INITIAL PUBLIC OFFERING GUIDE

IPO Guide

Seventh Edition

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GUIDE TO THE INITIAL PUBLIC OFFERING

Steven E. Bochner, Esq. • Jon C. Avina, Esq.

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This booklet is not intended to provide legal advice as to any specific situation. This booklet is intended only as a general overview for the non-lawyer and does not address the full range of federal and state securities laws, the rules of the Financial Industry Regulatory Authority and the listing standards and other requirements of the trading markets, or the myriad other laws, rules and practices that are applicable to an initial public offering. These laws and rules are detailed and complex, and securities counsel should therefore be intimately involved throughout the public offering process. The views expressed in this booklet are those of the authors only.

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INTRODUCTION

In the fall of 2008, companies that were pursuing initial public offerings had to put their dreams on hold following the collapse of the financial services industry. Although the prospect of an initial public offering continued to be a topic of discussion among high quality, rapidly growing companies, it was not until the last half of 2009 that the IPO market started to come back to life with strong performances from companies like SolarWinds and Fortinet. While the capital markets remain fragile, we are starting to witness a renewed sense of optimism from many of the players in the IPO market, including investment bankers, venture capitalists and emerging growth companies, especially those in the technology, life sciences, and energy and clean technology industries. Given this development, we felt that the time was right to update our Guide to the Initial Public Offering to provide a new set of readers with an overview of the most important aspects of planning, launching and completing a successful IPO.

We have organized this booklet into three major chapters. In Chapter One, we discuss the period leading up to a decision to proceed with an initial public offering, with a focus on the prerequisites to, as well as the costs and benefits of, proceeding with an initial public offering and becoming a public company.

In Chapter Two, we turn to the period beginning with the decision to proceed with the offering and continuing through the closing of the sale of the shares to the public. We first describe the events and legal restrictions encountered prior to the filing of the registration statement with the Securities and Exchange Commission (the "SEC"). We include an overview of the process and factors impacting the timing of the offering, the members of the working group and their respective roles during the process, structural and organizational issues affecting the offering, preparation of the registration statement, and the "due diligence" process. This "pre-filing period" is followed by what is often called the "waiting period," during which time the company responds to comments to the registration statement from the SEC and markets the offering to potential investors in what is referred to as the "road show." Once the company completes the SEC comment process and marketing, it will ask the SEC to declare the registration statement "effective," at which time the company can begin selling stock to the public.

In Chapter Three, we conclude with a discussion of certain consequences of becoming a public company, including the company's disclosure obligations, corporate governance requirements, and the trading restrictions and reporting obligations applicable to the company and its directors, executive officers and other affiliates.

The initial public offering should not be viewed as an end point or ultimate goal. Rather, it is one step in the growth and maturation of a business enterprise. This booklet is intended to provide a high-level perspective on this exciting process and the key issues that impact it.

As a final cautionary point, please note that this booklet does not attempt to address all existing laws or regulations applicable to the subjects covered. The booklet summarizes certain of the applicable statutory and regulatory provisions and, in the interest of brevity, is deliberately incomplete. In making legal determinations, you should not rely on this booklet but rather on the advice of experienced corporate and securities counsel.

CHAPTER ONE:
THE INITIAL PUBLIC OFFERING DECISION

1.1 Introduction

Many factors affect the success of an initial public offering, both within and outside of a company's control. These factors include:

- the state of the public equity markets generally;
- the perception of the company and its industry segment by the financial community;
- the financial condition and recent operating results of the company; and
- the quality, experience and commitment of the company's management and the board of directors, as well as other members of the working group.

While the benefits of going public, such as the capital raised in the offering, improved future access to the financial markets, and liquidity for investors and employees, are significant, the board of directors and management should fully understand the costs and consequences of becoming a public company before proceeding with an IPO. These consequences include potentially greater exposure to liability, increased emphasis on corporate governance (including composition of the board of directors and its various committees), greater transparency and, as a result, less ability to control the disclosure of sensitive company information, and a marketplace that focuses largely on short-term operating results, as well as a significant increase in management time and administrative costs necessary to support the expanded governance, internal control, SEC reporting and investor relations functions of a public company.

1.2 Prerequisites to an Initial Public Offering

A major factor to consider in determining whether to proceed with an IPO is the state of the stock market generally. Market conditions can have a significant impact on the timing of an IPO and the valuation that a company can receive in the transaction. The state of the company's industry can also affect the success of the offering. The valuations of companies that are already public and that the investment community considers to be comparable to the company contemplating an IPO typically have a direct impact on the company's valuation and market reception. Various industries can fall into favor or disfavor with the investment community, as demonstrated by the significant interest in networking, internet and communications companies in the late 1990s and the subsequent decline in interest in such companies which characterized the "post-bubble" era. An experienced investment banking firm can assist management in evaluating the condition of the market and its effect on the company's planned offering.

However, the most critical factor is the company itself. With the adoption of the Sarbanes-Oxley Act of 2002 ("SOX"), the bar has been significantly raised with respect to the level of maturity and infrastructure that a company must have in place before it embarks on an IPO. In determining whether a company is ready for an IPO, the board and management should consider:

- the company's business and financial outlook;
- principal risks of the business;
- the adequacy of internal financial reporting and accounting controls;
- the maturity of the company's governance structures; and
- the company's willingness to accept the need for transparency and disclosure that go hand in hand with being a public company.

These factors must be evaluated in terms of their impact on the feasibility and timing of an offering, their implications for valuation, and their effect on potential liability of officers and directors both during and after the offering.

Finally, the board and management need to take a hard look at themselves. The burdens of running a public company, with the attendant liability risks and reporting obligations under the close watch of the SEC, analysts and the public, require a strong, ethical, experienced and disciplined board and management team.

1.3 Deciding Whether to Undertake an Initial Public Offering

1.3.1 Benefits of an Offering and Being a Public Company

Raise Capital and Provide Liquidity for Current Investors

The most obvious benefit of an IPO is the capital raised in the offering. In addition, the offering creates an active trading market that provides an avenue to liquidity for existing investors, management and employees. Of course, this liquidity will be delayed, as managing underwriters typically require officers, directors and stockholders to sign "lockup" agreements that prohibit these individuals and entities from selling their shares for a period of time, usually six months, after the offering. Federal and state securities laws can place additional restrictions on sales of stock after the offering. As a result, an IPO should not be viewed as an "exit." We describe some of these contractual and legal limits in more detail later in this booklet.

Future Access to Financial Markets; Attractive Currency to Acquisition Targets

Following the offering, the company will have greater access to the financial markets. An established public market for a company's stock provides the advantages of name recognition, liquidity, and a readily ascertainable market value. The company may gain access to many investors who would not be interested in or suitable for an investment in a private company. These factors may also make the stock more attractive to potential acquisition targets.

1.3.2 Costs of an Offering and Being a Public Company

Reduced Flexibility

A major consequence of becoming a public company is reduced flexibility of the board of directors, management and significant stockholders. The existence of a large number of new stockholders, to whom fiduciary duties are owed by the board of directors, and the realities of operating under the scrutiny of regulators and the public markets with increased potential liability will generally make management more cautious in undertaking corporate actions such as acquiring other companies, issuing shares to employees, and setting executive compensation.

The company will become subject to the requirements of SOX, including audit committee governance standards and internal control disclosure and attestations, as well as the listing standards of The Nasdaq Stock Market ("Nasdaq"), the New York Stock Exchange ("NYSE") or any other market on which the company's stock will be listed. These listing standards have increased significantly in recent years, particularly in the area of corporate governance. Among other things, these standards set forth requirements concerning board and board committee composition and independence from management, and require certain matters, such as equity compensation to employees and the issuance of a significant amount of the company's equity, to be approved by the company's stockholders, even in cases in which a stockholder vote would not otherwise be required under state corporation law. These new requirements are discussed in more detail later in this booklet.

In recent years, public companies have experienced a rise in institutional stockholder activism focused on corporate governance and executive compensation matters. Stockholders have submitted proposals that address such issues as declassifying the board of directors and providing for a majority vote (rather than the plurality vote standard) to elect the board of directors. Today, 75 of the 100 largest companies in the Fortune 500 have adopted a majority vote standard. A rise in the amount of executive compensation, especially "golden parachutes" (i.e., compensation distributed to executives upon the acquisition of their company), has served to fuel this activism. As a result, the SEC has substantially revised its compensation disclosure rules in an effort to improve the disclosure that public companies must provide to their stockholders regarding their compensation practices, including the possible impact that such practices may have with respect to the company's risk management. In addition, the SEC has proposed new rules that would allow certain stockholders to nominate directors using a company's proxy statement and would eliminate the company's ability to exclude stockholder proposals that seek to amend the company's director-nomination procedures. These changes and proposals, taken together, significantly increase the ability of stockholders to affect corporate decision making on matters of corporate governance.

Various corporate decisions have an impact on the price of the company's stock. Because that price often fluctuates in response to short-term financial results, management may face more pressure to make decisions that favorably affect short-term results at the expense of long-term strategic goals.

The existence of an established trading price for the company's stock, together with accounting and tax rules, increased institutional stockholder activism and heightened director liability, will reduce management's flexibility in providing employees with equity, which in turn could have an impact on employee retention and recruiting.

Disclosure Obligations

Another major burden of being a public company is the significant disclosure obligations imposed by the federal securities laws. The required disclosures include extensive information concerning the company's business and finances as well as detailed information relating to executive compensation and transactions with insiders. SEC regulations require disclosure even when such disclosure may negatively impact the company's business. Directors, certain officers and certain significant stockholders will be required to file reports with the SEC describing their ownership of, and transactions in, the company's securities.

In connection with these disclosure obligations, the chief executive officer and chief financial officer of the company will be required to certify in the company's periodic reports as to the adequacy of the company's disclosure controls and procedures and the effectiveness of the internal accounting controls designed to ensure the accuracy and completeness of the company's public filings. The company's outside auditors will, in addition to their annual audits of the company's financial statements, need to audit the company's internal controls as well as attest as to management's assessment of the adequacy of such controls.

In addition to the burden of creating and maintaining these disclosure controls and procedures and internal accounting controls, the company will also lose the ability to maintain the confidentiality of certain competitive information that it would otherwise prefer not be made public.

Increased Risk of Legal Exposure

The company and its directors and officers will be subject to potential liability under the federal securities laws for material misstatements or omissions in the IPO registration statement as well as in periodic reports, stockholder communications, press releases, and other public disclosures. This potential liability is a very real risk, especially for young, rapidly growing companies whose operating results can fluctuate significantly from quarter to quarter and year to year. These fluctuations oftentimes cause a company to fail to meet the expectations of stock analysts and investors, resulting in a decline in the company's stock price.

Companies face an active group of plaintiffs' attorneys who carefully monitor the public announcements, public disclosure and stock price performance of publicly traded companies, and these attorneys will frequently file class action lawsuits on behalf of security holders against companies that have experienced a decline in stock price, allegedly due to material misstatements or omissions. Although federal securities reform legislation, including significant limitations and restrictions on securities class action litigation, was passed in 1995, securities litigation cases continue to be brought, presenting an ongoing risk for companies undertaking an IPO.

Boards of directors are also increasingly becoming a target in related lawsuits alleging breach of fiduciary duty through insufficient oversight of corporate activities, allegedly causing losses to stockholders. While recent case law in Delaware has made the pursuit of these claims more difficult for plaintiffs, corporate directors remain subject to claims of willful or grossly negligent misconduct when material losses occur, particularly in situations where insufficient oversight mechanisms have been put in place.

Further, SEC enforcement actions and other government prosecutions against directors, officers and other employees of public companies in connection with misreporting of corporate results and other regulatory violations remain a risk for public companies. In order to minimize the risk of these lawsuits and enforcement actions, it will be in the interest of the company, its board and management to design and maintain robust controls and procedures designed to prevent misreporting or misconduct and ensure regulatory compliance.

Increased stockholder activism, director independence requirements, increased potential liability, and increased stockholder power to impact director elections, executive compensation and other corporate decisions have resulted in boards of directors becoming much more engaged in their management oversight function than in the past. In light of these potential liabilities, the company's board of directors is well advised to secure adequate directors' and officers' ("D&O") liability insurance coverage before proceeding with an IPO.

Time and Expense to Complete the Offering

Other significant costs of a public offering are the burden it will place on management and the significant expense that the company will incur in connection with the offering, even if it is not successful. The public offering process will demand significant management involvement, particularly from the chief executive officer, the chief financial officer and the accounting and legal staff. Costs of the offering include payment of discounts and commissions to the underwriters in exchange for their services (usually 7% of the offering proceeds), accounting fees and legal fees. There are also additional costs such as the cost of printing prospectuses and stock certificates, costs of retaining a transfer agent, and listing fees payable to the relevant trading market. Finally, there are filing fees paid to the SEC and the Financial Industry Regulatory Authority ("FINRA"), formerly the National Association of Securities Dealers ("NASD"), which regulates broker-dealers such as the underwriters. Many of these costs will be incurred before the company knows whether the offering is likely to be successful.

As the timeline on the following page suggests, a typical public offering can take several months to complete, even if everything goes smoothly. Prior to the commencement of the events described on this timeline, the company should have already selected its managing underwriters. The process of interviewing and selecting underwriters may be undertaken over a period of several months prior to the organizational meeting for the initial public offering. In addition, the company will need to examine the composition of its board and board committees and its disclosure controls and internal controls with an eye to bringing them into compliance with the standards required of public companies, a process that may take a significant amount of time. There may be situations in which the offering timeline will need to be extended to permit a young company to create governance structures, risk management processes, internal controls and other corporate infrastructure elements that are adequate for a public company.

Timeline for a Typical Initial Public Offering

Week	Event
1	• Conduct organizational meeting.
2	• Draft registration statement and conduct due diligence including attention to board and committee composition, disclosure controls and internal controls.
3	
4	
5	• Finish drafting registration statement at the financial printer and file registration statement with SEC.
6	
7	
8	
9	
10	• Receive initial comments from SEC (approximately 4-5 weeks after date of initial filing). Revise registration statement and file first amendment to registration statement. Submit comment response letter to SEC. Management prepares for road show.
11	
12	
13	
14	
15	• Receive additional comments from SEC. File necessary amendments to registration statement. Once SEC comments have been resolved, print preliminary prospectus and begin marketing efforts.
16	
17	• Road show.
18	
19	• Request that the SEC declare the registration statement effective. Price the offering and commence trading. File final prospectus. Typically four business days after pricing (three business days after commencement of trading on Nasdaq or the NYSE), close the offering.
20	

Long-Term Costs

There are long-term costs associated with being a public company. Complying with periodic reporting requirements, as well as general investor relations, is time-consuming and expensive. Direct costs include increased legal, accounting and investor relations fees due to increased complexity of the company's legal and accounting functions, including the requirement that the company's outside auditors conduct an audit not just of the company's financial statements but also of its internal controls. In particular, many companies will need to increase the size and expertise of their internal finance staff to ensure that it can develop and maintain adequate internal controls for a public company in today's post-SOX environment. Other expenses include insurance premiums on D&O liability insurance, and the costs of preparation of periodic reports and proxy statements.

1.3.3 Making the Decision

In weighing the benefits and costs of undertaking an IPO, a company should also evaluate alternatives to achieving the company's capital raising, liquidity, or other objectives, such as a private sale of the company's securities, bank financing, corporate partnering arrangements, or a merger or sale of the company. In the final analysis, before determining to proceed with an IPO, the company should evaluate the costs and benefits of all available alternatives to meeting its corporate goals and perform a candid assessment as to the company's readiness to undertake the process of becoming, and maintaining itself as, a public company.

