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Going Public: A Decision Maker's Guide

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Going Public: A Decision Maker's Guide

SECTION 1: INTRODUCTION

If you're the leader of a privately owned company, you may be considering going public. Going public can be an exciting, rewarding experience, providing a powerful tool for achieving your capital, liquidity, and other needs. But it's also an enormous undertaking. Too often, business owners make the mistake of underestimating the commitment of resources required to conduct a successful initial public offering ("IPO") and to operate as a public company after an IPO.

This guide provides a general introduction to going—and being—public. It highlights the benefits and costs of going public, explains how to determine when the time is right for an IPO, discusses alternative financing sources, and describes the process of preparing for an IPO and registering your offering with the Securities and Exchange Commission ("SEC").

This guide also discusses the enhanced corporate responsibilities that characterize life as a public company. In exchange for access to the public markets, you'll be accountable to a new set of shareholders, an independent board of directors, the SEC, and other Federal and state agencies. And you'll need to adopt more formal corporate governance practices and become accustomed to sharing more information about your company's finances, compensation arrangements, and business plans.

Taking a company public is a highly complex endeavor that demands intensive preparation and precise timing. The key to success is to start preparing as early as possible and to assemble a team of qualified advisors—including lawyers, investment bankers, and accountants—who have extensive experience working with IPOs and public companies.

SECTION 2: IS GOING PUBLIC RIGHT FOR YOU?

As you analyze this decision, it's critical to keep in mind that going public is not an end in itself. Rather, it's a *means* to an end. Like any form of financing, an IPO should be viewed as a tactical response to a strategic need. As your company grows, it may reach a point in its evolution where going public becomes the most effective tactic for raising the capital it requires to execute its business plan and to satisfy its owners' liquidity needs.

Despite the potential rewards, however, going public isn't for everyone. It is important to carefully weigh the advantages and disadvantages—and consider the alternatives—before you venture down this road.

Even if you conclude that going public is the right strategy, you need to consider whether the timing and market conditions are right for a successful IPO.

Advantages

Key advantages of going public include:

Access to capital. Tapping the public markets through an IPO (and, later, through follow-on offerings) provides immediate access to substantial amounts of capital. Your company can use these funds to meet working capital needs, expand facilities or product lines, finance mergers and acquisitions, or achieve a variety of other business objectives.

Also, assuming that you use an IPO to sell equity securities rather than debt securities, it will improve your company's debt-to-equity ratio, facilitating bank borrowings or other debt financing in the future.

If your company does well, market demand for its stock can make it relatively easy to raise additional capital by issuing more stock.

Creation of a new "currency." Publicly traded stock provides your company with a new currency that may be more valuable than cash for certain purposes. A stock deal, for example, may be more attractive to an acquisition target. And publicly traded stock can be a powerful tool for attracting, retaining, and motivating management talent through the use of stock options, stock purchase plans, or other equity-based incentives.

Personal liquidity. When a company goes public, its owners' shares become more readily marketable (subject to SEC and underwriter restrictions on post-IPO sales by certain insiders). This increased liquidity facilitates a number of personal financial planning goals, including diversification, asset allocation, and estate planning.

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Competitive advantages. To many, going public is a sign that your company has "made it." The prestige associated with being a public company can provide a competitive advantage when dealing with lenders, customers, distributors, suppliers, vendors, and employees. Public companies are subject to intense scrutiny by investors, the SEC, and the exchanges on which their stock is listed. For this reason, most lenders and other prospective business partners perceive public companies as better credit risks, which can result in more favorable financing terms.

Disadvantages

The advantages of going public are significant, but so are the disadvantages. They include:

Loss of control. Owners accustomed to making business decisions with little oversight will suddenly find themselves accountable to public shareholders, a board of directors with independent members, the SEC and other regulatory agencies, and securities analysts. The transition can be particularly difficult for an entrepreneur who founded the company. Of course, if your company has previously obtained financing from a venture capital or private equity firm, you've already experienced some loss of autonomy, but going public will require you to share control even more.

In addition, after an IPO, you'll own a smaller percentage of the company's outstanding shares. Secondary offerings may dilute your ownership interest further, and ultimately you may be vulnerable to investors who acquire large holdings or band together to effect changes in the board or management. You may even be vulnerable to an unsolicited tender offer that can take the company away from you altogether.

Disclosure of financial and strategic information. When you first go public—and periodically thereafter—you're required to file audited financial statements and detailed disclosures about your operations with the SEC (see Sections 4 and 5). Because these filings are available to the public, you may be forced to share sensitive information you previously considered confidential or proprietary. Information about sales and profits, officer and director compensation, strategic plans, products, and key business relationships will be open to scrutiny by your competitors, your customers, your employees, even your next-door neighbor.

In some cases, these disclosure requirements can be a potential deal breaker. Suppose, for example, that one customer accounts for 20 percent of your revenues and that your contract with the customer requires you to keep its identity confidential. This creates a dilemma because, if you go public, SEC regulations may require you to disclose your major customers by name.

Another example is an acquisition by a public company. Say you're interested in acquiring one of your competitors. Depending on the size of the transaction, as a public company you'll be subject to significant disclosure requirements, possibly including the target's audited financial statements. If audited financial statements aren't available, you may not be able to consummate the transaction until they've been prepared.

These are just two examples of public company requirements that can disrupt your business. It's critical to identify these issues early so that you can take steps to resolve them before you begin the IPO process.

Pressure to achieve short-term results. A public company's management is under a great deal of pressure to meet quarterly earnings estimates and maintain or increase the company's stock price. The need to focus on achieving short-term results can make it difficult to pursue long-term growth strategies.

It may be possible to overcome this disadvantage with a proactive investor relations program that keeps shareholders informed of the company's plans and manages their expectations.

