

The Initial Public Offering Handbook:

A Guide for Entrepreneurs, Executives, Directors and Private Investors

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with

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and Contributing Authors from Perkins Coie LLP**

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Dedication

We dedicate this to our families, Virginia, Nicholas and Luke Allison; Christine, Nicole and Denali Hall; Sophia, Isabella and John McShea; and Mark and Chris VanYe, who have given us tremendous support, inspiration and encouragement throughout the creation of this handbook and our careers.

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Perkins Coie LLP is legal counsel to great companies. Attorneys in our Corporate Finance group represent market leaders in a wide range of industries, including wireless technology, hardware, software, telecommunications, Internet, aerospace, biotechnology, e-commerce and manufacturing. We advise clients in a wide range of public and private debt and equity financings. We are a recognized leader in venture capital transactions, IPOs and follow-on public offerings and have substantial experience in virtually all major aspects of public and private finance, including Rule 144A transactions and other public and private placements of debt and preferred and convertible securities. For more information about Perkins Coie LLP, please visit the firm's website at www.perkinscoie.com.

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Chapter 1—Contemplating an IPO: Benefits and Costs of the IPO and Being Public

Introduction

An initial public offering is the realization of a dream for many entrepreneurs, executives, board members and stockholders, a singular achievement that demonstrates their success in building a strong business and creating value for owners, employees and customers. However, an initial public offering is not only a milestone, it is also the entrance into a new stage—life as a public company—that possesses its own unique opportunities, risks and challenges. Some of those opportunities, such as opening a door to liquidity for investors, can be achieved in other ways, such as with a sale or private equity recapitalization of a company. In choosing to pursue an initial public offering, a company's board and executive officers should analyze the relevant considerations, and weigh the advantages and disadvantages carefully in light of the company's particular circumstances.

Initial Considerations

An initial public offering requires a great deal of effort, cost and management focus. The preparation and execution of an IPO require the company, working closely with legal counsel, auditors and underwriters, to identify, analyze and resolve a myriad of legal, accounting and business issues. General considerations that an IPO candidate should evaluate to determine whether it is prepared for an IPO include:

- The ability of the management team and board of directors to transition into a public company;
- The company's profitability, growth prospects, financial condition and results of operations;
- The company's visibility into, and the predictability of, its future financial results;
- The strength of the company's intellectual property position and key commercial arrangements;
- The company's competitors and competitive position, and the status of the company's competitive barriers to entry;
- Risk factors relevant to the company, its industry and the public markets generally;
- The status of the public markets generally and market conditions for the particular company's industry;
- Legal, accounting and regulatory compliance obligations of public companies, including extensive initial and ongoing U.S. Securities and Exchange Commission ("SEC") and national securities exchange filings and disclosure requirements, corporate governance, disclosure controls and internal controls over financial reporting;
- Investor relations demands, including the need to build and preserve credibility with analysts, the financial press, regulators, institutional stockholders and other players in the capital markets; and

- Complexities involved in changing a company's corporate and capital structure, or taking other actions that require stockholder approval, once the company is public.

There are a number of other considerations that a company should evaluate when contemplating an IPO, including restrictions on publicity before and during the offering; selection of underwriters; disclosure of related-party transactions; disclosure of executive compensation; prohibition on loans to directors and officers; structure of the board and board committees; adequacy of disclosure practices and procedures; ethics and conduct codes and procedures; accounting and corporate law matters; listing on a stock exchange; and compliance with the SEC registration process.

Costs of IPO

Going public entails significant costs. These include the underwriters' discount, legal and accounting costs, printing costs, stock exchange listing fees and SEC filing fees. The legal and accounting costs for different companies will vary widely depending on the amount of corporate cleanup required and the level of complexity of the offering. The aggregate expenses for an offering, excluding underwriters' discounts and commissions, exceed on average \$3 million. The trend of increasing IPO expenses, attributed in part to more stringent corporate governance requirements and regulation resulting from the Sarbanes-Oxley Act of 2002, has continued in recent years. From 2005 to 2007, overall IPO expenses, excluding underwriters' discounts and commissions, rose 9.2% from an average of approximately \$2,733,000 to \$3,031,000, with IPO legal expenses rising 17.9%, from an average of \$1,118,000 to \$1,319,000, and IPO auditor fees rising 40% from an average of \$636,000 to \$892,000. Source: www.IPOVitalSigns.com, © 2008 CCH, a Wolters Kluwer Company. Used by permission.

Costs of Maintaining a Public Company

Life as a public company after the initial public offering also entails significant ongoing expenses. Public companies must comply with the reporting requirements of the Securities Exchange Act of 1934 (the "Exchange Act"), including filing an annual report, quarterly reports, a proxy statement and any necessary current reports. Each of these reports can result in legal and accounting fees, and in some cases can cause a company to incur printing costs and filing fees. In addition, a public company's directors, officers and principal stockholders will be required to file reports with the SEC regarding their ownership of, and transactions in, the company's stock and equity incentives. A public company will also have the increased internal costs of maintaining staff whose focus is to make sure that the company complies with the legal and regulatory obligations of being a public company.

The Sarbanes-Oxley Act of 2002, and the legal and accounting regulations adopted in its wake, have greatly increased the legal, accounting and business costs of being a public company. Estimates on post-IPO compliance costs vary widely, especially when trying to ascertain internal costs, and can range from hundreds of thousands of dollars to upwards of several million dollars. Costs seemed to have leveled off and even declined somewhat since the early years of Sarbanes-Oxley and internal accounting control compliance. However, these costs remain a significant burden that any company contemplating an IPO must consider.

We discuss in more detail post-IPO legal compliance requirements in Chapter 10.

Advantages and Disadvantages of Being Public

Advantages

Going public is an attractive alternative for many companies because of the many advantages it confers. These include:

- The acquisition of a large amount of cash for company growth (whether internal or through acquisitions), hiring of talent, increased marketing, greater research and development and expanded products and services;
- Access to the public capital markets after the IPO, which generally enables a company to raise money more quickly with less cost and more flexibility than in the private markets;
- The ability to use the company's stock as "currency" to acquire the stock or assets of other companies because sellers are more willing to accept stock having a liquid public trading market than illiquid private company stock in a sale transaction;
- Greatly increased liquidity for investors and employees through the creation of a liquid public market and greatly expanded pool of potential purchasers to facilitate sales of stock;
- Expanded potential use of stock options and restricted stock to incentivize, motivate and compensate employees;
- Creation of potential significant wealth for founders and pre-IPO stockholders;
- Increased corporate reputation, stature, visibility and credibility with investors, customers, business partners and current and potential employees; and
- Increased market value for the company, because the illiquidity discount applicable to private company stock has been eliminated.

Disadvantages

Going public is not necessarily a panacea. Becoming a public company has significant disadvantages as well, some of which include:

- Extensive public disclosure requirements applicable to publicly held companies, which invite scrutiny, may effectively reduce management flexibility and may disadvantage the company by providing valuable information to competitors, suppliers, customers and business partners;
- Significantly increased capital and human resource costs in executing an IPO and subsequently maintaining status as a public company;
- Pressures on management engendered by reporting quarterly and annual financial results and the short-term bias of Wall Street expectations;
- Increased risk of class-action lawsuits and personal liability for directors and officers and the significant cost of obtaining director and officer liability insurance;
- Distraction of management's attention from the business during the IPO process, and afterward during public company life when management must devote substantial effort to comply with laws and regulations, such as those relating to public company corporate governance and disclosures, and investor relations;

- Requirements for certifications by chief executive and chief financial officers as to a variety of accounting, disclosure and internal control over financial reporting issues;
- More complex corporate governance structure and regulations and increased demands on the time and attention of directors;
- Ownership dilution with regard to founders and other current stockholders, which can lessen their control over company affairs;
- Restrictions on sales by insiders arising under Rule 144 and Rule 10b-5 of the Exchange Act, as well the short-swing trading profit rules of Section 16(b) of the Exchange Act, which require that certain officers and directors “disgorge” profits obtained from the purchase and sale of company stock within a six-month period; and
- Risk of hostile takeover bids, which is increased when the insiders’ ownership percentage is decreased by the IPO and large portions of the company’s stock can change hands publicly. (This risk can be mitigated by anti-takeover protections, which we discuss in Chapter 3.)