CHAPTER TWO: THE INITIAL PUBLIC OFFERING PROCESS

2.1 Overview of the IPO Process

An initial public offering is actually a series of related processes culminating in the sale of stock to the public and the establishment of a public market for the company's securities. These processes include the following:

1. Preparing the registration statement and prospectus and performing due diligence with respect to the company and its business to confirm the accuracy and completeness of the information presented in the prospectus;
2. Strengthening the company's corporate structures and policies as necessary to become a public company, including attention to (i) board and committee independence, (ii) disclosure controls and internal controls, (iii) revisions to the company's articles and bylaws, (iv) updating the company's equity plans and (v) adopting board committee charters, a code of conduct, insider trading policy and other corporate governance policies;
3. Negotiating lock-up agreements and the underwriting agreement with the investment bank that is underwriting the offering;
4. Formalizing relationships with a financial printer, transfer agent, and stock certificate printer;
5. Responding to SEC comments on the registration statement and clearing FINRA review of the underwriting compensation arrangements;
6. Marketing the company's securities to potential investors through the circulation of the preliminary prospectus and the road show; and
7. Complying with the listing standards of Nasdaq, the NYSE or other market on which the company chooses to list.

2.2 The Players

Before describing the process of going public in the U.S., it is useful to review the members of the public offering team, or working group, and their various roles. The ability, experience, and commitment of the working group that will assist the company in the offering process will directly affect the success of the offering. For this reason, assembling the right team is one of the more important tasks the company will undertake at the beginning of the offering process.

2.2.1 The Company's Board and Management

The company's board of directors and its management, usually led by the chief executive and chief financial officers, play a critical role in the offering process. In consultation with the managing underwriters and company counsel, they make the major structural and timing decisions affecting the offering. Each director and officer who signs the registration statement must also invest the time necessary to ensure that the prospectus accurately describes the company and its business. Members of management make presentations to the financial and investor community during the road show, so the success of the marketing effort is directly affected by their performance. Members of management are also responsible for providing the working group with information about the company in due diligence and drafting sessions.

The fundamental role of the company's management in the IPO process is to help the working group understand and describe in the prospectus the company's business, strategy and strengths, as well as its vulnerabilities. The chief financial officer often coordinates the due diligence process, prepares the required financial disclosures with assistance from the company's auditors, and works closely with company counsel to coordinate all aspects of drafting the registration statement. Other members of management will be necessary for the information-gathering process and for the preparation and review of the registration statement to ensure that it accurately describes the company's business. Careful review by scientific or engineering personnel is also important in businesses that are technologically complex. The time required of management may become a substantial disruption in their ability to handle daily operating duties.

As a result of recent corporate governance reforms, the independent members of a company's board of directors have a significantly expanded role to play both during and after the offering. As discussed later, market listing rules require that a majority of the company's board consists of directors who meet specific criteria for independence from management. Furthermore, these rules require a company to have audit, nominating and compensation committees consisting solely of such independent directors, with certain limited exceptions. Audit committee rules, in particular, require that members meet not only market listing standards but also strict SEC standards for independence and that the audit committee have sole responsibility for engagement and oversight of the company's outside auditors. The audit committee will consequently play a central role as an independent watchdog with respect to the company's internal controls and the financial information provided in the registration statement.

2.2.2 The Managing Underwriters

Most IPOs are made through investment banking firms that act as “firm commitment” underwriters for the company’s stock, which means that the company does not sell shares to the public directly but rather sells the shares to the underwriters at a negotiated discount to the price at which the shares will be offered to the public. The underwriters then resell the shares to dealers and to their institutional and retail customers.

Underwriting Syndicate

To help ensure a diversified, successful distribution of stock, a selling group of underwriters is usually formed, typically consisting of twenty to thirty members. The core of the selling group is the underwriting syndicate, a group of firms that, in a firm commitment underwriting, is assembled in order to spread the financial risk of purchasing the shares and reselling them to the public. The syndicate is generally led by one or more managing underwriters who coordinate the process on behalf of the syndicate. Early in the process of considering a public offering, the company’s management should interview prospective underwriters about the possibility of their acting as a managing underwriter. Frequently, more than one manager is selected, in which case one of the managers is generally designated the “lead” or “book-running” manager and plays a leadership role in the registration and offering processes. The lead manager is typically named on the left hand side of the front cover page of the prospectus. The managers will select and assemble a syndicate and selling group, offer advice on the structure and size of the offering, assist in the preparation of the prospectus and presentation of the road show, coordinate the due diligence review and sell the largest portion of the stock to be offered to the public.

Selection of Managing Underwriters

For a company contemplating an IPO, the selection of managing underwriters involves both selling the attributes of the company to prospective managers and evaluating the strengths of the prospective managers. A key factor in this selection process is the level of interest of a prospective manager in the company and whether its perception of the company is consistent with that of the board of directors and management. The prospective manager’s experience with IPOs for companies at similar stages of development and in similar industries is also an important consideration.

Historically, the reputation of the research analyst in the prospective manager's investment banking firm has been a significant factor for companies selecting a managing underwriter because the coverage provided by a well respected research analyst can be critical to maintaining investor interest. However, the role of the research analyst in the selection of a managing underwriter and the IPO process in general has in recent years become heavily regulated. Consequently, the research and investment banking departments of investment firms have been separated from each other. Investment bankers have no role in determining which companies are covered by the analysts and are not allowed to influence the content of research reports, nor are research analysts permitted to participate in the road show or other marketing efforts. Firewalls restrict interaction between the investment banking and research arms of an investment firm except in very limited circumstances. Nevertheless, the quality and reputation of a particular investment banking firm's research arm remains an important factor in underwriter selection.

The company should evaluate the prospective manager's selling and distribution capabilities. Does the underwriter have a history of effectively selling IPOs and does it generally assemble quality syndicates? More specifically, the company must evaluate whether the prospective manager directs its selling efforts to the audience that the company is seeking to target. Certain investment banks, for example, focus their attention on large institutions, while others have more of a retail orientation. Investment banks may also specialize and have particular strengths and experience in certain industries or regions. If the company will be selecting more than one manager, it may wish to select investment banks with complementary strengths. For example, if a company wishes to sell both to institutional and retail buyers, it may wish to select two co-managers, each of which is particularly strong in one of these distribution channels.

2.2.3 The Company's Counsel

Detailed laws and rules govern disclosures in registration statements and the conduct, obligations and liabilities of the company and its officers and directors during and after the public offering. As a result, the company's counsel typically guides the company through the IPO process, coordinates all aspects of the registration, due diligence and listing processes, provides crucial recommendations concerning required corporate structures and policies, and acts as a contact point between the working group and the SEC. The company's counsel also assists the company in negotiating the underwriting agreement with the underwriters. Finally, the company's counsel assists the company's officers and directors in complying with their myriad legal responsibilities following the offering.

2.2.4 The Company's Auditors

The auditors' primary role in the public offering is to audit and deliver a report on the company's financial statements. The auditors work closely with the rest of the working group during the company's preparation of the various financial disclosures in the registration statement, including the portion of the prospectus known as "Management's Discussion and Analysis of Financial Condition and Results of Operations." The auditors will review and confer with the company concerning the company's responses to comments from the SEC staff relating to accounting matters in the registration statement. The auditors are a focal point in the working group's due diligence review of the company's accounting and internal control functions. Finally, the company's auditors are responsible for delivering to the underwriters and board of directors a "comfort" letter, which confirms the auditor's independence from the company and confirms the presentation of the financial information contained in the registration statement.

2.2.5 The Underwriters' Counsel

The underwriters' counsel represents the underwriters in ensuring that the prospectus and the offering comply with the various securities laws and SEC rules, FINRA rules, and the listing standards of Nasdaq, the NYSE or other market on which the shares will be listed for trading. In addition, underwriters' counsel is intimately involved in the process of gathering and reviewing information about the company in order to assist the underwriters in meeting their "due diligence" obligations, which are described in more detail later. The underwriters' counsel also represents the underwriters in negotiating the underwriting agreement with the company and its counsel and the comfort letter with the company's auditors.

2.2.6 The Financial Printer

The prospectus that is included within the registration statement and that is delivered to prospective investors is a professionally printed document, and high standards must be met in its preparation. The company should select a financial printer that has expertise in the printing of prospectuses and filing of registration statements with the SEC. Printers also provide conference rooms and business services to the working group during the drafting process and in connection with the filing of the registration statement.

2.2.7 Other Participants

If the company has special counsel concerning patent, regulatory, litigation or other matters, such counsel will be involved in the public offering process, advising the working group in the areas of their particular expertise and reviewing drafts of the relevant portions of the registration statement. In addition, the company must select a registrar and transfer agent to administer issuances and transfers of its stock. The company may also employ a graphic artist if visuals are to be used in the registration statement or the road show presentations. Finally, companies generally employ the services of professionals to aid in the preparation of the road show materials and to groom management for their presentations to potential investors during the road show.

2.3 The Process Through the Filing of the Registration Statement

2.3.1 Structuring the Offering

Number of Shares and Price

An IPO typically involves an offer and new issuance of common stock by the company. Among the key issues in structuring the offering are the number of shares to be offered and the price per share. Tentative decisions about the number of shares to be offered are usually made early, but the price is dependent on so many changing factors, such as market conditions and anticipated operating results, that the price is usually expressed as a range at the structuring stage. The preliminary prospectus used to market the stock contains this price range, while the final prospectus that is filed following the marketing effort includes the final price per share.

The number of shares to be offered is a function of a number of factors, including the amount of capital the company expects to raise, the valuation of the company, the need to create enough of a “float” (shares held by the general public) to have a reasonably liquid market for the stock after the offering, and the desire to avoid too great a reduction of existing stockholders’ ownership interest or dilution of earnings per share.

The actual per share price is a function of the company’s valuation divided by the number of shares to be outstanding after the public offering, after giving effect to any stock split or reverse stock split considered advisable by the managing underwriters to achieve an appropriate initial per share price for marketing purposes. Many IPOs of emerging growth companies, for example, have stock prices in the range of $10 to $20 per share. The determination of valuation is both an art and a science. The managing underwriters and management typically agree on a list of comparable companies and compare the financial characteristics of those companies against the IPO candidate’s historical and anticipated financial condition, position in the market and operating results.

It is important to emphasize that for a company contemplating a public offering, long-term value and happy investors are more important to the company's success than short-term value. A successful offering characterized by an increasing stock price after the offering can be of great long-term value in terms of public perception and the ability of the company to access the capital markets in the future. If the price declines after the offering due to an inappropriately high valuation or a "surprise" following the offering, the company will face significant negative perceptions and a higher risk of a stockholder lawsuit.

American Depositary Receipts

One question to be considered by a non-U.S. company is whether to offer and list its shares directly or instead to use an American Depositary Receipt ("ADR") structure.

An ADR is a negotiable receipt issued by a U.S. bank as depositary, which evidences one or more Depositary Shares ("ADSs"), each of which in turn represents a specified number of underlying non-U.S. securities which the sponsoring issuer has deposited with a custodian. (In this booklet, the terms ADR and ADS are on occasion used interchangeably.) Under the deposit agreement for an ADR facility sponsored by the company (this discussion does not address so-called "unsponsored" ADR facilities), the depositary accepts deposited shares, issues ADSs evidenced by ADRs, registers transfers of ADRs, converts dividends into U.S. dollars and distributes them to ADR holders, and mails to ADR holders annual reports and proxy materials which the company furnishes to its stockholders.

ADRs have been developed to alleviate certain legal restrictions and practical problems which could affect U.S. securityholders trading in the underlying securities. For example, the settlement and clearance process in U.S. trading markets for transactions in other domestic securities is generally the same for transactions in ADRs.

Selling Stockholder Participation

Another significant structural issue is determining the participation, if any, by selling stockholders in the offering. This decision can be affected by a number of factors. If the company does not need to raise a large amount of capital, stockholder participation may be solicited to increase the size of the offering so that the public float and investor liquidity are increased. Also, a holder of a large block of stock with a desire to sell a portion of his or her holdings may be solicited to sell in the offering. In this manner, the company and the underwriters can avoid the potentially depressing effect on the stock price of a large block of stock that might enter the market at any time following the offering, possibly creating an imbalance between supply and demand for the stock.

The company may also have a contractual obligation to register shares requested to be included in the offering by certain stockholders. For example, venture capital investors often require such registration rights when negotiating earlier private financings. However, the company and its managing underwriters often have the right to limit or exclude such shares from an IPO entirely if market factors so require. The company's counsel and management should review and address the company's contractual registration obligations early in the process.

Significant sales by insiders in the offering can create a perception on the part of prospective investors that insiders are "bailing out" of the company, which would make the offering more difficult to sell. The amount of selling stockholder participation should be made in consultation with the managing underwriters in light of these factors.

Underwriting Arrangements

The underwriting arrangement for the IPO is another fundamental structural issue to consider. High-profile IPOs are typically underwritten on a "firm commitment" basis. In a firm commitment underwriting, the underwriters commit to purchase the shares from the company at a negotiated discount and then resell the shares to the public. This commitment is made by a contract, called the underwriting agreement, signed by the company, the managing underwriters and any selling stockholders. Because the underwriting agreement is generally not signed until after the marketing efforts are completed, the contractual commitment is not finally made until just prior to selling the shares. This booklet generally assumes that the offering will be conducted on a firm commitment basis.

An alternative to a firm commitment underwriting is a "best efforts" underwriting, in which the underwriters act only as agents for the company and never actually take title to the shares. To reduce their inherent uncertainty, best efforts underwritings may be designed on an "all or nothing" basis, under which none of the shares are sold unless all of the shares are sold, or on a "minimum" basis, under which a specified minimum number of shares must be sold for the offering to be completed.

A provision that has become standard in firm commitment underwritings is the overallotment or "green shoe" option. In an overallotment option, the company, the selling stockholders, or both, grant an option (typically of

30 days duration) to the underwriters to purchase additional shares (generally 15% of the number of shares sold in the offering, the current FINRA-imposed maximum) on identical terms to those on which the original shares were sold to the underwriters. The green shoe allows the underwriters the ability to exercise the option and purchase additional shares to cover overallotments made in the offering process.

An additional underwriting issue that the company may wish to consider and discuss with the underwriters is whether the company would like to implement a "directed shares" program, under which a portion of the shares to be sold in the offering are directed to certain friends of the company who might not otherwise be able to purchase shares in the offering. FINRA rules and securities laws of other countries place specific limits on the structure and size of a directed shares program. The company's and the underwriters' counsel should therefore be consulted early in any discussion of such a program.

"Dutch Auction" Underwriting Arrangements

Another alternative offering structure that has recently emerged in the equity markets is the so-called "Dutch auction," pursuant to which the public offering price is determined by an auction process. Under this system, bids are solicited from interested potential buyers, indicating share quantities desired along with a per share price at which the buyer would be willing to pay for those shares. Based on the bids received, at the close of the auction process, the company, as seller, ascertains the "clearing price," i.e., the highest price at which all shares being offered can be sold (though the company may reserve the right to set the public offering price below the clearing price if it chooses). Bids at or above the offering price are then accepted, and the company allocates the shares being offered among all successful bids on either a pro rata basis (proportionate to the number of shares indicated in each bid) or on another basis, as disclosed in the prospectus.

