwise unaffiliated with the company. In fact, a Rule 10b5-1 trading plan can be used by an entity (*e.g.,* a stockholder of the company that is a venture capital firm) as an affirmative defense to insider trading if it can demonstrate (1) that the individual making the investment decision on behalf of the entity was not aware of any material, non-public information and (2) the entity had implemented reasonable policies and procedures to ensure that individuals making investment decisions on its behalf would not violate insider trading laws.

Trading plans, if properly constructed, may provide insiders with liquidity and diversification opportunities, while reducing the risk of insider trading allegations by serving as an affirmative defense. Even if the insider is aware of material, non-public information at the time of a trade, he will not be liable for insider trading if he can demonstrate that the trading plan complied with Rule 10b5-1.

While Rule 10b5-1 trading plans can provide several potential benefits, they do present a few risks. For example, there have been limited interpretations of these plans. Also, implementing a trading plan requires the insider to plan future trades in advance, resulting in reduced flexibility. The insider essentially relinquishes the ability to easily modify those future trades, even if his financial situation or the value of the stock changes significantly. And while trading plans can be modified, and terminated, there are risks to entering a plan and then modifying or terminating the plan. In the first half of 2007, the SEC publicly stated that it would increase its scrutiny of 10b5-1 trading plans and possible abuses of the plans. Insiders should consider adopting a trading plan only if they intend to follow it to the letter, amend it or terminate it infrequently if at all, and will not sell any additional shares outside of the plan.

Persons subject to Section 16 who adopt trading plans must still file Forms 4 and avoid short-swing trading, and Rule 144 still applies to sales made pursuant to trading plans by affiliates. However, the SEC has clarified that an insider may modify the Form 144 to state that the representation regarding the seller's lack of knowledge of material information is made as of the date the plan was adopted, rather than the date the person signs the Form.

A company should consider various issues regarding trading plans as well. The company must ensure that its insider trading policy permits trades made pursuant to compliant plans. The company must also determine to what extent it desires to retain authority to approve an insider's proposed trading plan before allowing the insider to benefit from an exemption from the insider trading policy. The company and insiders must also decide how much information they are going to publicly disclose regarding the adoption of trading plans. Disclosing that insiders' trades are being made pursuant to pre-established Rule 10b5-1 plans may help avoid unintended signaling effects that the market may infer from such sales, and may deter some potential plaintiffs from filing securities lawsuits based in part on insiders' trades.

## Additional Reporting Requirements for Certain Stockholders

### *Section 13 of the Exchange Act; Schedules 13D-G*

Sections 13(d) and 13(g) of the Exchange Act, and the related SEC regulations, require any person who acquires beneficial ownership of more than 5% of the outstanding shares of any class of the company's securities that is registered under Section 12 of the Exchange Act (a "5% Stockholder") to report such ownership to the SEC by filing a Schedule 13D or Schedule 13G with the SEC via its EDGAR system. A 5% stockholder must also provide a copy of the filing to the company and the national securities exchange on which the company's securities are traded.

#### *Determining beneficial ownership for purposes of Sections 13(d) and (g)*

Rule 13d-3 provides that a person is the beneficial owner of a security if the person has or shares the power to vote, or direct the voting of, or the power to dispose, or direct the disposition of, that security. In addition, such person is the beneficial owner of securities where such power can be obtained within 60 days through (1) the exercise of any option, warrant or right, (2) the conversion of a security, (3) the revocation of a trust, discretionary account or similar arrangement, or (4) the automatic termination of a trust, discretionary account or similar arrangement. Finally, a person is the beneficial owner of securities if the rights described in (1), (2) or (3) above are acquired for the purpose of changing the control of the company, irrespective of whether that right can be exercised within 60 days.

Beneficial ownership may be acquired either individually or as a group. If two or more persons agree to act together in acquiring or voting securities, a group is considered to have acquired the securities of each member thereof as of the date of that agreement.

***Initial reporting on Schedule 13G***

Within 45 days following the calendar year in which the company completes its IPO, each 5% Stockholder who became a 5% Stockholder before consummation of the company's IPO must report such ownership to the SEC on a Schedule 13G. These pre-offering stockholders are identified as "exempt" stockholders because their shares were acquired before the company's public offering was consummated.

***Continuing reporting following the IPO***

As soon as the company becomes a public company, any exempt stockholders who acquire more than 2% of the company's stock within any 12-month period, or any other person who becomes a 5% Stockholder, may be required to file a Schedule 13D, which is a significantly more extensive form than the Schedule 13G. However, the Schedule 13D filing need not be made if the 5% Stockholder is a "passive investor," meaning such 5% Stockholder beneficially owns less than 20% of the company's common stock and did not acquire the company's securities for the purpose, or with the effect, of influencing or changing control of the company. A 5% Stockholder who qualifies as a passive investor may continue filing reports on Schedule 13G in lieu of the more burdensome report on Schedule 13D. Directors and officers, because of their positions of influence in relation to the company, have been deemed by the SEC staff not to qualify as passive investors under any circumstance and are required to file reports on Schedule 13D, as applicable.

Generally, reports on Schedule 13G must be amended annually to indicate any change in beneficial ownership. In addition, whenever a passive investor who was filing reports on Schedule 13G acquires more than 10% of the company's securities, the investor is required to file an amendment to its report on Schedule 13G promptly after the date of the additional acquisition of the company's securities. From that time on, such investor must file an amendment to its report on Schedule 13G promptly anytime after its beneficial ownership in the company's outstanding securities changes (whether by increase or decrease in holdings) by more than 5%. A non-passive investor must amend its report on Schedule 13D promptly to indicate any material changes to the information on such schedule and must also promptly amend its report to indicate any change of 1% or more in such investor's beneficial ownership in the company's outstanding securities.

# Chapter 11
# Special Considerations for Non-U.S. Companies

A public offering in the United States can provide a non-U.S. company with access to the world's largest capital markets at favorable valuations. It can also subject the company to numerous expenses, regulatory compliance burdens and liability. This chapter highlights issues of special concern to non-U.S. companies contemplating a public offering in the United States and points out certain areas where non-U.S. issuers are treated differently from U.S. issuers. Except as noted below, most of the issues identified in the preceding chapters of this book also apply to non-U.S. issuers.

## Foreign Private Issuers

Under the U.S. securities laws, a "foreign private issuer" is subject to somewhat narrower disclosure obligations than U.S. issuers and is exempt from the application of certain U.S. securities regulations. The U.S. securities laws define a "foreign private issuer" as a corporation or other organization (other than a foreign government) that is incorporated or organized under the laws of any foreign country unless:

- more than 50% of the outstanding voting securities of the issuer are directly or indirectly held of record by residents of the United States; and
- any of the following:
  - the majority of the executive officers or directors are United States citizens or residents;
  - more than 50% of the assets of the issuer are located in the United States; or
  - the business of the issuer is administered principally in the United States.

In general, a company may rely upon a review of the addresses of its security holders in its records in determining whether or not it meets the requirements to be deemed a foreign private issuer. However, securities that are held of record by brokers, dealers, banks and other nominees in the United States will be counted as held in the United States by the number of separate accounts for which the securities are so held. The SEC has stated that a company may rely in good faith on information supplied by brokers, dealers, banks and nominees as to the number of separate accounts for which such parties hold securities. In determining the percentage of outstanding voting securities held by U.S. residents, the inquiry may be limited to accounts held by brokers, dealers, banks and other nominees located in the United States, the issuer's jurisdiction of incorporation, and the jurisdiction that is the primary trading market for the issuer's voting securities, if different than the jurisdiction of incorporation.

## Mechanics of the Public Offering

### *Type of security to be offered*

A non-U.S. issuer may offer its shares directly to United States investors or instead may make its public offering in the United States through the use of American Depositary Receipts (ADRs).

An ADR is a negotiable instrument issued by a third-party financial institution, referred to as a Depositary, and evidences ownership of a certain number of underlying shares of the non-U.S. issuer, which underlying shares are held by the Depositary's correspondent bank, referred to as a Custodian Bank, located in the home country of the non-U.S. issuer. Investors trade in the ADRs and not the underlying security.

There are specific advantages in using ADRs as opposed to making a direct offer of shares of a non-U.S. issuer in the United States. Laws in certain foreign jurisdictions prohibit or limit direct foreign ownership or impose a transfer or stamp tax for transfers of shares. Use of ADRs avoids the concerns associated with direct foreign ownership or transfer taxes, as the shares underlying the ADRs are held by the Custodian Bank located in the issuer's home country, and when ADRs are transferred, the underlying shares held by the Custodian Bank are not transferred.

Advantages may also accrue to U.S. investors as a result of holding ADRs as opposed to directly holding shares of a non-U.S. issuer. ADRs can be transferred and exchanged by presentment to the Depositary rather than having to deal with a transfer agent located outside the United States. Further, dividends can be paid to U.S. investors in U.S. dollars. The Depositary takes on the responsibility of handling currency conversions and facilitating stockholder communications and voting rights in exchange for fees, which are paid by the ADR holders.

The question of whether shares of a non-U.S. issuer should be offered directly or through ADRs should be discussed with counsel at the beginning of the offering process.

***Form of registration statement to be used***

Foreign private issuers are eligible to register shares in connection with an initial public offering on a registration statement on Form F-1, which is similar in many respects to a registration statement on Form S-1. However, the Form F-1 registration statement must contain additional disclosure relating to the following:

- the nature and extent of the principal non-U.S. trading market for the company's securities;
- limitations on the rights of investors outside of the home jurisdiction to hold and vote the stock;
- governmental restrictions applicable to the export or import of capital, and the payment of dividends and interest to investors outside of the home jurisdiction, as well as procedures for nonresident holders to claim dividends;
- taxes to which United States investors may be subject under the laws of the home jurisdiction or treaties between the home jurisdiction and the United States;
- historical exchange rates between U.S. dollars and the home country currency;
- the ability of United States stockholders and the SEC to make claims under U.S. securities laws against the company and its officers and directors located outside of the United States; and
- laws or regulations of the home jurisdiction applicable to rights of stockholders, stockholder meetings, restrictions on changes of control, and other material rights, where such laws or regulations are significantly different from those in the United States.

The Form F-1 registration statement may omit some of the more detailed executive compensation and stock ownership information required in a Form S-1 registration statement. However, in order to appear less "foreign" to U.S. investors, many foreign issuers elect to include some amount of the information that they may otherwise omit under the SEC rules.

A non-U.S. company wishing to make a public offering in the United States using ADRs, in which it intends to raise capital, is required to work with a Depositary to register the ADRs on a registration statement on Form F-6, and to register the underlying shares on a Form F-1 registration statement. Different variations of ADR programs exist. A non-U.S. company wishing to use the ADR program should consult its U.S. counsel for information on the procedures and implications of doing so.

***Review process***

One important difference between registration on a Form F-1 registration statement by a foreign private issuer and registration on a Form S-1 registration statement by a United States issuer is the review process. While the Form S-1 review process does not commence until the Form S-1 registration statement is publicly filed with the SEC via EDGAR, the initial submission of a Form F-1 registration statement to the SEC can be done on a confidential, paper basis. This allows the foreign issuer to receive the first round of SEC comments before making any public disclosure of its offering plans. As a result, if the SEC comments reveal any "show stoppers," the company may simply terminate the offering process without having exposed any sensitive business or financial information, or even the fact that it was contemplating a public offering.

***Translation of certain documents into English***

Documents required to be filed as exhibits to the registration statement, such as charter documents and material contracts, must be filed in English, or a summary of such documents in English must be filed. Translation may require a significant amount of lead time. Therefore, it is important to identify the documents that will need to be filed and begin translation early in the registration process.

## Financial Disclosure Requirements

A foreign private issuer must include in its registration statement on Form F-1 financial statements and selected financial data covering the same periods as would be required of a U.S. issuer filing a registration statement on Form S-1. The company's financial statements may be prepared either in accordance with U.S. generally accepted accounting principles (U.S. GAAP) or another comprehensive body of generally accepted accounting principles. If the financial statements are not prepared in accordance with U.S. GAAP, the registration statement must disclose the basis of preparation, discuss the material differences in accounting principles between U.S. GAAP and the principles used, and provide a table which reconciles the primary financial statements to U.S. GAAP by quantifying material variances applicable to the income statement and balance sheet.

A foreign issuer is not required to select the U.S. dollar as its reporting currency, and may state amounts in its financial statements in any currency that it deems appropriate. However, only one currency may be used as the reporting currency, and such reporting currency must be prominently disclosed on the face of the financial statements. A foreign issuer must also disclose if dividends will be paid in a different currency from the reporting currency.

If the reporting currency is not the U.S. dollar, the issuer may include a translation for the most recent fiscal year and any subsequent interim period presented using the exchange rate as of the most recent balance sheet included in the filing. If materially different, the exchange rate as of the latest practicable date should be used. In addition, an issuer that does not prepare its financial statements in U.S. dollars must provide disclosure of the exchange rate between the reporting currency and the U.S. dollar which shows:

- the exchange as of the last practicable date;
- the high and low exchange rates for each month during the previous six months; and
- for the five most recent financial years, and any subsequent interim period covered by the financial statements, the average rates for each period.

Financial reporting under one set of accounting standards and in one currency is difficult enough. Reporting under two sets of accounting standards and providing a translation into a second currency can be overwhelming. Underwriters often recommend that a company report in U.S. dollars and U.S. GAAP, if at all possible, to allow for easier comparison of the company's performance with that of U.S. issuers. A foreign issuer planning a public offering in the United States should consult with its counsel and auditors in its home jurisdiction and explore whether financial statements prepared in accordance with U.S. GAAP and reported in U.S. dollars can be used to satisfy local reporting requirements.

## Ongoing Reporting Requirements

Foreign private issuers are not required to file annual reports on Form 10-K, quarterly reports on Form 10-Q or current reports on Form 8-K.

Rather, foreign private issuers with securities registered under the Exchange Act must file an annual report on Form 20-F with the SEC within 6 months after the end of each fiscal year. Quarterly reports are not legally required, although the company's underwriters may insist that the company file quarterly reports on Form 6-K to provide investors with the same level of information as would be provided by a U.S. issuer. A foreign private issuer generally must file a report on Form 6-K whenever the company gives public information under the laws of its home jurisdiction. In addition, Form 6-K requires that a foreign private issuer must promptly provide to the SEC any information that is filed with any foreign stock exchange on which its securities are listed and made public by such exchange or information that is distributed to its securityholders. While a foreign private issuer is not specifically required by SEC regulations to file a current report on Form 8-K to report acquisitions, dispositions or other material events, companies listed on the NASDAQ Stock Market or the New York Stock Exchange must disclose to the United States public any material information that would reasonably be expected to affect the value of its securities or influence investors' decisions. In addition, a company with shares listed on the NASDAQ Stock Market or the New York Stock Exchange must provide a formal annual report to its stockholders.

## Corporate Governance

Certain corporate governance requirements are imposed by U.S. securities laws, the rules and regulations of NASDAQ and other U.S. stock exchanges, and the expectations of U.S. investors. Many of these requirements may seem strange to a non-U.S. issuer, but compliance with them may be essential to a successful offering in the United States. For example, U.S. investors expect a company's management team to operate under the ultimate authority of the company's board of directors, which should exercise independent judgment on important matters. U.S. stockholders expect the board of directors to have the authority to issue additional shares of the company's authorized stock in connection with financings, certain acquisitions or other events without stockholder approval or compliance with stockholder preemptive rights. In addition, the NYSE and NASDAQ have adopted a number of requirements relating to director independence, including provisions regarding independent directors, and establishing independence requirements related to auditing, nominating and compensation functions of the board of directors, many of which are discussed in earlier chapters of this guidebook.

The Sarbanes-Oxley Act of 2002 introduced sweeping reform covering corporate governance of and disclosures by reporting issuers in the United States. Although there are some differences between the treatment of U.S. issuers and non-U.S. issuers under the Sarbanes-Oxley Act and the SEC rules adopted under that Act, particularly with respect to audit committee independence requirements, blackout trading restrictions and the use of non-GAAP financial measures, the reforms generally apply equally to both. In preparing for an IPO in the United States, a foreign issuer should consult with its U.S. counsel regarding the application and impact of the Act and any corporate governance restructuring or housekeeping that may be necessary or advisable.

## Exemptions from Certain Provisions of the Exchange Act

Foreign private issuers are exempt from certain provisions of the Exchange Act, including the proxy solicitation requirements of Section 14 of the Exchange Act and the short-swing trading prohibition and reporting requirements of Section 16 of the Exchange Act.

In addition, foreign private issuers are expressly exempt from the provisions of Regulation FD, which was discussed in detail in Chapter 10. However, many foreign private issuers that file reports with the SEC endeavor to comply with the requirements of Regulation FD. This decision is usually driven by two compelling concerns: the need to comply with laws regarding selective disclosure that are mandated by an issuer's home jurisdiction, and the exposure to potential liability under U.S. securities laws resulting from selective disclosure, such as lawsuits related to the "tipping" of securities analysts or selected shareholders.

While a company may qualify as a foreign private issuer at the time of its IPO, it may later cease to qualify as a foreign private issuer due to changes in the composition of its stockholder base, management team, board of directors or in the nature of its operations. Therefore, it is important for management to keep a close eye on the foreign private issuer tests in order to determine if the company will no longer be eligible to operate under the more lenient rules applicable to foreign private issuers.

# Appendix A
## NYSE Listing Standards for Domestic Companies
(as of July 1, 2008)

**Size / Volume Criteria** (a company must meet one of the following size/volume criteria):

| | |
|---|---|
| 1. Round-lot Holders$^{(A)}$ | 400 |
| *OR:* | |
| 2. Total Shareholders$^{(A)}$ | 2,200 |
| *together with* average monthly trading volume for the most recent six(6) months | |
| *OR:* | 100,000 shares |
| 3. Total Shareholders$^{(A)}$ | 500 |
| • *together with* average monthly trading volume for the most recent twelve (12) months; and | 1,000,000 shares |
| • *number of publicly held shares outstanding*$^{(B)}$ | 1,100,000 shares |

**Market Value of Public Shares$^{(B, C)}$** (a company must have an aggregate market value of):

| | |
|---|---|
| 1. IPOs, Spin-offs, Carve-outs and Affiliated Companies | $60,000,000 |
| *OR:* | |
| 2. Public Companies | $100,000,000 |

**Financial Criteria** (a company must meet one of the following financial standards):

| | |
|---|---|
| 1. Earnings Test | |
| *Aggregate pretax earnings:*$^{(D)}$ | $10,000,000 |
| (a) Over the last 3 years (must be positive amounts in all 3 years); and | |
| (b) Each of the two (2) most recent years | |
| *OR:* | $2,000,000 |
| 2. Valuation with Cash Flow Test (a company must meet either of the following requirements): | |
| *Valuation / Revenue with Cash Flow Test:* | $500,000,000 |
| (a) Global market capitalization; | |
| (b) Revenues during the most recent 12-month period; and | $100,000,000 |
| (c) Aggregate cash flows$^{(E)}$ for the last 3 fiscal years (must be positive amounts in all 3 years) | |
| *OR:* | $25,000,000 |
| 3. Pure Valuation Test | |
| (a) Global market capitalization$^{(F)}$; and | $750,000,000 |
| (b) Revenues during the most recent fiscal year | |
| *OR:* | $75,000,000 |
| 4. Affiliated Company Test | $500,000,000 |
| (a) Global market capitalization; | |
| (b) At least 12 months of operating history (although it is not required to have been a separate entity for that long); | |
| (c) Parent or affiliated company is a listed company in good standing; and | |
| (d) Parent or affiliated company retains control of the entity or is under common control with the entity. | |

**Notes:**

(A) The number of beneficial holders of stock held in "street name" will be considered in addition to the holders of record. The Exchange will make any necessary check of such holdings that are in the name of Exchange member organizations.
(B) In connection with initial public offerings, spin-offs and carve-outs the NYSE will accept an undertaking from the company's underwriter to ensure that the offering will meet or exceed the NYSE's standards.
(C) If a company either has a significant concentration of stock or changing market forces have adversely impacted the public market value of a company that otherwise would qualify for an Exchange listing, such that its public market value is no more than 10 percent below the minimum, the Exchange will consider stockholders' equity of $60 million or $100 million, as applicable, as an alternate measure of size.
(D) Pre-tax income is adjusted for various items as defined in Section 102.01C of the NYSE Listed Company Manual.
(E) Represents net cash provided by operating activities excluding the changes in working capital or in operating assets and liabilities, as adjusted for various items as defined in Section 102.01C of the NYSE Listed Company Manual.
(F) Average global market capitalization for already existing public companies is represented by the most recent six months of trading history. For IPOs, spin-offs and carve-outs, it is represented by the valuation of the company as represented by, in the case of a spin-off, the distribution ratio as priced, or, in the case of an IPO/carve-out, the as-priced offering in relation to the total company's capitalization.

**Additional Considerations:**

In addition to meeting the NYSE's minimum numerical standards listed above, there are other factors that the NYSE will consider, and the NYSE has broad discretion regarding the listing of a company. Thus, the NYSE may deny listing or apply additional or more stringent criteria based on any event, condition, or circumstance that makes the listing of the company inadvisable or unwarranted in the opinion of the NYSE. Also note that the NYSE can make such a determination even if the company meets the standards set forth above.