The decision to go public typically engenders a range of emotions for the leaders and owners of a company—from excitement to anxiety and from enthusiasm about the benefits of going public to concern about the burdens it brings. Being well informed about the process of going public will help the board, management and their advisors channel that excitement and energy into preparation, planning and thoughtful execution—precisely the steps that will ensure a smooth, successful IPO and make the entrance into life as a public company memorable and rewarding.

The Statistics

“On the Rebound”: IPO Filings, Withdrawals and Completions Since the Passage of the Sarbanes-Oxley Act of 2002

The Sarbanes-Oxley Act effectively increased the compliance costs of going public and being a reporting public company. Passed in 2002, it may have helped depress the initial public offering market, with only 87 IPOs completed in 2003. Between 2002 and 2007, riding the coattails of a resurgent economy, the IPO market rebounded strongly, with 282 IPOs completed in 2007. Although far off the banner year 1999 during the bubble, when a stunning 541 IPOs were completed, the trend did signal an IPO market that had returned to stability and strength.

If you file for your IPO, what are the odds that you will complete it? If the totals for the years 2002 through 2007 are any indication, approximately 7 in 10. Does that mean that 30% of attempted initial public offerings fail? Certainly not. Many IPO filings are abandoned for sound, positive business reasons. For example, a company that has filed for an IPO may receive an acquisition offer that is simply too good to pass up. In that situation, the company will typically withdraw its IPO filing in connection with completing its sale to a buyer.

The Statistics***“On the Rebound”: IPO Filings, Withdrawals and Completions
Since the Passage of the Sarbanes-Oxley Act of 2002 (cont’d)***

Year	Initial IPO Filings	IPO Withdraws	IPO Completions
2007	381	68	282
2006	337	60	246
2005	332	57	234
2004	355	48	253
2003	128	35	87
2002	152	26	92
Total	1685	294	1194

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Chapter 2—Picking the Players: Selection of Underwriters and Advisors

An initial public offering requires close collaboration with the underwriters, legal counsel and auditors. Knowing the roles that the underwriters and advisors play and the right questions to ask them will help in choosing the right IPO team.

Top Questions to Ask When Selecting Underwriters

After company management, the underwriters will play the most critical role in the IPO—managing the marketing and sale of the company’s stock to public investors. An IPO typically has one but sometimes two lead underwriters. The lead underwriter or the company may select one or more additional underwriters to co-manage the offering, depending on its size and complexity. The lead underwriter has primary responsibility for and control over the underwriting of the offering, including providing comment on the offering prospectus, running the road show, agreeing with the company on the price per share for the IPO, determining the number of shares that co-managers may sell in the IPO and controlling the allocation of shares among purchasers in the IPO.

Peek at the Process

“Know What You Need to Know”: Factors to Consider in Underwriter Selection

Primary factors to consider when choosing the underwriter are:

- **Track record.** Has the underwriter led other recent, successful IPOs of companies similar in size, stage of development and industry? Has the underwriter recently begun IPO processes for companies that were not completed? Why?
- **Reputation and experience.** Does the underwriter enjoy a strong reputation with investors? Does its experience in the company’s industry enable the underwriter to provide special insights and quality advice and research? Does the underwriter have strong, sustained relationships with investors active in the company’s industry?
- **Commitment to the company.** Aside from reputation and experience, will the underwriter make the company’s offering a priority? What are the offering schedules of other, possibly larger or more valuable, offerings the underwriter is working on?
- **Aftermarket support.** Life as a public company only begins with the IPO. How has the stock price of other companies the underwriter has taken public performed in the months and quarters after the IPO? Is the underwriter willing to make a market or use its own capital after the initial offering distribution to support trading in the company’s stock? Will the underwriter continue to provide advice, introduce the company to potential investors and help interest other analysts in covering the company?
- **Analyst coverage.** While the underwriter is not allowed to promise analyst coverage while securing work on an IPO, does the underwriter have prominent analysts that cover the industry and similarly situated companies? How likely are those analysts to cover the company?

Peek at the Process

“Know What You Need to Know”: Factors to Consider in Underwriter Selection (cont’d)

- Distribution strength. Can the underwriter build a strong syndicate? Does the underwriter have strong distribution capabilities with retail (individual) investors and institutional investors? How effective is its retail sales force and its institutional sales force? Is the underwriter’s reach regional (e.g., only one coast), national or international?

The choice of underwriting firm is important, but perhaps just as important is the team that will actually work on the IPO. Getting the underwriter’s “A” team, and a team that is motivated about the particular IPO, will increase the likelihood of a smooth, orderly and professional offering and a positive reception from investors on the road show.

The underwriter will spend considerable time analyzing how to “position” the company with investors to achieve a successful offering. This marketing task involves more art than science. However, the company should engage in a dialogue with potential underwriter candidates to gauge how well the underwriters understand the company and its industry, and the factors that investors will focus on in deciding whether to invest in the shares at the offered price. For example, discuss with a potential underwriter which companies the underwriter believes are the company’s “comparables.” The discussion will help the company understand the sophistication of the underwriter’s knowledge about the industry and the competition, as well as how keenly it grasps the unique value proposition the company offers the market. Other areas to probe with a potential underwriter include how would the company’s stock pricing compare to the “comparables,” what other recent offerings have occurred in the company’s industry group, what factors drive the pricing of stocks in the industry, and to what extent will pricing of the company’s stock depend on historical earnings, future earnings projections or revenue trends.

The company should seek a potential underwriter’s view of the company’s valuation and related offering price range for the IPO. The analytical rigor and persuasiveness of the underwriter’s response will help the company assess whether the company valuation proffered by the potential underwriter when pitching for the IPO work is likely to hold up during the IPO, or erode after the company becomes well engaged with the underwriter during the IPO process or worse, when the company is on its road show with potential investors. A company should also take with a grain of salt what it perceives as an overly-optimistic valuation offered by a potential underwriter, however flattering. Remember that once the company has publicly filed for the offering there may be pressure to complete the IPO, even if the company valuation slips to a more realistic level, rather than face the unfulfilled expectations and questions that can follow an abandoned IPO.

Practical Tips
“Let Me Ask You This”:
Key Questions to Ask Potential Underwriters

- How have the underwriter’s previous IPOs performed historically? How often does the underwriter price the IPO within the filing range? In general? In the industry? If not, what were the reasons?
- What other firms would the underwriter anticipate adding to the syndicate? Will the underwriter allow co-managers in the syndicate? What does the underwriter think are the advantages and disadvantages of a co-manager?
- What does the underwriter recommend as to the IPO’s timing? Is one part of the year, or one part of the business cycle, better than another? How sensitive will the offering be to a drop in the stock market from current levels? How positive does the company’s earnings trend need to be in order to make the IPO desirable? What financial statements need to be included in the IPO prospectus?
- What would the underwriter recommend for the offering’s size? What should be the minimum number of shares offered in the IPO? Will the underwriter support allowing stockholders to sell shares (so-called “secondary” shares) in the IPO?
- Will any recent hiring of key officers and their lack of track record with the company affect the timing or pricing of the offering? Which officers do the underwriters expect to be involved in the offering process?
- What are the underwriter’s views on whether to list on Nasdaq, NYSE or AMEX?
- What is the expected underwriting discount? Confirm that the underwriters will bear their own expenses (except for blue sky law legal fees) as part of the underwriting discount. Will the underwriter accept suggestions for underwriter’s counsel?
- Does the underwriter suggest marketing the offering to retail (individual) investors, institutional investors or both? Institutional investors may be less likely to hold shares as long as retail customers. Retail purchasers can stabilize the aftermarket of a stock because they tend to hold stock for longer periods of time. However, institutional investors may understand a complex company or technology more readily than retail investors.
- What is the underwriter’s view of the time commitment and cities involved in the road show? Can the underwriter accommodate management’s schedule and time demands?
- Will the underwriter be able to grow with the company after the IPO by handling financings and M&A once the company is public? If the company needs additional capital, would the underwriter support a follow-on offering after the IPO?