In contrast to a traditional IPO, the auction process allows the company to view all bids that have been submitted and elicits a precise demand curve that forms the basis for the offering price. Thus, the auction process can mitigate first-day "flipping" of shares by some institutional investors and allow the issuer to retain a greater share of those potential profits. For companies that are contemplating a Dutch auction, price optimization should not be viewed as the sole goal. Companies should also consider where best to place the securities.

Listing Arrangements

In the early stages of the offering process, the company should also consider the relative advantages and disadvantages of listing its shares for trading on

Nasdaq, the NYSE or another securities market. Nasdaq and the NYSE post their listing requirements on their websites.

Listing on a market will also necessitate compliance with a number of corporate governance and other standards, described later in this booklet.

At this early stage of the process, management should discuss with the managing underwriters the appropriate market for trading the company's shares, an informal inquiry should be made to determine that the company's application to that market is likely to be approved, and a trading symbol should be reserved.

Lockup Agreements

Another important structuring issue to consider is the subject of lockup agreements. In order to ensure an orderly trading market following the offering, the managing underwriters generally require the company to agree, and to cause its directors, officers and stockholders to agree, not to sell any securities of the company for a period of time after commencement of the public offering. Securing the agreement of directors and officers who are in favor of the public offering is usually not a problem. Securing the agreement of a stockholder who is not contractually bound by a prior agreement with the company to lock up its shares may be more difficult. The larger the potential overhang (shares held by existing stockholders that can be sold into the market following the public offering), the more critical obtaining lockup agreements becomes from the perspective of the underwriters and the investment community. An overhang analysis should be conducted at the start of the offering process, and potential issues in this area should be raised with the managing underwriters as early as possible.

The typical lockup has historically been 180 days long. However, pursuant to FINRA and NYSE rules, some underwriters have recently introduced a minor modification to their form of lockup agreement. Those rules govern research analysts and research reports and prohibit, with certain exceptions, the publication of research reports by the underwriting firms that served as managers or co-managers of the offering within 15 days on either side of the expiration, waiver or termination of a lockup agreement (such reports often referred to as "booster shots"). One example of a modification made to lockup agreements in response to these rules provides that if, prior to expiration of the scheduled 180-day lockup period, the company reports earnings results or other material news, or announces that it will report earnings within a short period of time after such expiration, then the term of the lockup is automatically extended for a short additional period of time so that analysts will not be precluded from issuing research reports around the time of such material news.

Another point to note in this regard is the effect of FINRA Rule 5110, which governs permissible underwriter compensation. Unless the criteria for certain exceptions are met, the rule imposes a 180-day lockup on the underwriters and certain related persons with respect to unregistered securities of the issuer that they acquired within approximately 180 days prior to the initial filing date of the registration statement or after such date and which FINRA deems to be underwriting compensation.

2.3.2 Structuring the Company: Governance, Controls and Housekeeping

Although many executives think of the public offering process as beginning with the selection of underwriters, companies should plan for the offering much earlier, particularly in light of the additional requirements imposed as a result of SOX and more stringent listing standards. Early preparation may enable the company to avoid many of the tasks that would otherwise have to be performed, often at significant incremental expense, shortly before the offering. Careful maintenance of stockholder records, for example, can forestall or limit debates over ownership claims, and careful drafting of preferred stock purchase documents, particularly with respect to automatic conversion features, registration rights and lockups, can ensure that these issues do not present problems in a public offering.

Corporate Governance

As discussed in greater detail in Chapter Three under the heading "Corporate Governance," a company that wishes to list its shares for trading on Nasdaq, the NYSE or elsewhere will need to achieve compliance with an array of corporate governance listing standards imposed by those markets. Although there is a structured phase-in of certain of the requirements for companies conducting an initial listing in connection with an IPO, many companies and their underwriters will seek to achieve compliance with those standards prior to filing the registration statement with the SEC and commencing the marketing effort. In addition to analyzing the "independence" of current and proposed directors and satisfying the board and committee composition requirements, companies will also need to adopt committee charters and a code of ethics and develop adequate internal and disclosure controls required of public companies as discussed more fully below. Because recruiting new board members and taking the other steps necessary to satisfy the new corporate governance requirements and develop adequate internal and disclosure controls can take time, this is a process best begun early.

Financial Statements; Controls and Procedures

Many young, rapidly growing companies seeking to go public may find it necessary to strengthen their financial accounting and related controls and procedures.

The company will need to ensure that it will have available the financial statements required by the SEC and prospective investors in the offering. Moreover, as a result of recent reforms, following the IPO the company will be affirmatively required by rule to maintain "internal control over financial reporting" ("internal controls") to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements in accordance with generally accepted accounting principles ("GAAP"), and to maintain "disclosure controls and procedures" ("disclosure controls") designed to ensure that the totality of information required to be disclosed by public companies (i.e., not only financial but all other disclosure as well) is recorded, processed, summarized and reported within the required timeframes. In essence, these are procedures and processes designed to ensure the company can make its various disclosure obligations as a public company. The company's CEO and CFO will be required personally to sign certifications to the SEC concerning the company's internal controls and disclosure controls. In addition, the company's auditors may be required to audit such internal controls and attest to management's assessment of those internal controls. Prior to the IPO, these requirements may necessitate remediation of deficiencies identified by the auditors in the company's internal controls.

For non-U.S. companies, differences in accounting standards also need to be addressed. A company falling within the definition of "foreign private issuer" that proposes to use Form F-1, discussed in greater detail later, will be required either to present its financial statements in accordance with U.S. GAAP or International Financial Reporting Standards ("IFRS") as issued by the International Accounting Standards Board ("IASB"), or, if prepared in accordance with any other accounting principles, such financial statements must be accompanied by a reconciliation to U.S. GAAP and a discussion of the material differences in accounting principles used. Either way, this can be a time-consuming process that should be discussed with the company's auditors and commenced early.

Amendments to Charter

Even with careful planning, an effort will need to be made shortly before the offering to ensure that the company is in proper legal form to complete the offering. This will require a legal audit to determine what changes are necessary or desirable. Amendments to the company's charter may be necessary to authorize additional shares, implement a dual class structure for the company's common stock, provide for the conversion of preferred stock, effect a forward or reverse stock split in order to target a certain per share price for the company's stock in the offering, or accomplish other changes that may be desired. Consents of certain stockholders or third parties may consequently need to be obtained.

Fundamental changes are almost invariably easier for a private company to make than a public company, such as adopting a classified board, prohibiting cumulative voting, requiring advance notice at stockholder meetings, authorizing "blank check" preferred stock to enable the company to adopt a "poison pill" rights plan, or reincorporating into another jurisdiction, typically Delaware.

Employee Benefit Plans

Prior to the IPO the company will also want to review its existing employee benefit plans and make modifications or enhancements that are appropriate for a public company.

In connection with the transition to public reporting and trading status, a company will typically adopt a new form of stock plan for grants subsequent to the IPO. Although historically stock options have been the favored form of equity compensation for many public companies, changes to the accounting treatment of such options, pursuant to which option grants are now reflected as compensation costs on the income statement, are leading to new trends in equity compensation, such as grants of restricted stock units, performance shares and stock appreciation rights, in addition to or in lieu of options. Many companies going public also put in place an employee stock purchase plan providing employees with the ability to purchase the company's stock through payroll deductions. A company should consult with its advisors as to the advantages and disadvantages of various equity compensation plans and structure its arrangements accordingly.

Another change in this area is that recent reforms now require all equity compensation arrangements, with certain exceptions, to receive stockholder approval. While obtaining stockholder approval in the private company context can often be quite simple, it is a more complex, costly and uncertain undertaking for public companies. As a consequence, a company will want to carefully consider anticipated future equity compensation needs and work closely with both its own counsel and the underwriters to create, before the company goes public, equity compensation arrangements sufficient for those anticipated needs without having an unduly adverse impact on the marketing of the offering.

Subject to certain restrictions, employees who exercise vested stock options are generally able to sell such stock in the public market in brokers' transactions beginning three months after the IPO (although employees are typically subject to lockup agreements, discussed earlier). Moreover, shortly following an IPO a company will typically register the shares issuable under an employee stock plan by filing a registration statement on Form S-8, a special registration statement for securities offered under employee benefit plans. This will generally enable employees who exercise options or vest in other equity awards after the IPO to freely sell their shares in the public market (subject to contractual lockups as well as insider trading laws and the company's insider trading policy).

At this stage of a company's life cycle, it usually has in place other standard benefit plans in addition to its equity compensation plans, such as a 401(k) plan and group health insurance. However, this is a good time to reevaluate the benefits the company provides to its employees to ensure that such arrangements will be sufficient following the offering. Certain benefit plans and arrangements adopted early in a company's development may not be sufficient for the needs of a public company.

"Cheap Stock" Charges

One frequently occurring issue in connection with the IPO is whether the SEC accounting staff will require the company to take a non-cash charge to earnings for certain options granted at exercise prices that the staff deems to have been below the fair market value of the underlying common stock at the date of grant. This is often referred to as a "cheap stock" charge. Although private company boards typically grant options with exercise prices equal to the board's best estimate of the fair market value of the common stock at the time of grant, the SEC staff does not always in hindsight concur with such determinations.

A challenge in valuing private company common stock, and thus setting a fair market value exercise price for options, is that there does not exist active open market trading in the stock to set a market price, and myriad variables not susceptible to easy quantification must be considered by a board in arriving at its best estimate of fair market value. Of particular importance in such valuations are the disparity of the different rights of the common stock and preferred stock in the typical venture capital-backed private company's capital structure.

In addition, as an additional challenge in valuing private company stock, the Internal Revenue Service (the "IRS") issued regulations under Internal Revenue Code (the "Code") Section 409A that significantly impact how private companies should determine the fair market value of their common stock for purposes of setting stock option exercise prices. These regulations provide guidance regarding acceptable methods for determining the fair market value of private company common stock. The general valuation factors must include: (i) the value of tangible and intangible assets; (ii) the present value of future cash-flows; (iii) the market value of similar entities engaged in a substantially similar business; and (iv) other relevant factors (such as control premiums or discounts for lack of marketability). Valuations may be relied upon for 12 months, unless there is new information available after the date of the valuation materially affecting the company's value.

The regulations under Section 409A of the Code also provide that using one of three methods for determining the fair market value of a private company's common stock will result in a valuation that is presumed reasonable, unless the IRS can show that the valuation method was "grossly unreasonable." These include: (i) the valuation is determined by a qualified independent appraiser as of a date no more than 12 months before the stock option grant date; (ii) the valuation is made reasonably, in good faith, evidenced by a written report; or (iii) the valuation is based on a binding formula. However, if a company reasonably expects to have a change in control within 90 days or an IPO within 180 days, then this independent appraisal presumption is the only presumption that is practically available under Section 409A of the Code.

It is often advisable for a Board to retain an independent appraiser of fair market value in the period leading up to the IPO, although such determinations are not binding on the SEC. These valuations may also reduce the risk of adverse tax consequences associated with cheap stock such as the potential tax penalties that may be asserted for below market grants under Section 409A of the Code. Over the years, the SEC has taken a stricter approach to cheap stock issues and has begun to reject many justifications for a company's historical differentials in prices for its common stock and preferred stock. Particular attention must be paid to valuations of the common stock during the last 12 to 18 months prior to the expected date of the company's IPO. During this final period, the grant price should gradually rise to approach the expected IPO price, reflecting a presumably increasing likelihood that the IPO will occur. It is therefore important for late-stage private companies to consult closely with their auditors, counsel and, in the leadup to an IPO, their underwriters concerning the likely accounting consequences of proposed option grants and how any cheap stock charges might affect a company's public market capitalization and the offering process. The public markets have come to expect these non-cash compensation charges and may be willing to analyze the company's operating results independently of these charges. As the pricing of employee stock options becomes more in line with the valuation concepts articulated in the Section 409A regulations, the likelihood that the SEC will have support for continuing to require the imposition of cheap stock charges should be reduced, as the stock valuations should become more supportable by an independent valuation under the Section 409A regulations done prior to an IPO. However, given that the final Section 409A regulations were only recently issued, this remains to be seen.

2.3.3 The Organizational Meeting

When the managing underwriters have been selected, the company should assemble the working group for an organizational meeting. At this meeting, structural and timing issues are discussed, and a schedule is established for the offering that allows sufficient time for the due diligence process, the preparation of the registration statement, the SEC review period and the road show. One of the issues to be addressed in setting the offering schedule is the availability of financial statements to be included in the preliminary prospectus that is distributed to potential investors and in the final prospectus to be delivered to investors after the commencement of the IPO. Specific considerations include the date of the last audit, any subsequent interim period or quarterly information to be included in the prospectus, and the need for financial statements for any businesses acquired during the period leading up to the offering. The company should also allow time for any required corporate housekeeping tasks and a stockholders' meeting, as necessary, to approve amendments to the company's charter documents, employee stock plans or other proposals the company wishes to put in place before the IPO.

2.3.4 Statutory Restrictions on Publicity

At the commencement of the public offering process, the company's counsel should review with management and the board of directors restrictions on publicity relating to the offering.

Prohibited Publicity

The Securities Act of 1933, as amended (the "Securities Act"), provides that, absent an exemption, it is illegal to offer to sell any security prior to the initial filing of the registration statement. The Securities Act defines "offer" broadly, and the SEC has made clear that publicity that has the effect of conditioning the public mind or arousing public interest in the issuer can be construed as an offer to sell. Consequently, certain activities or publicity prior to the filing of the registration statement may result in a "gun jumping" violation of the Securities Act, even if the activity or publicity was not phrased in terms of an express offer to sell stock and regardless of whether it was made orally or in writing.

Upon discovering a potential gun jump, the SEC may delay the effectiveness of the registration statement, often for an extended period (a "cooling off" period). If an underwriter is involved, the SEC may exclude that firm from the underwriting syndicate. The company may also be required by the SEC to include disclosure in the prospectus to the effect that the company could, if a violation of the Securities Act is found to have occurred, be required to repurchase the shares sold in the offering.

Guidelines to Avoid Publicity Problems

Observing a few general guidelines will help avoid pre-filing publicity problems. The SEC recently enacted significant reforms to the registered securities offering process, including changes that impact the manner in which company's address pre-filing publicity. Prior to these reforms, companies have restricted their communications with the general public during the pre-filing period to avoid gun jumping violations. The SEC's guidance on what constituted a gun jumping violation was general, but over time, certain practices evolved for determining whether any particular communication could be viewed as a gun jumping violation. The recent reforms essentially codify as a safe harbor what was already current practice, as well as provide a new safe harbor for certain communications made more than 30 days prior to filing a registration statement.

Factual Business Information. A company conducting an IPO can continue to regularly release ordinary course factual business information intended for use by persons other than in their capacity as investors or potential investors, such as customers and suppliers. Factual business information is defined as factual information about the company, its business or financial developments, or other aspects of its business, and advertisements of, or other information about, the company's products or services. In order for a company to avail itself of this safe harbor, the information must be regularly released in the ordinary course of business by or on behalf of the company, cannot include information about the registered offering, and cannot include forward-looking information. Finally, the information must be disseminated by the same employees or agents who historically have been responsible for providing the information.