Greater liability. A public company's officers and directors have greater exposure to personal liability—both civil and criminal—than do officers and directors of privately owned companies. The IPO itself, as well as regulatory filings and corporate communications as a public company, can give rise to securities fraud litigation or an SEC enforcement action if investors or regulators believe that the company or its representatives made materially misleading statements.

Also, in the event the company restates its financial statements—for example, to correct a material overstatement of earnings—executives who received bonuses or other incentive compensation based on reported earnings may have to return a portion of that compensation. This "clawback" of compensation may be required regardless of whether the overstatement resulted from error or fraud and regardless of whether the executive was responsible for, or even knew about, the overstatement.

Finally, under the Sarbanes-Oxley Act of 2002 ("SOX"), the CEO and CFO must periodically certify in writing that certain financial reports are accurate and that the company's internal controls over financial reporting are effective. Officers who knowingly or willfully file a false certification are subject to civil and even criminal penalties.

Higher costs. The costs associated with getting ready to go public, completing an IPO, and operating as a public company are substantial. As discussed in further detail in Section 3, preparing your company to go public requires you to evaluate—and, in many cases, strengthen—management quality, corporate governance, internal controls, and financial reporting policies and procedures. The IPO process itself involves a number of significant expenses, including underwriting commissions and discounts, legal and accounting fees, printing costs, "Blue Sky" compliance costs, and various filing, registration, and transfer agent fees (see Section 4).

Once your company becomes public, there are ongoing costs associated with SEC compliance and reporting, legal and accounting fees, directors and officers ("D&O") insurance, independent director compensation, and public/investor relations, to name a few.

Cultural changes. Making the transition from privately owned to a reporting public company requires a cultural shift on the part of all employees, from senior management to the rank-and-file. These cultural changes stem primarily from the increased formality and discipline required in an environment characterized by greater board and regulatory oversight and closer scrutiny of internal controls.

This isn't so much a disadvantage as it is a requirement to adopt sound business practices. But for managers and employees accustomed to conducting day-to-day transactions more informally, it can be a challenge.

Alternatives

As you weigh the pros and cons of going public, it's important to explore alternative financing and liquidity options. The alternatives lie on a continuum, with "friends and family" financing on one end and an IPO on the other. In between are options such as angel financing, bank loans, private placements, private equity capital, and venture capital, each of which may be appropriate at various stages in the company's development.

If going public is your goal, but your company isn't quite ready to take the plunge, some of these options may be viewed as milestones on the road to an eventual IPO. Working with a venture capital or private equity firm, for example, can help company management prepare for going public by answering to independent investors and board members and adopting stronger corporate governance and financial reporting practices. Another option for generating liquidity is to sell your company to a strategic or financial buyer.

You might also consider a reverse merger or a special-purpose acquisition company ("SPAC").

In a reverse merger, your company acquires a public shell corporation and merges your company into it. When the dust settles, your shareholders control a public company that contains your company's active business and continues to operate under your company's name. A reverse merger transforms your private company into a public one, but it does nothing to raise capital. To accomplish that, reverse mergers are often accompanied or followed by a private investment in public entity ("PIPE") transaction. PIPEs are generally made by sophisticated investors looking for access to the public markets as an exit vehicle. Like a public offering, a PIPE requires you to register your securities with the SEC.

At one time, reverse mergers were viewed as a quick, inexpensive way to go public. Today, however, SEC regulations and filing requirements for reverse mergers are virtually as stringent as those for an IPO. And reverse mergers present some significant risks, not the least of which is the potential liability and other baggage brought by the public shell and its shareholders.

A SPAC, on the other hand, is a company with nominal assets that's taken public by promoters, who then use the proceeds of this IPO to acquire a company. Getting acquired by a SPAC can be an attractive alternative because the promoters have already covered the cost of an IPO and sold the stock. In most cases, your shareholders end up with a majority interest in a public company. A SPAC can be a viable alternative to an IPO, but like all major financing transactions, a successful SPAC involves significant costs, effort, and due diligence.

Is It the Right Time?

No matter how attractive an IPO may seem, it won't be successful unless you're able to generate sufficient interest in the marketplace to meet your company's capital and liquidity needs. Assessing an IPO's potential for success can be a challenge because it depends on a confluence of factors—both internal and external—including the public's appetite for IPOs, stock market conditions, general and industry-specific economic conditions, and your company's future prospects.

As the economy continues to recover, the general climate for IPOs has also been improving. The market virtually dried up in 2008 and 2009, but the number of IPOs increased significantly in 2010 and this trend has continued into 2011. To gauge potential interest in your company, take a look at private investment groups to see what types of companies they're investing in, and examine the performance of public companies in your industry.

Take a critical look at your company from the perspective of a potential investor. Do you have a compelling business plan, a quality management team and workforce, and a track record of sales, profitability, and growth?

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Is your company "established"? This is important for two reasons. First, established companies tend to have a more stable earnings stream, which is attractive to investors. Second, to achieve your liquidity goals, you'll need a market capitalization that's large enough to support substantial trading in your company's stock. There may be exceptions, of course, for businesses with cutting-edge products and strong prospects for rapid growth, such as certain early-stage biotech or technology companies.

It's also important to work with your advisors to estimate the value of your company and project the size and share price of an IPO in light of anticipated market conditions on the offering date. Will the expected net proceeds be sufficient to meet your objectives and fairly compensate the owners for handing over a portion of the business to outside investors?

Once you've weighed the advantages and disadvantages of going public and assessed your company's prospects for success, the next step is to examine what is required to get your company ready for an IPO.

SECTION 3: PREPARING TO GO PUBLIC

Preparing your company to go public is a time-consuming process that should begin at least six months—and, ideally, a couple of years—before the anticipated offering date.

The moment a company becomes public, it's subject to the enhanced corporate governance, internal control, financial reporting, and regulatory compliance requirements discussed below. But going public isn't simply a matter of flipping a switch—it's more like rewiring your company to operate in a public environment, and that takes time.

There are two critical reasons for starting the preparation process as early as possible. First, putting the various pieces into place well in advance gives you time to work through any problems and avoid costly delays that can disrupt or even derail the IPO process. Second, the more your company behaves like a public company, the more attractive it will be to underwriters and investors.

The first step in this process is to conduct a readiness assessment to determine where your company is now, where it needs to be to position itself for a successful IPO, and what it will take to get there. This will give you a better idea of the lead time required. Following are some of the key issues you'll need to address.

Corporate Governance

As a public company you'll need to meet strict corporate governance standards established by SOX and, if applicable, the listing requirements of one of the national or foreign stock exchanges.

Board of directors. As a public company you'll need to comply with tougher rules regarding the composition and responsibilities of your board and its committees. The specific requirements will depend, in part, on where your stock is traded.

Under SOX, for example, your audit committee (rather than management or the full board of directors) will be directly responsible for appointing, compensating, and overseeing the company's external auditors and approving most audit and non-audit services provided by outside accountants.

SOX requires your audit, compensation, and nominating committees to be comprised of independent outside directors. It also requires you to disclose whether at least one member of the audit committee is a "financial expert," as defined by SEC regulations, and, if not, to explain why. Listing on the New York Stock Exchange ("NYSE") requires at least one member of the audit committee to have "accounting or related financial management expertise."

The national stock exchanges require a majority of your board members (not just committee members) to be independent. The exchanges allow you to phase in board and committee independence requirements over your first year as a public company, but from a marketing perspective it's preferable to meet these requirements from day one.

Your advisors can help you recruit board members, if necessary, and there are recruiting firms that specialize in placing directors on corporate boards. If you've previously obtained financing from a venture capital or private equity firm, it's likely that your board already includes one or more independent directors.

Internal control. Section 404 of SOX requires a public company to conduct annual evaluations of its internal control over financial reporting and include in its annual report a report by management on the results. If a company has a public float of more than $75 million, it must also obtain an opinion from its external auditors on the effectiveness of internal control over financial reporting. Public float means the value of shares held by public investors, as opposed to officers, directors, or other insiders. Internal controls are also critical to compliance with the Foreign Corrupt Practices Act ("FCPA").

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In addition, with each quarterly SEC filing (Form 10-Q), both the CEO and CFO must certify in writing—subject to civil and criminal penalties—that the company's financial information is materially accurate and complete and that its internal control over financial reporting and disclosure controls and procedures are adequate.

SOX and the FCPA do not recommend specific internal control procedures; they merely require management to maintain a system of internal control and evaluate its effectiveness. To develop an internal control structure, most companies follow guidelines issued in 1992 by the Committee of Sponsoring Organizations of the Treadway Commission ("COSO") in its publication *Internal Control—Integrated Framework*.

Documenting, evaluating, and testing your company's internal controls—not to mention correcting any material weaknesses you uncover—takes time, so it's a good idea to begin the process well before you go public. Technically, newly public companies aren't required to comply with Section 404 until their second annual report (Form 10-K) has been filed with the SEC, but from a practical standpoint, you should have your internal control house in order before an IPO. For example, when you go on the "road show" to drum up interest in your offering (discussed in further detail in Section 4), prospective investors invariably ask: "If you had to sign a Section 404 certification today, could you do it?" It's important to be in a position to answer "yes."

Note that the NYSE requires listed companies to have an internal audit function. This guide does not discuss the internal audit function in detail. But if you expect to list your stock on the NYSE—or if you plan to implement an internal audit function voluntarily—it's often a good idea to coordinate your SOX and internal audit efforts. Internal auditors are experienced in documenting, evaluating, and testing internal controls.

An audit advisor (other than your external auditor) can assist you in designing, implementing, and testing internal controls as well as with internal audit work. SOX's independence provisions prohibit your external auditor from doing this work or from providing certain other non-audit services. You might engage another firm to advise you on internal controls as well as other accounting matters. Alternatively, if your current firm is not willing or able to conduct public company audits, you should engage a separate firm as your external auditor.

Audited Financial Statements

For your company to go public, the SEC requires Public Company Accounting Oversight Board ("PCAOB") audited financial statements (generally for three years) prepared in accordance with U.S. generally accepted accounting principles ("U.S.-GAAP"). In addition, if your company has made any significant acquisitions, you may be required to furnish separate audited financial statements for the acquired companies.

Once public, your company must include audited financial statements with its annual SEC filings and reviewed statements with its quarterly filings (see Section 5). The audit must be conducted by an independent public accountant registered with the PCAOB.

If you don't already prepare audited financial statements, it's advisable to bring in a registered, independent auditor—and begin the audit process—as soon as possible after you decide to pursue an IPO. For one thing, if you wait until you're about to go public, obtaining audited financial statements for previous years can be difficult and costly and it could delay the IPO process. Conducting an audit "after the fact" can present a significant challenge, particularly if information or documents are missing or the auditor is unable to perform time-sensitive audit procedures, such as observing physical inventory counts.

Audited U.S.-GAAP financial statements will also provide a more accurate picture of your company's financial condition and operating results, giving you an idea of how prospective investors will view your company. Unpleasant surprises may lead you to delay the IPO or rethink your plans, so it's best to get this information in the early stages.

Public Company Financial Reporting

The impact of public company financial reporting goes beyond the audit and additional scrutiny from investors, analysts, and regulators. If your company isn't already preparing U.S.-GAAP-compliant financial statements, the switch to U.S.-GAAP can have a substantial impact (either positive or negative) on your financial results.

Even if you're already using U.S.-GAAP, certain standards are either unique to public companies or are more significant or challenging for public companies. These include revenue recognition, stock-based compensation, private equity investments, fair value measurements, segment reporting, consolidation, and earnings-per-share calculations, to name a few.

Making the transition to public company financial reporting is not just a matter of presenting your financial information in a different format or making certain calculations differently. Many of the accounting standards will require your company to make critical estimates and judgment calls, and to track and collect different types of data. This may require new accounting and internal control policies, procedures, and systems. You should begin incorporating these changes well in advance of going public.

Management should also become accustomed to preparing quarterly interim financial statements and to completing the financial statement closing process on a timely basis after the end of each interim and annual reporting period to meet SEC filing deadlines.

Formatting and electronic filing requirements. The SEC has very specific requirements regarding the format of printed registration statements and prospectuses, as well as quarterly and annual reports, so it's critical to work with a qualified financial printer. In addition, most filings must be submitted electronically using the SEC's Electronic Data Gathering Analysis and Retrieval ("EDGAR") system. Many financial printers, and some law and accounting firms, offer EDGAR services.

Public companies are now required to provide their financial statements and schedules to the SEC in XBRL format. XBRL, which stands for Extensible Business Reporting Language, incorporates "data tags" that allow users to search for financial information and to manipulate it to allow for easy analysis and comparison to data from other public companies. Companies are also required to post XBRL financial statements on their websites.

Impact of financial statement errors. It's important to understand that when your company becomes public, financial statement errors have more serious and far-reaching consequences than in a privately held company. A restatement of your company's financial statements can lead to SEC inquiries or securities fraud litigation and can have a negative impact on your stock price. In addition, under current "clawback" rules, executives may be forced to return bonuses that were calculated on the basis of overstated earnings.

IFRS. Be aware that there's a movement today toward adopting a single set of high-quality, global accounting standards. The objective is to create a universal accounting language to improve financial statement comparability from country to country, facilitate cross-border transactions, and make the global capital markets more efficient.

In furtherance of this objective, the SEC is considering whether to require U.S. public companies to adopt International Financial Reporting Standards ("IFRS") at some point in the future. In addition, the Financial Accounting Standards

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Board ("FASB"), which develops U.S.-GAAP, has been working closely with the International Accounting Standards Board ("IASB") to converge U.S.-GAAP and IFRS. In other words, the two boards have been jointly revising their respective standards to bring them closer together.

The SEC issued its Proposed Roadmap for the adoption of IFRS by U.S. registrants, but has yet to fully commit to IFRS. As a result, many reporting entities have chosen to ignore, at least for the present time, the differences between IFRS and accounting principles generally accepted in the United States.

However, every major non-U.S. capital market is either using IFRS or moving in that direction. Currently, there are more than 120 countries that have adopted or are in the process of adopting IFRS. Since U.S. domiciled businesses are not functioning in a vacuum, IFRS demands our attention right now.

IFRS can be relevant to U.S. domiciled businesses seeking capital or targeting foreign acquisitions, or those that are targets for acquisition by foreign domiciled businesses. IFRS can be relevant to U.S. subsidiaries of foreign domiciled parents and U.S. domiciled entities with foreign subsidiaries and/or foreign trading. The differences that exist between the two accounting platforms including, but not limited to, revenue recognition, fair value accounting, accounting for leases, and share-based compensation, can significantly impact business practices. These differences may arise in dealing with customers, vendors, employees, or sources of financing, but eventually the challenges created by these differences will become evident and require attention.

Stakeholders should develop a general understanding of IFRS early and obtain insight into how the differences between IFRS and their current accounting platform can impact their business practices.

If the SEC ultimately mandates conversion to IFRS for U.S. public companies, the impact on public company financial reporting will be significant.

Management

The quality and depth of your management team is one of the most important factors for underwriters and investors. As discussed elsewhere in this guide, managing a public company can be very different than managing a private company. Your senior executives should be experienced professionals who understand your industry and are prepared for the enhanced accountability, formality, and discipline associated with a public company. Your CFO and other financial executives, in particular, should have the experience and training necessary to deal with public company accounting and financial systems.

Public and Investor Relations

The earlier you develop a public relations and investor relations program, the better. To succeed in a public offering—and in the public markets thereafter—you need to tell your "story" to underwriters and potential investors, maintain a positive image in the business community, and enhance your company's reputation and name recognition.

Getting Your House in Order

There are a variety of housekeeping issues you and your advisors should attend to as you prepare to take your company public. They include but are not limited to:

- Making sure your stock ownership records are up-to-date;
- Reviewing and, if necessary, simplifying your company's organizational and capital structure to facilitate a public offering;
- Reviewing current contracts, pending litigation, and related-party transactions and addressing any issues that may disrupt the IPO process or make your stock less desirable;
- Ensuring that your compensation arrangements are fair; and
- Reviewing your company's articles of incorporation, bylaws, and other corporate documents to ensure that you're authorized to issue additional shares of stock and that the documents are otherwise suitable for a public company.

The preparation process may seem daunting, especially when there's no guarantee that it will result in a successful IPO. But keep in mind that even if you don't go public, preparing to do so involves the adoption of best practices that may potentially make your company more profitable and help position it for a sale, private placement, or other liquidity event.

SECTION 4: THE IPO PROCESS

The process of going public starts with putting together a multidisciplinary team consisting of key executives and qualified, experienced advisors and drafting and filing the registration statement; revising the registration statement based on SEC comments; conducting due diligence; qualifying your offering under state "Blue Sky" laws; selecting an exchange or other trading market for your securities; and marketing your offering.

Putting Together a Team

The success of a public offering can depend on the talent and experience of your team. The following discussion focuses on management, accountants, lawyers, and underwriters. Other professionals may also play important roles (including public relations consultants, financial printers, transfer agents, and registrars).

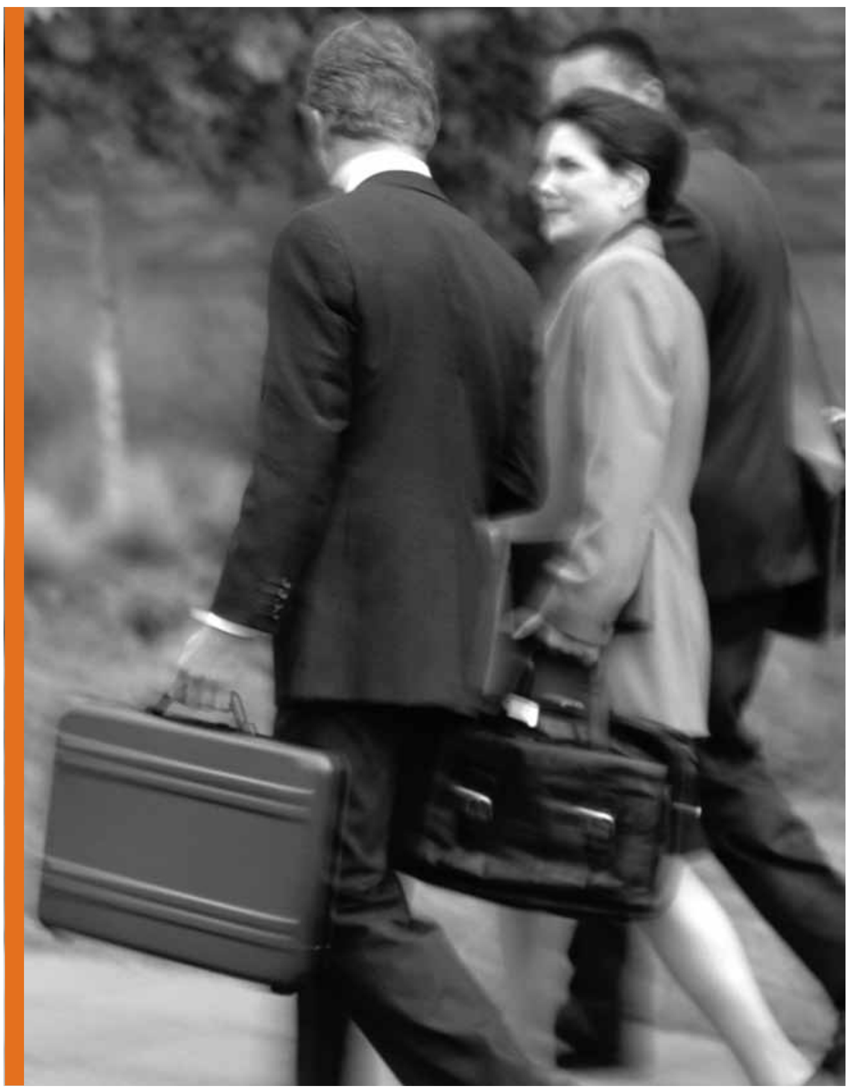
Management. The CEO, CFO, and other key executives play a critical role in preparing your company to go public and market the offering. In addition to representing the company in its dealings with underwriters and other advisors, management is responsible for putting together a solid, detailed business plan and ensuring that the company's story is properly told in the registration statement.

It's important to understand that the registration statement—which includes the prospectus that's distributed to prospective investors—is both a disclosure document and a marketing tool. Management must work closely with legal counsel and the underwriters to ensure that the registration statement is accurate and complete while also doing its job to promote the company. This can be a delicate balancing act.

Auditors and accounting advisors. As discussed previously, your existing accounting firm may or may not be equipped to conduct public company audits. In addition, SOX prohibits a public company's external auditor from providing many consulting and other non-audit services. As you prepare to go public, therefore, it's advisable to engage one firm to serve as auditor and another to provide accounting and financial reporting advice.

Your auditor plays an important role in the IPO process by auditing the financial statements that accompany the registration statement, issuing comfort letters to underwriters, and helping you formulate responses to SEC comments on financial statement matters. Factors to consider in selecting an auditor include the firm's reputation, familiarity with your industry, experience working on SEC matters, and, as noted earlier, its required registration with the PCAOB.

Your accounting advisor can assist you in areas that may be off limits to your external auditor. These include consulting on internal controls and financial reporting systems, reviewing the underwriter's compensation and other financial terms of the underwriting agreement, and providing general accounting, financial, tax, and business advice before, during, and after the IPO. If you select a new accounting firm as



your auditor, keeping your existing firm on board as an accounting advisor may be a good strategy because the firm is already familiar with your business.

Legal advisors. A significant non-management member of the team is your legal advisor. Experience with securities matters is important for all of your advisors, but it's absolutely essential for your legal advisor. An IPO is a complex, heavily regulated, technical process that requires a lawyer with extensive experience. Your legal advisors are closely involved in the preparation of the registration statement and in ensuring that it is complete and contains no false or misleading information. They also issue opinions on the legality of the stock sale and other matters.

Experienced counsel can streamline the IPO process by anticipating SEC needs, coordinating communications among regulatory agencies, and ensuring that the process stays on schedule. This can make the difference between success and failure, because the window of opportunity for a public offering is often a narrow one, and excessive delays can be fatal.

In addition to securities experience, you should look for counsel with knowledge about your industry. This knowledge can be invaluable as counsel reviews descriptions in the registration statement of the company's business and evaluates whether disclosures regarding industry risks and other factors are adequate.

Underwriters. The lead underwriter is an investment bank that spearheads efforts to market your public offering. It assists you in preparing your offering, provides advice on valuing your company and pricing your shares, and helps create a market for your offering by forming a syndicate of co-underwriters to market and sell your stock to their customers. The number of underwriters in the syndicate depends on the size of the offering and can range from a few to 100 or more. A lead underwriter may also provide post-IPO "aftermarket" support to help maintain your stock's market price and other ongoing financial advice.

Choosing the right underwriter is critical to an IPO's success, so it's wise to start researching investment banks and developing relationships with some of them soon after you make the decision to go public. The more familiar an investment bank becomes with your business, the greater its ability to help you determine how much capital you need, price your stock, and sell it. Your accountants, lawyers, and other advisors can be good referral sources, as can other companies in your industry that have gone public.

> "The price of stock that will be offered to the public is developed through a negotiation between the underwriter and management."

Other factors to consider in choosing an underwriter include reputation, experience with your industry, research capabilities, experience with similar-sized offerings, pricing track record, and availability of aftermarket support. You should also be sure that the underwriter's customer relationships and distribution network are a good match for your company's needs. For example, if you expect your offering to be most attractive to individual "retail" investors, consider investment banks whose client base mirrors that need.

Investment banks tend to be quite selective about the types of companies they work with. Some, for example, work primarily with larger, established companies with national reputations. Others focus on companies in a particular industry or geographical region. Once you identify a potential lead underwriter, it will scrutinize your company before committing to take it public. Among other things, it will examine your business plan, management team, products, customers, suppliers, financial position, earnings history, and other factors that affect your prospects for future growth and, therefore, the marketability of your stock.

It will also inquire about your plans for using the proceeds. If a significant portion of the proceeds will go to shareholders or if senior executives plan to sell their stock, the underwriter may see this as a signal that they've lost confidence in the company. This may cause the underwriter to walk away absent assurances that shareholders aren't "bailing out."

Underwriting Arrangements

Once you've found a suitable underwriter that's willing to take your company public, the next step is to sign a letter of intent that outlines the estimated stock price, the underwriter's compensation, and other terms of the arrangement. Typically, underwriters are compensated in two ways: The lead underwriter receives a commission equal to a percentage of the gross offering proceeds (seven percent is common), plus unaccountable expenses. In addition, the lead underwriter and other syndicate members enjoy an underwriting discount (typically seven percent to eight percent) represented by the spread between the price they pay for the stock and the IPO's offering price. Investment bankers may also receive additional compensation in the form of stock or stock warrants and fees for certain post-offering services.

Underwriting arrangements generally fall into one of two categories: A firm commitment or a best efforts agreement. Under a firm commitment, the underwriters agree to buy all of the stock your company is offering and assume the risk of reselling it to the public. A best efforts agreement, as the name suggests, requires underwriters to use their best efforts to sell your stock, but they make no commitment to purchase any stock that doesn't sell. Some best efforts agreements provide for termination of the offering if a minimum sales threshold isn't reached.

> "Even though the lead underwriter is an important advisor and a valuable member of your team, certain conflicts of interest exist."

A firm commitment is the most desirable arrangement from the company's perspective. Practically speaking, however, the underwriters' risk under such an arrangement is minimal. The final underwriting agreement isn't signed until the deal prices, shortly before the stock is sold. By that time, the underwriters have collected "indications of interest" from potential buyers and can predict the outcome with a high degree of confidence. If it appears that the offering will fall short of expectations or if market conditions have deteriorated, the underwriters can back out.

Pay close attention to any "greenshoe" or "overallotment" option in the underwriting agreement. This provision allows underwriters to buy more shares—typically an additional 15 percent—if they overbooked the offering or if it is more popular than anticipated. A greenshoe provision should be considered carefully because it affects the original shareholders' percentage ownership in the public company.

Even though the lead underwriter is an important advisor and a valuable member of your team, certain conflicts of interest exist. Many terms of your arrangement—including the underwriter's compensation—are negotiable, so it's important to have your lawyers and accountants review the draft underwriting agreement. In addition, the Financial Industry Regulatory Authority ("FINRA") will review the agreement for fairness. FINRA is the successor to the National Association of Securities Dealers ("NASD"). It is not a government agency; rather, it's a self-regulatory organization ("SRO") that serves as an independent regulator for its member brokerage firms and registered securities representatives, as well as for the major stock exchanges.

Pricing

The price of stock that will be offered to the public is developed through a negotiation between the underwriter and management. The underwriter will develop its estimate of the company's value using traditional valuation methodologies; however, the primary basis for pricing the company's stock is a comparison of comparable companies. This pricing decision is often difficult to make and can cause the transaction to fail. There have been many cases of IPOs that failed, even after being declared effective by the SEC, because of disagreements between management and the underwriters over pricing. The cost of a failed IPO can be substantial, and it is borne primarily by the company.

The Registration Process

The process of "going public" involves registering your company's securities with the SEC pursuant to the Securities Act of 1933 (the "1933 Act"). That Act regulates the sale of securities to the public, while the Securities Exchange Act of 1934 (the "1934 Act") regulates the public securities markets and governs public companies' ongoing financial reporting and disclosure obligations.

The two acts and their related regulations are complex, but their ultimate purpose is a simple one: To protect the investing public against fraudulent or misleading representations in connection with the purchase and ownership of securities.

Registration is accomplished by filing a registration statement—in most cases using Form S-1—with the SEC. Your company becomes public, and may sell its shares in the public markets when the SEC declares the registration statement "effective."

The process—which usually takes between three and six months, though sometimes longer—requires a concerted effort by company management, investment bankers, auditors, and legal counsel. Typically, it begins with one or more "all hands" or "kickoff" meetings in which the key players agree on a timetable and coordinate the various tasks for which they are responsible. Careful planning is critical, because a successful IPO depends on meeting your target effective date.

Generally, your company's legal counsel will lead the registration process and take responsibility for drafting the nonfinancial portions of the registration statement. Management is responsible for providing details about the company and its industry. Your auditors will report on the audited financial statements included with the registration statement, while the lead underwriter will furnish information about the underwriting arrangements.

Following is a rough outline of the registration process.

Preparing the registration statement. The registration statement consists of a prospectus—the selling document distributed to potential investors—and certain supplemental information. The prospectus provides important disclosures about the company and the offering, including:

- Information about the offering, including the number of shares to be sold, the estimated per share price, underwriting arrangements, any sales by shareholders, the intended use of the proceeds, and dilution resulting from the offering;
- Information about the company, including the backgrounds and compensation of officers and directors, and information about the principal shareholders;
- Detailed information about the company's business, including business plans, products and services, markets and distribution methods, competition, significant business segments, major customers and suppliers, critical intellectual property, government contracts, employees, and facilities;
- Dividend policies;
- Industry and company risk factors;
- Related-party transactions;
- Material legal proceedings; and
- Financial data, including three years of audited financial statements (two years for smaller reporting companies, defined as those with an expected market capitalization of less than $75 million).

The prospectus also includes management's discussion and analysis ("MD&A") of financial condition and results of operations. Often the most important section of the prospectus for investors, the MD&A provides a plain-English summary of trends and uncertainties, by business segment, that have an impact on the company's future prospects. Key areas covered include liquidity and capital requirements; anticipated future sources of funds; critical accounting policies; and other factors that explain the company's historical results and affect future performance.

Responding to due diligence requests. Under the 1933 Act, the company and its advisors are potentially liable for any material misstatements or omissions in the registration statement. To protect themselves, your external advisors will conduct thorough due diligence to verify the accuracy and completeness of the information contained in the registration statement. The underwriter will likely request comfort letters from an independent auditor regarding the financial information contained in the registration statement and any recent developments that have an impact on that information.

Review by the SEC. When the registration statement is complete, your legal counsel will file it with the SEC for review by the Commission's Division of Corporate Finance. SEC analysts do not opine on the merits of the offering as an investment. Rather, their job is to ensure that the registration statement provides adequate disclosures and otherwise complies with applicable securities laws and regulations.

The review, which usually takes around four to six weeks, culminates in an SEC comment letter asking you to clarify or revise information in the registration statement. There may be several rounds of comments and responses, which may include meetings with SEC staff, either by phone or in person. Once the SEC is satisfied, it will declare your registration statement effective.

"Blue Sky" compliance. You may be required to qualify your public offering in each state where your stock will be sold. Most states have their own laws regulating the sale of securities, and these laws can vary dramatically from state to state. They're referred to as "Blue Sky" laws, a term coined in a court decision that referred to "speculative schemes which have no more basis than so many feet of blue sky."

Unlike SEC registration, qualifying your offering under state "Blue Sky" laws generally involves a review of the merits of your offering. Because each state has its own criteria for accepting your offering, this can be an enormous undertaking, making qualified legal counsel even more critical.

FINRA clearance. SEC regulations also require clearance by FINRA (see page 10). FINRA's role is to review the underwriting arrangements and ensure that the underwriter's commission, underwriting discount, and other compensation is fair and reasonable.

Listing Your Securities

During the registration process, you should also decide on a market for your securities. For most companies, the major U.S. exchanges—NYSE, NASDAQ, and Amex—are most desirable, although some smaller companies may trade their shares on a regional exchange or in the over-the-counter ("OTC") markets. Another option is a foreign exchange, such as the London Stock Exchange's Alternative Investment Market ("AIM"). AIM is an international market that targets growth companies.

The first step in choosing a market is determining whether your company meets the listing requirements. The major U.S. exchanges, for example, require listed companies to meet certain qualifications, including minimum levels of earnings, assets, market capitalization, and stock distribution.

Assuming that you qualify, you should choose an exchange that best enhances your company's prestige, reputation, and attractiveness to investors, and that gives you the greatest exposure to the types of investors you're trying to reach.

You should also consider the costs associated with listing your securities on an exchange, as well as any corporate governance or other standards the exchange imposes.

Marketing Your Offering

Once a registration statement is filed with the SEC, the marketing process begins, starting with the lead underwriter's formation of a syndicate. Throughout the IPO process, it's important to be mindful of the "quiet period" during which your company's public statements and communications regarding the planned IPO are strictly limited. During this

> "Additional publicity about the offering is generally prohibited, with the exception of a 'tombstone ad,' placed in relevant newspapers and business publications, announcing the offering and letting people know how to obtain a copy of the prospectus."

period, it's a good idea to have your legal advisors review any proposed press releases or other communications to be sure that they don't run afoul of the rules.

Unfortunately, Federal securities laws do not define the term "quiet period," and it's often used to refer to different stages of the IPO process. Traditionally, one quiet period begins as soon as your company enters into substantive discussions with investment bankers, strictly limiting the information you can release to the public and prohibiting you from offering your securities for sale.

Another quiet period, also referred to as the "waiting" period, begins when you file your registration statement and extends until the time the SEC declares your registration statement effective. During this period you are permitted to offer, but not sell, your securities. Offers are generally limited to distribution of a preliminary prospectus. If you violate these restrictions—known as "gun-jumping"—the SEC may impose a delay, or "cooling off period," to allow any effects of improper offers to subside. Even after the registration statement becomes effective and you're authorized to sell your securities, there are limits on the information you're permitted to release for a period of time.

Distributing the "red herring." Once the SEC review process reaches a point where you're confident that the SEC will declare your registration effective without extensive changes, your marketing efforts begin in earnest. The next step is to share a preliminary prospectus—indicating a price range but not the final offering price—with underwriting syndicate members for distribution to potential investors. The prospectus is commonly referred to as the "red herring" because its cover contains a "subject to completion" statement in red ink.

If the SEC requires substantial changes after you distribute the "red herring"—or if the final offering price will fall outside the stated price range—it may be necessary to recirculate the red herring.

Taking the show on the road. During the SEC review process, the underwriter generally organizes a "road show" in which your CEO, CFO, and other top executives tour key cities to meet with securities analysts and potential investors and generate interest in the company. Thorough preparation is critical to ensure that your representatives steer clear of any potentially misleading statements. Participants should work closely with legal counsel, the underwriters, public relations consultants, and other advisors to prepare and rehearse their presentations as well as their answers to any anticipated questions.

Closing the deal. Once the SEC declares your registration statement effective, things move quickly. Assuming that the red herring and road show attracted sufficient indications of interest to proceed with the IPO, you and the lead underwriter will determine the offering price, sign the underwriting agreement, and distribute a final prospectus to everyone who received the red herring.

Additional publicity about the offering is generally prohibited, with the exception of a "tombstone ad," placed in relevant newspapers and business publications, announcing the offering and letting people know how to obtain a copy of the prospectus.

Shortly thereafter—usually within a week or less after the pricing—the deal closes. Your shares are sold, the underwriters are paid, and your company receives the net proceeds. Keep in mind, though, that if sales fall short of a minimum threshold set by the underwriting agreement, you may be forced to extend or withdraw the offering.

SECTION 5: BEING PUBLIC

Once your company has *gone* public, you'll enter the exciting and challenging world of *being* public. We've already reviewed several aspects of being a public company elsewhere in this guide, including:

- Stricter corporate governance standards, including internal control evaluation and certification;
- Audited financial statements;
- Quarterly financial statements;
- Timely completion of financial statements;
- EDGAR requirements;
- XBRL requirements;
- Management quality and depth;
- The need to manage for shareholder value as well as long-term growth; and
- Greater exposure to legal liability for the company, its officers, and its directors.

As part of a public company, officers and directors will need to deal with many other new issues, including:

Ongoing Financial Reporting and Disclosure

Public companies must comply with the 1934 Act, which governs their ongoing financial reporting and disclosure obligations. Key requirements include:

- Annual reports with the SEC on Form 10-K. These reports contain information similar to the initial registration statement, including audited financial statements;
- Quarterly reports with the SEC on Form 10-Q for the first three quarters of each fiscal year. The financial statements in these reports must be reviewed by your auditor, but need not be audited;
- Form 8-K, which is used to disclose significant changes—generally within four business days after they occur—such as acquisitions, changes in control, entry into or termination of material contracts, and other "reportable events." It's also used for disclosures required by Regulation FD, which provides that if your company discloses any "material nonpublic information" to certain people, including securities analysts or major shareholders, then it must also make that information available to the public; and
- Proxy statements, which are distributed to shareholders in advance of the annual shareholders meeting, often together with an annual report to shareholders. They include information about matters to be voted on at the meeting as well as compensation and other information about the company's officers and directors.

Insider Activities

Federal securities laws also place restrictions on the activities of insiders, which include directors, certain officers, and more-than-10-percent shareholders. Insiders must report their holdings—as well as any changes in their holdings—to the SEC, and are subject to severe civil and criminal penalties for insider trading.

They're also prohibited from benefiting from "short swing profits"—that is, profits generated by the purchase and sale of company stock within a six-month period. The rule is intended to prevent insider trading, but it applies regardless of whether the shareholder actually possesses any inside information.

Foreign Corrupt Practices Act

If your company does business in foreign countries, compliance with the Foreign Corrupt Practices Act ("FCPA") is critical. Added to the 1934 Act in 1977, the FCPA makes it illegal for U.S. public companies (and certain foreign issuers) to "bribe" a foreign official. Bribery means paying or offering to pay money or anything else of value to a foreign official—either directly or indirectly—for the purpose of obtaining or retaining business. These payments violate the FCPA regardless of whether they are legal or culturally acceptable in the country in which they occur.

To ensure that foreign payments are legitimate, the act also requires companies to maintain "reasonably accurate" records of their transactions and to maintain internal controls designed to prevent and detect violations.

Violators are subject to steep monetary penalties, potential disgorgement of any profits flowing from the violation, and even jail time. And noncompliance with the act's accounting provisions can result in penalties even without any evidence that an illegal bribe occurred.

Life in the Fish Bowl

Apart from the extensive financial reporting, disclosure, and other legal requirements, life as a public company is, simply, different. Dealing with securities analysts and the financial press takes some getting used to, as does public scrutiny of all of your company's activities.

Going public is a significant undertaking but it also offers significant rewards. At J.H. Cohn, we have the expertise and experience to help you weigh the advantages and disadvantages. If you decide that taking your company

public is the right strategy, we can help you start preparing for this major event in your company's life cycle. Not only is preparation the key to a successful public offering, but it's also essential in order to minimize the impact of the process on your ability to manage your company's day-to-day affairs as you make this important transition.

If you have questions about going public or would like us to conduct a readiness assessment for your company, please contact Richard Salute, CPA, J.H. Cohn partner and director of the Firm's Capital Markets and SEC Practice at 516-336-5501 or rsalute@jhcohn.com, or go to www.jhcohn.com.

For updated editions of this guide as well as tools and other information, visit us online at www.jhcohn.com.

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