A Note About Analyst Coverage

Reforms in the early 2000s sought to address potential conflicts of interest by changing the role a research analyst can play in certain investment banking activities. As a result, underwriters cannot guarantee research coverage to a prospective IPO candidate. The regulations also limit a research analyst’s involvement in an IPO (for example, research analysts cannot attend road shows) and restrict the timing of when research reports can

be published in conjunction with an IPO. Despite the change in regulations, it is still important to determine whether an underwriter has respected analysts with expertise in the company's industry. If the investment bank's research analyst in the industry has a high stature, it reflects well on the investment bank's decision to underwrite a company's IPO, and investors will gain confidence from the fact that the company could receive expert, sophisticated analyst coverage after the offering.

The Statistics

"Lonely at the Top": Lead Underwriters in IPOs

Each IPO has one, and many times two, "lead" underwriters, even if ultimately a number of underwriters participate in the syndication of the offering. The company's primary contacts in the marketing effort are the lead underwriters, who provide input on the prospectus, identify and help the company resolve marketing concerns, and organize the company's road show. In 2007, 61 firms led or co-led an IPO. However, there is a reason "bulge bracket" investment banks make that bracket bulge: the top 10 firms led the vast majority of offerings; 24 firms led or co-led only one IPO.

Lead Underwriter*	Number of IPOs	Percent of IPOs
Merrill Lynch	49	17.40%
Morgan Stanley	49	17.40%
Lehman Brothers	41	14.50%
Citi	40	14.20%
Credit Suisse	36	12.80%
Goldman Sachs	36	12.80%
JPMorgan	32	11.30%
UBS Investment Bank	31	11.00%
Deutsche Bank Securities	23	8.20%
Banc of America Securities	15	5.30%

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*If there is more than one lead underwriter, each will have an IPO listed

The Role of Legal Counsel and Auditors

Sophisticated, experienced legal counsel and auditors round out the key members of the IPO team. Legal counsel should have a strong understanding of the securities laws and the IPO process to guide the company through its offering. Legal counsel handles the preparation of the registration statement, and advises the company on compliance with related disclosure requirements. They will also play a key role in making required filings with the SEC, responding to SEC comments on the filings and resolving issues that the SEC may raise. Equally important, legal counsel should have strong expertise in public company law. This expertise will enable legal counsel to help the company make decisions before and during the IPO that will benefit the company during its public company life. For example, legal counsel will advise the company on the establishment of its corporate governance structure, policies and procedures so that the company can operate effectively

and in compliance with applicable governance laws and regulations after the IPO. Legal counsel with strong public company experience can help the company set legal strategy so that it can continue to build value after the IPO, whether through mergers and acquisitions, additional financings or organic growth.

The company's auditors are also key players on the company's IPO team. The auditors will help the company comply with its disclosure obligations relating to financial statements and other financial information included in the registration statement. The SEC will assign accounting staff to review the company's financial statements and the other financial aspects of the company's disclosure, including the company's accounting methods and policies. The auditors may also serve as a liaison with the SEC's accountants on accounting issues relating to the offering.

The registration process with the SEC will proceed more smoothly if the auditors have the knowledge needed to anticipate and address possible SEC comments on the company's financial statements and related disclosures. Note that the auditor's SEC or "public company" review personnel will do a special review of the financial disclosures in the registration statement before it is filed with the SEC. The company should obtain assurances from its auditors that this review personnel will be available and accessible during the IPO so that the review is timely and does not affect the IPO timeline.

Chapter 3—Building Your Foundation: Public Company Considerations and Requirements

Organizational and Preliminary Matters

Basic Organizational Matters

A company needs to address several organizational and preliminary matters during the run-up to the initial public offering. Some of these matters can be addressed in a straightforward manner, such as whether to increase the amount of stock that can be issued under charter documents; others will require greater analysis and time to resolve, such as the extent of anti-takeover measures to implement before going public. Legal counsel can help the company prioritize and resolve these matters so the IPO stays on time and on track.

A fundamental question is whether, on balance, it makes sense for the company to remain incorporated in its current jurisdiction of incorporation or to reincorporate into another state before going public. Companies may consider reincorporation into Delaware because it has a sophisticated corporate code and a well-developed body of corporate case law, which lend clarity and predictability to how the laws will apply to board and corporate actions. Delaware also boasts the Court of Chancery, a special court dedicated to corporate cases whose judges have strong expertise in adjudicating business law matters. On the other hand, incorporation in Delaware can be expensive—the state levies an annual franchise tax that can be costly compared to maintaining incorporation in many other states, which may have little or no annual franchise tax. For instance, Microsoft reincorporated out of Delaware at least in part because of the cost relative to perceived benefits. In addition, a company may believe it enjoys a sympathetic “home court” advantage in the legal courts of its home state if it is incorporated there, should litigation arise.

Equally important, a company will need to put its legal house in order by analyzing changes it should make to its charter documents (articles or certificate of incorporation and bylaws) so that they suit a public company. The company should complete this task before going public. Prior to the initial public offering, the stockholder base is typically small and stockholder approval is relatively easy to obtain. Stockholders generally will agree to charter amendments when they view them as a stepping stone to going public and achieving liquidity for their shares. After the IPO, obtaining stockholder approval to amend the charter is more costly and time-consuming because it requires a formal proxy statement and solicitation in accordance with SEC regulations, and it may be subject to institutional stockholders’ scrutiny.

In particular, the company should determine whether to amend its certificate of incorporation to increase the overall number of authorized shares, especially of common stock. The certificate of incorporation should have sufficient authorized, unissued shares for the initial public offering, as well as for potential corporate needs after the offering, such as for issuance in future financings, under equity compensation plans or in connection with acquisitions. The underwriters will offer their views on the right number of authorized shares and shares that should be offered in the IPO because they will want the company to implement a capitalization structure that will optimize pricing for the IPO. If the company

has too many or too few shares outstanding, it can do a forward or reverse stock split to right-size the number and help achieve the desired target stock price for the IPO.

In addition to addressing capitalization, the company will need to analyze whether it wants to amend its charter documents to add any protective or anti-takeover provisions. We discuss these provisions in greater detail below under “Good Fences Make Good Neighbors—Anti-Takeover Considerations.”

Practical Tips

“Prelude to an IPO”: 12 Pre-IPO Action Items

Considering an initial public offering and want to get started? Here are 12 steps to prepare your company so it can move swiftly when it ultimately decides to undertake an IPO.

1. **Accounting**—Discuss in detail with your auditors steps that will prepare your financial statements and reporting processes for the IPO and public reporting, including:
 - ◆ ensuring “national” review of the company’s financial statements to assess whether they meet public company standards;
 - ◆ undertaking any review of items of concern (such as option grants) and identifying all significant accounting policy issues; and
 - ◆ assessing whether the company has the staffing to handle the demands of public reporting, including the speed and accuracy required for quarterly and annual reports.
2. **Liquidity Rights**—Review stockholders’ and registration rights agreements to determine whether any current stockholders have a right to sell shares in the IPO, and plan for giving proper notice to those stockholders.
3. **Compensation Arrangements**—Establish or amend director and employee compensation arrangements, particularly equity compensation plans, and plan for repayment and termination of any outstanding executive or director loans.
4. **Board of Directors**—Review the board of directors with an eye toward public company requirements and needs. Does the company’s board have sufficient independent directors and the right mix of skills for the overall board and for board committees? If necessary, begin recruitment of additional independent directors or directors with needed skills and experience. Consider quality and level of director and officer liability insurance (D&O insurance).
5. **Communications**—Discuss with counsel the do’s and don’ts of pre-offering communications and establish an internal and external communications policy. Review the company’s website with counsel and consider changes necessitated by a potential public offering.
6. **Corporate Governance**—Review internal staff and procedures in the context of public company compliance requirements.
7. **Corporate Cleanup**—Review minute books and equity records to identify and resolve any issues.

Practical Tips

“Prelude to an IPO”: 12 Pre-IPO Action Items (cont’d)

8. **Delaware?**—If not incorporated in Delaware, consider whether to reincorporate in Delaware.
9. **Litigation**—Identify and, if beneficial to the IPO, resolve any material outstanding disputes with employees, stockholders, customers or business partners.
10. **Due Diligence**—Prepare for the due diligence process by organizing files, asking counsel for a due diligence request list and appointing due diligence coordinators at the company. Ensure that any material customer or supplier relationships and all material transactions are fully documented.
11. **Confidential Treatment**—Identify material contracts with highly sensitive terms for which the company may want to request confidential treatment when publicly filed with the SEC as part of the IPO registration statement. Identify contracts required to be filed, but that contain confidentiality provisions, and determine how to resolve.
12. **Drafting**—Allocate responsibility for offering process tasks, and identify the company’s point person or persons for the IPO (often the Chief Financial Officer or General Counsel). Begin preparation of an initial draft of the prospectus.

Accounting Issues

Accounting issues often are some of the most complex and time-intensive matters to resolve before a company can go public. The company, the underwriters, counsel and the auditors should identify and resolve accounting issues as early as possible to prevent delays in the initial public offering process.

Heightened Financial Statement Scrutiny. Even if the company has a national firm audit, it should not assume that its financial statements are ready for inclusion in an initial public offering registration statement. The issues and scrutiny applicable to the financial statements change if they are being used for a public company, in part as a result of SEC policies and regulatory requirements that apply to the IPO process. It is common for an auditing firm to require that its SEC specialty group closely review the company’s financial statements before the firm will consent to their inclusion in the company’s IPO registration statement. As a result of this review, past accounting practices may become an issue. For instance, the company’s revenue recognition may be questioned. The company should be ready to explain its revenue recognition methodology and reasoning in the prospectus and to the SEC. In addition, issues then in the public company spotlight or the press, such as recent option back-dating travails, may cause the auditors to spend significant time reviewing, and in some cases re-examining, the company’s past records and procedures. This process can take significant time and may cause changes to the financial disclosure on which the company is relying for a successful offering.

Non-GAAP Disclosure. Rules adopted under both the Securities Act of 1933 (the “Securities Act”) (for registration statements) and the Exchange Act (for ongoing periodic and current reporting) require that the company limit the use of non-GAAP financial measures in its financial reporting. To the extent that the company wants to use any non-GAAP measure, it must (1) be able to justify its use by explaining why the measure is useful to

an investor in understanding the company; (2) provide the most comparable GAAP measure; and (3) reconcile the non-GAAP measure to the most comparable GAAP measure. Other than EBIT or EBITDA, the company may not use non-GAAP financial measures that exclude charges or liabilities requiring cash settlement. Also, while the company may be able to present a non-GAAP financial measure to exclude a nonrecurring or extraordinary expense or gain, it may not attempt to smooth results by excluding recurring expenses.

Cheap Stock. Under Financial Accounting Standards Board Statement of Financial Accounting Standards No. 123(R), companies must calculate the value of each equity compensation award they grant, and recognize this value as an expense on their financial statements. Private companies by definition lack a public trading market to set the fair market value for their stock. In examining the company's financial statements, the SEC may dispute the company's determination of the fair market value used to set the exercise prices of stock options or to determine the value of stock awards. If the SEC concludes, for example, that the exercise prices of certain stock option grants were set below fair market value per share on the grant date, the so-called "cheap stock" problem, the SEC will require that the company record additional compensation expense in its financial statements. While this is a noncash expense, it nonetheless negatively affects the company's financial statements and results and may negatively affect the market price for the company's IPO.

As the date of the initial public offering approaches, the company's stock is likely to be valued higher and higher, so adequately determining and documenting the fair market value of the company's stock within 12 to 18 months of an IPO are important if the company is to avoid having to record additional compensation expense because of a "cheap stock" issue. A company may need to provide the SEC with specific data to support its determination of fair market value that it used in calculating the value for each equity compensation award grant, and the IRS and SEC apply very different standards for scrutinizing these valuations.

409A. A relatively-new equity compensation issue arose from the enactment of Section 409A of the Internal Revenue Code. Congress enacted Section 409A as a revenue-producing provision intended to stop common deferrals of executive compensation by subjecting nonqualified deferred compensation plans to earlier taxation and an additional 20% tax penalty. However, this legislation's broad reach means that many common compensation practices for ordinary employees likewise potentially face earlier taxation and the tax penalty.

Most private companies find that stock options present their most significant area of exposure for Section 409A issues. Under Section 409A, the definition of "nonqualified deferred compensation plan" includes stock options granted with an exercise price that is less than the fair market value of the company's common stock on the grant date. Because private companies have no market for their stock, they face an increased risk that their stock options will be subject to Section 409A because the options may be determined to have been granted with an exercise price below the fair market value on the grant date.

As part of the due diligence process for an initial public offering, companies may be required to demonstrate for each stock option potentially subject to Section 409A that its exercise price was not below the underlying common stock's fair market value on the grant date. If the due diligence process uncovers Section 409A issues, solving them may slow the IPO process.

Auditor Independence. In preparing to go public, the auditors will need to determine their independence from the company in accordance with Sarbanes-Oxley conflict of interest rules. For instance, a company must determine whether its chief executive officer, chief financial officer, chief accounting officer or controller was employed by the company's outside auditors in the year prior to the last audit. Pursuant to Sarbanes-Oxley, such "conflicts of interest" are prohibited for public companies.

Liquidity Rights

Private companies, especially those that are venture- or private equity-backed, often grant registration rights to investors. The company should review the registration or other liquidity rights granted prior to the initial public offering to ensure it gives any required notices to the rightsholder. If any investors are entitled to exercise registration rights and sell stock in the IPO, the company should analyze whether the sales can be accommodated without compromising the success of the IPO. Often, investor registration rights or investor desire for liquidity creates complex timing and relationship issues as the company and underwriters try to determine the appropriate offering size and price range. A company should attempt to manage process and expectations at an early stage.

Equity Compensation Programs

In recent years, equity compensation has become a hot topic for public companies. Once they go public, companies face different considerations affecting how they structure and administer their equity compensation programs.

A key goal for all stock compensation programs is to provide a benefit for employees and an incentive for employee performance that are at least as valuable, if not more valuable, as the expense that the company recognizes in its financial statements with respect to this equity compensation. Both privately held and public companies must expense equity compensation today under SFAS No. 123(R), but this expense typically affects financial results for public companies far more significantly. In addition, public stockholders will scrutinize the value and expense associated with a company's equity compensation programs much more closely than private investors.

Peek at the Process

"The Compensation Foundation": Addressing Compensation Plans Before the IPO

Before going public, companies often adopt a new equity compensation plan that will replace existing equity compensation plans. There are four key reasons.

Increased Flexibility. A company going public often desires to adopt equity compensation plans that have greater flexibility than their current plans. For example, public companies today increasingly use forms of equity compensation other than stock options, such as restricted stock units, to incentivize employees. If a company has an equity incentive plan that is limited to stock options, it may wish to amend it, or adopt a new plan, so that the company has the latitude to grant additional types of equity incentives once it is public.

Avoidance of "Hot Buttons" That May Trigger Institutional Stockholder Opposition. Institutional stockholders and stockholder activist groups often cast a critical and

Peek at the Process

“The Compensation Foundation”: Addressing Compensation Plans Before the IPO (cont’d)

pitiless gaze on a public company’s equity compensation plans. For example, ISS Governance Services analyzes a public company’s compensation plans to determine whether they are structured in a manner that transfers too much stockholder equity from the company to plan participants as awards are granted, and the potential dilution of existing stockholders’ voting power that could result from stock issuances under the plan. A company going public may wish to adopt a new equity plan that meets ISS guidelines and excludes provisions the ISS opposes, for example, a plan provision that permits repricing of “underwater” stock options without stockholder approval. (Conversely, if any of these “hot buttons” are important to a company, it obviously would be easier to have such provisions in the plan before the company goes public rather than ask for stockholder approval of a plan with such provisions after the company goes public.)

Grandfather Protection from Certain Internal Revenue Code Restrictions. Section 162(m) of the Internal Revenue Code limits a public company’s deduction for compensation to the chief executive officer and certain other executives to \$1 million unless such compensation meets the requirements of “performance-based compensation.” Time-vested restricted stock or restricted stock units generally will not meet the requirements of “performance-based compensation.” The requirements of Section 162(m) generally do not apply for at least three years (or until the plan is materially modified) to awards under a plan adopted before a company goes public if the IPO prospectus provides certain descriptive information regarding the plan.

Ease of Adoption. Adopting new plans or amending existing plans is relatively easy before an IPO. For a privately owned company, stockholder approval may not even be required depending on the type of awards to be granted and the company’s governance documents. Even when stockholder approval is required, obtaining stockholder approval for a new equity compensation plan is typically much faster, simpler and less expensive for a privately owned company than for a public company. Private companies typically need to solicit a relatively small number of stockholders to obtain approval. A public company, on the other hand, must solicit a far greater number of stockholders and comply with the extensive federal proxy solicitation rules when obtaining stockholder approval.

Companies going public should also consider whether to offer employees the opportunity to periodically purchase shares of the company’s common stock after the IPO under a tax-qualified employee stock purchase plan (“ESPP”). **ESPPs** typically encourage broad-based employee stock ownership by permitting employees to use some of their cash compensation to purchase shares of the company’s common stock at a modest discount to the fair market value (generally up to a 15% discount). If the ESPP meets design and administration requirements to qualify under Sections 421 and 423 of the Internal Revenue Code, an employee subject to U.S. tax law who satisfies the applicable holding period requirements will receive preferred tax treatment upon sale of the ESPP shares. Frequently, ESPPs are put in place shortly following an IPO.

Good Fences Make Good Neighbors— Anti-Takeover Considerations

Once a company is publicly traded, anyone can acquire ownership of its shares. If a large portion of the company's stock is publicly held (as opposed to held by insiders such as founders), the company is a potential target for a takeover. As part of pre-IPO planning, a company should consider whether it would benefit by adopting various protective or "anti-takeover" protections before going public.

In general, well-designed and carefully considered anti-takeover protections are not designed to prevent a well-financed takeover of a company. Rather, the primary benefit of anti-takeover protections is to give a board of directors sufficient time and negotiating leverage to evaluate the offer, communicate with stockholders and negotiate with a potential buyer to preserve the company's long-term objectives and maximize stockholder value. When potential buyers are forced to negotiate with the company's board, as opposed to acquiring control of shares through open market purchases or tender offers, the result is often greater value received for the stockholders.

A company must describe in its IPO registration statement any structural aspects of the company that may have an anti-takeover effect. Implementing overly restrictive anti-takeover protections may cause stockholders and prospective investors to suspect that the company is unwilling to entertain even advantageous takeovers and is more concerned about entrenching management than maximizing stockholder value.

Rating agencies, such as ISS Governance Services, rate public companies and give them a score called a "corporate governance quotient." One factor in that score is a company's anti-takeover protections. ISS generally views anti-takeover protections as pro-management and anti-stockholder. However, certain protections are more common and less troublesome to ISS than others. For example, ISS generally considers a stockholder rights plan, or "poison pill" (if adopted without stockholder approval), as a more potentially harmful anti-takeover device than an advance notice provision in the company's bylaws, which requires stockholders to comply with certain procedures to bring business before a stockholders' meeting. Many institutional investors rely on ISS's corporate governance guidelines and recommendations for proxy voting. Companies should be aware of, and consider how their policies will affect, their corporate governance quotient. In addition, many institutional investors in the public markets enjoy the short-term returns driven by hostile takeovers. Consequently, anti-takeover protections may hurt the company's relationship with its institutional stockholders and potential investors. For these reasons, a company should take a measured and selective approach to the adoption of anti-takeover measures.

Peek at the Process

“The Recommended List”: ISS Recommendations on Company Proposals

The ISS generally recommends that stockholders vote against public company proxy proposals that may have anti-takeover effects. According to ISS’s 2008 U.S. Proxy Voting Guidelines Summary dated December 17, 2007, ISS generally recommends that stockholders vote:

- Against proposals to classify the board;
- Against proposals to restrict or prohibit stockholder ability to act by written consent;
- Against proposals to restrict or prohibit stockholder ability to call special meetings;
- Against proposals to require a supermajority stockholder vote; and
- For proposals requiring the adoption or redemption of poison pills to be put to a stockholder vote.

Many large institutional stockholders rely on ISS’s recommendations. Companies that expect to have large institutional stockholder bases should consider the ISS’s policy guidelines when deciding what types of anti-takeover protections to adopt.

Common Anti-Takeover Protections

The following are common protections that may have anti-takeover effects for a Delaware corporation:

- **Classified boards**—A board of directors may be classified by dividing the total number of directors into two or three classes, with each class serving a staggered two- or three-year term. If there are three classes, since no more than one-third of the directors can be replaced in any one year, a staggered board can help provide continuity and prevent a hostile acquirer from replacing more than one class within one year through a proxy fight. On the negative side, the adoption of a classified board can complicate board politics and decrease the company’s own flexibility to change its board’s membership.
- **No stockholder action by written consent**—The certificate of incorporation may prohibit stockholder action by written consent. This prohibition has the effect of giving all the stockholders the opportunity to discuss a proposed action at a stockholders’ meeting, and of preventing the holder or holders of a majority of the voting stock of the company from taking preemptive, unilateral action without a meeting.
- **Advance notice bylaws**—A company’s bylaws may provide that stockholders seeking to bring business before, or to nominate directors at, a stockholders’ meeting must provide timely advance notice to the company. The bylaws should also specify certain requirements for a stockholder’s notice to be in proper written form. These provisions are designed to prevent surprises from dissident stockholders at stockholders’ meetings.

- **DE Section 203**—Section 203 of the Delaware General Corporation Law, a business combination statute, limits any investor that acquires 15% or more of a company's voting stock from engaging in certain business combinations with the company for three years following the date it passed the 15% threshold, unless certain conditions are met.
- **Blank check preferred stock**—If a company authorizes “blank check” preferred stock, it empowers the board to create and issue one or more series of preferred stock with the rights and preferences that the board deems appropriate. Having blank check preferred stock, as well as a substantial reserve of authorized but unissued shares of common stock, provides the board with the means to take certain strong anti-takeover actions, such as implementing a stockholder rights plan, issuing a substantial block of shares (for valuable consideration) to a friendly party, reorganizing the company or making a defensive acquisition.
- **Stockholder restrictions on calling special meetings**—The certificate of incorporation may impose conditions on stockholders' ability to call a special stockholders' meeting. For example, the certificate may require that a stockholder request to call a meeting must be made by holders of at least a specified percentage of the outstanding shares (for example, 25%) and that notice of the meeting be given at least 20 days before the meeting date. These conditions save a company from the considerable expense of calling and holding a special stockholders' meeting if only a small stockholder minority desires it. Requiring a specified percentage of outstanding shares to call a special meeting, if high enough, can also help defend against a hostile takeover. If the hostile acquirer does not own enough shares to meet the percentage, it may be required to delay submitting a stockholder proposal or taking control of the board until the next regularly scheduled annual meeting. This delay may give the existing board time to develop appropriate alternative strategies or negotiate with the acquirer for a favorable transaction. Conversely, many states' corporate laws provide that the percentage of stockholders required to call a meeting cannot exceed a maximum percentage specified by state corporate law.
- **Supermajority voting**—A company's certificate of incorporation may require supermajority voting for amendments to the certificate or bylaws. Requiring a supermajority vote of stockholders to approve certain amendments to the certificate and bylaws, also known as “lock-in” provisions, requires a hostile acquirer to control a greater share percentage to amend the certificate and bylaws to eliminate the company's anti-takeover provisions. Supermajority voting requirements, however, reduce a company's flexibility to make favorable changes to its charter documents. As a result, a company may choose to retain a majority-approval requirement for amendments to most of the provisions of the certificate but require a two-thirds or more supermajority approval for any amendment to certain provisions that provide takeover protections, such as provisions for a classified board, the right of stockholders to call special meetings and supermajority voting provisions for business combinations.
- **Poison pill**—A stockholder rights plan, or “poison pill,” can be a powerful anti-takeover device. Its effect is to encourage acquirers to negotiate with the board so the board can seek to obtain the best value for stockholders in the event of an acquisition. Generally, a stockholder rights plan entitles stockholders to purchase common stock of the company at a highly discounted price if a third party acquires a substantial block of the company's common stock, thus severely diluting the third-party acquirer. A company can adopt a stockholder rights plan through

board action at any time, if sufficient authorized, unissued preferred shares or common stock shares are available under the certificate of incorporation for issuance pursuant to the poison pill. Many institutional investors view stockholder rights plans with disfavor. Many companies consequently choose to defer adoption until after the IPO, and adopt it afterward only if special circumstances (e.g., substantial ownership by a dissident stockholder, consolidation in the industry or an undervalued stock price) warrant it. Companies are increasingly seeking stockholder approval or ratification of stockholder rights plans, although it is not generally required.

Corporate Governance, Transparency and Oversight

The collapse of Enron in 2001 and other corporate failures focused public attention on the integrity and quality of disclosures in public companies' annual, quarterly and current reports. Congress mandated reforms to periodic reporting and corporate governance through the Sarbanes-Oxley Act of 2002, and the SEC, New York Stock Exchange (NYSE) and Nasdaq raced to keep pace.

As a result of the reforms, a public company must adopt and adhere to a number of written corporate governance policies and procedures. At the time of or shortly after an initial public offering, depending on which exchange the company lists its stock, a company must have or should at least consider having the following in place, most of which will be required to be accessible on the company's website:

For NYSE listed companies:

- Audit Committee Charter
- Compensation Committee Charter
- Nominating (and Governance) Committee Charter
- Codes of Business Conduct and Ethics
- Corporate Governance Guidelines
- Whistleblower Procedures (although not formally required)
- Insider Trading Policy (although not formally required and usually not posted on website)

For Nasdaq listed companies:

- Audit Committee Charter
- Nominating Committee Charter (if using one)
- Code of Business Conduct that also complies with the SEC Code of Ethics requirements
- Whistleblower Procedures (although not formally required)
- Insider Trading Policy (although not formally required and usually not posted on website)

These items are discussed in detail in Chapter 10, in addition to ongoing, post-IPO governance and compliance matters.

Chapter 4—Focus at the Top: The Board of Directors

Corporate Governance and the Public Company Boardroom

The ultimate responsibility for the oversight of a company's business and affairs rests with the board of directors. The board monitors financial reporting and public disclosure and oversees internal controls and compliance with laws. In addition to making choices about strategic focus and significant policies, the directors set the ethical tone of the business.

Assembling a Public Company Board

A well-assembled public company board will consist of a diverse collection of individuals who bring a variety of complementary skills relevant to the company's business and objectives. In deciding who should be on the board, companies should consider the candidates' financial and business understanding, industry background, public company experience, leadership skills, character and reputation.

The Statistics

“One Size Does Not Fit All”: Board Size and Compensation

There is no “right” board size—it of course depends on many factors, such as the needs of the business and the talents and skills of the individual members—and the board size should be tailored accordingly. Nevertheless, as a company prepares for an IPO, there is usually some anxiety regarding whether its board has the right size and composition for the rigors of public company life. Pre-IPO companies often find themselves seeking to attract new board members and puzzling over what the appropriate kind of compensation would be for an individual signing on to help oversee a soon-to-be public corporation.

In 2007, the median and average number of directors serving on boards of companies completing an IPO was seven, with 54% having six to eight directors. Approximately 17% had boards with nine or more members, 17% with five members and 12% with four or fewer members. Nearly 69% of the independent directors on those boards received compensation, with 53% receiving a combination of cash and equity, 11% cash only and 5% equity only.

Source: www.IPOVitalSigns.com, © 2008 CCH, a Wolters Kluwer Company. Used by permission.

Requirement of a Majority of Independent Directors

NYSE and Nasdaq require that a majority of a public company's directors be “independent” within a relatively short period of time following the company's proposed initial public offering. However, if possible, it is better if the majority of the board is independent at the time of the IPO, because investors may focus on this aspect of a company's governance at the time of the offering.

Independence

A company should determine whether current outside board members meet the definition of “independent” under the applicable rules and identify any new needs regarding board composition. If the company desires to add additional independent board members, it should begin the process of identifying and recruiting them several months in advance of the public offering, or as soon as practicable. Any agreement with a new director may have to be disclosed in the IPO prospectus.

An “independent director” is an individual who can exercise judgment as a director independent of the influence of company management. An independent director will be free from business, family or personal relationships that might interfere with the director’s independence. Many institutional investors suggest that a “substantial” majority of a company’s directors be independent.

NYSE and Nasdaq establish a number of relationships that will disqualify a director from being independent. For example, each of the following may disqualify a director under NYSE and Nasdaq independence standards: previous employment relationships, receipt of compensation over \$100,000 (other than for board service), certain relationships with the company’s auditor, significant business relationships between the listed company and another entity where the director serves as an executive officer or significant stockholder and certain interlocking directorships.

Key Board Committees

A strong committee system is the hallmark of an effectively functioning board. Sarbanes-Oxley, NYSE and Nasdaq standards and SEC rules prescribe the existence, composition and many of the activities of three core committees: the Audit, Compensation and Nominating & Governance committees.

All public companies will have an Audit Committee. NYSE requires, and Nasdaq suggests, a Compensation Committee comprised of independent directors. NYSE requires a Nominating & Governance Committee, while Nasdaq requires either a Nominating & Governance Committee or that independent directors meet in executive session to deal with director nominations. Prior to going public, the company should form each of these committees and draft its respective charter.

With the corporate scandals of Enron and WorldCom, the importance of clear, accurate financial reporting and of having an Audit Committee comprised of independent directors came to the forefront. As a result of the Sarbanes-Oxley Act, a public company’s Audit Committee generally must be composed at least three individuals and entirely of “independent” directors who may not receive any consulting, advisory, or other compensatory fees from the company, other than board or committee fees, or be an “affiliated person” of the company or its subsidiaries. In addition, Audit Committee members must be able to read and understand financial statements, and the public company must disclose in its annual reports whether at least one member is a “financial expert” (and if not, why not). The company will also need to establish an Audit Committee charter that complies with the SEC rules and the listing standards of the exchanges. Chapter 10 discusses in more detail the committee requirements.

Coming Aboard: A Director's Guide to Deciding Whether to Serve on the Board of Directors

You've been asked to join a board of directors of a company preparing for its initial public offering? Congratulations! But wait—aren't there some downsides that might go with this honor? What are they? And how do you distinguish between a board that you'd like to join and one that it would be better to avoid? This section describes why to stop, look and listen before accepting a board seat and includes a practical set of questions to ask that will help lead you to the right decision.

The Big Picture

The best way to ensure that you'll be an effective director is to join a board of directors that is already doing a highly effective job of leadership. A recent study suggests that only half of all boards are highly effective. The other half are either adequate or negative performers. In getting past the prestige associated with being asked to serve, a potential board member can ask questions that will enable him or her to make sure that this is an effective board that he or she would be excited to serve on.

A thorough inquiry into the company can include:

- Interviews with management, other board members, and industry and community contacts who would be able to help triangulate the company's reputation and culture;
- A review of available information about the company;
- A direct conversation about the "tone at the top"; and
- An exploration of the company's culture of compliance with laws and with its own ethical code.

So How Do I Decide if This Is the Right Board for Me?

Most public company boards, even when offering above-average compensation, will call upon a director for a significant investment of time—and a responsible director will make a greater investment in time and risk than he or she can be repaid for. In making this investment decision, a director candidate may consider five categories of information (discussed in more detail below):

- **Industry.** Is this the right industry for me? Do I have something to add? To learn?
- **Company.** Within the industry, is this the right company?
- **Stockholders.** Can I learn the nature of, and am I comfortable with, the stockholder base of this company?
- **Colleagues.** Am I comfortable with the board and the way that it conducts its business?
- **Skill.** Can I, together with the skills and the personality that I bring to the table, make an appropriate contribution to this board?

Industry. When considering whether to join a board, a potential director either will have significant experience in the industry or will launch him- or herself into what would be a new or relatively unknown industry and then become an expert on that industry in a short period of time. Before deciding to devote a significant part of his or her professional life, a potential director should consider the following three ways to learn enough about the industry:

Coming Aboard: A Director's Guide to Deciding Whether to Serve on the Board of Directors (cont'd)

- Ask the company for industry analyses written by any nationally known consulting firms;
- Ask one of the major consulting firms, as a courtesy to you, to arrange a 1- to 2-hour meeting or call with a consultant within the industry who could help you understand the key drivers in the industry; and
- Read the earnings announcements (and SEC reports) and listen to earnings conference calls of public companies in the industry.

In doing this, a director candidate can also become better at assessing the company and its role in the industry—in much the same way one would become familiar with a sector before closing an investment, or a neighborhood before deciding on the selection of a home.

The Company. When asking questions about the company, the main goal of the director candidate is to be able to make an appropriate assessment—without being overwhelmed by data. Key information for assessing a company includes:

- **Its Financial Statements.** Read the company's financial reports, then have a direct conversation with the company's chief financial officer and controller. This is the most rapid way to understand the company's financial position. You should also consider asking for an interview by phone or in person with the company's outside audit partner.
- **Its Strategy.** Understand—and be able to articulate—the company's strategy. A key role of the board will be to understand the strategy and ensure that the CEO is the right person to fulfill that strategy. Consider trying to recite the strategy aloud after reading the company's material. Then sit down with the CEO and repeat it to see where you have it right and where wrong.
- **Its Risks.** Make inquiries regarding the company's internal policies and procedures. Does the company have the right internal policies and procedures to identify the principal risks to the company? What have been the issues that have risen to the top through that system? How does the company address them?

Stockholders. Stockholder lawsuits are the source of virtually all board liability. So before joining the board, a director should consider: Just who are these stockholders? Is the company a first-generation start-up owned principally by the venture capital firms organizing the initial public offering? Do they expect to be the major stockholders after the offering? Is the company a more mature company, owned as a portfolio company of private equity funds, likely to have a strong institutional stockholder base soon after the public offering? Is the company a lightning rod for the attention of nonstockholder constituencies, such as environmental, safety, union or other groups? If so, these groups could, as stockholders after an IPO, have a keen interest in the work of the board in the future.

Colleagues—The Board. After becoming comfortable with the industry, knowledgeable about the company and aware of its stockholder base, the next step is to focus on whether the board is well-functioning. This focus should be on the board's makeup and the processes by which it makes its decisions. Is there a diversity of experience, backgrounds, skills or areas of competence, and industry expertise? Who chooses the directors? The majority of the board after the IPO should be truly independent, which means

Coming Aboard: A Director's Guide to Deciding Whether to Serve on the Board of Directors (cont'd)

being selected not by the CEO but by an independent nominating committee. What will the new director's role be? Does the board have a robust decision-making process? Have the board chair and CEO come from backgrounds where their boards have had a history of robust and active independent discussion and an active oversight role? The board should be involved in such matters as strategic planning and the regular review of the CEO's performance, as well as the business of the board, such as approving an operating and capital budget and overseeing issues that touch on strategy.

Time and Skill. Finally, the director candidate needs to frankly assess his or her own willingness to make the time commitment, level of interest in the business of the company and relevant skills.

- **Time.** Think of board service on a public company board as being equivalent to 1/10th to 1/5th of your professional time. It could be as little as 1/10th for a well-functioning board with no major surprises. But for a chair of a critical board committee, such as the Audit Committee, or for someone who needs to participate in a special committee during major changes in the corporation, the board could easily take up 1/5th of your time over the course of a year.
- **Interest.** Is this company in this industry going to grab your attention enough to motivate you to devote a serious part of your professional life to it for the next several years?
- **Skills.** Why exactly are you being asked to join the board? Is it for your prestige or skill base? What are the needs of the board? Is there enough overlap with what you view as your true skills?

Take the Ethics Temperature

One topic that a strong board chair and CEO will welcome is a discussion of ethics at the company. The board is ultimately accountable for the selection of the CEO, and the board and CEO are jointly responsible for setting a "tone at the top" that helps protect against corruption and impropriety at a company. The systems that a board oversees (compensation incentives, a culture of hierarchy or open communication, etc.) can impact the ability of the organization to identify misconduct and address it promptly. A strong whistleblower program—under the oversight of the Audit Committee—will enable staff members throughout the organization to feel that they can communicate ethical concerns.

How can a potential director do more than take the CEO's word at face value? After all, what CEO will not respond "of course" to the question, "Do you have a good ethical tone"? This can be a new director's first effort to dig below the surface to understand the ethical tone of the organization. A potential director can speak to the head of the internal audit, or to the Compliance Officer, and ask questions, including:

- "Can you help me understand the company's approach to ethics on a practical, day-to-day level—not a broad, philosophical level?"
- "How exactly do you communicate ethical imperatives to your staff, and can you summarize how you hear them from senior management?"
- "Who, quite specifically, is responsible for ethics at the company?" (Don't take "everyone" as a satisfactory answer) "Is it an HR function? The chief compliance officer?"

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- “Can you tell me—if you had an ethical concern this afternoon, to whom and how you would report it? Would you feel confident that when you went home tonight there would be no retaliation or negative implication of your report?”
- “Can you think of any examples in which ethical integrity has been rewarded at the company? Or examples of it being penalized—either explicitly or more subtly, through lack of advancement?”

Considering Board Membership? A Baker's Dozen Questions

“Thank you, but I've got some questions!” Here is a quick checklist to use for that first lunch or interview when you are invited to sit on a board.

The Industry

1. Where does this company fit into the industry? Is it a leader? An up-and-coming member? A pioneer of a new industry sector?
2. Is there a description of the company and its place in the industry that the company's investment bankers or one of the major consulting firms or other industry analysts have provided on the company?

The Company

3. What are the two or three most critical issues facing this company today?
4. What is the company's strategy today—and how has that changed over the last two years? What are the top three most significant strategic issues for the company, and how do you see those impacting the company's strategy over the next 3 years?
5. What is the financial state of the company? What are its financial controls, procedures for developing accounting procedures, the strength of its chief accounting officer and chief financial officer, and internal control functions (including internal audit)? Does this provide you with a sense of confidence that the company has policies and procedures in place to identify its principal business and financial risks? In what circumstances have these issues in these areas been brought before the board of directors in the past several years?

Stockholders

6. What is the principal makeup of the stockholders now, and how do you expect that to change over the next 18 months as the company expands its stockholder base? Do any of these stockholders have a representative—formal or by way of understanding or suggestion—on the board? If so, how will that change with the IPO?

Considering Board Membership? A Baker's Dozen Questions (cont'd)

The Board

7. What is the role of nonmanagement directors? Is the chair an independent director, or if not, does the board have a lead independent director? Who chairs the Audit Committee? Who are the Audit Committee financial experts? Who currently chairs each committee or serves core functions on each of the committees?
8. What is the role of the CEO on the board? Is the CEO going to be open to divergent or new opinions? Are the CEO and the more experienced members likely to be listeners?
9. What is the procedure for selecting directors? Is the procedure managed by the Nominating & Governance Committee or principally by the CEO or an inside chair? Can I get bios for each director and information on who is considered independent?
10. What is the procedure for oversight? What issues with respect to noncompliance with law or policy or procedure have come up in the past and how have they been handled by the Audit Committee or the board?
11. What are the liability protections? Does the company have exculpation provisions, director and officer liability insurance, or director indemnification agreements? Can you send me a summary? (As you review this information, analyze your own personal D&O or umbrella policy and consider how that will fit with the company's D&O insurance.)

Your Skills and Fit

12. Why am I being asked to serve on the board? What particular skills or experience do you think I bring that would improve the board, and how do those complement the other directors? How much time are board members spending on board or committee activities? What committees would I be expected to serve on, and what role would I be expected to play?
13. What is the compensation? Is it in shares or in cash? Is it commensurate to the time that a director dedicates? What are the stock ownership guidelines?

Rules of the Road—Legal Responsibilities

Basic Board Duties

The cornerstones of a director's responsibilities are to act in good faith, to carefully fulfill the director's duty to be loyal to the company and to comply with the duty of care under applicable state law. To protect directors who have fulfilled the duty of care and the duty of loyalty, state corporate laws and corporate charter documents provide for indemnification and exculpation. In addition, most companies have director and officer liability insurance.

Under most state laws, corporate directors primarily perform an oversight role. These laws typically provide, in one form or another, that all corporate powers be exercised by or under the authority of, and the business and affairs of the corporation be managed under the direction of, its board of directors.

The principal duties of care and loyalty when overseeing the management of the company mean:

- **The Duty of Care.** This is the duty to exercise “due care” in managing the business and affairs of the corporation. This means that directors need to inform themselves of information related to their decisions—and seek input from management or outside advisors as appropriate in making those decisions. Directors also need to develop procedures for board decision-making and oversee the procedures of the company. Procedures at the board level will help to ensure that the board has appropriate opportunities to consider and deliberate on all relevant, material information. By overseeing operating procedures, the board also ensures that the affairs of the company are being appropriately managed.
- **The Duty of Loyalty.** The duty of loyalty requires directors to act—without exception – in what would reasonably be believed to be in the best interest of the corporation and its stockholders. When a conflict of interest does arise, the board needs to implement mechanisms, such as recusing interested directors or delegating the decisions to a special committee made up solely of noninterested directors, to ensure that the transaction or other decision is considered in a way that allows the board to make a decision in full compliance with its duty of loyalty to the best interests of the company.

In general, as long as the directors act in good faith, comply with the duty of due care, and avoid any conflicts of interest or self-dealing, a board’s decisions will be subject to the “business judgment rule.” The business judgment rule is a principle that courts will respect the decisions of boards unless the decision has no “rational purpose.” This rule is designed to protect directors from judicial second-guessing, as long as they have gone about their decision-making process in an appropriate way. If those decisions were properly made, they are not second-guessed by the courts, even if they turn out to be bad decisions.

Securities Law Duties (and Liability) of Directors in Connection With an Initial Public Offering

Directors and officers incur responsibilities under the federal securities laws with respect to the registration statement for the initial public offering that the company prepares and files with the SEC. The Securities Act imposes a high standard of care on a company’s directors and officers with respect to the accuracy and adequacy of the disclosures in the registration statement. Even a future director who, with consent, is named in the registration statement as being, or about to become, a director is as responsible as the current directors for the accuracy of the disclosure in the offering prospectus and overall registration statement.

Directors and officers may be liable for losses suffered by purchasers in the IPO if the registration statement contains material misstatements or omissions. The losses are generally measured as the difference between the price at which the securities were sold and the price on the day the suit is filed, regardless of whether the price subsequently recovers. The potential liability of directors and officers for losses is without regard to bad conduct. The purchaser does not have to establish that a director or officer had an intent to deceive, manipulate or defraud; even innocent misstatements or omissions may be sufficient to establish liability.

As a result, the company's directors and officers must take care to ensure that the registration statement is accurate and contains without omission all material information relevant to making an informed investment decision. Information is material if there is a substantial likelihood that its disclosure would be viewed by a reasonable investor as having significantly altered the total mix of information made available, and if there is a substantial likelihood that a reasonable investor would consider the information important in making an informed investment decision.

A director or officer can defend against liability for material misstatements or omissions only if the director or officer is able to prove that (a) with respect to the financial statements, the director or officer did not believe, and had no reason to believe, that the financial statements were incomplete or misleading or (b) with respect to the rest of the registration statement, after a reasonable investigation, the director or officer had reasonable grounds to believe, and actually did believe, that the registration statement was not misleading and contained all material information necessary for an informed investment decision.

"Reasonable investigation" and "reasonable grounds for belief" are determined from the standpoint of a prudent individual acting in the management of his or her own property. The extent of a director's or officer's duty to investigate depends on the facts and circumstances of a particular situation (and sometimes the vagaries of a particular court). At a minimum, however, each director or officer must read the registration statement carefully for accuracy and completeness and question the company's officers regarding any material matters that he or she believes may not be described accurately and fully. In addition, he or she must insist that any material misstatements or omissions be corrected. Most fundamentally, a director should take steps, whether by talking with management, the company's legal counsel and outside auditors, or otherwise, to ensure the company is doing thorough "due diligence" to confirm that the registration statement contains completely truthful statements and does not suffer from omissions that might make the disclosure in the registration statement misleading.

Although the company's charter documents likely provide for indemnification of directors and officers in certain circumstances, the SEC takes the position that it violates public policy for an issuer to indemnify directors and officers against liabilities arising under the Securities Act. In Part II of the registration statement, the company is required to undertake that, unless the director or officer successfully defends against any suit for which indemnification is sought or there is controlling precedent in favor of the director or officer, the company will submit to an appropriate court the question of whether such an indemnification is against public policy and will be governed by the final adjudication of the issue. Accordingly, it is possible that directors and officers may not be able to rely on the company's indemnification provisions with respect to violations of federal securities laws. However, the imposition of these limitations on director and officer indemnification and reimbursement is rare because lawsuits involving a claim of Securities Act violations are often resolved, either in pretrial motions or through settlement, before a final adjudication of liability on that claim.

Indemnification of Directors and Officers and D&O Liability Insurance

Prior to the IPO, the company should ensure that appropriate indemnification provisions are in place for directors and officers, either in the charter documents or pursuant to contractual agreements, or both. Additionally, virtually every company purchases insurance prior to its initial public offering to cover liabilities arising from certain directors' and officers' actions on behalf of the company. D&O coverage for an IPO is expensive but should be demanded by any person asked to serve on a public company board. D&O insurance provides a potential source of reimbursement to the company for indemnification payments it makes to its directors and officers and can provide coverage to directors and officers directly. D&O insurance serves directors and officers by reducing their exposure to personal liability from potential gaps in the availability of indemnification, and in situations, such as insolvency, where the company cannot adequately indemnify its directors and officers. Most D&O policies include "entity" coverage, which also insures the company directly for its liability on certain defined claims, though this coverage may dilute available coverage for directors and officers because any insurance reimbursements will be applied toward the overall insurance policy limits. All D&O policies have coverage limits.

Practical Tips

"Know the ABC's of Director and Officer Liability Insurance Coverage"

Side A, Side B and Side C coverage and what on earth each of them means:

- