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Emerging Growth Company Practice Guide

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Overview

Question 1: What is an Emerging Growth Company?

Under the Jumpstart Our Business Startups Act (the JOBS Act) (112 P.L. 106, 126 Stat. 306), which was passed in April 2012, a company qualifies as an emerging growth company (EGC) if at the time of its initial public offering (IPO) total annual gross revenues were less than $1 billion during its most recently completed fiscal year. EGC status affords an issuer the ability to enjoy certain reduced disclosure requirements, including providing fewer years of historical audited financials and reduced compensation disclosure, and reduced corporate governance requirements, particularly around internal controls over financial reporting and say-on-pay advisory votes. A company will retain EGC status until the earliest of the:

- Fifth anniversary of the company's IPO
- Last day of the first fiscal year in which its annual gross revenue exceeds $1 billion
- Date it becomes a large accelerated filer, meaning the last day of the fiscal year in which it (1) has a public equity float held by non-affiliates of $700 million or more (measured as of the last business day of its second fiscal quarter of such year) and (2) has been a reporting company under the Securities Exchange Act of 1934, as amended (the Exchange Act) for at least 12 calendar months
- Date on which the company has issued more than $1 billion in non-convertible debt during the preceding three-year period

Other than excluding certain types of issuers, such as issuers of asset-back securities and investment companies registered under the Investment Company Act of 1940, there are no restrictions on companies qualifying for EGC status. In addition, companies organized in foreign jurisdictions as well as in the United States can qualify as EGCs.

Applicable Securities Laws and Regulations

Question 2: What are the relevant statutes and regulations governing securities offerings by EGCs?

A securities offering by an EGC is generally governed by the same statutes and regulations as those by non-EGCs, with the exception of the additional provisions of the JOBS Act and the Fixing America's Surface Transportation Act (the FAST Act) that apply to EGCs. The following key statutes and regulations govern a typical securities offering by an EGC:

- **Securities Act of 1933 (the Securities Act) and the rules and regulations promulgated thereunder.** The Securities Act regulates the offer and sale of securities, including those of EGCs. Generally speaking, any securities offered or sold in the United States must be registered or otherwise exempt from registration under the Securities Act. For a general review of statutes and regulations governing securities offerings, see U.S. Securities Laws: An Overview.

- **Exchange Act and the rules and regulations promulgated thereunder.** The Exchange Act addresses the ongoing obligations attendant with listing a class of securities on a national stock exchange, including periodic reporting and the initial registration of the class. See Periodic and Current Reporting Resource Kit. In addition, a company with a large number of stockholders (excluding holders of most compensatory equity) may also be subject to the reporting requirements of the Exchange Act. Companies (other than banks and bank holding companies or savings and loan holding companies) with either (1) 2,000 or more stockholders or (2) 500 or more stockholders who are not accredited investors are required to register. See Understanding the Registration Requirements under Section 12 of the Exchange Act.

- **Regulation S-K promulgated under the Exchange Act.** This set of rules interplays with the Securities Act forms on which the offering is filed to provide specific disclosure requirements. Regulation S-K is also the framework for non-accounting-specific disclosure in reporting under the Exchange Act.

- **Regulation S-X promulgated under the Exchange Act.** This set of rules addresses the various accounting-specific disclosures required in Securities Act forms. Regulation S-X is also the framework for accounting-specific disclosure in reporting under the Exchange Act. See Financial Statements and Reporting Resource Kit and Securities Offerings and Financial Statements.

- **The JOBS Act.** The JOBS Act specifically amended the Securities Act and Exchange Act to provide for certain reduced disclosure, reporting, and governance requirements for EGCs. Most notably, the JOBS Act reduced the audited financial statements required in a Securities Act filing from three prior fiscal years to two, deferred internal control reporting for up to five years following an IPO, reduced the executive compensation disclosures required, permitted testing-the-waters communications outside of the offering and allowed EGCs to review their Securities Act registration statements with the SEC on an confidential basis.

- **The FAST Act.** The FAST Act further enhanced certain benefits under the JOBS Act for EGCs. Most notably, the FAST Act provided further flexibility for EGCs to begin the SEC review process on Securities Act registration statements without all the required years of audited financial statements if those statements would not be required later when the registrant planned to launch the offering.

- **Regulation G promulgated under the Exchange Act.** This set of rules addresses a registrant's use of financial measures not calculated in accordance with generally accepted accounting principles (non-GAAP financial measures). Regulation S-K also addresses the use of non-GAAP financial measures included in a registration statement filed under the Securities Act for an offering by an EGC, but Regulation G extends broadly to any public disclosure of material information made by the registrant that contains a non-GAAP financial measure. See Drafting Regulation G Compliant Disclosure and Understanding SEC Regulation of Non-GAAP Financial Measures.

- **Regulation FD promulgated under the Exchange Act.** This set of rules addresses the selective disclosure of material nonpublic information. See Understanding the Requirements of Regulation FD.

- **Regulation M promulgated under the Exchange Act.** This often overlooked set of rules addresses the timing of certain purchases and sales by a registrant in its own securities. This is relevant to EGCs that are already listed and may be engaged in any activity, including activity by affiliates, to repurchase its securities at a time proximate to a distribution of securities. See An Overview of Regulation M.

Securities Offering Process

Question 3: What is the typical process for securities offerings by EGCs, including general steps, timeline, key transaction documents, due diligence process and required regulatory and stock exchange filings?

The IPO Process for EGCs

EGCs receive key accommodations during the IPO process. The IPO on-ramp contemplated by the JOBS Act relaxed certain regulatory barriers that policy-makers believed were keeping EGCs from accessing the public markets. These accommodations include, among other benefits, confidential submission and review of IPO registration statements, reduced financial statement audit and disclosure requirements, and the ability to engage in oral or written test-the-waters communications with certain types of sophisticated investors before filing a registration statement with the Securities and Exchange Commission (SEC). This response focuses on the IPO process for an EGC, which is the principal point in its lifecycle where an EGC first benefits from its differentiated status as an EGC.

Key Transaction Documents and Regulatory and Stock Exchange Filings

The documents and filings required in the IPO process for an EGC generally mirror those in the process for non-EGCs. Some of the key documents in the IPO process are described below.

Draft Registration Statement

A registration statement provides key financial and non-financial information about the company, its business operations, and the securities being offered to the public. The JOBS Act allows an EGC to submit a draft of its registration statement and exhibits to the SEC on a confidential basis via the EDGAR system. For a form of transmittal letter, see SEC Transmittal Letter (Confidential Treatment of an Emerging Growth Company Registration Statement). The confidential submission and review process provides EGCs with greater control over the timing of their IPO process and keeps them out of the public spotlight during the planning phase of the transaction. Although the SEC Staff has stated that they will review a confidential submission in draft form so long as it at least complies with the financial statement requirements, EGCs generally should provide a reasonably complete and high quality draft to the Staff to reduce the likelihood of a long comment process and as a courtesy. In addition, although the confidential draft submission is not initially filed, it eventually becomes publicly available on EDGAR as part of the registration process. EGCs are also reminded that to the extent they have members of the Financial Industry Regulatory Authority (FINRA) involved in the offering, they will be required to file the draft confidential registration statement with FINRA for review as well. See Understanding FINRA Regulations and Filings. For a further discussion of confidential treatment requests, see Preparing a Confidential Treatment Request for an IPO.

As part of its draft registration statement, EGCs are required to include only two fiscal years of both audited financial statements and abbreviated selected financial data. (By comparison, non-EGCs generally must provide three years of audited financial statements and five years of selected financial data.) However, despite the JOBS Act's accommodation, some EGCs choose to provide more than the minimum two years of financial information in the selected financial statements and also sometimes in the audited financial statements to provide greater transparency to investors. Providing more information to prospective investors may have a positive impact when marketing the IPO.

Relevant to both the draft registration statement as well as ongoing reporting once public, EGCs require fewer named executive officer in their summary compensation table under Item 402 (17 C.F.R. § 229.402) of Regulation S-K compared to non-EGCs. An EGC may have as few as three named executive officers, including the CEO and the two next most highly paid executive officers of the company. Non-EGCs that are not smaller reporting companies are required to have at least five named executive officers (assuming they have that many executive officers), including the CEO, CFO, and the next three most highly paid executive officers.

Under the JOBS Act, EGCs can also engage in written or oral test-the-waters communications with certain types of sophisticated investors while the registration statement is still under review. Although limited to qualified institutional buyers (QIBS) and institutional accredited investors, these communications allow EGCs to gauge investor interest in a contemplated offering of securities without violating the gun-jumping rules of the Securities Act of 1933, as amended (the Securities Act). However, EGCs should be careful regarding the timing and content of such communications, as information in the draft registration statement is likely to change and antifraud provisions of the federal securities laws still apply to test-the-waters communications. In addition, the SEC may request copies of any written test-the-waters materials. For a further discussion of testing-the-waters, see Preparing for a Road Show.

Registration Statement (Preliminary and Final Prospectuses)

EGCs must publicly file their IPO registration statement at least 15 days prior to the start of the road show for their offering. This filing will include the preliminary prospectus for marketing the offering.

Later in the process, following pricing, a final prospectus—updated with pricing information and further detail on the underwriting syndicate—must be prepared and filed with SEC. For a form of response to an SEC comment letter on an EGC registration statement, see SEC Comments Response Letter (Emerging Growth Company Registration Statement).

Listing Application with Stock Exchange

Securities issued in an IPO are not restricted securities, so they can be freely resold after the initial sale except to the extent they are also control securities. Companies contemplating an IPO typically apply for listing on a major stock exchange such as the New York Stock Exchange (NYSE) or the NASDAQ Stock Market (NASDAQ). An EGC could of course conduct an IPO without listing, but market forces would generally dictate the EGC list the class of equity on an exchange to ensure there will be ongoing reporting and an aftermarket for the securities.

Each stock exchange publishes information about its listing requirements and standards, the process for listing, and fees. EGCs should become acquainted with the various listing requirements and corporate governance standards early on in the planning process, so any necessary changes can be made (e.g., compliance with corporate governance standards on director and board committee independence). Although EGCs have the ability to take advantage of certain reduced reporting requirements, the independence requirements of the exchanges are as rigorous for an EGC as they are for a non-EGC. See Complying with NYSE and Nasdaq Listing Requirements.

Underwriting Agreement

The underwriting agreement is the primary agreement for the sale of the securities in a public offering. It contains details about the terms of the public offering, as agreed by the issuing company and the group of investment banks that will work together as a syndicate to underwrite the securities offering. Most EGC underwriting agreements are identical to their non-EGC counterparts but for a few additional representations about the issuer's status as an EGC as well as the conduct of any test-the-waters activities by the EGC and its underwriters.

High-profile IPOs, including those of some EGCs, are typically underwritten on a firm commitment basis in which the underwriters commit to purchase the shares from the company at a negotiated discount and then resell the shares to the public.

The underwriting agreement will generally also contain an over-allotment option (greenshoe), which typically gives underwriters 30 days to purchase additional shares—often up to 15% of those sold in the offering—at the offering price. For a form of underwriting agreement, see Underwriting Agreement.

Comfort Letters

As a condition to the underwriting, the company's auditors will be requested to deliver a comfort letter to the underwriters and the board of directors. The comfort letter confirms the auditor's independence with respect to the issuer, describes the procedures performed by the auditor on the issuer's financial statements and also provides certain negative assurance as to changes in those financial statements since the date thereof. In addition, the comfort letter provides certain assurance as to various financial and related information that is presented in the registration statement that is derived from the issuer's books and records on which the auditor performed procedures. See Comfort Letter Review and Negotiation Checklist and Reviewing the Comfort Letter.

Lock-up Agreements

In an effort to promote an orderly trading market following the offering, the managing underwriters generally require the company and key stockholders to sign lock-up agreements. Lock-up agreements require a company's directors, officers, and existing stockholders not to sell any securities of the company for a period of time after the commencement of the public offering. This lock-up period for an EGC is now typically limited to 180 days, since the JOBS Act effectively eliminated the booster shot rules from FINRA and the NYSE that provided for certain extension of lock-up periods if the release date coincided with an issuer's material public announcements. Not long after the JOBS Act, FINRA largely eliminated the booster shot provisions for non-EGCs as well. For a form of lock-up agreement, see Lock-Up Agreement (IPO).

General IPO Timeline for an EGC

A general overview of the steps and timeline of the IPO process for an EGC is summarized below. An EGC usually takes about the same amount of time for an IPO as a non-EGC. However, the key difference is that an EGC will generally be completing the SEC review process confidentially, which allows an EGC substantially more control over the public message regarding commencement of an IPO. For example, an EGC can complete a rigorous SEC comment process without close public scrutiny as to its expected launch timing. This helps protect EGCs from negative market conditions that are external, but are often blamed on issuers that have publicly filed and failed to launch their offering.

- Week 1:
  - Conduct organizational meeting
  - Begin due diligence
- Weeks 2-4:
  - Draft registration statement
  - Continue due diligence

- Weeks 5-6
  - Finish drafting registration statement at the financial printer
  - Submit draft registration statement confidentially to SEC
- Weeks 10-12
  - Approximately four weeks after date of initial confidential submission, receive review comments from SEC on the draft registration statement
  - Revise draft registration statement
  - Submit revised draft registration statement to SEC, along with response letter to comments
- Weeks 13-14
  - Continue to resolve comments from SEC
  - Submit additional revised draft registration statements, as necessary
- Weeks 15-16
  - Make first public filing of registration statement at least 15 days prior to the start of road show
- Week 17:
  - Once SEC comments have been resolved, print preliminary prospectus
  - Begin road show
- Weeks 19-20
  - Request that the SEC declare the registration statement effective
  - Price the offering, sign the underwriting agreement and commence trading
  - File the final prospectus with SEC
  - Close the offering

Due Diligence

Due diligence will vary across industries, rather than by EGC and non-EGC status. For example, issues and concerns faced by a software company will almost certainly differ from those faced by a midstream oil and gas company, even if both technically qualify as EGCs. Due diligence for the software company will likely focus more on intellectual property, licensing agreements, and customer lists; while the review for the oil and gas company may emphasize documenting ownership of tangible property, partnership and joint venture agreements, and compliance with environmental regulations. Regardless of industry, due diligence will likely extend across certain important areas, including basic corporate documents, financial information, and information about directors and officers. Although EGCs are permitted to file draft confidential registration statements with the SEC, most EGCs attempt to complete material due diligence and factual backup verification prior to any disclosure that will eventually become public to avoid creating a factual record for plantiffs' lawyers later that might suggest the EGC was lax in its reporting ability. Legal counsel typically requests the following information during IPO due diligence:

- Basic corporate documents, including certificate of incorporation, bylaws, and board minutes
- Comparable documents for any subsidiary
- Stockholder information, including stockholder lists
- Information with respect to any issuance of securities, including copies of agreements
- Financial information
- Copies of material agreements
- Operational information, including lists of suppliers and manufacturers

- Sales and marketing information
- Industry information
- Director and officer information, including compensation plans and other agreements
- Employee information, including organizational charts and copies of agreements
- Intellectual property, including lists of patents and licensing agreements
- Tangible property, including copies of leases and documents of title
- Litigation information
- Insurance information
- Partnership or joint venture agreements
- Foreign operations
- Government regulations and filings

For a further discussion of due diligence in general, see Managing the Due Diligence Process for an IPO and Due Diligence for Securities Offerings Resource Kit.

Disclosure Obligations

Question 4: What information must be made available to potential investors in connection with securities offerings by EGCs?

Generally, the information required to be made available to potential investors in connection with a securities offering by an EGC is the same as those of non-EGCs. One of the benefits of being an EGC, however, is that EGCs are permitted to provide less historical financial information to potential investors in connection with securities offerings – in particular, reduced financial statement (and correspondingly MD&A if fewer periods are presented) disclosure requirements and reduced compensation-related disclosure requirements. EGCs are only required to provide two years of audited financial statements (instead of three) plus unaudited interim financial statements. Additionally, if an EGC is required to include separate financial statements for an acquired business, the maximum time period for which separate financial statements must be provided is also two years, regardless of the significance of the acquisition under Regulation S-X. Further, in January 2016, the SEC adopted rules as required by the FAST Act that further reduce financial statement disclosure requirements for pre-effective IPO registration statements filed by EGCs as follows:

- EGCs may omit financial information related to a historical period that the EGC reasonably believes will not be required to be included in the registration statement at the time of the contemplated offering.
- Prior to distributing preliminary prospectuses to investors, the EGC must amend its registration statement to include financial information required by Regulation S-X as of the date of the amendment.

For a further discussion of EGC requirements, see Emerging Growth Company versus Smaller Reporting Company Comparison Chart.

A. Risk Factors

Please describe the common risk factors that are specific or unique to issuers in this industry. Have there been any recent developments or changes that counsel should be aware of when preparing these risk factors?

EGCs typically include a risk factor which states: “We are an emerging growth company and cannot be certain if the reduced disclosure requirements applicable to emerging growth companies will make our common stock less attractive to investors.” This risk factor details the reduced reporting requirements, including:

- Not being required to comply with the independent auditor attestation requirements of Section 404 (15 U.S.C.S. § 7262) of the Sarbanes-Oxley Act
- Reduced disclosure obligations regarding executive compensation in periodic reports and proxy statements

- Exemptions from the requirements of holding a nonbinding advisory vote on executive compensation and stockholder approval of any golden parachute payments not previously approved
- Extended transition periods for complying with new accounting standards

EGCs also typically note in a separate risk factor regarding internal control risks that their independent registered public accounting firm is not required to audit the effectiveness of their internal control over financial reporting until after it is no longer an emerging growth company, as defined in the JOBS Act. At that time, the EGC's independent registered public accounting firm may issue a report that is adverse in the event it is not satisfied with the level at which the EGC's internal control over financial reporting is documented, designed or operating.

More generally, the SEC has provided guidance for all issuers indicating that risk factors should enumerate what management believes to be the most material risks the registrant faces, prioritized with the largest risks first. Additionally, the SEC has indicated that registrant should include specific examples and not simply recite every potential risk that the registrant or other companies in its industry faces. The SEC has also expressed that including mitigating language in the risk factors section is not appropriate, but may be discussed elsewhere in the registration statement. For a further discussion of risk factors, see How to Draft Risk Factors for a Registration Statement.

B. MD&A and Business

Please provide the key discussion points that counsel should consider when preparing the business and MD&A sections for issuers in this industry.

For issuers in the technology industry, key discussion points when preparing the Business sections for issuers are largely driven by the underwriters and the sub-sector within technology that the registrant is in. Typically, the underwriters will be integrally involved in the drafting of the preliminary subsections within the Business section, including Overview, Industry, Strengths and Strategy. The underwriters will help the registrant to articulate its story in a way that resonates with investors. The remaining subsections within the Business section tend to be more fact-based or are included per specific form requirements, and include Products, Technology, Sales and Marketing, Customer Support, Research and Development, Intellectual Property, Competition, Employees, Facilities, and Legal Proceedings.

Key operating or financial metrics are also typically dictated by sub-sectors within the technology industry (e.g., fintech, adtech, edtech, Software as-a-service companies, etc.). The key is that companies, including EGCs, and their counsel are disclosing metrics that management is using to evaluate the business and will be comfortable disclosing on a quarterly basis going forward and that are also compliant with SEC rules. Counsel is encouraged to review the SEC's recent guidance on non-GAAP financial measures to ensure compliance with SEC rules for key operating metrics that are not GAAP compliant. See Non-GAAP Financial Measures, Compliance & Disclosure Interpretations (May 17, 2016), available at https://www.sec.gov/divisions/corpfin/guidance/nongaapinterp.htm. For a further discussion of non-GAAP regulations, see Understanding SEC Regulation of Non-GAAP Financial Measures.

Market practice for the technology industry has also developed around providing eight prior quarters of financials so that investors can see more detailed trends on a quarter-by-quarter basis for the prior two years. Auditor comfort issues typically arise around this historical financial information, so it is best to discuss the level of comfort the auditors can provide early with the underwriters and their counsel to ensure there are no surprises later that could delay the offering. or create unforeseen risk for the offering participants.

Additionally, when drafting MD&A, as opposed to merely providing a period-over-period comparison, registrants and their counsel should provide thoughtful trend analysis around the historical performance of the business and expected future trends that may impact results of the business. Registrants should view the MD&A as a way to tie the Business section disclosures to the financials to explain why the business has performed and will perform the way management expects it to. See Management's Discussion and Analysis Section Drafting Checklist.

One area of focus that often arises with EGCs in MD&A is the disclosure of equity incentive compensation, known as the cheap stock disclosure issue. The SEC often seeks to understand if the registrant has taken adequate accounting expense for stock awards in the periods leading up to the IPO, with a particular focus on the valuation applied to such awards made in the 1-2 years immediately prior to the offering. Many registrants now use third-party valuation consultants to inform their decisions of fair value on a quarterly or less than annual basis, which is largely reducing the SEC's focus on this area. However, EGCs should take appropriate steps to validate their valuation of equity awards leading up to the IPO to prepare for the inevitable disclosure.

C. Other Prospectus Disclosure

Is there any other additional or special disclosure that should be included in the prospectus or registration statement for issuers in this industry, either required by the SEC or from market practice?

The following additional information is typically included and/or required for EGCs:

- An explicit statement on the cover page of the prospectus indicating such company is an EGC
- An extra paragraph in the box summary of the prospectus regarding the implications of being an EGC
- The risk factors noted above
- A short section in the MD&A noting that the EGC intends to take advantage of lengthier phase-ins for new accounting pronouncements, if appropriate

D. Additional Disclosure Issues

Please discuss any other special disclosure issues or advice applicable to issuers in this industry.

The disclosures for EGCs in registration statements have become relatively settled at this point. As described above, there is standard language that registrants should be sure to include in the registration statement. Outside of these disclosures, the emphasis of registrants and their counsel should be on company- and industry-specific disclosures that help investors understand the story, business, risk profile, and financial performance of the registrant, as with any non-EGC company going through the registration process.

Underwriting Agreements

Question 5: What types of underwriting arrangements are commonly used? What are some of the standard clauses and clauses that are heavily negotiated in an underwriting agreement in connection with an offering by an EGC?

An underwriting agreement is a contract where an issuer and any selling shareholders promise to sell securities to the underwriters on a specified future closing date at a price and in a quantity set forth in the underwriting agreement and a corresponding promise by the underwriters to purchase those securities at the specified price. Although EGC status modestly affects certain representations and warranties, covenants and some aspects of how an offering are conducted, whether a company is an EGC generally does not have a material impact on the terms or negotiation of underwriting agreements.

The basic structure of an underwriting agreement is as follows:

Introduction	Provides overview of transaction terms and creates defined terms.
Representations and warranties of the company	Establishes the representations and warranties that the issuer makes about itself and its business. Unlike non-EGC offerings, these will include a representation that the issuer is an EGC and a representation as to any details about test-the-waters communications.
Representations and warranties of the selling shareholders	Establishes the representations and warranties that the selling shareholder makes about itself and its ownership of the securities to be sold.
Agreement to sell and purchase	Contains basic agreement of the sellers to sell the securities and the securities to be sold.
Terms of the public offering	Establishes the price at which the securities will be sold to the underwriters and at which the underwriters will sell the securities to the public. The pricing does not necessarily vary from EGCs to non-EGCs. However, non-EGCs are often larger issuers that may have increased leverage to obtain better IPO discounts from their underwriters.
Payment and delivery	Sets out the mechanics of the closing.
Conditions to the underwriters' obligations	Establishes the conditions that have to be met for the closing to occur.
Covenants of the company	Establishes the issuer's agreements to take and refrain from taking, specific actions.

Expenses	Establishes the allocation of offering-related expenses among the sellers and the underwriters.
Indemnity and contribution	Allocates the risk in the event of litigation that alleges material misstatements or omissions in the prospectus or registration statement.
Directed share program	Establishes indemnification of the underwriter if litigation arises from a program where the issuer can direct the placement of a portion of the securities being sold.
Termination	Establishes the conditions under which the underwriting agreement can be terminated.
Effectiveness, defaulting underwriters	Establishes when mutual obligations created by the underwriting agreement become effective, and what happens if some, but not all, of the underwriters default at their obligations at closing
Remaining provisions	Miscellaneous technical provisions.

Compared to other types of transactions, underwriting agreements for securities offerings registered under the Securities Act are not heavily negotiated. There are at least a few reasons for this dynamic. First, the actual purchase and sale is relatively straightforward. Second, there is an established and well understood legal and regulatory regime regarding liability (and therefore risk allocation) for registered offerings. Third, given the first two points, there really is not much variation in the form agreements used by various underwriters, and underwriters are disciplined in maintaining adherence to those forms across time and issuers, particularly since the form of underwriting agreement is publicly filed with the registration statement and creates substantial precedential value.

There are, however, certain sections where transaction participants can expect to spend more time on than others.

Company Representations and Warranties

The Company representations and warranties serve three purposes:

- As a basis for termination of the underwriting agreement by the underwriters if the representations and warranties are untrue at the closing
- As a basis for risk allocation
- As an information-forcing mechanism to support disclosure and to aid to the underwriters as they seek to establish a due diligence defense

Of the three, the last is by far the most important as a practical matter. Although it certainly can happen, given that typically only three or four trading days pass between signing the underwriting agreement and closing, it is highly unusual for a breach of company representations and warranties to trigger termination. In addition, the primary risk to a company in connection with a registered securities offering relates to a material misstatement or omission from the disclosure contained in the offering materials. With the exception of very limited information provided by the underwriters that is unlikely to be material, companies agree to indemnify underwriters for liability that arises from such disclosure-based liability. As a result, although the parties to the underwriting agreement will spend time negotiating around the edges of the company reps and that negotiation will surface issues that impact the disclosure in the company's offering materials, they typically are not showstoppers.

Selling Shareholder Representations and Warranties

Most of the selling shareholder representations and warranties relate to technical matters that are not controversial. However, some underwriters' standard forms will include representations and warranties regarding the accuracy of the company's representations and warranties as well as the accuracy and completeness of the company's offering materials. In addition, underwriters' standard forms will include representations and warranties that each selling shareholder has reviewed the company's offering materials and that (a) the selling stockholder is not aware of a material omission or misstatement in the registration statement (sometimes called a clean hands representation) and (b) the selling stockholder is not motivated by some undisclosed reasons to sell securities (sometimes called a sandbagging representation). Selling shareholders and their counsel generally resist inclusion of any of these provisions, arguing that they are not in a position to provide such representations and warranties beyond the limited information about themselves that they are required to include in a registration statement. This argument is not as strong for selling shareholders that have access to more information than shareholders generally (e.g., as a result of having representation on the company's board of directors), but institutional shareholders are typically successful in resisting inclusion of such provisions altogether or particularly

underwriter-friendly formulations of such provisions. Practice varies with respect to selling shareholders that are affiliates or part of a company's senior executive team, such as the issuer's chief executive officer, but parties should expect at least some coverage of the company's information by such management selling shareholders.

Lock-up Provisions

In connection with any registered offering of equity or equity-linked securities, the company will also be subject to a lock-up restriction on transactions in its own securities that often parallels the lock-up entered into by stockholders. The purpose of the lock-up agreement to allow time for the market to discover the worth of the stock in a stable market as well as give comfort to investors that insiders will continue to act in line with the goals of the company. In connection with an IPO, the lock-up period extends for 180 days after the offering. The lock-up period for other offerings can vary, but most usually extend 90 days after the offering.

The issuer may negotiate exceptions to the restrictions imposed by the lock-up provisions. Companies will generally have exceptions for activity it is already contractually obligated to honor, such as the grant and settlement of options and RSUs, made pursuant to their employee equity incentive agreements and for the settlement of equity-linked securities, like warrants and convertible debt securities, that are outstanding as of the time of the offering. Companies may also ask for additional exceptions to allow them to pursue other types of transactions, like the acquisition of other companies, that might involve the issuance of company stock. As long as there is a reasonable basis for such exceptions, the persons to whom the shares will be transferred will be subject to the provisions of the lock-up agreement, and if there is no immediately public announcement of such transfers that create market "noise," underwriters will often accommodate such exceptions.

Expenses

Most underwriters' standard forms provide that almost all expenses incurred in connection with a registered offering will be borne by someone other than the underwriters. There are exceptions for the underwriters' out-of-pocket expenses, such as the legal fees of the counsel they engage to advise them in connection with the offering, but even here the underwriters will seek to shift some of those costs, such as fees and costs associated with FINRA compliance back to the company. Some companies attempt to negotiate such provisions (including imposing caps for maximum amounts) with varying levels of success based on the leverage they are in a position to exert.

The expense provisions will also allocate responsibility for expenses between the company and the selling shareholders. The underwriter discount applicable to the selling shareholder shares is for the account of the selling shareholders. Other expenses are typically allocated in accordance with a pre-existing investor rights agreement, with a bulk of the expense more often than not borne by the company.

Continuous Disclosure and Corporate Governance

Question 6: What specific continuous disclosure and corporate governance requirements apply to EGCs?

Once public, EGCs are generally subject to the same ongoing disclosure and corporate governance requirements that apply to non-EGCs, with several key differences highlighted below.

- EGCs are exempt from the requirement that a public accounting firm attest to internal controls, as required by Section 404(b) of the Sarbanes-Oxley Act. However, most try to comply with the underlying internal controls requirements even if they do not provide the public report until required.
- EGCs are exempt from the mandatory say-on-pay vote requirement as well as the related shareholder advisory votes on the frequency of say-on-pay votes. Most EGCs take advantage of this exemption.
- EGCs are exempt from the chief executive officer pay ratio disclosure rules, as required under The Dodd-Frank Wall Street Reform and Consumer Protection Act (111 P.L. 203, 124 Stat. 1376). Most EGCs take advantage of this exemption.
- EGCs are exempt from formal requirements for compensation discussion and analysis (CD&A) in periodic reporting. Most EGCs take advantage of this.
- EGCs are exempt from any new or revised financial accounting standard as issued by the Financial Accounting Standards Board until such accounting standard becomes broadly applicable to private companies. Many EGCs opt out of this extended transition period, choosing to voluntarily comply with such standards as they are adopted. However, it is important to note that this election is irrevocable. Practice on this was historically mixed. However, as the new revenue recognition rules are the

first major accounting standard that allows delayed adoption by EGCs, many EGCs are now taking advantage of this where permitted.

- EGCs also enjoy reduced financial disclosure requirements for future registration statements, such as for follow-on offerings. Most EGCs use this to the extent they have not subsequently filed additional financial statements under the Exchange Act.

Stock Exchange Requirements

Question 7: Are there any special listing or corporate governance standards required by major stock exchanges, including NYSE and NASDAQ?

Listing Requirements

Generally, both major stock exchanges subject EGCs to the same listing requirements as non-EGCs. One exception is that the NYSE affords EGCs a minor accommodation in meeting its minimum financial standards, requiring only two years of pre-tax earnings from continuing operations to qualify rather than three years. NASDAQ's financial and liquidity requirements for initial listing apply uniformly to EGCs and non-EGCs.

Corporate Governance Standards

The major stock exchanges' corporate governance standards generally treat EGCs and non-EGCs alike. There are additional exceptions for foreign private issuers and controlled companies that may apply to some EGCs but those are unrelated to EGC status.

Several key corporate governance issues relevant to EGCs navigating the IPO process are discussed here for reference, but counsel should note that these same issues would also apply in the non-EGC context. Also, there are additional requirements not discussed here for the sake of brevity, including differences between the NYSE and NASDAQ, the requirements of which can be very similar but are not always identical. See NYSE Corporate Governance Listing Requirements Table and NASDAQ Corporate Governance Listing Requirements Table.

Majority of Independent Directors

Both exchanges require that a public company must have a board of directors comprised of a majority of independent directors within one year of listing.

There are phase-in periods for compliance with director and board committee independence requirements to help ease the company's transition to public status. Despite these available phase-in periods, EGCs may try to comply with these independence requirements early as it is useful in marketing the offering. As a practical matter many companies (and their underwriters) may wish to ensure that the company fully meets the independent board and committee requirements before even marketing the offering both for diligence purposes and also for investor marketing purposes.

Independent Audit Committee

Both exchanges also require that a public company has a fully independent audit committee, subject to a one-year phase-in period as follows:

At least one independent member of the audit committee by the listing date (or in the case of NASDAQ, by the effective date of the IPO registration statement); a majority of independent members within 90 days of the effective date of the IPO registration statement; and a fully independent audit committee within one year of the effective date of the IPO registration statement.

In addition, both exchanges require that audit committee members must meet the enhanced independence requirements under Section 301 of the Sarbanes-Oxley Act and Rule 10A-3(b)(1) (17 C.F.R. § 240.10A-3) of the Exchange Act.

Number of Audit Committee Members

Both exchanges require a minimum of three audit committee members within one year of listing. The NYSE allows a phase-in over one year: at least one member of the audit committee at listing; at least two members within 90 days; and at least three members within one year. NASDAQ, however, requires at least three members of the audit committee at listing.

Independent Compensation and Nominating/Governance Committees

Both exchanges also require that a public company has fully independent compensation and nominating/ governance committees (or NASDAQ requires the nomination be made solely by the independent members of the board of directors if not by an independent nominating committee), subject to one-year phase-in periods detailed below.

The NYSE requires at least one independent member on each committee within 5 business days of listing or by the IPO closing date, whichever is earlier; a majority of independent members on each committee within 90 days of listing; and fully independent committees within one year listing. Similarly, NASDAQ requires at least one independent member on each committee by listing; a majority of independent members within 90 days of listing; and fully independent committees within one year of listing.

An EGC may consider making changes to its board of directors and committee composition early on in the IPO process to comply with these requirements before listing.

For a further discussion of independence requirements, see Meeting the Exchange Independence Requirements for Boards and Committees.

Other Key Laws and Regulations

Question 8: What are other key laws and regulations that a securities lawyer working with an EGC needs to be aware of?

An EGC will generally be subject to all of the laws and regulations of its industry. Since private placements or public offerings of debt or equity will typically require some combination of representations and disclosures regarding an issuer, a securities lawyer will need to be versed in the laws relevant to the issuer's industry. Most EGCs will have issues related to employees and taxes, but some EGCs may require specialized disclosure on subjects such as oil and gas regulations, consumer protection laws, communications laws, financial services and insurance laws, cybersecurity, data privacy, export controls, and numerous other fields. A securities lawyer should take care to consult with experts within their own firm or the other counsels representing the EGC in those areas to help plan for the necessary disclosures and representations.

Regulatory Trends

Question 9: What are the major regulatory trends affecting EGCs?

A handful of key trends are likely to affect EGCs in the near term, including:

- Accounting regulations
- The SEC's recent calls for comments on business and financial disclosure effectiveness
- The SEC's recent evaluation of the definition of accredited investors

Accounting regulations are expected to have the most substantial effect on EGCs in the coming months, particularly as U.S. GAAP continues efforts to converge with international financial reporting standards (IFRS). Most notably, recent changes in revenue recognition under U.S. GAAP will begin to affect EGCs in financial years beginning on or after December 15, 2017.

The SEC also recently solicited comments on Regulation S-K and various disclosure topics in an effort to improve the quality of its rulemaking under Regulation S-K. The results of those comment responses will likely begin to show effects in SEC rulemaking in the coming months and years.

Finally, in December 2015, the SEC issued a report on various considerations that may be addressed in determining the definition of an accredited investors, which is key to the ability of EGCs to raise capital in exempt transactions. The SEC's report suggested that the number of households that were originally considered to be accredited investors when the rulemaking was last evaluated was a substantially lower percentage of U.S. households and that the dollar-value criteria may need further consideration to ensure that the definition continues to appropriately include only investors that can more readily protect themselves and do not require the mandated disclosure of a registered offering. The Staff also considered other factors such as professional background that might include other investors that would not previously have been deemed an accredited investor. Although the Staff has not disclosed further comment, it is likely that any rulemaking in this area could have a profound effect on EGCs. For further information on the importance of the accredited investor definition for private transactions, see Understanding the Impact of the JOBS Act on Private Placement Transactions.

The SEC has also signaled a potential scaling back of regulations generally in connection with the Republican majorities in Congress and a Trump White House. In January 2017, a Republican commissioner of the SEC indicated that further rulemaking on Dodd-Frank would be delayed and suggested some or all of Dodd-Frank was subject to imminent repeal. Although uncertain, it seems likely that new SEC rulemaking will slow down in the coming months or actions may be taken to scale back existing securities regulations.

Commercial Trends

Question 10: What are the major commercial trends affecting EGCs?

In recent months, several EGCs have financed late-stage private rounds of finance from somewhat unusual sources as valuations grew for the largest unicorn (i.e., privately-estimated enterprise valuation in excess of $1 billion) and decacorn (i.e., privately-estimated enterprise valuation in excess of $10 billion) EGCs. The JOBS Act substantially increased the minimum number of holders of a class of an EGC's securities that would trigger an automatic requirement to begin publicly reporting. In addition, the enhanced flexibility that the JOBS Act brought to general solicitation under private placement exemptions further broadened the ability of EGCs to remain private for longer periods. Combined with volatility in the market, more EGCs were opting to postpone IPOs in late 2015 and throughout 2016. Investors that historically invest upon an IPO or later, such as mutual funds, were increasingly entering the pre-IPO market to avoid missing out on opportunities to invest in attractive EGCs that appear to be staying private longer. This trend seems to be abating somewhat as investors and EGCs alike are increasingly wary of such investments and the onerous conditions that come with it, including an EGC's potential inability to achieve an IPO as hoped.

Practice Tips

Question 11: What practice points can you give to lawyers working with EGCs?

In addition to the legal implications, lawyers working with EGCs must be mindful of the business implications of their disclosure and governance decisions. For example, EGCs are afforded much greater flexibility in implementing and certifying internal controls as compared to non-EGCs. However, that does not necessarily mean that an EGC should not implement stronger internal controls over financial reporting concurrently or prior to an IPO. The risk of a restatement or fraud is just as great for an EGC, and the issuer's directors, officers, and underwriters continue to expect a due diligence defense for offerings of securities. Simply complying with the SEC-mandated disclosure may not always be sufficient to protect the issuer and investors. EGCs should consult closely with their lawyers, auditors, and bankers to make sure that their decisions reflect both legal practice and market practice that is consistent with the risks of their business.

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