# Appendix A
# (Cont'd)

## NASDAQ Global Market
## Listing Requirements
(as of July 1, 2008)

For initial listing on The NASDAQ Global Market, a company must meet *all* of the financial requirements under at least one of the three listing standards.

| Financial Requirements | Standard 1 | Standard 2 | Standard 3 |
|---|---|---|---|
| Stockholders' equity | $15 million | $30 million | N/A |
| Market value of listed securities **or** Total assets and Total revenue | N/A | N/A | $75 million[1, 2] **or** $75 million and $75 million |
| Income from continuing operations before income taxes (in latest fiscal year **or** in 2 of last 3 fiscal years) | $1 million | N/A | N/A |
| Publicly held shares[3] | 1.1 million | 1.1 million | 1.1 million |
| Market value of Publicly held shares | $8 million | $18 million | $20 million |
| Bid price | $5 | $5 | $5[2] |
| Shareholders (round lot holders)[4] | 400 | 400 | 400 |
| Market makers[5] | 3 | 3 | 4 |
| Operating history | N/A | 2 years | N/A |
| Corporate governance[6] | | | |

**Notes**:

1. For initial and continued listing under Standard 3, a company must satisfy one of the following: the market value of listed securities requirement **or** the total assets and the total revenue requirement. Under the applicable rule, listed securities is defined as "securities quoted on NASDAQ or listed on a national securities exchange."
2. Seasoned companies (those companies already listed or quoted on another marketplace) qualifying only under the market value of listed securities requirement of Standard 3 must meet the market value of listed securities and the bid price requirements for 90 consecutive trading days prior to applying for listing.
3. Publicly held shares is defined as total shares outstanding, less any shares held by officers, directors or beneficial owners of 10% or more.
4. Round lot holders are shareholders of 100 shares or more.
5. An electronic communications network (ECN) is not considered a market maker for the purpose of these rules.
6. The company must meet the NASDAQ corporate governance provisions, including Marketplace Rules 4350, 4351 and 4360.

# Appendix A (Cont'd)

## NASDAQ Global Select Market Listing Requirements (as of July 1, 2008)

For initial listing on The NASDAQ Global Select Market, a company must meet *all* of the financial requirements under at least one of the three listing standards, as well as each of the liquidity requirements in its specific category.

| Financial Requirements | Standard 1 | Standard 2 | Standard 3 |
|---|---|---|---|
| Pre-tax earnings[1] (income from continuing operations before income taxes) | Aggregate in prior three fiscal years ≥ \$11 million and Each of the two most recent fiscal years ≥ \$2.2 million and Each of the prior three fiscal years > \$0 | N/A | N/A |
| Cash flows[2] | N/A | Aggregate in prior three fiscal years ≥ \$27.5 million and Each of the prior three fiscal years ≥ \$0 | N/A |
| Market capitalization[3] | N/A | Average ≥ \$550 million over prior 12 months | Average ≥ \$850 million over prior 12 months |
| Revenue | N/A | Previous fiscal year ≥ \$110 million | Previous fiscal year ≥ \$90 million |
| Bid price[4] | \$5.00 | \$5.00 | \$5.00 |
| Market makers[5] | 3 | 3 | 3 |
| Corporate governance[6] | | | |
| **Liquidity Requirements** | **Initial Public Offerings and Spin-Off Companies** | **Affiliated Companies[7]** | |
| Beneficial Shareholders (round lot) **or** Beneficial Shareholders **or** Beneficial Shareholders **and** Average monthly trading volume over past twelve months | 450 **or** 2,200 | 450 **or** 2,200 **or** 530 **and** 1.1 million | |
| Publicly held shares[8] | 1,250,000 | 1,250,000 | |
| Market value of publicly held shares **or** Market value of publicly held shares and Shareholders' equity, | \$70 million | \$70 million | |

**Notes**:

1. In calculating income from continuing operations before income taxes, NASDAQ will rely on an issuer's annual financial information as filed with the SEC in the issuer's most recent periodic report and/or registration statement. If an issuer does not have three years of publicly reported financial data, it may nonetheless qualify if it has: (i) reported aggregate income from continuing operations before income taxes of at least \$11 million and (ii) positive income from continuing operations before income taxes in each of the reported fiscal years. A period of less than three months shall not be considered a fiscal year, even if reported as a stub period in the issuer's publicly reported financial statements.
2. In calculating cash flows, NASDAQ will rely on the net cash provided by operating activities reported in the statements of cash flows, as filed with the SEC in the issuer's most recent periodic report and/or registration statement, excluding changes in working capital or in operating assets and liabilities. If an issuer does not have three years of publicly reported financial data, it may nonetheless qualify if it has: (i) reported aggregate cash flows of at least \$27.5 million and (ii) positive cash flows in each of the reported fiscal years. A period of less than three months shall not be considered a fiscal year, even if reported as a stub period in the issuer's publicly reported financial statements.
3. In the case of an issuer listing in connection with its initial public offering, compliance with NASDAQ market capitalization requirements will be based on the company's market capitalization at the time of listing.
4. The bid price requirement is not applicable to a company listed on The NASDAQ Global Market that transfers its listing to The NASDAQ Global Select Market.
5. An electronic communications network (ECN) is not considered a market maker for the purpose of these rules. Note that the company must also have sufficient market makers to NASDAQ Rules, which may require four (4) market makers.
6. The company must meet the NASDAQ corporate governance provisions, including Marketplace Rules 4350 and 4351.
7. For purposes of NASDAQ rules, an issuer is affiliated with another company if that other company, directly or indirectly though one or more intermediaries, controls, is controlled by, or is under common control of the issuer. For purposes of these rules, control means having the ability to exercise significant influence. Ability to exercise significant influence will be presumed to exist where the parent or affiliated company directly or indirectly owns 20% or more of the other company's voting securities, and also can be indicated by representation on the board of directors, participation in policy making processes, material intercompany transactions, interchange of managerial personnel, or technological dependency.
8. In computing the number of publicly held shares, NASDAQ will not consider shares held by an officer, director or 10% shareholder of the issuer.

# Appendix B

## Sample Due Diligence Checklist

Please provide copies of the indicated documents or the information requested and indicate items that the Company considers inapplicable. In each instance, requests for documents or information regarding the Company extend to similar documents and information regarding subsidiaries of the Company, if any.

### 1. Basic Corporate Records

a. Articles/Certificate of Incorporation, including amendments since inception.

b. Bylaws, including amendments since inception.

c. Minutes or other records of all meetings or actions of the board of directors, any committees thereof, and of stockholders, including written notices (if given) or waivers thereof since inception.

d. Communications with stockholders since inception, including annual reports, proxy statements and correspondence.

e. Press releases since inception.

f. Summary of the corporate history of the Company and any predecessors, including any mergers, acquisitions, changes in control and divestitures.

g. List of countries and U.S. states where the Company is qualified to do business.

h. List of cities and countries where the Company operates its business or maintains inventory, owns or leases property or has employees, agents or independent contractors, with approximate size and number of employees and a description of operations or services performed at each location.

i. List of cities and countries in which the Company currently contemplates undertaking business operations, either directly or through other parties.

j. List of any subsidiaries, including the address of each such subsidiary's headquarters.

**2. Stockholder Information**

a. List of names, addresses and holdings of current record and beneficial owners of Company stock, indicating the dates such stock was issued and fully paid for.

b. List of names, addresses and holdings of current record and beneficial owners of Company options and warrants, including date of grant, exercise price, number of shares subject to the option or warrant and vesting terms.

c. List of any oral or written promises to receive stock, options, warrants or any other form of interest in the Company.

d. Share, option or warrant books, ledgers and other records of share, option or warrant issuances of the Company since inception.

**3. Securities Issuances**

a. Documents generated in connection with equity financings of the Company, including stock purchase agreements and related documentation, such as offering circulars, private placement memoranda and prospectuses relating to the offer or sale of equity securities.

b. Documents generated in connection with any convertible debt financings of the Company.

c. Samples of common stock certificates, warrants, options, debentures and any other outstanding securities.

d. Stock option and purchase plans and equity incentive plans of any sort, including forms of option and purchase agreements which have been or may be used thereunder, and any options or warrants not under an equity plan.

e. Agreements and other documentation (including related permits) relating to repurchases, redemptions, exchanges, conversions or similar transactions involving the Company's securities and schedule of any dividends paid or declared since inception.

f. Voting trust, stockholder, or other similar agreements covering any of the Company's securities.

g. Agreements relating to registration rights.

h. Agreements relating to preemptive rights or co-sale rights.

i. Agreements or other documents setting forth any arrangement with or pertaining to the Company to which directors, officers or owners of more than 5% of the voting securities of the Company have been a party since inception including indemnification agreements or agreements relating to the voting or transfer of securities.

j. Forms D or any other forms filed to qualify for an exemption under the Securities Act of 1933.

k. Governmental permits, notices of exemption and consents for issuance or transfer of the Company's securities and evidence of qualification or exemption under applicable blue sky laws.

**4. Corporate Finance**

a. List of banks or other lenders with which the Company has a financial relationship and brief description of nature of relationship, e.g., lines of credit, *etc*.

b. Summary of short-term debt, long-term debt, intercompany debt and capital lease obligations of the Company.

c. Summary of currently outstanding interest rate or foreign currency swaps, caps, options, forwards or other derivative instruments or arrangements to which the Company is a party.

d. Agreements evidencing borrowings by the Company, whether secured or unsecured, documented or undocumented, including loan and credit agreements, mortgages, deeds of trust, letters of credit, indentures, promissory notes and other evidences of indebtedness, and any amendments, renewals, notices, or waivers.

e. Documents and agreements evidencing other material financing arrangements, including capital leases, synthetic leases, sale and leaseback arrangements, installment purchases, or similar agreement.

f. Documents and agreements relating to any guarantees by the Company or releases of guarantees.

g. Bank letters or agreements confirming lines of credit, including any amendments, renewal letters, notices, waivers, etc.

**5. Financial Information**

a. Contact information for outside parties responsible for providing the Company with accounting or tax advice.

b. Written investment policies of the Company.

c. Financial statements of the Company since inception.

d. Current internal financial projections, forecasts, budgets and cash flow analyses of the Company.

e. Management letters or special reports by auditors and any responses thereto.

f. Description of and reasons for any change in accounting methods or principles.

g. Detailed aging schedule for accounts receivable and accounts payable at end of each fiscal quarter of last five years.

h. Detailed description of critical accounting policies, and explanation of revenue and cost recognition methods.

i. Information on planned acquisitions and dispositions.

j. Information on bad debt reserves and unusual charges to operations for the past three fiscal years.

k. Detailed description of any off-balance sheet arrangements, liabilities or obligations of any nature (*i.e.*, fixed or contingent, matured or unmatured) that are not shown or otherwise provided for in the Company's current financial statements. Please include: the nature and purpose of any such off-balance sheet arrangements; the importance to the Company of such arrangements; the amounts of revenue, expenses and cash flows arising from such arrangements; and any known event, demand, commitment, trend or uncertainty that is reasonably likely to result in the termination (or reduction in availability to the Company) if any such arrangement and the course of action the Company has taken or proposes to take in response to such circumstances.

l. Description of any non-GAAP financial measures, accompanied by the most directly comparable GAAP financial measure and a reconciliation to GAAP, along with the reasons for use of non-GAAP measures.

m. Any reports on internal controls.

n. Proposed disclosure controls and procedures and list of persons serving (or proposed to serve) on the Disclosure Committee, along with a copy of the committee charter.

o. Detailed explanation of any change in or disagreement with auditors on accounting and financial matters in the last five fiscal years.

**6. Taxes**

a. Federal, state, local and foreign tax returns since inception, including sales tax returns and consolidated returns of the Company.

b. Information with respect to any foreign, Internal Revenue Service or state audit of the Company's or any of its subsidiaries' or their respective predecessor's returns and the results of each audit.

c. Description of any undertakings given by the Company to tax authorities or any special tax rulings or agreements arranged with tax authorities.

d. Description of any preferred tax status or tax benefit which may be adversely affected by the proposed initial public offering and any related transactions.

e. Information to analyze tax positions taken in connection with acquisitions, dispositions, restructurings, reorganizations, or the like since inception and any tax strategies in connection with any transactions currently proposed including any ongoing tax indemnities.

f. Any notices, elections, or other correspondence with foreign, federal, state and local tax authorities regarding the reorganization of the Company and its predecessors to the extent material.

**7. Intellectual Property**

a. List of U.S. and other country patents and patent applications held by the Company.

b. List of U.S. and other country trademarks, trade names, service marks or registered copyrights, including applications for each of the foregoing filed by the Company, indicating in each case the date of expiration of the rights and material coverage.

c. List of proprietary processes controlled by the Company and other trade secrets.

d. List and copies of material license agreements.

e. Lists of proprietary third-party tools, code protocols and other third-party intellectual property employed in the Company's products and services.

f. Name of law firm(s) handling patent, trademark, copyright or other proprietary rights matters for the Company including contact person and telephone number.

g. Any correspondence from third parties regarding potential infringement of intellectual property rights of others.

h. List of any claims by third parties with respect to the intellectual property rights of the Company.

i. Material research and development agreements relating to product research, development and testing to which the Company is a party.

**8. Operations**

a. Business plans.

b. List of third-party developers showing total and type of project for each developer during the last and current fiscal years, with contact names and phone numbers, and forms of agreements entered into with third-party developers.

c. List of major licensees indicating which product is subject to the license and showing royalty obligations, advance payment on royalty, credits of any royalties against advance payment and frequency of accounting obligation for each licensee during the most recent fiscal year, with contact names and phone numbers.

d. List of top 10 accounts payable with contact names and phone numbers.

e. List of top 10 accounts receivable with contact names and phone numbers.

f. Backlog at end of most recent fiscal year and most recent fiscal quarter.

g. Form of agreements relating to the sale or lease of the Company's equipment.

h. Service contracts without royalty agreements.

i. List of service price changes over past five years.

j. Backlog of orders to customers at end of three most recent fiscal years and four most recent fiscal quarters.

k. Any agreements containing non-competition obligations or exclusivity provisions.

l. Any intercompany agreements between the Company and its subsidiaries.

m. Description of any toxic chemicals used in production and manner of storage and disposition. Description of any EPA, Toxic Substances Control Act or other investigation or claim.

n. Any other material agreements or drafts of proposed material agreements of the Company.

**9. Sales and Marketing**

a. List of the Company's products and services.

b. List of the Company's ten largest customers or groups for the last three years, indicating amounts and nature of services provided and providing contact names and phone numbers for each customer.

c. List of the Company's suppliers (other than suppliers of goods and services generally required by all businesses, *e.g.*, office supplies, utilities, etc., unless in excess of $50,000 from an individual supplier during any 12-month period) including for each supplier, (i) total and type of purchases by the Company from that supplier during current and prior fiscal years and (ii) details of products and services purchased from such supplier that are available only from that supplier or which are potentially difficult to obtain in sufficient quantities or in a timely manner from other suppliers.

d. List of the Company's competitors.

e. Pertinent market research or marketing studies (including any studies or reports relied on or commissioned or prepared by the Company).

f. Any recent analyses of the Company prepared by investment bankers, engineers, management consultants, auditors or others.

g. Recent presentations to industry, trade or investment groups.

h. Marketing and sales literature and forms, including price lists, catalogs, purchase orders, technical manuals, user manuals, etc.

i. Service and support contracts, marketing agreements and material agency and advertising contracts, if any.

j. Distribution agreements, if any.

k. Forms of warranties and guarantees provided to customers.

**10. Employees**

a. Organizational charts by department and by legal entity.

b. Number of employees by department and by functional area.

c. Forms of employment agreements, if any, including independent contractor service agreements.

d. Employee Confidentiality and Invention Assignment Agreements and any consultant or contractor agreements.

e. Employment agreements or non-competition agreements or invention assignment agreements of officers and other key employees with former employers.

f. Employee benefit, pension, profit sharing, compensation and other plans.

g. Description of commissions paid to managers, agents or other employees since inception of the Company.

h. Any collective bargaining agreements or other material labor contracts.

i. Description of any significant labor problems or union activities the Company has experienced.

j. Copies of any NLRB or U.S. Department of Labor filings.

**11. Officers and Directors; Corporate Governance**

a. Completed Officers' and Directors' Questionnaires (including the FINRA Questionnaire).

b. Resume for each officer and director/director nominee.

c. Employment, "change of control" agreements, and severance agreements with any key employee or member of management, indemnification agreements and "golden parachute" agreements, if any.

d. Schedule of compensation paid during the last five fiscal years to officers, directors and key employees showing separately salary, bonuses and non-cash compensation (*e.g.*, use of cars, property, etc.).

e. Bonus plans, retirement plans, pension plans, deferred compensation plans, profit sharing and management incentive agreements.

f. Agreements for loans to officers or directors (including relocation loans) and any other agreements (including consulting and employment contracts) with officers or directors, whether or not now outstanding, including (i) loans to purchase stock and(ii) consulting contracts.

g. Description of any transactions between the Company and any officer, director, or owner of 5% or more of any class of the Company's securities or any associate of any such person or entity or between or involving any two or more of such persons or entities.

h. List of directors who have been determined by the board of directors to be "independent" under applicable SEC and NYSE/NASDAQ rules.

i. List of directors who serve on the Audit Committee and name of the director who is the "financial expert" on the Audit Committee, along with a copy of the committee charter.

j. Audit Committee pre-approval procedures for audit and non-audit serves and regarding auditor fees.

k. Corporate policies relating to the engagement of the Company's auditors, including policies relating to the scope of services to be performed by the Company's auditors.

l. List of directors who serve on Compensation Committee, along with a copy of the committee charter.

m. List of directors who serve on Nominating and Governance Committee, along with a copy of the committee charter.

n. Lists of directors who serve on any other committees of the board of directors, along with a copy of the charters from such committees.

o. Corporate codes of ethics, corporate governance guidelines or other codes of conduct of the Company, including "whistleblower" policies and procedures.

p. Insider trading compliance program and policies.

q. Description of any defensive measures or anti-takeover provisions.

**12. Tangible Property**

a. List of real and material personal property owned by the Company.

b. Documents of title, mortgages, deeds of trust, leases and security agreements pertaining to the properties listed in 12(a) above.

c. Outstanding leases for real and personal property to which the Company is either a lessor or lessee, including ground leases and subleases, estoppel certificates and related subordination or non-disturbance agreements.

d. List of any security interests in personal property, including any UCC filings.

e. Description of any toxic chemicals used in production and manner of storage and disposition. Description of any EPA or other investigation or claim.

f. Environmental Site Assessments or reports concerning any real property owned or leased by the Company.

g. Environmental, Health and Safety compliance verification reports (*e.g.*, compliance audits) and quality assurance documents.

h. Correspondence, memoranda, notes or notices of violation from foreign, federal, state or local Environmental, Health and Safety authorities.

**13. Litigation and Audits**

a. Letters from counsel sent to auditors for year-end and current interim audits.

b. Complaints, orders or other significant documents in pending or threatened matters involving claims of $25,000 or more or seeking injunctive or other equitable relief.

c. Active litigation files, including letters asserting claims, complaints, answers, etc. (non-privileged material only).

d. Any litigation settlement documents.

e. Any decrees, orders or judgments of courts or governmental agencies.

f. Correspondence, memoranda or notes concerning inquiries from governmental (i) tax authorities, (ii) occupational safety, health and hazard officials, (iii) environmental officials, or (iv) authorities regarding equal opportunities violations, antitrust violations, or violations of any other law, rule or regulation.

g. Description of any warranty claims that have been made against the Company, any subsidiary, or any partnership or joint venture and the resolution of such claim.

h. Information regarding any material litigation to which the Company is a party or in which it may become involved.

**14. Insurance**

a. List and copies of material insurance policies of the Company covering property, liabilities and operations and any significant claims currently pending thereunder.

b. List of any other insurance policies in force, such as “key person” policies, director indemnification policies or product liability policies.

**15. Partnership, Joint Venture Agreements and Other Corporate Transactions**

a. List of partnership or joint venture agreements, if any.

b. Partnership roll-up documents, if any.

c. Any material purchase agreements and other significant documents relating to any acquisitions or dispositions by the Company since inception or currently proposed.

d. Any material purchase agreements and other significant documents relating to any reorganization and any going private transactions, mergers, consolidations, spin-offs or reincorporation since inception or currently proposed.

e. List of special purpose entities in which the Company, any of its current or former executive officers or directors have a significant interest (on an individual or an aggregate basis) or that have purchased assets or assumed liabilities from the Company or that have significant obligations to the Company (each a "SPE"). Include a brief description of each SPE's primary purpose or activities. Any agreements or documents setting forth any arrangements (or if not memorialized, a description of any such arrangement) between or among the Company and any SPE.

**16. Governmental Regulations and Filings**

a. Summary of material inquiries by a governmental agency, if any.

b. Status of foreign and domestic government contracts subject to renegotiation, if any.

c. Material foreign and domestic governmental permits, licenses, certificates, etc. which the Company has obtained or had revoked.

d. Material filings made and significant correspondence by the Company with any state, federal or foreign governmental or regulatory agencies since the Company's inception.

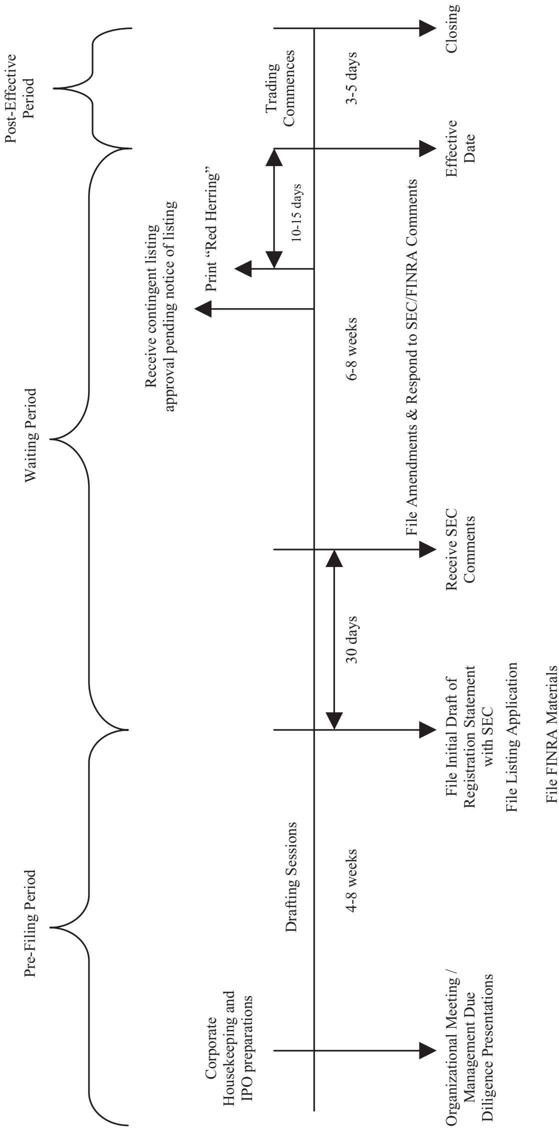
**17. Miscellaneous**

a. Materials that support statements to be made in the prospectus, including any documents to be cited, summarized or quoted in the prospectus.

b. Any other materials or documents that are significant or should be reviewed and considered regarding the Company, its business and financial condition, or any subsidiary.

# Appendix C

## Sample IPO Timeline



# Glossary

*The definitions below are intended to convey plain English explanations of certain terms. For technically complete, legally precise definitions, experienced counsel should be consulted.*

*The definitions of many of the words and phrases in this Glossary use other defined words and phrases. Terms in a given definition that themselves (or variations thereof) appear elsewhere under their own listings are italicized.*

***Accelerated Filer.*** A public company that meets the following conditions as of the end of its fiscal year:

- The company's common equity public float (*i.e.* held by its non-*affiliates*) was $75 million or more, but less than $700 million, as of the last business day of its most recently completed second fiscal quarter;
- The company has been subject to the reporting requirements of Section 13(a) or 15(d) of the *Exchange Act* for a period of at least 12 calendar months;
- The company has previously filed at least one annual report pursuant to Section 13(a) or 15(d) of the *Exchange Act*; and
- The company does not satisfy the requirements for smaller reporting companies for its annual and quarterly reports.

***Acceleration Request.*** A written (or, in some cases, oral) request to the SEC to declare a *registration statement* effective at a certain date and time. The SEC requires that the request be delivered at least two business days prior to the anticipated *effective date.*

***Affiliate.*** A person or entity that directly or indirectly controls, is controlled by, or is under common control with, a company. Examples of affiliates include executive officers, directors, large stockholders, subsidiaries and sister companies.

***Aftermarket.*** Trading on stock exchanges and over-the-counter markets in a company's stock after an *initial public offering*.

***Aggregate Offering Price.*** The total offering price of an offering to the public, which is equal to the number of offered shares multiplied by the price per share to the public.

***American Depositary Receipts (ADRs).*** Negotiable instruments, created by a U.S. bank, that evidence ownership of a specified number of shares of a foreign security held in a depositary in the issuing company's country of domicile. The certificate, transfer, and settlement practices for ADRs are identical to those for U.S. securities. U.S. investors often prefer

ADRs to direct purchase of foreign shares because of the ready availability of price information, lower transaction costs, and timely dividend distribution.

***American Stock Exchange (Amex).*** The second-oldest U.S. stock exchange, located on Wall Street in New York City. The Amex typically lists small to medium cap stocks of younger or smaller companies. The Amex is the only primary exchange that offers trading across a full range of equities, options and exchange traded funds (ETFs). The Amex is also one of the largest options exchanges in the U.S., trading options on broad-based and sector indexes as well as domestic and foreign stocks.

***Analyst.*** A person with expertise in evaluating financial investments. An analyst performs investment research and makes recommendations to institutional and retail investors to buy, sell, or hold; most analysts specialize in a single industry or business sector.

***Annual Report.*** A report containing financial statements and certain other information required by *SEC* regulations which is distributed to stockholders on an annual basis. One method of satisfying the annual report requirement is to distribute a copy of the company's *Form 10-K*, which is often accompanied by a letter from the CEO, and is commonly referred to as a "10-K wrap."

***Banknote Company.*** A public company must provide a physical certificate of ownership to holders of the company's stock who request it. A banknote company specializes in the design and printing of stock certificates.

***Beneficial Ownership.*** The beneficial owner of a security includes any person who directly or indirectly, through any contract, arrangement, understanding, relationship or otherwise, has or shares voting or investment power with respect to such security. A person or entity may be the beneficial owner of a security even though title may be in another name for safety, convenience or otherwise (such as when securities beneficially owned by an individual are held by a *broker* in street name). There may be more than one beneficial owner of a single security.

***Best Efforts Offering.*** As opposed to a *firm commitment underwriting*, refers to an offering where the *underwriters* do not purchase the securities from the issuer or resell them to the public. In a best efforts offering, *underwriters* act only as an agent of the issuer in marketing the securities to investors. Most best efforts offerings today are handled by investment banks specializing in lesser known or more speculative securities.

***Blue Sky Laws.*** State securities laws loosely analogous to the federal securities laws. The term is said to have originated with a judge who asserted that a particular stock offering had as much value as a patch of blue sky.

***Broker.*** An individual or firm that trades securities for buyers or sellers in exchange for a commission.

***Capitalization.*** The total amount of a company's outstanding debt and *equity* securities. The term also is commonly used to refer to the capital (debt and equity) structure of a company.

***Charter Documents.*** A company's basic incorporation documents, including the Articles or Certificate of Incorporation and the Bylaws.

***Cheap Stock.*** The term used to describe securities, most commonly stock options, granted to employees, directors, consultants or other service providers with an exercise price below the fair value of the underlying security as of the date of grant. The SEC generally views the difference in exercise price and fair market value (measured as of the date of grant) as compensation and requires that the company record a corresponding compensation expense.

***Closing.*** The closing of an offering is held on the third or fourth business day following the effective date. At the closing, the company delivers the registered securities to the *underwriters* in exchange for the *net proceeds.*

***Comfort Letter (or "cold comfort" letter).*** A letter written by the company's accountants and delivered to the *underwriters* and the company's board of directors as part of the due diligence process. The comfort letter gives assurance to the *underwriters* and the company's board of directors that the financial information included in the *registration statement* corresponds to the audited and unaudited financial statements and other financial records of the company and may also discuss the results of certain additional agreed upon procedures.

***Confidential Treatment.*** The method whereby a company can request that certain sensitive or confidential information contained in exhibits to filings made with the SEC be redacted from the documents and not made available to the public. Typical examples of the type of information for which confidential treatment may be sought include financial information (such as pricing terms, royalty rates and milestone payments) and trade secrets (such as technical specifications).

***CUSIP Number.*** CUSIP is an acronym for the Committee on Uniform Security Identification Procedures. This committee was established in 1964 by the American Bankers Association's Department of Automation to create a uniform security identification system. The CUSIP Service Bureau, operated by Standard & Poor's, administers this system and assigns unique numbers (CUSIP numbers) and standardized descriptions of securities, both of which are critically important for the accurate and efficient clearance and settlement of securities transactions.

***Dealer.*** Individual or entity acting as a principal in a securities transaction.

***Depository Trust Company (DTC).*** DTC provides a central securities certificate depository through which brokers deliver securities by computerized bookkeeping entries, vastly reducing physical transfer of stock certificates

***Directed Shares.*** Refers to shares of stock sold in an *initial public offering* which are directed to certain individuals by the company.

***Director and Officer (D&O) Liability Insurance.*** A form of insurance against liability asserted against directors and officers of a company and incurred by such persons in those capacities or arising out of such persons' status as directors and officers of the company.

***Director and Officer (D&O) Questionnaire.*** A questionnaire distributed by the company to its directors and officers during the early stages of a public offering. The questionnaire solicits information regarding executive compensation, securities ownership and insider transactions. The D&O Questionnaire aids the company in the *due diligence* process and confirms data that is disclosed in the *registration statement.*

***Division of Corporation Finance.*** The division of the SEC that reviews *registration statements* filed pursuant to the *Securities Act.*

***Due Diligence.*** A fact-finding process conducted by various working group members to verify the accuracy and completeness of the *registration statement.*

***Earnings Per Share (EPS).*** Net income of a company for a specified period of time divided by the number of equity securities outstanding at such time. Fully diluted EPS assumes the exercise or conversion of certain warrants, options and convertible securities into common stock.

***EDGAR System.*** The Electronic Data Gathering, Analysis, and Retrieval system, which is an electronic system implemented by the

SEC for the receipt, acceptance, review and dissemination of documents submitted in electronic format.

***EDGAR Filer Manual.*** The manual prepared by the SEC setting out the technical format requirements for *EDGAR* filings. *See also Regulation S-T.*

***Effective Date.*** The date of the SEC order declaring the *registration statement* for a public offering to be effective, at which time the sale of shares to the public can commence.

***Electronic Communication Networks (ECNs).*** In addition to traditional market makers, the NASDAQ network also includes other broker-dealers operating as Electronic Communication Networks, or ECNs, which provide electronic facilities for investors to trade directly with one another without going through a market maker. ECNs operate as order-matching and order-routing mechanisms and do not maintain inventories of securities themselves.

***Equity.*** Represents the ownership interest of stockholders in a company.

***Exchange Act.*** *See* Securities Exchange Act of 1934, as amended.

***Executive Compensation Disclosure Rules.*** Final rules adopted by the SEC on July 26, 2006, August 29, 2006 and December 22, 2006 regarding executive compensation disclosure and related items, including related-party transactions, corporate governance matters and Form 8-K triggers related to executive compensation events. See Rel. No. 33-8732, Rel. No. 33-8732A and Rel. No. 33-8765.

***Final Prospectus.*** The offering document sent to all purchasers of the company's stock in and immediately following a public offering. The final prospectus is an updated version of the *preliminary prospectus*, contains all final offering information (such as pricing and underwriting details) and reflects amendments to the *registration statement* subsequent to the date of the *preliminary prospectus.*

***Financial Printer.*** A printer that specializes in printing financial documents, such as *registration statements* and other documents filed pursuant to the *Securities Act* and the *Exchange Act.*

***Financial Industry Regulatory Authority, Inc. (FINRA).*** FINRA is the largest non-governmental regulatory body for securities firms doing business in the United States. FINRA was formed in 2007 through the consolidation of the NASD and the member regulation, enforcement and arbitration functions of the NYSE.

FINRA is involved in virtually every aspect of the securities business, including registering and educating industry participants; examining securities firms; writing rules; enforcing FINRA rules and the federal securities laws; informing and educating the investing public; providing trade reporting and other industry utilities; and administering a dispute resolution forum for investors and registered firms. FINRA also performs market regulation under contract for the NASDAQ Stock Market and the American Stock Exchange.

***Firm Commitment Underwriting.*** As opposed to a *best efforts offering*, the firm commitment underwriting refers to an underwriting where the *underwriters* commit to purchase shares from the company at a negotiated discount and then resell the shares to the public.

***FINRA Questionnaire.*** A questionnaire distributed by underwriters' counsel to the directors, officers and security holders of a company in connection with a public offering in order to gather and confirm information that must be provided to *FINRA.*

***Flipping.*** "Flipping" refers to purchasing shares in an *IPO* and then reselling the shares for a quick profit. Most *brokers* strongly discourage the practice because they do not want to be shut out of future offerings or lose commissions because too many of their customers are flipping new issues. In fact, it has become fairly commonplace for *IPO underwriters* to require that participants in directed share programs (DSPs) agree to be bound by the same lock-up terms to which pre-*IPO* stockholders and *insiders* are bound. *Issuers* also prefer to have long-term stockholders and do not appreciate stockholders flipping their *IPO* shares. Regardless, *institutional investors* routinely "flip" new issues.

***Foreign Private Issuer.*** Any foreign issuer other than a foreign government, except an issuer meeting the following conditions: (1) more than 50% of the outstanding voting securities of such issuer are owned by U.S. residents; and (2) any of the following: (i) the majority of the executive officers or directors are U.S. citizens or residents; (ii) more than 50% of the assets of the issuer are located in the U.S.; or (iii) the business of the issuer is administered principally in the U.S. Foreign private issuers are subject to somewhat narrower disclosure obligations than U.S. issuers. *See also Form 20-F* and *Form F-1.*

***Form 3.*** Used to report initial beneficial ownership of securities. A Form 3 must be filed by all *Section 16 Insiders* within 10 days after such person becomes a *Section 16 Insider*, except in connection with the initial registration of securities under the *Exchange Act* when the report is due on the *effective date* of the *registration statement*. Required pursuant to *Section 16* of the *Exchange Act.*

***Form 4.*** Used to report changes in beneficial ownership of securities. *Section 16 Insiders* must file a Form 4 by the end of the second day following the day on which a reportable change in such person's beneficial ownership of securities occurred, except where extensions may be available in connection with a Rule 10b5-1 trading plan or for transactions eligible for deferred reporting on Form 5. Required pursuant to *Section 16* of the *Exchange Act.*

***Form 5.*** Used to report beneficial ownership of securities annually. *Section 16 Insiders* must file a Form 5 on or before the 45th day after the end of the *reporting company's* fiscal year to report certain transactions in such company's equity securities. However, if each of such transactions has been reported on a previous Form 3 or Form 4, no Form 5 need be filed. Required pursuant to *Section 16* of the *Exchange Act.*

***Form 8-A.*** A form of *registration statem*ent used to register securities pursuant to the *Exchange Act.*

***Form 8-K.*** The prescribed form for current reports of certain specified events, such as:

- Entry into, termination or amendment of a material agreement;
- Certain public announcements of financial results;
- Incurring certain financial obligations;
- Incurring certain costs associated with exit or disposal activities;
- Material impairments;
- Receipt of notice of delisting or the failure to satisfy a condition of continued listing from a national securities exchange;
- Sales of unregistered securities;
- Material modifications to the rights of security holders;

- Change in accountants;
- Non-reliance on previously issued financial statements or a related audit report or completed interim review;
- A change in control;
- Departure of directors or certain officers;
- Election of directors;
- Appointment of certain officers;
- Entry into compensatory arrangements with certain officers;
- Amendments to Certificate of Incorporation or Bylaws;
- Change in fiscal year;
- Temporary suspension of trading under employee benefit plans;
- Amendments or waivers of the code of ethics; and
- Certain changes in shell company status;

The Form 8-K may also be used to voluntarily report other important events.

***Form 10-K.*** An annual report on Form 10-K is required to be filed by a *reporting company* within 90 days after the end of each fiscal year, unless the *reporting company* is an *accelerated filer or large accelerated filer* subject to accelerated filing deadlines as discussed in *Chapter 10*. The Form 10-K consists of the cover page, Part I (information relating to the company's business, risk factors property, legal proceedings and votes of security holders), Part II (financial and control information), Part III (information relating to the company's directors, officers, principal stockholders and principal accounting fees and services) and Part IV (exhibits and financial statement schedules). *See also Annual Report.*

***Form 10-Q.*** *Reporting companies* are required to file quarterly reports on Form 10-Q within 45 days after the end of each of the first three quarters of each fiscal year, unless the *reporting company* is an *accelerated filer* or *large accelerated filer* subject to accelerated filing deadlines as discussed in *Chapter 10*. The Form 10-Q is less comprehensive than the *Form 10-K*.

***Form 20-F.*** Form 20-F may be used by *foreign private issuers* both to register securities under the *Exchange Act* and as an annual report which must be filed within six months after the end of each fiscal year.

***Form F-1.*** Form F-1 is used by *foreign private issuers* to register shares pursuant to the *Securities Act.*

***Form S-1.*** The basic *registration statement* form used to register securities pursuant to the *Securities Act* when no other form is authorized or prescribed. Form S-1 *registration statement* is the form most commonly used in connection with an *IPO*. The Form S-1 requires comprehensive disclosure about the company and permit, *incorporation by reference* of documents or information only under specific circumstances in connection with a *follow-on offering.*

***Form S-3.*** The Form S-3 *registration statement* is available for any U.S. company that has been subject to the reporting requirements of the *Exchange Act* for at least 12 months and has filed all required reports pursuant to the *Exchange Act* in a timely manner for at least the preceding 12 months and any portion of the month preceding filing of the *registration statement,* with limited exceptions. Depending on the type of offering, there may be additional financial thresholds and other requirements.

***Form S-4.*** The Form S-4 *registration statement* is used to register securities issued by *reporting companies* in connection with certain business combinations, reclassifications, mergers, consolidations and asset transfers.

***Form S-8.*** The Form S-8 *registration statement* may be used by *reporting companies* to register securities to be offered pursuant to employee benefit plans.

***Free-Writing Prospectus.*** A written communication outside of the company's statutory prospectus which may take any form and is not required to comply with the information requirements otherwise applicable to statutory prospectuses.

***GAAP (Generally Accepted Accounting Principles).*** Rules and procedures generally accepted within the accounting profession. The Financial Accounting Standards Board (FASB) is the body primarily responsible for developing rules governing U.S. generally accepted accounting practices.

***Green Shoe.*** This term refers to the option typically granted to the underwriters to cover over-allotments in the offering. This name derives from the fact that the over-allotment option technique was first used in a public offering of the securities of The Green Shoe Company. *See Over-allotment option.*

***Gross Proceeds.*** Offering proceeds before *underwriting discounts and commissions* are deducted.

***Hot Issues.*** A hot issue is an *IPO* that trades up in the *aftermarket* in the period immediately following initial sales of the stock. Special *FINRA* rules apply to the distribution of hot issues.

***Incorporation by Reference.*** Certain forms filed under the *Securities Act* and *Exchange Act* enable the incorporation of certain required disclosure documents and information by reference to other previously filed documents and information, thereby simplifying the registration or filing process.

***Independent Director.*** *See* the discussion of various director independence in *Chapter 2*. In general, an independent director is a person other than an officer or employee of the company or its subsidiaries or any other individual having a relationship, which, in the opinion of the company's board of directors, would interfere with the exercise of independent judgment in carrying out the responsibilities of director.

***Initial Public Offering (IPO).*** The process of a company registering shares of its capital stock with the SEC and offering the shares to the public for the first time. In an IPO, the company's shares may sometimes be offered for sale by *selling stockholders* in addition to the *issuer*. The portion of shares offered by the *issuer* is referred to as the "primary" component of the IPO, while shares offered for sale by *selling stockholders* is referred to as the "secondary" component of the IPO.

***Insider.*** Generally, an insider is a person with access to material information relating to a company before it is announced to the public, and who has a duty to the issuer not to misuse such information. The term includes, but is not necessarily limited to, directors, officers and key employees.

***Institutional Investors.*** Organizations whose primary purpose is to invest their own assets or those entrusted to them by others, the most common of which are employee pension funds, insurance companies, mutual funds, university endowments, and banks.

***IPO.*** *See Initial Public Offering.*

***Issuer.*** In a public offering, the company whose securities are sold in the offering is referred to as the issuer.

***Large Accelerated Filer.*** A public company that meets the following conditions as of the end of its fiscal year:

- The company's common equity public (*i.e.*, held by its non-*affiliates*) was $700 million or more as of the last business day of its most recently completed second fiscal quarter;
- The company has been subject to the reporting requirements of Section 13(a) or 15(d) of the *Exchange Act* for a period of at least 12 calendar months;
- The company has previously filed at least one annual report pursuant to Section 13(a) or 15(d) of the *Exchange Act*; and

The company is not eligible to use the requirements for smaller reporting companies for its annual and quarterly reports.

***Lock-Up Agreement.*** An agreement between a company or the *underwriters* on the one hand, and a stockholder on the other hand, whereby the stockholder agrees that it will refrain from reselling its shares for a specified period of time after the effective date of a *registration statement. See also Overhang Analysis.*

***Management's Discussion and Analysis of Financial Condition and Results of Operations (MD&A).*** The section of the *registration statement* discussing and analyzing the company's financial condition, changes in financial condition and results of operations. The MD&A typically includes period-to-period comparisons of the three most recent fiscal years and the current fiscal year to date compared to the corresponding prior year period.

***Management Interviews.*** *Due diligence* meetings conducted by the *managing underwriters* where members of the company's management team make presentations and answer questions about the company.

***Managing Underwriters.*** The *underwriters* who, singly or together with co-managers, participate in the preparation of the *registration statement,* conduct portions of the *due diligence* and conduct the *road show.*

***Market Capitalization.*** The value of a company as determined by the market price of its issued and outstanding common stock. It is calculated by multiplying the number of outstanding shares by the current market price of a share.

***Market Makers.*** The *FINRA* member firms that use their own capital, research, retail or systems resources to represent a stock and compete with each other to buy and sell the stocks they represent. Market makers, also known as *dealers,* provide liquidity (the ability of a security to absorb a large amount of buying and selling without substantial movement in price) by standing ready to buy or sell securities at all times at publicly quoted prices for their own account and by maintaining an inventory of securities for their customers. There are over 500 member firms that act as NASDAQ market makers.

***MD&A.*** *See Management's Discussion and Analysis of Financial Condition and Results of Operations*.

***NASD.*** The predecessor of *FINRA* and previously known as the National Association of Securities Dealers. *See FINRA.*

***National Association of Securities Dealers (NASD).*** The NASD was a self-regulatory organization for the securities industry in the United States. In 2007, the NASD was consolidated with the member regulation, enforcement and arbitration functions of the NYSE to form FINRA, and FINRA now serves as the primary self regulatory organization that oversees the securities industry, subject to the oversight of the SEC.

***NASDAQ Global Select Market.*** The highest tier on the *NASDAQ* market, consisting of more than 1,200 companies that have a national or international shareholder base, have applied for listings, meet stringent financial and liquidity requirements and agree to specific corporate governance Standards. The listing requirements of the NASDAQ Global Select Market are set forth in Appendix A.

***NASDAQ Global Market (formerly known as NASDAQ National Market).*** The middle tier on the *NASDAQ* market, consisting of more than 1,450 companies that have a national or international shareholder base, have applied for listing, meet stringent financial and liquidity requirements and agree to specific corporate governance standards. The listing requirements of The NASDAQ Global Market are set forth in *Appendix A*.

***NASDAQ Capital Market (formerly known as NASDAQ SmallCap Market).*** The lower tier of the *NASDAQ* market, and it is comprised of more than 550 companies that desire the sponsorship of *Market Makers,* have applied for listing and meet specific financial and liquidity requirements.

***NASDAQ.*** The NASDAQ Stock Market LLC, or NASDAQ, is the largest electronic equity securities market in the U.S., in terms of number of listed companies and traded share volume. According to NASDAQ, it was home to 3,115 listed issuers with a combined market capitalization of approximately $3.9 trillion as of March 31, 2008. In February 2008, The Nasdaq Stock Market, Inc. (NASDAQ's parent company) and OMX AB combined their businesses and became The NASDAQ OMX Group, Inc., which is now the holding company whose subsidiaries operate the following exchanges: The NASDAQ Stock Market LLC in the U.S. and the Nordic Exchange in the Nordic-Baltic region. The Nasdaq Stock Market was originally founded in 1971 as a wholly owned subsidiary of NASD (now known as FINRA) and became a holding company on August 1, 2006 when NASDAQ commenced operations as a registered national securities exchange. With exchange registration, NASDAQ received its own status as a SRO.

***Net Proceeds.*** *Gross proceeds* of an offering less the *underwriting discounts and commissions* and offering expenses.

***New York Stock Exchange (NYSE).*** The oldest and largest U.S. stock exchange, located on Wall Street in New York City. Tracing its origins back to 1792, the NYSE is one of the few remaining financial markets to use a physical trading floor to conduct trading. The NYSE operates an auction market in which orders are electronically transmitted for execution, which is known as an "agency auction trading model." Specialists on the trading floor are charged with maintaining fair, orderly and continuous trading markets in specific stocks by bringing buyers and sellers together and, when circumstances warrant, adding liquidity by buying and selling stock for their own account. Floor brokers act as agents on the trading floor to facilitate primarily large or complicated orders. The NYSE is also known as "the Big Board" and "the Exchange." The listing requirements of the NYSE are set forth in *Appendix A.*

***No-Action Letter.*** *See "SEC No-Action" Letter.*

***NYSE Euronext.*** NYSE Euronext operates the world's leading exchange group. Its family of exchanges, located in six countries, include the New York Stock Exchange (NYSE), the world's largest cash equities market; Euronext, the Eurozone's largest cash equities market; Liffe, Europe's leading derivatives exchange by value of trading; and NYSE Arca Options, one of the fastest growing U.S. options trading platforms. According to NYSE Euronext, its nearly 4,000 listed companies represented a combined $30.5 trillion in total global market capitalization as of December 31, 2007.

***Options.*** Options are securities giving the holder the right to purchase securities of the company at a certain price.

***Over-the-Counter (OTC) Bulletin Board Market.*** An electronic screen-based market maintained by NASDAQ for equity securities that, among other things, are not listed on *The NASDAQ Stock Market* or any primary U.S. national securities exchange. Companies do not list on the OTC Bulletin Board; rather, *FINRA* members may post quotes only for companies that file periodic reports with the SEC or with a banking or insurance regulatory authority.

***Over-allotment option.*** The option granted in an *initial public offering*, or other underwritten securities offering, by the *issuer, selling stockholders* or both to the *underwriters* to purchase additional shares, to cover over-allotments on identical terms to those on which the original shares were sold to the underwriters. Also known as the *Green Shoe.*

***Overhang Analysis.*** An analysis of the number of outstanding shares of a company's stock that become freely tradeable at particular intervals following the *IPO.*

***Periodic Reporting Requirements.*** The ongoing requirements applicable to *reporting companies* to make filings pursuant the *Exchange Act*, including current reports on *Form 8-K*, quarterly reports on *Form 10-Q* and annual reports on *Form 10-K.*

***Plain English Disclosure.*** The SEC requirement for the orderly and clear presentation of complex information contained in *registration statements*. The rule requires companies to write the cover page, summary and *risk factors* sections of *registration statements* in "plain English."

***Poison Pill.*** A type of strategic defensive measure that is designed to delay the timing and raise the cost of an unsolicited or hostile acquisition and thereby encourage would-be suitors to negotiate with the company's board of directors. A poison pill is typically implemented by means of a stockholder rights plan.

***Preliminary Prospectus.*** The offering document used by the company and the *underwriters* to market a public offering. The preliminary prospectus is essentially Part I of the *registration statement* and may omit certain information relating to the offering (such as the final offering price). Also known as the *Red Herring* because of the red ink typically used on the front page, which indicates that some information, including the price and size of the offering, is subject to change.

***Primary offering.*** The portion of a registered offering being offered and sold by the issuer.

***Prospectus.*** *See Final Prospectus* and *Preliminary Prospectus.*

***Proxy Statement.*** A document containing information prescribed by SEC regulation that must be provided to stockholders in connection with the solicitation of their votes.

***Public Offering Price.*** The price at which a new issue is offered to the public by *underwriters.*

***Public Company Accounting Oversight Board (PCAOB).*** The PCAOB is a private-sector, nonprofit corporation created by the Sarbanes-Oxley Act of 2002 to oversee accounting professionals who provide independent audit reports for publicly traded companies. The PCAOB's responsibilities include the following:

- registering public accounting firms;
- establishing auditing, quality control, ethics, independence, and other standards relating to public company audits;
- conducting inspections, investigations, and disciplinary proceedings of registered accounting firms; and
- enforcing compliance with Sarbanes-Oxley.

***Quiet Period.*** Extends to the 25-day period following the *effective date* of a *registration statement* in connection with an *IPO* (or 90-day period if, following the *IPO*, the company is not listed on a stock exchange or over-the-counter market).

***Red Herring.*** See *Preliminary Prospectus.*

***Registrar and Transfer Agent.*** An agent, usually a commercial bank, appointed by a company to maintain records of security owners, to cancel and issue certificates and to resolve problems arising from lost, destroyed or stolen certificates.

***Registration Rights.*** Contractual rights to participate in or require a public offering of equity securities.

***Registration Statement.*** The document that must be filed with the *SEC* to register shares of a company's stock in connection with a public offering. *See also Form F-1, Form S-1, Form S-3, Form S-4 and Form S-8.*

***Regulation AC (Analyst Certification).*** An SEC rule that requires that *brokers, dealers* and certain persons associated with a *broker* or *dealer* include in research reports certifications by the research *analyst* that the views expressed in the report accurately reflect his or her personal views, and disclose whether or not the *analyst* received compensation or other payments in connection with his or her specific recommendations or views.

***Regulation BTR (Blackout Trading Restriction).*** An SEC rule that addresses the operation of Section 306(a) of the *Sarbanes-Oxley Act* and its prohibition against trading in *issuer* equity securities by an *issuer's* directors and executive officers during a pension plan blackout.

***Regulation FD (Fair Disclosure).*** An SEC rule that provides that when an *issuer,* or person acting on its behalf, discloses material, non-public information to certain enumerated persons (in general, securities market professionals and holders of the issuer's securities who may well trade on the basis of the information), it must make public disclosure of that information.

***Regulation G.*** An SEC rule that requires public companies that disclose or release non-*GAAP* financial measures to include, in that disclosure or release, a presentation of the most directly comparable *GAAP* financial measure and a reconciliation of the disclosed non-*GAAP* financial measure to the most directly comparable *GAAP* financial measure.

***Regulation S-K.*** An SEC rule that sets forth the disclosure requirements applicable to the content of the non-financial statement portions of *registration statements* and other filings under the *Securities Act* and the *Exchange Act.*

***Regulation S-T.*** An SEC rule that sets forth the format and other technical requirements for documents filed with the *SEC* in electronic, or *EDGAR*, format. *See also EDGAR Filer Manual.*

***Regulation S-X.*** An SEC rule that sets forth the form and content of and requirements for financial statements included with *registration statements* and other filings under the *Securities Act* and the *Exchange Act*.

***Reincorporation.*** The process of changing the jurisdiction of incorporation of a company (often to Delaware).

***Reporting Company.*** Any business entity that (1) has filed a *registration statement* pursuant to the *Exchange Act* which has become effective, or (2) has become required to file *periodic reports* pursuant to the *Exchange Act* because such business entity has exceeded certain maximum thresholds regarding the number of equity holders and amount of assets.

***Restricted Securities.*** Securities of a company acquired directly or indirectly from the company in a transaction or chain of transactions not involving any public offering. Restricted securities may only be resold in the public markets by way of a registered offering or exemption pursuant to the *Securities Act. See also Rule 144.*

***Risk Factors.*** The portion of a *registration statement* that sets forth the principal risks faced by the company and other factors that make the purchase of stock in the offering speculative or high risk.

***Road Show.*** The presentations made by the executive management of the company, during a public offering, in one-on-one or group presentations, to prospective purchasers of securities in the public offering, typically *institutional investors.* The road show for an *IPO* typically lasts from one to three weeks.

***Rule 10b-5.*** An SEC Rule that provides that it is unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails or of any facility of any national securities exchange,

a. To employ any device, scheme, or artifice to defraud,

b. To make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or

c. To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person,

in connection with the purchase or sale of any security.

***Rule 144.*** An SEC rule that provides a "safe harbor" that sets forth the conditions whereby a holder of unregistered securities may make a sale in the *aftermarket* without registration under the *Securities Act*. Stockholders making resales of unregistered securities without complying with the Rule 144 requirements bear a high burden of proof in establishing compliance with the federal securities laws.

***Rule 135.*** An SEC Rule that permits companies to announce its proposed *IPO,* without such communication being deemed an "offer" of securities under the *Securities Act,* so long as the announcement contains only the information permitted by Rule 135.

***Rule 163A.*** An SEC Rule that excludes from the definition of "offer" any communication made by a company more than 30 days before the filing of its *registration statement,* so long as the communication does not reference an offering that is or will be the subject of a *registration statement,* is made by or on behalf of the company (as opposed to an *underwriter* or *dealer*), and the company takes reasonable steps within its control to prevent further distribution or publication during the 30-day period prior to filing of the *registration statement.*

***Rule 169.*** An SEC Rule that permits a company to release or disseminate factual information about the company, its business or financial developments, or other aspects of its business and advertisements of, or information about, its products or services; provided that certain conditions are satisfied.

***Rule 701.*** Rule 701 under the *Securities Act* sets forth the conditions whereby a holder of unregistered securities received pursuant to a written compensatory benefit plans may resell such securities in the public markets without registration under the *Securities Act*. In some cases, Rule 701 may allow resale prior to the date that would otherwise be allowed under Rule 144.

***Sarbanes-Oxley Act of 2002 (SOX).*** An Act that made a number of significant changes to federal regulation of public company corporate governance and reporting obligations.

***Schedule 13D.*** *See Section 13.*

***Schedule 13G.*** *See Section 13.*

***SEC.*** *See Securities and Exchange Commission.*

***SEC "No-action" Letter.*** A letter that is issued by the SEC stipulating that it does not object to a course of action proposed by a registrant. If the staff of the SEC issues such a letter, it generally confirms in the letter that it will not recommend that the SEC take enforcement action relating to the proposed action. Also, the SEC generally states specifically that the positions discussed in the letter are based on the specific facts and circumstances set forth in the request from the registrant, and that any different facts or circumstances may require a different conclusion.

***Secondary offering.*** The portion of a registered offering being offered and sold by *selling stockholders.*

***Section 13.*** Section 13 of the *Exchange Act*, which requires that any holder of more than 5% of any class of registered equity securities report such ownership on a *Schedule 13D* or *Schedule 13G.*

***Section 16.*** Section 16 of the *Exchange Act*, which requires the periodic disclosure of equity ownership (and changes in ownership) of *Section 16* *insiders.* Section 16 also requires the disgorgement of any profits ("short-swing" profits) realized by *Section 16 insiders* from the purchase and sale, or sale and purchase, of equity securities of the company in any 6-month period. *See also Form 3, Form 4, Form 5, Section 16 Insider* and *Short Swing Profits*.

***Section 16 Insider.*** Any executive officer, director or *beneficial owner* of greater than 10% of a class of registered equity securities. *See also Form 3, Form 4, Form 5, Section 16* and *Short Swing Profits.*

***Securities Act.*** The Securities Act of 1933, as amended, which is the federal statute prohibiting the offer or sale of a security (except certain exempt securities or in certain exempt transactions) unless the security has been registered with the *SEC*, and imposing *prospectus* delivery requirements. The Securities Act also contains antifraud provisions prohibiting false representations and disclosures. Enforcement responsibilities were assigned to the *Securities and Exchange Commission* by the *Exchange Act.*

***Securities and Exchange Commission (SEC).*** The federal agency created by the *Exchange Act* to administer the *Exchange Act* and the *Securities Act.* The statutes administered by the SEC are designed to promote full public disclosure and protect the investing public against fraudulent and manipulative practices in the securities markets

***Securities Exchange Act.*** The Securities Exchange Act of 1934, as amended, which is the federal statute regulating reporting obligations of *reporting companies*, tender offers, certain trading practices and insider trading. It created the *Securities and Exchange Commission* to enforce both the *Securities Act* and the *Exchange Act* and requires that public companies enter its continuous disclosure system and file annual and quarterly reports and *proxy statements* with the *SEC.* The Exchange Act also establishes a self-regulatory system for the supervision of the trading markets and gives the *SEC* oversight jurisdiction over stock exchanges and *FINRA*.

***Self-Regulatory Organization (SRO).*** A non-government organization (such as *FINRA*) that has statutory responsibility to regulate its own members through the adoption and enforcement of rules of conduct for fair, ethical and efficient practices.

***Selling Group.*** A group of *dealers* and *underwriters* selected by the *managing underwriters,* as the agent for the other *underwriters,* to market shares in a public offering.

***Selling Stockholder.*** A stockholder of a company that is selling shares in a registered public offering. *See also Secondary offering.*

***Short-Swing Profits.*** Profits realized from the purchase and sale, or sale and purchase, of an equity security of a *reporting company* by a *Section 16 insider* in any 6-month period. *Section 16* of the *Exchange Act* requires the disgorgement of short-swing profits realized by such persons.

***Standard Industrial Classification (SIC).*** Code used to classify entities by the type of economic activities in which they are engaged.

***Stock Split.*** An increase or decrease in the total number of outstanding shares of capital stock. An increase in the total number of outstanding shares is called a "forward split," and a decrease is called a "reverse split." For example, a "2-for-1 stock split" would double the total number of outstanding shares of capital stock of a company; each stockholder would be entitled to two shares for each one share he or she owns. A "1-for-3 reverse stock split" would reduce the total number of outstanding shares of capital stock of a company to one-third of that total number; every three shares of stock held by a stockholder would become one share after the reverse split. Stock splits are effected in two ways: (1) as a stock dividend or (2) as a stock split whereby the certificate of incorporation is amended. A stock dividend is the payment of additional shares to existing holders and can only be used to effect a forward split. A stock dividend can often be effected by resolution of the board of directors, and without the need for stockholder approval. A stock split is the division or combination of existing shares into new shares and requires both the resolution of the company's board of directors and the filing of an amended certificate of incorporation (which typically requires stockholder approvals).

***Syndicate.*** A group of *underwriters* selected by the *managing underwriters t*o market and sell shares in a registered public offering.

***Ticker Symbol.*** A one to four letter abbreviation used to identify a security whether on the floor, a TV screen, or a newspaper page. Ticker symbols are part of the lore of Wall Street and were originally developed in the 1800s by telegraph operators to save bandwidth. One-letter symbols were therefore assigned to the most active stocks. Railroads were the dominant issues at the time, so they retain a majority of the one-letter designations. Ticker symbols today are assigned on a first-come, first-served basis. Each marketplace – the *NYSE*, the *Amex*, *NASDAQ* and others – allocates symbols for companies within its purview, working closely to avoid duplication. A symbol used for one company cannot be used for any other, even in a different marketplace.

***Transfer Agent.*** A Transfer Agent keeps a record of the name of each registered stockholder, his or her address and the number of shares owned, and ensures that the certificates presented for transfer are properly cancelled and that new certificates issued in the name of the new owner.

***Underwriter.*** An investment bank that offers or sells securities to investors in a public offering on behalf of the company in either a *firm commitment underwriting* (which is most typical) or a *best efforts offering*. The *Securities Act* defines *underwriter* much more broadly, so as to encompass many other participants in a distribution of securities.

***Underwriting Agreement.*** In a registered offering, the principal agreement between the company and the *underwriters* stating the relationship between the parties. The underwriting agreement contains an agreement to sell and buy the offered shares, the *underwriting discount and commission*, representations and warranties of the parties, certain covenants, expense allocation and indemnification provisions.

***Underwriting Discount and Commission.*** A percentage of the *gross proceeds* of an *initial public offering* that constitutes the compensation paid to the *underwriters* for marketing and selling the offering.

***Waiting Period.*** The period of time between the filing of the *registration statement* and the *effective date*.

***Well Known Seasoned Issuer.*** A company that has timely filed for at least the prior year all required annual, quarterly and current reports, and either has at least $700 million in market capitalization (including only common stock held by non *affiliates*) or has issued $1 billion in debt securities in registered offerings for cash over the prior three years.

***WKSI.*** Please see *Well Known Seasoned Issuer.*

***Working Group.*** Consists of key company executives and employees, the company's board of directors, the *managing underwriters,* the company's counsel, the underwriters' counsel, the company's auditors, the financial printer and other parties. Members of the working group have various responsibilities in connection with preparing the *registration statement*, including the *prospectus*, and marketing and selling the company's stock to investors.

Wilson Sonsini Goodrich & Rosati
PROFESSIONAL CORPORATION

**(http://www.wsgr.com)**


**Palo Alto Headquarters**
650 Page Mill Road
Palo Alto, California 94304-1050
Phone | 650-493-9300
Fax | 650-493-6811
paloalto@wsgr.com

**Austin**
8911 Capital of Texas Highway North
Westech 360
Suite 3350
Austin, Texas 78759-8497
Phone | 512-338-5400
Phone | 512-338-5499
austin@wsgr.com

**New York**
1301 Avenue of the Americas
40th Floor
New York, New York 10019-6022
Phone | 212-999-5800
Fax | 212-999-5899
newyorkcity@wsgr.com

**San Diego**
12235 El Camino Real
Suite 200
San Diego, California 92130-3002
Phone | 858-350-2300
Fax | 858-350-2399
sandiego@wsgr.com

**San Francisco**
One Market Street
Spear Tower, Suite 3300
San Francisco, California 94105-1126
Phone | 415-947-2000
Fax | 415-947-2099
sanfrancisco@wsgr.com

**Seattle**
701 Fifth Avenue
Suite 5100
Seattle, Washington 98104-7036
Phone | 206-883-2500
Fax | 206-883-2699
seattle@wsgr.com

**Washington, D.C.**
1700 K Street, NW
Fifth Floor Washington, D.C. 20006-3817
Phone | 202-973-8800
Fax | 202-973-8899
washingtondc@wsgr.com

**Shanghai, China**
Jin Mao Tower
38 F, Unit 01-04
88 Century Boulevard
Pudong Shanghai 200121
People's Republic of China
Phone | 486-21-6155-1700
Fax | 486-21-6165-1799

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**Atlanta**
ph: 404-350-2000

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**Paris**
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**Philadelphia**
ph: 215-557-1870

**Phoenix**
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**Pittsburgh**
ph: 412-281-3838

**Rio de Janeiro**
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**San Antonio**
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**San Diego**
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**San Francisco**
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**Seattle**
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**Secaucus**
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**Seoul**
ph: +82-2-761-9506

**Singapore**
ph: +65-6536-6288

**South Bend**
ph: 574-251-4000

**St. Louis**
ph: 314-621-7400

**Tampa**
ph: 813-222-8600

**Tokyo**
ph: +81-3-5283-3300

**Toronto**
ph: 416-383-4545

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