Communications by Companies 30 days prior to Filing a Registration Statement. The SEC provided a bright-line safe harbor for communications made more than 30 days prior to the filing of the registration statement, provided that the communications do not reference the offering, are made by or on behalf of the company, and the company takes reasonable steps to prevent the further distribution or publication of such information during the 30-day period prior to the filing of the registration statement. If a company were to give an interview to the media more than 30 days prior to the filing of the registration statement, but the interview is published during the 30-day period prior to the filing of the registration statement, the company would not be able to rely on the safe harbor. However, assuming the other conditions are met, the company could continue to rely on this safe harbor by delaying the filing of the registration statement until 30 days after the publication.

Even though these SEC reforms have provided companies with better guidance in terms of managing publicity during the offering process, management should continue to consult with counsel before issuing any press releases, responding to any outside inquiries from financial analysts, newspaper reporters, or others who may relay information to the public, or consenting to any public speaking engagements. Company counsel should also review the contents of the company's website for compliance with the gun jumping prohibitions.

2.3.5 Purpose of the Registration Statement

The Securities Act requires the filing of the registration statement prior to making any offers to sell securities, unless the offer or the particular securities are specifically exempt. This federal regulation of offers and sales of securities to the public is designed to require the company to make full and fair disclosures of all material information necessary to allow potential investors to make qualitative judgments as to the relative merits and risks of the issue for themselves.

The registration statement, which is a public document filed with the SEC, consists principally of a prospectus which describes the business of, and other information relating to, the company, including key risk factors, audited annual and unaudited quarterly financial information for the company, known trends or uncertainties that may affect future period financial results, directors and officers and their compensation, the offering and underwriting arrangements, and other matters. The preliminary prospectus, certain other written materials meeting SEC requirements known as "free writing prospectuses," and a very limited form of press release are the only means by which written offers may be made to prospective investors before the effectiveness of the registration statement. An updated final prospectus containing pricing information must be made available to investors who buy in the public offering along with the delivery of a confirmation of their purchase. The offering process and free writing prospectuses are described later in this booklet.

There are detailed legal and accounting rules that must be complied with in preparing the registration statement. The securities laws provide that the company, certain members of management, directors, underwriters, experts (including auditors), and controlling persons may be liable to a purchaser of the company's securities for material misstatements or omissions in the registration statement. Furthermore, the SEC can under certain circumstances pursue enforcement action against individuals who participate in the preparation of a registration statement containing material misstatements or omissions. Accordingly, a registration statement is prepared to serve two critical, but seemingly contradictory, objectives: (1) to serve as a marketing document to interest prospective investors in the company and its stock; and (2) to protect the various participants in the process from liability by fully disclosing all material information, including the risks of an investment in the company.

To meet these objectives, a company can give a balanced presentation of the risks of its business and still attract potential investors. Sophisticated investors (particularly institutional investors) expect to see conservative disclosure and risk factors in an IPO prospectus, even in the prospectus of a very well regarded company. An examination of the prospectuses of companies that have had successful IPOs will show that these documents typically detail the risks in some depth but are still very effective selling tools. It is the job of the underwriters, the company's counsel, and the other members of the working group to assist the company in making its registration statement serve both the marketing and full disclosure functions.

2.3.6 The Due Diligence Process

Overview

The first stage in the process of drafting a registration statement, which usually begins prior to the organizational meeting, is the gathering of information about the company and the industry in which it does business. This due diligence process is a critical task of the working group. Generally speaking, each participant involved in the preparation of the registration statement is potentially liable for material misstatements or omissions in the prospectus unless such participant (other than the company itself, which is strictly liable and does not have this defense) can establish that he or she conducted a reasonable investigation to determine the accuracy of the information. A thorough due diligence effort is therefore one of the best ways to protect the members of the working group and the persons who sign the registration statement from liability.

The due diligence process can be tedious for the company. Management has to find, organize, and provide to members of the working group a large body of documents and other information. Management also has to expend many hours explaining various aspects of the company's business to members of the working group and verifying the information in the prospectus. Moreover, the process can be repetitive, with the working group going over the same issues more than once as their understanding of the company and its business increases and as they think of new questions that they need to ask about a particular topic. While this can be unpleasant at times, in the end, it is both a necessary part of the process and of real value to the company—the better the understanding and more information the various members of the working group have of the company and its business, the more effective they will be in assisting the company in selling its stock and in protecting the company and the members of the working group from liability.

The due diligence process has both a written and an oral component. Near the time of the organizational meeting, counsel for the company will distribute several written requests for information to the company. These requests often include a "D&O" questionnaire to the company's directors and officers to gather information about the company and individual members of management.

The following are types of information typically requested from a director or officer:

- Experience with the company
- Personal data
- Business experience
- Participation on committees of the board of directors of the company
- Information concerning the director's independence from the company and its management
- Arrangements for selection as an officer or director of the company
- Interests adverse to the company
- Knowledge of legal proceedings against the company
- Knowledge of voting arrangements among stockholders of the company
- Knowledge of changes in control of the company
- Ownership of company stock
- Compensation/benefits received from the company
- Indebtedness to the company
- Material transactions with the company
- Indemnification by the company
- Prior bankruptcy and other legal proceedings

Underwriter Due Diligence

The company's or underwriters' counsel will typically provide the company with a due diligence request list concerning documents relevant to the company and its business. These documents will be reviewed to assist in crafting the registration statement, identifying the documents that should be discussed in or filed as exhibits to the registration statement, and complying with the due diligence responsibilities of the members of the working group.

The following are types of information typically requested by legal counsel:

- Basic corporate documents, including charter, bylaws, and board minutes
- 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

Many companies are utilizing a Virtual Data Room ("VDR") to assemble the various due diligence materials. A VDR streamlines and accelerates the due diligence review by transforming the traditional due diligence process into a secure, centralized, online virtual data room, enabling the company's and underwriter's counsels to easily and securely comb through online materials in order to access critical information and collaborate on the review process. Companies may want to begin building their VDRs six to 12 months ahead of an IPO. By proactively managing their information, the management team can remain focused on the business while preparing for the IPO, instead of diverting resources to deal with assembling and presenting documentation.

In addition to information requested of the company, underwriters' counsel will also request that directors, officers and certain securityholders of the company complete a questionnaire designed to elicit information concerning any association or affiliation they might have with any member of FINRA. The underwriters are required to submit this information to FINRA in connection with its review of the underwriting arrangements to assure that they are fair to the company. FINRA must issue a letter of "no objection" to such arrangements before the SEC will declare the registration statement effective.

Management Presentations

In addition to documentary review, the due diligence process involves extensive discussions with company management. The most important of these are the management presentations. These meetings are typically held at the same time as or shortly after the organizational meeting and usually involve the chief executive officer of the company giving a presentation to the underwriters and counsel on the company's business. The CEO is generally followed by other managers with knowledge of significant aspects of the company's business, each of whom describes his or her background and responsibilities, as well as significant business issues relating to his or her specific area. In addition to management, experts affiliated with the company, such as patent counsel, may be interviewed. The underwriters also interview the company's auditors to discuss both the company's financial statements and its accounting staff, policies, systems and controls, including material weaknesses and areas for improvement, if any.

These initial management presentations, which usually last one or two days, put the working group in a position to begin work on the registration statement. They do not, however, end the due diligence process. New issues, or new perspectives on old issues, always arise in drafting, and management should be prepared to be available for additional questions and discussions with the working group as the drafting process continues.

Individual members of the working group will generally consult others as well. For example, in their due diligence requests, the underwriters typically ask for contact names and phone numbers for major suppliers, distributors, or customers. After clearance from the company, the underwriters typically make due diligence calls to some of these parties to ask about the company and its business. In addition, the underwriters may, in special cases, hire their own experts to investigate certain matters.

2.3.7 Contents of the Registration Statement

Form of Registration Statement; U.S. Issuers v. "Foreign Private Issuers"

Although the substance of each registration statement is different based on the particulars of the company and its business, the form of the registration statement, including the topics that must be discussed, is prescribed by SEC rules. There are several forms of registration statements applicable in the IPO context but by far the most commonly used form for IPOs is Form S-1, the standard default for the registration of securities of all issuers (other than foreign governments) for which no other form is authorized or prescribed.

When a foreign company falling within the definition of "foreign private issuer" offers its own equity securities to the U.S. public it may use Form F-1, which is similar in many respects to Form S-1 though tailored to foreign issuers. In addition, in an ADR facility, the requirements of Form F-6 must be complied with to register the ADSs.

A "foreign private issuer" is defined as any foreign issuer (other than a foreign government), except one which meets the following conditions: (1) more than 50% of its voting securities are directly or indirectly held of record by U.S. residents; and (2) either (i) the majority of its executive officers or directors are U.S. citizens or residents, (ii) more than 50% of its assets are located in the U.S. or (iii) its business is administered principally in the U.S.

There are also special forms and rules applicable solely to certain Canadian issuers, which are not addressed in this booklet.

The Form S-1 or Form F-1, and SEC Regulations S-K and S-X, to which the Forms refer, have a large number of specific disclosure requirements of a formal and technical nature. Beyond these specific requirements, the company is also legally obligated to disclose all other material information relating to the company. The company's counsel and auditors will be closely involved in reviewing and commenting on the registration statement in light of these requirements. For purposes of this booklet, we will briefly describe certain major sections of the registration statement in the order they typically appear, together with a brief discussion of certain additional disclosures applicable to foreign issuers.

The Prospectus Summary

The Prospectus Summary is generally several pages long and includes a short summary of the company and its business. This summary description is often viewed as the most important selling piece in the document. It will typically undergo many hours of discussion and many revisions before it is completed.

The Prospectus Summary also includes a brief description of the number of shares offered, the total number of shares to be outstanding after the offering, and the uses to which the proceeds of the offering will be put. Finally, summary financial data is provided, usually for a three- or five-year period prior to the filing of the registration statement, plus any subsequent interim (“stub”) period for which financial statements are included in the registration statement. This summary financial information includes capsule income statement information and a summary of the most recent balance sheet, plus the balance sheet as adjusted to reflect the receipt of the anticipated proceeds from the offering.

Risk Factors

In this section, the company identifies and separately describes the particular risks associated with an investment in the company. The Risk Factors section is commonly perceived simply as lawyers’ boilerplate, but a properly prepared risk factors discussion is carefully tailored to the company and can provide substantial protection from liability. Risks disclosed can include such items, if applicable and important to the company’s business, as the company’s early stage of development, its short history or lack of profitability in past periods, potential volatility of the company’s operating results, special risks in the company’s industry, the status of product development and need for follow-on products, competition, litigation, dependence on certain customers, distributors or suppliers, the need for additional funds, as well as any other significant business risks. In addition, if the company is foreign or has a significant international presence, then there may be other specific risks, including fluctuation in currency exchange rates, enforceability of United States judgments and different stockholder rights in foreign jurisdictions.

Selected Financial Data

The Selected Financial Data section presents selected income statement and balance sheet data (usually in more detail than in the Prospectus Summary) for the last five years, plus any subsequent interim period for which financial statements are included in the registration statement and the comparable interim period of the immediately preceding year. SEC regulations govern how current the financial information contained in any filing must be.

Management's Discussion and Analysis of Financial Condition and Results of Operations

In this critical section, often referred to as "MD&A," management is required to provide a narrative discussion of the company's financial statements that enables investors to see the company through the eyes of management, provides the context in which financial information should be analyzed, and provides information about the quality of and variability in earnings and cash flow, including known trends and uncertainties, so that investors can ascertain the likelihood that past performance will be indicative of future performance.

The MD&A generally includes a discussion of the material line items in the company's income statement for each of the last three years and for the current interim period compared to the prior-year interim period. The company should not simply repeat figures in Selected Financial Data or numbers derivable from those figures. MD&A is concerned with management's view of why any material changes occurred. Significant fluctuations in important line items from one period to another should generally be explained in MD&A. In addition to operating results, the company must discuss its liquidity and capital resources, generally comparing the end of the most recent period for which financial statements are presented with the end of the preceding fiscal year.

The MD&A section must also include disclosure concerning any off-balance sheet arrangements the company might have, and tabular disclosure concerning contractual payment obligations.

The MD&A is not simply a historical analysis of the company's operating results; rather, management must disclose known trends and uncertainties that are reasonably likely to have a material effect on future operating results or financial condition. Such trends could include anticipated decreases in revenue from a particular product line, decreases in gross margins due to decreasing prices or increasing costs, or increases in operating or capital expenditures.

The disclosure provided by the company in MD&A is often a central element in securities fraud lawsuits, and carefully crafted disclosure of trends, uncertainties and risks that could adversely affect operating results is critical to protecting the company and other members of the working group from liability. In addition, over the years the SEC has brought many highly visible enforcement actions for inadequate analytical and trend disclosure. As a result, the MD&A needs to be a focal point for management in the SEC reporting process.

Business

The Business section is the heart of the prospectus and registration statement, providing an overview of the company's business, often including a description of the industry background, the company's strategy, products, marketing and distribution, research and development, manufacturing, competition, intellectual property matters, litigation, human resources, and facilities.

The key to writing a successful Business section is to remember the dual purposes of the prospectus as a marketing and a disclosure document. The goal in drafting this section is to achieve a fair and balanced description that is grounded in hard data and supportable statements instead of vague and conclusory "puffing." Even if every statement in the registration statement can be proven to be true, liability can arise if the manner of reporting the facts conveyed a misleading impression or if material information was omitted. Liability for a false or misleading prospectus can be significant. With the benefit of hindsight, plaintiffs' counsel or the SEC may be able to construct a claim of material misstatement or omission with respect to even carefully drafted registration statements, and the time and expense associated with litigation can be substantial even for a company that eventually wins. Careful, conservative attention to disclosure is therefore critical to creating a defensible prospectus, as well as to establishing the due diligence defense described earlier.

Management

In this section, the company lists its directors and executive officers and provides a brief biography of each for at least the last five years. The rules require the company to list all compensation paid to its chief executive officer, chief financial officer, and each of its three other most highly compensated executives during the preceding fiscal year, as well as describing the compensation arrangements of the directors. The company also details amounts granted to and rights exercised by each such executive officer under employee benefit plans. Recent changes to the rules governing the disclosure of executive compensation now require that the company include a Compensation Discussion and Analysis ("CD&A") in the registration statement, which describes the company's rationale for providing specific compensation to its executives and directors, as well as detailed disclosure of various executive compensation practices. Like many other aspects of the registration statement, the preparation of the CD&A should begin early in the drafting process, as it will require input from the company's compensation committee, management, outside counsel and compensation consultants. The disclosure in this section for foreign private issuers is more limited. For example, a foreign private issuer is required to disclose only the aggregate amount of compensation paid to all directors and officers as a group.

Other Information

The company will also provide a variety of other information regarding the offering, including:

- the use of proceeds from the offering;
- determination of the offering price;
- dilution in net tangible book value per share which will be absorbed by purchasers in the offering;
- information relating to the company's capital structure;
- legal proceedings;
- transactions between the company and any director or officer or any of their affiliates;
- a table regarding stock ownership by directors, executive officers, 5% percent stockholders, and any selling stockholders;
- the underwriting arrangements; and
- the name of the company's counsel as well as any experts (such as the company's auditors) named in the registration statement as having prepared or certified a report for use in connection therewith. These experts will need to sign consents to the references to them to be filed with the registration statement.

Financial Statements

Two years of audited balance sheet data and three years of audited income statement, cash flow and stockholders' equity data are required for issuers other than certain smaller issuers, as well as unaudited data for any subsequent interim period and the comparable period of the prior year. These financial statements must be prepared on a consolidated basis. Detailed footnotes to the financial statements are also included.

Those companies falling within the definition of a "foreign private issuer" that will be filing a Form F-1 rather than a Form S-1 must also include financial statements in their filing. These statements may be prepared either in accordance with IFRS, U.S. GAAP or non-U.S. GAAP. However, if the financial statements are not prepared in accordance with U.S. GAAP or IFRS as published by the IASB, the registration statement must disclose the basis of preparation of the financial statements, discuss the material differences in accounting principles between U.S. GAAP and the accounting principles actually used, and provide a table that reconciles the primary financial statements to U.S. GAAP.

The SEC has also adopted rules that require companies to file an additional set of financial statements that have been translated into Xtensible Business Reporting Language, or XBRL. XBRL translation involves "tagging" each figure in a financial statement with one of 13,000 computer codes that each correspond to a precise accounting definition. The result is a machine-readable financial statement that can be downloaded on a computer and compared on an apples-to-apples basis with other companies' financial statements. According to the final rules, companies conducting IPOs will be required to file statements in XBRL beginning in 2011, with the exact date determined on the basis of the company's fiscal year end.

Exhibits

SEC rules require various documents, such as the underwriting agreement (which we will discuss shortly) and the company's charter documents to be filed as exhibits to the registration statement. These documents also include, for example, material contracts that are not in the ordinary course of the company's business and, subject in certain cases to exceptions for contracts that are immaterial in amount or significance, various other contracts, such as those upon which the company is substantially dependent, such as agreements with the issuer's key suppliers or customers. In addition, management contracts or compensatory arrangements in which any director or executive officer participates must also be filed. Part of the due diligence process is the selection and gathering of the contracts to be filed as exhibits and, for certain contracts with third parties, securing the consent of such third parties to disclose the contents of such contracts.

To the extent that any such contracts include information that would not be material to investors but the disclosure of which would be competitively sensitive and potentially damaging to the company (such as, for example, pricing terms in a customer contract), a key consideration is whether to request confidential treatment with respect to this information. If confidential treatment is sought, the sensitive information is excised from the copy of the publicly available document that is filed with the SEC. While drafting the registration statement, the company will thus have to consider whether any documents that will need to be filed as exhibits refer to competitively sensitive matters. If they do, the company's counsel should also be working on a request to be filed with the registration statement that will explain why this information should be treated as confidential. Confidential treatment of portions of filed documents is not automatic and must qualify for such treatment under federal law. It is important, therefore, to identify material contracts as early in the process as possible in order to avoid unnecessary delays caused by the confidential treatment process.

Certain Disclosures Applicable to Foreign Issuers

Certain disclosure requirements under Form S-1 and/or Form F-1 seek to elicit information relevant to investing in a foreign entity, touching on matters such as:

- the enforceability against foreign persons of civil liabilities arising under U.S. law;
- if applicable, a description of the ADR facility and related matters;
- foreign trading markets for the issuer's securities;
- governmental exchange controls that restrict the import or export of capital, or affect the remittance of dividends, interest or other payments to nonresident securityholders;
- limitations on the right of nonresident or foreign stockholders to own or vote securities;
- taxes to which U.S. securityholders are subject under local laws and the impact of reciprocal tax treaties; and
- historical exchange rates between the U.S. dollar and the foreign currency in question.

2.3.8 The Drafting Process

Shortly after the due diligence interviews, the company and its counsel will typically circulate a first draft of the registration statement. Both the company and its counsel will assist in the preparation of the draft. At this point, the draft may not be complete, but it usually includes the Business section.

After reviewing the first draft of the registration statement, the working group meets to discuss and comment on the first draft. Among the issues addressed are how the company will be positioned in marketing the offering to the investment community, the order in which the subjects discussed will be presented, and the general approach to each subject discussed. Finally, this is a good time to address whether there will be graphics ("artwork") in the registration statement, and if so, what they will depict. The creation of graphics can be a time-consuming process, and the working group will need an opportunity to respond to the graphics so that appropriate revisions can be made prior to filing the registration statement.

After this first drafting session, the company's counsel will usually prepare a new draft. For the next several weeks the process will continue, with the drafts growing incrementally more complete and editing comments by the working group more detailed. Eventually, when the registration statement is substantially complete, it is sent to the financial printer where it is professionally typeset. The final drafting sessions before filing generally occur at the printer, and usually involve final editing for style, grammar, and punctuation, as well as attention to substantive issues that were not resolved earlier or that have arisen in the meantime.

As may be apparent, the process is often not pleasant or predictable. When filed, the registration statement will likely differ substantially from the first draft and may seem like a different document entirely. But if the working group has done its job well, it will have produced a document that effectively describes the company and that, within the limits of what can be achieved, will protect the company, its officers and directors, and other members of the working group, from liability for material misstatements or omissions.

2.3.9 The Underwriting Agreement

The underwriting agreement is the document that governs the relationships and legal obligations among the company, the underwriters and selling stockholders. With respect to a traditional firm commitment underwriting, the underwriting agreement will include the following: obligations of the underwriters to buy, and of the company and any selling stockholders to sell, the shares to be offered, including provisions for the overallotment option; representations and warranties by the company relevant to its business; covenants of the company relating to the offering and information to be provided to stockholders and the underwriters after the offering; provisions requiring the company to reimburse the underwriters for certain expenses incurred in preparing for the offering; provisions requiring any party responsible for a material misstatement or omission to indemnify the other parties for any losses they sustain as a consequence; and conditions that must be met before the underwriters are obligated to close the offering, including formal closing documents, lockup agreements by the company's directors, officers, and significant stockholders, and various "outs," such as wars, stock market crashes or major adverse events in the company's business that permit the underwriters to refuse to consummate the public offering even after the underwriting agreement has been signed.

Each investment bank has its own form of underwriting agreement, which will be provided to company counsel by underwriters' counsel prior to filing of the registration statement. Company counsel and underwriters' counsel will work together to negotiate and complete the underwriting agreement so that it is available to file with the SEC and to mail to prospective members of the syndicate of underwriters assembled by the managers. The underwriting agreement will not be executed until after the road show is completed and the registration statement has been declared effective by the SEC, but its overall form is generally negotiated prior to the distribution of the preliminary prospectus, if not prior to filing the registration statement.

2.3.10 Board and Stockholder Approvals

While the registration statement is being drafted, company counsel is also involved in securing board approval for the offering, educating the directors regarding their due diligence and other responsibilities relating to the offering, and soliciting any other board or stockholder approvals that might still be required. As solicitation of stockholder approvals can be a time-consuming process, it should be started early so that it does not delay the public offering.

2.3.11 State Blue Sky Laws

In addition to federal registration requirements, state securities or "blue sky" laws generally require registration or "qualification" of securities to be offered and sold in a particular state, unless the security or the transaction in which it is offered is exempt.

Fortunately, for securities that will be listed on Nasdaq, the NYSE or certain other exchanges, federal law preempts and eliminates these state registration requirements. For other securities, state registration procedures will need to be followed. Blue sky matters are typically coordinated by the underwriters' counsel at the company's expense.

2.3.12 Filing the Registration Statement

After the registration statement has been prepared and the exhibits assembled, the company electronically files the registration statement with the SEC via the EDGAR system, an electronic system that makes all public filings available online to the public. The company must keep on file for five years a set of manually signed signature pages to the registration statement and any amendments that have been executed by the members of the board of directors, the principal executive officer, the principal financial officer and the principal accounting officer. In the case of Form F-1, a duly authorized representative of the company in the U.S. must also sign the registration statement. The company also files the exhibits to the registration statement via EDGAR, although, for those exhibits for which the company is seeking confidential treatment, only a redacted form of the agreement is filed via EDGAR.

In addition, if the working group is fairly certain that a particular issue is likely to be raised by the SEC's staff during the review process, the company may elect to raise the issue in a cover letter and explain and justify how it was handled in the filing. Indeed, certain matters are sufficiently important that the staff may have been consulted about them prior to the filing of the registration statement. If so, any understandings that were reached in such discussions should be mentioned in the cover letter. Concurrently with or shortly after the filing of the registration statement, any request for confidential treatment is also filed.

Unlike a U.S. company, a foreign private issuer may have its registration statement on Form F-1 initially reviewed by the SEC on a confidential basis. This gives foreign companies an opportunity to evaluate the SEC's comments before exposing competitive information to the public.

2.3.13 Using the EDGAR System

Prior to the filing of a registration statement via EDGAR, the company must take several steps. First, prior to the date of the company's first use of the EDGAR system, the company needs to obtain an EDGAR ID number by submitting an application on Form ID to the SEC. The Form ID application should be made soon after the organizational meeting to avoid any problems, although temporary EDGAR IDs can be obtained on a rush basis if required. The company should ask its financial printer to make a test filing prior to the first real filing to ensure that the company's EDGAR ID will be accepted. In addition, the SEC will not accept any EDGAR submission until the company has wired funds to cover the filing fee.

The company must also provide its financial statement with any exhibits that need to be filed with the registration statement so that such exhibits can be "EDGARized," a process in which text is prepared for electronic submission. Sufficient time should be allocated prior to the anticipated filing date to allow the company's financial printers to EDGARize these exhibits. In addition, the company should take care that sections of exhibits for which confidential treatment will be requested have been deleted from the EDGARized exhibits because once information is posted on EDGAR, it cannot be removed by the company.

2.3.14 FINRA Review of Underwriting Arrangements

At the same time the registration statement is filed, underwriters' counsel will submit a copy of the registration statement and the underwriting agreement to FINRA. The company will also need to submit a filing fee to FINRA at the same time as the underwriter's submission. FINRA, a self-governing body of which the underwriters are member firms, will review the proposed offering arrangements to determine whether the underwriters' compensation for the offering is fair and equitable to the company and any selling stockholders. Under FINRA guidelines, the underwriters must submit information about all relationships between directors, officers and certain securityholders of the company and any FINRA member, whether or not the member is a participant in the offering. This FINRA review process must be completed before the SEC will declare the registration statement effective.

2.3.15 Application for Listing on a Trading Market

By this stage in the process, the company should already have determined whether it proposes to list its shares for trading on Nasdaq, the NYSE or another trading market and reviewed whether it can meet the initial and ongoing listing standards required by the relevant market. Shortly after the organizational meeting, the proposed ticker symbol should be reserved with the market. Concurrently with filing the registration statement or shortly thereafter, the company files the formal application with the market, confirms the ticker symbol, and pays the application fee.

2.4 After Filing but Before Effectiveness

2.4.1 The SEC Comment Process

When the company's registration statement is received at the SEC, it is assigned to a branch within the Division of Corporation Finance, usually one that focuses on the company's industry. Generally, the Standard Industrial Code chosen by the company as most applicable to its business will determine the branch within the Division of Corporation Finance to which the registration statement will be assigned. Although the staff of the SEC is not required to review any registration statement, as a practical matter, a registration statement filed in connection with an IPO is always reviewed. The chief of the branch to which the registration statement was directed typically assigns two examiners to the registration statement, one to focus on legal, non-financial statement issues, and an accounting examiner to focus on the financial statements included with the listing. After the examiners have initially reviewed the registration statement (a process that typically takes approximately 30 days), they provide the company with a letter containing the SEC's initial comments on the registration statement.

The company will then prepare an amendment to the registration statement and a letter that explains whether the company made the requested change and, if not, the reasons why the company disagrees with the staff's comment. The staff's comment letter may also request information to be submitted supplementally (that is, in the comment response letter but not in the registration statement itself).

Following the amendment and comment response letter, the staff may reiterate a comment that it believes was not appropriately addressed by the company. For this reason it is sometimes advisable for company counsel to call the examiner to discuss the proposed changes prior to filing the amendment. However, because subsequent rounds of comments typically are generated from a review by the branch chief and often his or her immediate superior, an assistant director, the examiner may not be able to predict how a given response would be received by his or her supervisors. These reviews may lead to new comments that have not appeared before or, less frequently, to the reappearance of issues that had seemed to be resolved.

In preparing each response to the staff's comments, it is important to keep the ultimate goal in mind, namely, accurate and full disclosure of all material information. By the time the company receives the first comments from the staff, a month or more will have passed since the registration statement was filed. The working group needs to consider all that has happened during that time and amend the registration statement as appropriate to reflect new developments and to ensure that the registration statement is complete and accurate.

2.4.2 Additional Activities After Filing

During the SEC review and comment period a number of activities proceed in the background. There may, for instance, be further corporate housekeeping or restructuring matters to be pursued, such as finalizing a reincorporation into Delaware, effecting a reverse stock split, obtaining a waiver of registration rights, and obtaining stockholder approval of the new public company stock plans. Underwriter's counsel will coordinate FINRA's review of the underwriting arrangements. The market on which the company proposes to list its shares considers the listing application and may request additional information. The confidential treatment reviewer considers any application for confidential treatment and typically supplies comments on the application to company counsel. The company finalizes its relationship with its transfer agent and applies for a CUSIP number to identify its shares for electronic trading. Finally, the company will prepare a short, additional Exchange Act registration statement on Form 8-A (distinct from the main Securities Act registration statement on Form S-1), pursuant to which the class of securities to be offered will be formally registered under the Exchange Act. The company and its legal counsel will work with the company's transfer agent to coordinate the transfer of existing stock records and to facilitate the administration of the company's new stock plan.

2.4.3 The Marketing Effort

Offers to Sell the Company's Securities

Although the stock cannot actually be sold until the SEC declares the registration statement effective, following the initial filing of the registration statement oral offers (other than radio and television broadcasts) to sell the securities are now permitted. Telephone calls and face-to-face meetings, such as those with prospective investors during the road show, are thus allowed.

Written offers during this period are permitted only by means of the preliminary prospectus included in the registration statement or a free writing prospectus meeting certain requirements, as discussed below. The marketing effort is designed to comply with these requirements.

Press Release

The first step in the marketing effort may be the preparation of a press release announcing the filing of the registration statement. SEC Rule 134 provides companies with a "safe harbor" to allow them to publicly announce a limited amount of information regarding the offering after the registration statement is filed. As part of the SEC's recent reforms to the registered offering process, this safe harbor has been expanded so that the press release can describe not only the basic elements of the offering (i.e., the name of the company, the amount of securities to be offered and the names of the managing underwriters), it can also include a description of the intended use of proceeds, the anticipated schedule for the offering, the marketing events for the offering and the procedures for submitting indications of interest and conditional offers to buy. As with the pre-filing press release, the company is not required to announce the filing and frequently companies will "silently" file a registration statement.

The "Red Herring"

The purpose of the SEC's review and comment process is to ensure that the company's registration statement satisfies various technical disclosure requirements and to assist the company in conveying all information material to an investment decision. At some point during the review process, the working group will conclude that any further comments from the SEC are unlikely. At this point the prospectus included in the registration statement is ready to be used as a preliminary ("red herring") prospectus to be delivered to prospective investors as part of the marketing effort and prior to final effectiveness of the registration statement. The printer will at this point print high quality glossy prospectuses for use by the company and the underwriters in the marketing effort.

The red herring prospectus derives its name from the legend printed in red on the cover stating that offers to buy may not be accepted nor may sales be made prior to effectiveness of the registration statement. The red herring prospectus is essentially a printed form of the bulk of the registration statement, with blanks for certain limited information that will not be determined until immediately prior to the sale of the shares, such as the final price per share.

Free Writing Prospectuses

In addition to using the preliminary prospectus, the SEC's recent reforms to the offering process allow a company conducting an IPO to also use "free writing prospectuses" that contain additional written information beyond the preliminary prospectus, provided that any such free writing prospectus does not conflict with the information contained in the registration statement, contains a prescribed legend and is preceded or accompanied by a red herring preliminary prospectus containing the estimated price range for the offering. In the case of an electronic communication, a hyperlink to the preliminary prospectus would satisfy this delivery requirement. The information in free writing prospectuses should be subject to the same level of review by the company, attorneys, accountants and underwriters as changes to the registration statement.

A company could also use the flexibility afforded by the SEC rules governing free writing prospectuses to provide information about the company in media interviews during the registration process. Assuming the publication of this information is independently prepared and published by the media without compensation from the company, the company could participate in such an interview and then file the publication with the required free writing prospectus legend within four business days after the company becomes aware of its publication. Unlike other free writing prospectuses in the context of an IPO, the SEC rules do not require that such a publication be preceded or accompanied by a preliminary prospectus.

The Road Show

Once the red herring preliminary prospectus has been printed, the company and the underwriters will conduct a "road show" to market the company's stock.

In the leadup to the road show, the company's top management typically holds teach-ins at which they make presentations to the sales forces of the managing underwriters to enable them to market the stock more effectively.

Following the teach-ins, and armed with freshly printed copies of the red herring preliminary prospectus, the company and the lead managers will begin the road show, during which management travels to major cities in the United States and often abroad to make presentations to prospective investors and potential members of the underwriting syndicate concerning the company and its business. In addition, if there is a significant effort to sell to institutional investors, the company's management will have personal meetings called one-on-ones with representatives of major institutions.

Although these offers are permitted during the period prior to effectiveness, it is important to remember that it is always unlawful for an offer to be made that includes a misleading statement or omission of a material fact. Accordingly, the company should avoid making statements or projections at the road show that could be deemed to be factually inaccurate or misleading. Obviously, the easiest method of avoiding an unintentionally misleading oral statement is to limit the content of such statements to information contained in the preliminary prospectus.

It is also important to remember that the distribution of any written material during this period that could be deemed to be an offer to sell, other than the Rule 134 press release, the preliminary prospectus or a qualifying free writing prospectus, could be deemed to be a violation of the Securities Act.

Many companies now conduct "electronic road shows," which are road shows that are conducted or re-transmitted over the Internet or other electronic media and in some cases to broader audiences. If a company conducts an electronic road show as a live, real-time road show to a live audience, the road show will be considered an oral communication. Otherwise, the electronic road show is considered a written communication and, therefore, a free writing prospectus. However, in such a situation, the company conducting the IPO is not required to file the electronic road show as a free writing prospectus if the company makes at least one version of a "bona fide" electronic road show for the offering in question readily available without restriction electronically to any potential investor. A "bona fide" electronic road show is a road show that, if the company is conducting multiple road shows that constitute written communications, includes discussion of the same general areas of information regarding the company, management, and the securities being offered as such other road shows. However, the bona fide version of the road show does not need to address all of the same subjects or provide the same information as the other versions of the electronic road show, nor does it need to provide an opportunity for questions and answers or other interactions, even if other versions of the electronic road show do provide such opportunities.

Directed Share Programs

Companies should be particularly careful about marketing efforts in the context of directed share programs. A directed share program is a program whereby the lead underwriter agrees to reserve a certain portion of the shares registered in a public offering (e.g., up to 5% of the shares) for sale to persons designated by the issuer at the same price per share offered to the public. Issuers use such programs to involve their directors, officers, employees, suppliers and other business partners in the public offering, and to give them a stake in the issuer's future success. The SEC strictly monitors the administration of directed share programs from the perspective of compliance with the Securities Act with respect to disclosure requirements for written offers to sell, or solicitations of offers to buy, securities.

In order to stay prudently within the SEC's rules, issuers and underwriters should consider the following guidelines in conducting a directed share program:

- Companies will need to file written materials distributed to potential participants as free writing prospectuses unless such materials fall within the limits of SEC Rule 134.
- Underwriters administering the program should not begin implementation of a directed share program or contact potential participants until a preliminary prospectus containing a price range is available.
- Companies should be very clear with potential participants that there is no agreement on the number of shares that will be allocated to them because participants are often allocated fewer shares than they requested.

In addition to SEC regulation, directed share programs must also comply with FINRA Rule 5130, a regulation designed to place restrictions on the allocation of IPO shares to certain classes of persons associated with any FINRA member firm.

2.5 Effectiveness and Post-Effectiveness

2.5.1 Mechanics of Going Effective

Once all outstanding issues are resolved with the SEC, the FINRA and the market on which the shares will be listed, and at least 48 hours before the company and the underwriters wish to commence the offering, the company and the managing underwriters should provide the staff with "acceleration requests" asking that the SEC accelerate the effective date of the registration statement to a specific date and time or as soon thereafter as practicable. The working group will then ensure that each of the steps necessary before sales are made has been accomplished. FINRA must notify the SEC that it has no objection to the underwriting arrangements, and the listing market must be notified when it is anticipated that trading will commence. At this point the SEC will declare the registration statement effective, after which the company and the underwriters will complete negotiations as to the price at which the securities will be sold (the "pricing"), as well as the discounts and commissions to be retained by the underwriters as compensation for their services (typically 7% for an IPO). The company and the underwriters will then execute the underwriting agreement. Once all of the required logistics have been addressed, the underwriters will begin confirming sales of stock to those institutions and individuals who had previously indicated an interest in purchasing shares. Typically, effectiveness of the registration statement, pricing and execution of the underwriting agreement will all occur after the close of market on the last day of the road show, and trading on the selected market will begin on the next business day.

2.5.2 The Final Prospectus

At this point, the registration statement has several pieces of information missing—basically, information affected by the price at which the securities are being sold and the final composition of the underwriting syndicate. This information is typically not included in the registration statement because it is not available until after effectiveness. After pricing, the working group will prepare and file a "final prospectus" that will include this information. Until the SEC's recent reforms to the offering process, this "final prospectus" was delivered by the underwriters in the offering, and broker-dealers in the aftermarket, to purchasers with confirmations of their orders. However, the reforms now provide that these underwriters and broker-dealers generally do not need to provide paper copies of the final prospectus, although final prospectuses will still have to be prepared and filed with the SEC and furnished to purchasers upon request.

2.5.3 Mechanics of Closing

If the pricing occurs after 4:30 pm Eastern time, the closing of the offering must occur within four business days. (If pricing occurs earlier in the day, the closing must be held within three business days.) At the closing, various officer certificates, a comfort letter from the auditors relating to financial information in the prospectus, opinions of the company's and the underwriters' counsel, and a variety of other closing documents are delivered, along with certificates representing the shares sold by selling stockholders (shares sold by the company are not physically presented at the closing but are electronically registered on the books of the Depository Trust Company). The underwriters wire funds to the company and any selling stockholders for their respective portions of the net proceeds of the public offering.

2.5.4 Exercise of the Overallotment Option

As noted above, the company or certain selling stockholders typically grant the underwriters an option to purchase up to 15% of the number of securities initially sold in the offering on the same terms as the other shares that were sold. This option, which is for the purpose of covering overallotments, may be exercised at any time up to the end of the option period (usually 30 days).

CHAPTER THREE: CERTAIN CONSEQUENCES OF AN INITIAL PUBLIC OFFERING

3.1 Liability on the Prospectus

The Securities Act provides that the company, directors and officers (as well as, for Form F-1, a duly authorized representative of the company in the U.S.) signing the registration statement, underwriters, experts and controlling persons may be liable to investors for any misstatement or omission of a "material" fact in the registration statement, i.e., a fact as to which there is a substantial likelihood that a reasonable investor would consider such information important in deciding whether to buy the securities. This liability, often referred to as "Section 11 liability," does not require a showing of intent.

The liability of the company is absolute, and the company has no defenses for a material misstatement or omission in the registration statement. As described earlier, each other party has available a due diligence defense, provided they can establish that they exercised reasonable diligence and did not uncover the fact that is alleged to have been misstated or omitted. If a court were to conclude that a particular defendant other than the company had acted as a reasonably prudent person would have in the management of their own affairs and still did not know of the material misstatement or omission, the defendant would not be liable. This requirement is stricter than it may sound, however. It is clear, for example, that parties may not simply rely on statements of management. If "red flags" arise during the due diligence investigation of the company, the defendant will have to prove that it made sufficient inquiry to satisfy itself as to the accuracy of the information disclosed in the registration statement. In addition, the degree of inquiry required for this defense will vary depending upon the individual defendant. For example, if the alleged misstatement relates to an accounting issue, individual defendants with accounting expertise will likely be held to a higher standard. In addition to private litigation, the SEC has the power to pursue civil enforcement action, and the Department of Justice has the power to pursue criminal penalties, for fraudulent misstatements or omissions of material facts in violation of the Securities Act.

Lawsuits against public companies that report disappointing financial results or other news are commonplace, and there is an active and experienced securities class action bar available to disappointed investors. In addition to Section 11 liability, lawsuits are also often based on the premise that management made certain statements that should be subject to liability for securities fraud. In

1995, Congress passed legislation placing certain limitations and restrictions on securities class action plaintiffs that established a number of protections against meritless shareholder class actions. In addition, Congress also established a "safe harbor" for certain forward-looking statements, making it more difficult for plaintiffs' attorneys to file lawsuits based solely on a failure to meet expectations. However, this safe harbor is not available with respect to forward-looking statements made in connection with an initial public offering. Therefore, any forecasts or other forward-looking statements made orally or in writing during the offering process must be done with a high degree of due diligence.

3.2 Public Disclosure Obligations

Liability for material misstatements or omissions in the prospectus relating to the IPO is only the beginning. Liability also attaches to the statements in periodic and current reports that public companies are required to file with the SEC, as well as to stockholder communications and other public disclosures. All such statements should accordingly be carefully prepared with the assistance of counsel.

3.2.1 Periodic Reporting

Every company that completes an IPO, lists its securities for trading on a market, and consequently registers that class of securities under the Exchange Act, automatically becomes subject to the periodic reporting requirements under the Exchange Act.

Annual Reports on Form 10-K

Following the end of each fiscal year, the company must file an annual report on Form 10-K. This report includes audited financial statements and other detailed information similar in scope and content to information included in the Securities Act registration statement.

SEC rules require certain larger issuers to file their Form 10-K within 60 days after the end of the fiscal year. The Form 10-K must be certified in writing by the CEO and CFO, as discussed below.

Quarterly Reports on Form 10-Q

The company must also file a quarterly report on a Form 10-Q following the end of each of the company's first three fiscal quarters. Each Form 10-Q must include unaudited interim financial statements and a related MD&A discussing the interim results and known trends and uncertainties that are reasonably likely to have a potential impact on the company. In addition, disclosures are required regarding material litigation, certain changes in internal controls, stockholder actions and certain other matters.

SEC rules require larger issuers to file Form 10-Q within 40 days after the end of the fiscal quarter. The Form 10-Q must also be certified by the CEO and CFO.

Foreign Private Issuer Obligations

A foreign private issuer with its shares or ADRs listed on a U.S. market and subject to the reporting requirements of the Exchange Act must file an annual report on Form 20-F for the year, but the deadline for the filing is six months after the end of each fiscal year. While the deadline is significantly later than a U.S. company's filing deadline for the Form 10-K, the SEC recently shortened the deadline from six months to four months for the issuer's first fiscal year ending on or after December 15, 2011. The Form 20-F must contain audited financial statements prepared in accordance with IFRS, U.S. GAAP or otherwise reconciled to U.S. GAAP. While certain disclosures in Form 20-F are somewhat less detailed than in annual reports filed by a U.S. company, the form requires certain other disclosures unique to foreign issuers. A foreign private issuer is not required to file with the SEC any quarterly reports or current reports, discussed below. However, a foreign private issuer is required to promptly furnish to the SEC on Form 6-K material information that it makes or is required to make public pursuant to the law of the jurisdiction of its domicile or in which it is incorporated or organized, that it files or is required to file with a stock exchange on which its securities are traded and which was made public by that exchange, or that it distributes or is required to distribute to its securityholders. The information must be translated into or summarized in English, depending on the nature of the document. In order to meet the expectations of its investors, the foreign company may voluntarily choose (or may by its underwriters be required) to submit Form 6-K on a quarterly basis providing substantially the same information as a U.S. company would provide in its quarterly reports.

3.2.2 Current Reporting of Material Events

Material events do more than trigger the requirement that they be described in the next-filed periodic report; they may also require current filings or public disclosure on a prompt basis. These disclosure obligations may arise under the federal securities laws or under the company's listing agreement with a trading market.

Current Reports on Form 8-K

U.S. companies are required to promptly file, or in certain cases "furnish" (a technical legal distinction as to which company counsel can advise), a current report on Form 8-K upon the occurrence of certain events.

Although historically the categories of triggering events were fairly circumscribed, including such items as changes in control, significant acquisitions and dispositions, bankruptcy, a change in auditor, and the departure of a director, recent disclosure reforms have sharply increased the number of categories of triggering events and generally shortened the reporting deadline to four business days. Taken together, these various reforms have expanded the triggering events to include not only the items mentioned above but also, among other things, entry into or termination of a material definitive agreement, public announcements of material nonpublic information concerning results of operations or financial condition with respect to a completed fiscal period (e.g., earnings releases), creation of, or an increase or acceleration in, a company's obligations, material restructurings and writeoffs, financial restatements, any change in the company's directors or certain principal officers, and waivers of a company's code of ethics with respect to certain officers and personnel. The net effect of these reforms to Form 8-K is to move U.S. reporting companies in the direction of a current disclosure regime, as distinct from the historical model generally fashioned upon reporting in regular, quarterly intervals. This trend presents challenges for companies and requires instituting disclosure controls sufficient to ensure the timely filing of Form 8-K.

Disclosure Requirements of the Securities Markets

In addition to reporting requirements under the Exchange Act, the market on which the company's shares are listed for trading may also impose disclosure requirements. Under both Nasdaq and NYSE rules, companies whose securities are listed on the market must disclose to the public any information that might reasonably be expected to affect the value of its securities. In addition, the markets require prenotification of public announcements of material events so that the markets can appropriately monitor the trading of the company's stock and impose trading halts if deemed appropriate.

Additional Duties to Disclose Information

As discussed above, a reporting company is obligated to provide the information called for in various documents required by the Exchange Act and in any Securities Act registration statement, whenever they are filed. Prudence, good investor relations and the company's agreement with the market on which it is listed generally require prompt disclosure of material events. There may also exist from time to time certain special circumstances that may create a duty under the federal securities laws to disclose material events or conditions promptly as they arise.

For example, a company that has in place a currently effective resale registration statement on Form S-3, which registers a continuous offering extending over a period of time, will need to maintain the accuracy and completeness of the prospectus contained in such registration statement at all times. This occurs mechanically by automatic incorporation by reference into such a registration statement of all subsequently filed Exchange Act reports. But it does require that, as material information becomes available, it is promptly filed with the SEC in order to be so incorporated.

Another example has arisen from judicial caselaw. It is generally understood that the Exchange Act reporting system was not intended to create a regime whereby a company must disclose any material information simply because such information is material, but rather one that requires disclosure upon the occurrence of a specified duty (such as the filing of Forms 10-Q and 10-K) or as otherwise explicitly mandated (such as Form 8-K). However, some courts have been willing to conclude that disclosure concerning an event that, subsequent thereto, remains "alive" in the market may create a duty to update that disclosure if circumstances change. A change in anticipated and previously disclosed financial outlook is such an example. This is separate from and in addition to a duty to correct a disclosure that the company later learns was untrue when made.

Further, under SEC Regulation FD described below, if material, non-public information has been inadvertently selectively disclosed by the company, the company must make a public announcement regarding the subject of the selective disclosure. In addition, although the company is not generally under a duty to correct rumors circulating in the marketplace, such a duty can exist if a rumor is attributable to the company.

A number of considerations are relevant to disclosure decisions, and potential liability can be significant. For this reason, whenever an event occurs or condition arises that might require disclosure, counsel should be immediately consulted. Moreover, disclosure controls should be developed to ensure the issuer has the infrastructure necessary to comply with these complex rules. Such disclosure controls may include the formation of a disclosure committee along with written control procedures outlining the internal processes by which disclosure decisions are made and disclosure documents created.

Foreign Private Issuer Obligations

A foreign private issuer with its shares or ADRs listed on a U.S. market and subject to the reporting requirements of the Exchange Act is not required to file reports on Form 8-K as a U.S. company must. Instead, such foreign private issuers are subject to the Form 6-K furnishing requirements described above.

3.2.3 Proxy Rules and the Annual Report to Stockholders

Proxy Solicitation

Once a company has registered its securities under the Exchange Act, it will be required to comply with the SEC proxy rules. This means, among other things, that the SEC will have jurisdiction over the content of proxy solicitation materials for any meeting of stockholders of the company. It should be noted in this regard that a foreign private issuer is exempt from the SEC proxy solicitation rules.

In advance of each annual meeting of stockholders, public companies solicit proxies from their stockholders in order to increase the likelihood of stockholder approval for the slate of directors recommended by the nominating committee of the board of directors, for stock plans and amendments to such plans, and for certain other matters for which stockholder approval is either required or advisable. The "definitive" proxy solicitation materials are required to be filed with the SEC no later than the date they are made available to stockholders. In addition, if the proxy solicitation materials for such a meeting contain agenda items that go beyond the election of directors, ratification of the auditors selected by the board of directors, certain stockholder-sponsored proposals, and approval of stock plans or amendments thereto, then the company will first need to have filed its "preliminary" proxy solicitation materials with the SEC at least ten days prior to distributing the definitive materials. Because the SEC may review these preliminary proxy materials, it may be advisable to submit the preliminary materials earlier than ten days before the scheduled mailing date so that any changes requested by the SEC can be accommodated without disrupting the mailing schedule. A new rule gives companies the option to post their proxy materials on the Internet, rather than sending paper copies through the mail. However, if a stockholder specifically requests a paper or email copy of the proxy materials, the company must comply.

Recently, the SEC approved a proposal submitted by the NYSE to eliminate broker discretionary voting in director elections, which means that brokers may no longer vote shares on behalf of their clients in any director elections without specific voting instructions from their clients. As a result, companies will likely have to invest increased time and expense in achieving a quorum at their annual meetings. Moreover, the increasing number of companies that have adopted majority voting for director elections will likely face a significant challenge in soliciting enough votes to elect their nominees. Also, the SEC has proposed (for the third time in six years) proxy access rules, which, if adopted, would provide a company's stockholders with the ability to access management's proxy statement for nominations of directors. Finally, multiple bills have been introduced in Congress addressing a myriad of proxy and corporate governance issues, including "say-on-pay" for certain executive compensation matters, proxy access, majority voting, and heightened independence standards for compensation committee members.

Annual Report to Stockholders

The SEC proxy rules require that, where the solicitation is made on behalf 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 securityholders (often referred to simply as the "annual report"). This annual report must contain, among other things, audited financial statements, MD&A, a brief description of the business, and information regarding each of the company's directors and executive officers. Foreign private issuers are not required by U.S. law to provide an annual report to their stockholders, though they may be required to do so under home country law. Further, both Nasdaq and the NYSE require that companies listed for trading on those markets distribute to stockholders an annual report containing financial statements.

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, many companies prepare the annual report with great attention to both content and visual form. In such cases, preparation of the report involves significant lead time, especially with respect to graphics and color printing, and it is advisable to begin the process early enough so that the report will be completed in time for the proxy mailing. Certain smaller or newly public companies decide to forego the expense of an elaborate annual report and instead distribute a copy of the company's recently filed Form 10-K (often contained inside a glossy cover, or "wrap," that sets forth certain additional information), so long as the document distributed conforms with the annual report rules. 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.

3.2.4 Controls and Procedures; CEO/CFO Certifications

In connection with the foregoing public company reporting requirements and as a result of recent reforms, companies now face explicit new requirements concerning their processes and controls in preparing their financial statements and other public disclosures. Moreover, a company's chief executive and financial officers as well as the outside auditors also face significant new requirements in this regard. These new rules apply to both U.S. companies and, with certain modifications, to foreign private issuers.

As discussed earlier, public companies are now affirmatively required to maintain disclosure controls designed to ensure that all of the information required to be disclosed by the company to the SEC (i.e., not just in Forms 10-Q and 10-K, but also in Form 8-K and any other submission to the SEC) is recorded, processed, summarized and reported within applicable reporting deadlines. This includes controls and procedures designed to ensure that such information is accumulated and communicated to management, including the CEO and CFO, as appropriate to allow timely decisions regarding required disclosure.

As also discussed earlier, public companies are now affirmatively required to maintain internal controls designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with GAAP. Although disclosure controls and internal controls overlap to a fair extent, the scope of disclosure controls extends to all disclosures, not just financial ones, and internal controls extend down into a level of detail that can be much more granular than overall disclosure controls.

Moreover, in connection with every Form 10-Q and Form 10-K, the principal executive officer and principal financial officer, or persons performing similar functions (typically the CEO and CFO), must each sign certifications that set forth certain prescribed matters. Broadly speaking, they must certify that the information contained in the 10-Q or 10-K is complete and accurate in all material respects. They must also certify that they designed the company's disclosure controls to ensure that relevant information is made known to them in timely fashion, conducted an evaluation thereof as of the end of the fiscal period, and presented their conclusions concerning the effectiveness thereof in the periodic report (i.e., in the 10-Q or 10-K). In addition, they must certify that the periodic report contains disclosure concerning any material changes in internal controls during the period, and that they have reported certain matters to the auditors and audit committee.

Rules adopted pursuant to Section 404 of SOX require that the annual report on Form 10-K contain an evaluation by management of the effectiveness of the company's internal controls and that the company's outside auditors audit such internal controls and attest to management's assessment thereof. Small public companies with a public float of less than $75 million must comply with these rules beginning with their annual reports for fiscal years ending on or after

June 15, 2010. Effective at the same time as these new requirements, the rules also expand the form of CEO/CFO certification under Section 302 of SOX to include certain additional statements concerning the company's internal controls.

The overall effect of these rules on public companies is significant. Although they have always faced potential liability for SEC filings, CEOs and CFOs now have to personally certify as to their accuracy and completeness and must take personal ownership of the design and evaluation of the company's financial and other public disclosure processes. This includes disclosure controls sufficient to ensure compliance with the tight Form 8-K filing deadlines and expanded triggering events.

3.2.5 Regulation G and Item 10(e): Restrictions on Non-GAAP Financial Measures

Quarterly earnings press release and conference call practices have been significantly affected not only by the new Form 8-K requirements referred to above but also by the SEC's new regulations concerning the use of non-GAAP financial measures set forth in Regulation G ("Reg G") and in Item 10(e) of Regulation S-K ("Item 10(e)").

Non-GAAP financial measures are, broadly speaking, those which either include or exclude items contained in the most closely comparable GAAP measure. EBITDA (earnings before interest, taxes, depreciation and amortization) is a classic example. Although historically such measures were often referred to as "pro forma," e.g., "pro forma operating expense," many companies now instead explicitly designate such measures as non-GAAP, e.g., "non-GAAP operating expense."

Reg G is broad in its scope. It applies to any public disclosure, at any time, whether in writing or oral, of material information that includes a non-GAAP financial measure. It thus applies far beyond the scope of earnings releases and related conference calls to cover all public communications by the company. By contrast, Item 10(e) generally applies only to information filed with the SEC, though it imposes tighter restrictions.

Reg G and Item 10(e) require that a non-GAAP financial measure be accompanied by and reconciled to the most closely comparable GAAP measure. Reg G also contains a broad antifraud provision along the lines of Rule 10b-5, namely, that a company shall not make public a non-GAAP financial measure that, taken together with any accompanying information and discussion, contains an untrue statement of a material fact or omits to state a material fact necessary in order to make the presentation not misleading.

There is an accommodation for oral, telephonic, webcast or similar disclosure of non-GAAP measures where, if the company has previously posted the comparison measure and reconciliation to its website, the speaker is permitted to simply refer listeners to the website during the presentation. The rules also contain an exception for non-GAAP measures in certain communications relating to business combinations and contain an accommodation for certain disclosures made outside the U.S. by foreign private issuers.

In filings with the SEC, Item 10(e) also requires that in each instance the GAAP comparison measure be presented with equal or greater prominence than the non-GAAP measure, that non-GAAP measures not appear on the face of the financial statements, and that non-GAAP measures not use titles or descriptions that are the same as or confusingly similar to the titles or descriptions used for GAAP measures. It also prohibits the use of certain types of non-GAAP measures, namely the exclusion from a non-GAAP liquidity measure (other than EBIT and EBITDA) of charges or liabilities that required or will require cash settlement, or adjusting a non-GAAP performance measure to eliminate or smooth items identified as nonrecurring, infrequent or unusual when a similar charge or gain occurred within the prior two years or is reasonably likely to recur within the following two years.

There is an additional Item 10(e) requirement that applies not only to information filed with the SEC but also to information merely "furnished" to the SEC pursuant to the Form 8-K disclosure item relating to public disclosure of material nonpublic information regarding results of operations or financial condition for a completed fiscal period, such as earnings releases. This requirement provides that the information include (and thus that the earnings release or at least the Form 8-K on which it is furnished include) a statement of the reasons why management believes the non-GAAP financial measure provides useful information to investors and, to the extent material, the additional purposes, if any, for which management uses the non-GAAP financial measure.

As a result of these requirements and the Form 8-K rules, the quarterly earnings release process, already a time of legal sensitivity and careful review, has become even more structured and heavily regulated.

3.2.6 Regulation FD: The Prohibition on Selective Disclosure

In 2000, the SEC adopted Regulation FD ("Reg FD"), designed to ban selective disclosure of material information. With certain limited exceptions, Reg FD requires that, whenever a public company intends to disclose material information, it must do so through public dissemination. In addition, if an issuer discovers that it has mistakenly made material selective disclosure, it must make prompt public disclosure of the information within 24 hours.

Although materiality is often difficult to assess, guidance as to future results is normally considered material, as is any information that will likely have an effect on the stock price.

In light of Reg FD, public companies cannot communicate financial guidance or other material nonpublic information to research analysts in one-on-one or other private settings. To communicate important information to "the street," companies accordingly use methods such as press releases and preannounced, publicly accessible conference calls and webcasts.

Although there is no private right of action under Reg FD, the SEC has in recent years taken a number of enforcement actions for Reg FD violations. Several of such enforcement actions have been brought following "one-on-one" meetings with institutional investors or analysts, subsequent to which the company's stock price reacted, suggesting the disclosure of material non-public information. The adverse consequences of enforcement actions on both companies and individuals involved can be significant and highlight the importance of consultation with legal counsel prior to all material corporate disclosures.

3.3 Corporate Governance

Reforms over the last decade have significantly altered the ground rules for how public companies govern themselves internally.

Although corporation law has historically resided in the domain of the states, over the course of time the SEC and the major markets, such as Nasdaq and the NYSE, have introduced regulations that directly or indirectly bear upon the internal corporate governance of public companies. Examples include Nasdaq and NYSE listing requirements concerning audit committee standards and stockholder approval of certain corporate actions, along with SEC regulation of the proxy solicitation process.

At the initiative of the SEC and mandated in part by SOX, Nasdaq, the NYSE and other U.S. markets have now introduced sweeping corporate governance rules applicable to companies listed on those markets. The new rules place the balance of power on listed company boards in the hands of "independent" directors, broadly speaking persons who neither constitute part of, nor otherwise have a material relationship with, management, nor may be economically affected in a material fashion by decisions of management.

Due to the prevalence of listing on Nasdaq and the NYSE in connection with IPOs, the discussion below focuses solely on such companies.

3.3.1 Definitions of "Independent"

The term "independent" has several different definitions in this context. There are those set forth by Nasdaq and the NYSE, referred to here as "Nasdaq independent" and "NYSE independent," respectively. There is also the SOX's and SEC's distinct and generally more restrictive definition applicable solely to members of the audit committee, referred to here as "SEC independent."

For a director to be considered Nasdaq or NYSE independent, those markets provide that the board must make a general finding that an individual does not have relationships with the company or management that would interfere with the exercise of independent judgment in carrying out the responsibilities of a director (Nasdaq) or any material relationship with the company (NYSE). Both markets then set forth an enumerated list of relationships that prima facie preclude a finding of independence.

Without going into too great detail, in broad terms both Nasdaq and the NYSE generally provide that an individual cannot be considered independent if, among other things, they are a current officer or other employee of the company or directly or indirectly receive certain significant payments from the company other than in their capacity as a director or committee member. Both markets provide for a look-back as to whether any of such relationships have existed, and look also to whether family members of directors have enjoyed such relationships. However, both markets specify that ownership of stock does not in and of itself preclude a finding of independence, except with respect to audit committee service as described below.

SOX and SEC rules are significantly more restrictive in that they preclude an individual from serving on the audit committee if such person is receiving any, even de minimis, compensatory payments from the company other than in their capacity as a board or committee member, or if such person is an "affiliate" of the company other than in their capacity as a director (as discussed later, officers and 10% or greater stockholders would typically be considered affiliates for these purposes). Thus, while for Nasdaq and NYSE purposes a significant stockholder of the company or a representative thereof, such as the general partner of a venture capital fund that financed the company through the private phase and continues to hold large amounts of stock, might be considered Nasdaq or NYSE independent and thus both count toward the majority independent board requirement and be able to serve on the nominating and compensation committees, as discussed below, such a person might be barred from serving on the audit committee.

Beyond these various requirements, state corporate law may impose additional and more stringent independence requirements. For example, recent Delaware case law suggests that otherwise independent directors may not be reviewed as independent if, depending upon the matter voted on, their social, philanthropic or other connection to management is too close.

3.3.2 Majority Independent Board

Both Nasdaq and the NYSE require that the majority of the board of directors of a listed company consist of Nasdaq independent or NYSE independent directors, as applicable, and that the independent directors hold certain executive sessions at which the other directors are not present.

Both markets provide exceptions from the board and committee rules (though generally not from the audit committee rules) for "controlled companies." And there are certain circumstances in which cure periods or temporary exemptions from the board and committee independence requirements may apply, which for the sake of brevity have not been discussed here but as to which counsel can advise.

Foreign private issuers are permitted to apply for an exemption from Nasdaq's corporate governance standards (other than the audit committee requirements of SOX and the SEC) if such rules would require the issuer to do anything contrary to the laws, rules, regulations or generally accepted business practices of the issuer's home country. Even more liberally, the NYSE provides that, with the exception of most of the audit committee requirements of SOX and the SEC and certain notification and certification requirements concerning compliance with the NYSE's corporate governance standards, foreign private issuers are permitted to follow home country corporate governance practices in lieu of the NYSE's rules as long as they disclose the differences between their corporate governance practices and those required of U.S. issuers. For purposes of their corporate governance rules, Nasdaq and the NYSE treat foreign private issuers that use an ADR structure in the same manner as foreign private issuers that list their equity directly for trading.

In connection with an IPO, both Nasdaq and the NYSE provide newly listed companies a grace period to achieve compliance, requiring that a majority of the board be Nasdaq or NYSE independent within one year. Each independent committee (audit, compensation and nominating/governance) must have one independent member at the time of listing, a majority of independent members within 90 days, and be fully independent within one year. However, 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 marketing the offering.

3.3.3 Audit Committee

Each listed company must have an audit committee consisting of at least three directors who are not only Nasdaq or NYSE independent but also SEC independent. All members of the committee must meet certain financial literacy requirements, and one member must have past employment experience in finance or accounting, requisite professional certification in accounting, or any other comparable experience or background that results in the individual's financial sophistication (Nasdaq), or have accounting or related financial management expertise (NYSE). Each company is also required to disclose whether it has on the committee an "audit committee financial expert," as defined by SEC rules.

The audit committee's role in overseeing the company's relationship with its auditors has been significantly strengthened. The audit committee now must be directly responsible for the appointment, compensation, retention and oversight of the auditors, and the auditors must report directly to the committee. Nasdaq company audit committees (or another independent body of the board) must also review and approve all related party transactions.

The audit committee is also required to establish "whistleblower" procedures for the receipt and treatment of complaints regarding accounting, internal accounting controls, or auditing matters, including confidential, anonymous submissions by employees regarding questionable accounting or auditing matters.

NYSE companies are also required to maintain an internal audit function.

3.3.4 Nominating Committee

Each listed company must have a nominating committee (in the case of the NYSE, a nominating and corporate governance committee) consisting solely of independent directors (though Nasdaq as a technical matter permits a company, if it so chooses, to forego the formal committee as long as director nominations are determined or recommended by a majority of the independent directors). NYSE companies must also adopt and disclose corporate governance guidelines.

Companies are also required to make certain disclosures in their proxy statement concerning the director nominations process, including disclosures regarding the background and qualifications of directors and nominees, and whether the company maintains a process for stockholders to communicate with the board. Finally, recent SEC rule changes require companies to disclose whether and how the board or nominating committee considers diversity in identifying director nominees.

3.3.5 Compensation Committee

Each listed company must likewise have a compensation committee consisting solely of independent directors (though Nasdaq again as a technical matter permits a company, if it so chooses, to forego the formal committee as long as executive officer compensation is determined or recommended by a majority of the independent directors).

In addition to satisfying market listing requirements, companies will also likely wish to ensure that they satisfy certain criteria concerning the composition of compensation committees set forth in Section 162(m) of the Internal Revenue Code and in rules under Section 16(b) of the Exchange Act.

3.3.6 Stockholder Approval of Equity Compensation

Stockholder oversight of equity compensation arrangements, such as stock plans, has also been significantly strengthened. With certain exceptions, all such arrangements now require stockholder approval.

3.3.7 Code of Ethics

Each listed company must have a code of conduct and ethics complying with SEC rules and market listing requirements that is applicable to all directors, officers and employees. Companies must promptly disclose any waivers of the code with respect to directors or executive officers.

3.3.8 Governance Reporting Requirements

Companies must promptly notify their market of any material noncompliance with the corporate governance listing standards, and in the case of the NYSE, certain certifications must be made to the NYSE concerning compliance with those standards.

3.4 Restrictions and Reporting Obligations Applicable to Insiders and Others

3.4.1 Insider Trading

Insider trading can lead to both severe civil and criminal penalties for those trading on, or conveying to third parties who trade on, material non-public information. The company may also be liable for the insider trading of its employees if it fails to enact certain procedures and policies to prevent such insider trading, such as the adoption of an insider trading policy and compliance program discussed below. Under certain circumstances this can also lead to liability for a company where one of the company's employees has engaged in insider trading.

"Insider" Status

Under federal law, a person may be deemed to be an "insider" despite the fact that he or she is not an officer, director, stockholder or employee of the company. For example, an individual not employed by the company who has learned material facts with respect to the company's business through a "tip" from an officer would in many circumstances be considered an insider for purposes of these rules.

Material Information

The determination of what constitutes material information that must be disclosed before an insider can trade should be made in consultation with securities counsel. As a general rule, the same inquiry applies to determining whether a fact is material for insider trading purposes as applies to determining whether the fact should be included in a Securities Act registration statement: Is there a substantial likelihood that a reasonable investor would attach importance to the information in deciding whether to buy or sell the company's stock?

While it may be difficult under this standard to determine whether particular information is material, there are various categories of information that are particularly sensitive and are generally considered material. Examples of such information may include, depending on the particular circumstances, the following:

- Current financial results
- An impending restatement of prior financial results
- Projections of future operating performance
- News of a pending or proposed merger or acquisition
- News of the disposition of a subsidiary, division, or line of business
- Impending bankruptcy or financial liquidity problems
- Gain or loss of a substantial customer or supplier
- Changes in dividend policy
- New product announcements of a significant nature
- Significant product defects or modifications
- Significant pricing changes
- Stock splits
- New equity or debt offerings

- Significant litigation exposure due to actual or threatened litigation
- Major changes in management

Adoption of Insider Trading Policy

Prior to the effective date of its registration statement and as part of the process of preparing to go public, the company should consult with counsel regarding the adoption of an insider trading policy and compliance program prohibiting all directors, officers, employees, consultants and others with access to material nonpublic information from trading while in the possession of such information. Such policies also often prophylactically require that trades by directors, officers, and certain employees in informationally sensitive positions (e.g., in the finance or legal departments), be pre-cleared through a designated compliance officer within the company, and that no trades by such persons will be permitted at all during a predetermined blackout period (often commencing one month prior to the end of a quarter and ending shortly, e.g., two business days, after earnings are announced) when such insiders are increasingly likely to be privy to material inside information. In addition to the automatic blackout period, the policy may provide that the trading "window" can be closed by the compliance officer at any time and with respect to any group of insiders or other employees if material nonpublic information (e.g., concerning a pending acquisition or adverse financial news), develops during an otherwise open window period.

The compliance officer can also assist in monitoring whether proposed trades by Section 16 reporting persons, discussed below, would lead to short-swing trading liability under Section 16, and in preparing the required reports of changes in beneficial ownership.

Programmed Trading Plans

At the same time it adopted Reg FD in 2000, the SEC also adopted Rule 10b5-1, which is an affirmative defense to an insider trading claim under SEC Rule 10b-5 for stock trades by company insiders. The Rule enables insiders (or the company itself when it buys or sells its own stock, such as during a repurchase program) to trade even during periods when they are in possession of material nonpublic information so long as they do so pursuant to a written plan that contains predetermined trading instructions and was created at a time they were not in possession of material nonpublic information. Programmed trading plans can thus, if the company's insider trading policy is drafted accordingly, permit trades to be made during periods where trading would otherwise be prohibited under the insider trading policy. These plans are an important tool for reducing the potential liability exposure of corporate insiders if and when they seek to achieve liquidity and diversification. These plans must meet the specific requirements of Rule 10b5-1 in order to be effective, so counsel should be involved in the preparations of such plans.

3.4.2 Section 16

Overview

Each director, officer and 10% stockholder of the company (each a "Section 16 insider") is subject to Section 16 of the Exchange Act. What follows is a brief description of some of the more salient points concerning Section 16 that are relevant to a newly public company. However, Section 16 and the rules thereunder are highly technical, and counsel should always be consulted with any questions. Foreign private issuers are exempt from Section 16 and the following discussion accordingly applies only to U.S. companies.

Section 16 Reporting

Section 16(a) requires Section 16 insiders to report their beneficial ownership of equity securities of the company and all changes in such ownership. The discussion below assumes that the only outstanding class of equity security of the company is common stock.

Section 16 insiders must file an initial statement of stock ownership on Form 3 no later than the effective date of the Exchange Act registration statement on Form 8-A (which will typically be the same date on which the Form S-1 becomes effective).

Thereafter, Section 16 insiders must report most transactions in the stock, e.g., sales, purchases, receipt of option grants, etc., on Form 4. All Form 4 reports must be filed within two business days after the transaction. Certain residual items, such as gifts, can be reported on Form 5 within 45 days after the end of the calendar year in which the transaction occurs. However, the great bulk of all transactions by Section 16 insiders in the company's stock falls within the ambit of Form 4 and its tight two business day filing deadline.

SEC rules require the company to disclose in its annual proxy statement information regarding delinquent Section 16 filings, including the name of each insider involved and the number of delinquent filings for each insider.

Liability for Short-Swing Profits

Section 16(b) makes Section 16 insiders liable to return to the company any profits from "short-swing" transactions (i.e., a purchase followed by a sale, or a sale followed by a purchase) in equity securities of the company within any period of six months. This is a bright line rule, and no misuse of inside information or other wrongdoing need be shown to impose liability.

The party entitled to recover short-swing profits under Section 16(b) is the company. However, if the company fails to bring a suit against an insider within 60 days after demand by a stockholder to do so or fails to prosecute the suit diligently, suit may be brought on behalf of the company by the stockholder. There is a substantial bar of plaintiffs' lawyers who actively review computerized databases of all Forms 3, 4 and 5 filed by insiders in the hopes of finding matching opposite-way transactions that result in Section 16(b) liability. These lawyers threaten suit on behalf of stockholders of the company seeking to recover the profits for the company, and they may be able to collect attorneys' fees from the company if they are successful in recovering the profits from the insider.

Other Section 16 Rules

Subject to certain exemptions, Section 16(c) provides that it is unlawful for a Section 16 insider to sell any equity security of the company if: (i) the insider does not own the security sold (i.e., a "short sale"); or (ii) if owning the security, does not deliver it against such sale within twenty days thereafter, or does not within five days after such sale deposit it in the mails or other usual channels of transportation (this latter provision designed to target "short selling against the box").

3.4.3 Ownership Reporting Requirements (Schedules 13D and 13G)

Any person who beneficially owns more than 5% (a "5% stockholder") of a class of equity security, typically common stock, that is registered under the Exchange Act must report that beneficial ownership to the SEC, the company and each exchange on which the company's stock is traded. Schedule 13D, the long form of beneficial ownership report, is the default form for reporting such ownership. In lieu of Schedule 13D, the shorter Schedule 13G may be used by certain institutions holding shares in the ordinary course of business, and by certain passive investors holding less than 20% of the class, but only if in each case there is neither the purpose nor effect of changing or influencing control of the issuer. Schedule 13G is thus available to many 5% stockholders who acquired their shares prior to the IPO.

There are detailed rules concerning amendments to Schedules 13D and 13G. In addition, beneficial ownership may be acquired either individually or as a group. If two or more persons act as a group for the purpose of acquiring, holding or disposing of such securities, they are treated as a single person for purposes of the rules and their ownership is therefore aggregated in applying the 5% test. In such circumstances, each member of the group is required to report such ownership, either in separate filings or a single joint filing.

3.5 Liquidity of Stockholders After the Offering

3.5.1 "Affiliate" Status

The rules governing sales of the company's stock after the offering are complex and technical, but in general the greatest restrictions are placed on "affiliates" of the company. SEC Rule 144 defines "affiliate" to mean "a person that directly, or indirectly through one or more intermediaries, controls, or is controlled by, or is under common control with" the company.

Although affiliate status depends on all the facts and circumstances rather than a bright line test, a common starting point in the analysis is to presume that a person who is neither a director nor an officer nor a 10% or greater stockholder of the company is not an affiliate.

Conversely, although a person who is a director, officer or 10% stockholder might under certain exigent circumstances successfully be able to argue that they are not in a control position and therefore should not be treated as an affiliate, the conservative common practice is for such persons to comply with any rules that apply to affiliates in order to avoid potential violations. Close cases must be analyzed under the specific circumstances with the assistance of counsel.

3.5.2 Sales by Affiliates

Subject to lockup agreements with the underwriters and insider trading laws and policies, affiliates may sell stock under SEC Rule 144 provided that: (1) the company is current in its Exchange Act reports; (2) the shares to be sold plus all other shares of the company sold by the stockholder during the three months preceding the sale (including certain sales required to be aggregated as described below) do not amount to more than the greater of (i) one percent of the outstanding stock of the class or (ii) the average weekly trading volume of the stock during the last four weeks; (3) the shares are sold in a brokerage transaction or directly to a market maker; and (4) a Form 144 is filed concurrently with either the placing with a broker of the order or the execution of the trade directly with a market maker. Affiliates who purchased their stock in private placements from the company must also satisfy a six-month holding period before they can resell (except to the extent that Rule 701, described below, is available to such holders). Under certain circumstances, sales by more than one person must be aggregated with each other for purposes of establishing compliance with Rule 144's volume limitations.

3.5.3 Sales by Nonaffiliates

Legal restrictions on sales by nonaffiliates are influenced primarily by how and when the prospective seller acquired the stock to be sold. Subject to lockup agreements and insider trading laws and policies, nonaffiliates who bought their shares in the offering or in the after-market may freely resell their shares without restriction.

Nonaffiliates who received their shares under employee benefit plans meeting the requirements of SEC Rule 701 would, beginning 90 days after the effectiveness of the registration statement, be able to sell their shares freely in brokerage transactions. In addition, the company will typically file a separate registration statement on Form S-8 that will permit nonaffiliate employees who exercise options after the IPO to resell their shares without restriction. However, it is typically the case that companies will have imposed lockup agreements restricting sales prior to the expiration of such agreements.

Nonaffiliate stockholders that acquired their shares from the company in private placements before the public offering, such as is the case with most venture capital financings, may not resell into the public market under Rule 144 until six months have elapsed since the shares were acquired from the company or an affiliate of the company. After six months, such stockholders can freely resell their stock without restriction, provided that they have not been affiliates of the company at any time during the three months preceding the sale and the company is current in its Exchange Act reports. After one year, the requirement that the company is current in its Exchange Act reports no longer applies to resales by such stockholders.

The company's counsel can assist with particular questions, and experienced traders at brokerage firms used to dealing with newly public companies can coordinate any required filings and other mechanics.

3.6 Prohibition on Loans to Directors and Executive Officers

Among many other reforms, SOX prohibits, subject to limited exceptions, any public company (commencing with the date the company first files its registration statement under the Securities Act, rather than effectiveness of that registration statement and completion of the offering) from extending or maintaining credit, arranging for the extension of credit, or renewing an extension of credit, in the form of a personal loan to any director or executive officer. Loans that preexisted enactment of SOX are grandfathered but may not be renewed or materially modified.

Loans to other employees of the company may also be subject to regulatory requirements, and counsel should therefore be consulted.

3.7 Investment of IPO Proceeds

As a result of the receipt of a large amount of cash as proceeds from the IPO, many companies are faced with choices in how to invest these proceeds. In so doing, companies must carefully analyze their investments in order to avoid being deemed an "investment company" within the meaning of the Investment Company Act of 1940 and becoming subject to all of its regulations. Counsel will frequently investigate the company's status as an investment company in connection with the closing of the IPO in order to deliver its legal opinion. The company's financial officers should continue to consult with counsel following the IPO and before investing any of the proceeds of the offering in any securities.

CONCLUSION

The laws and rules that govern the public offering process and that apply to public companies are complex and constantly changing, and we have attempted to provide only a general overview of some of these requirements. Securities counsel should therefore be consulted regularly in connection with the IPO and with respect to the ongoing responsibilities of a public company and its officers and directors following the offering. We wish you much success in your IPO endeavors.

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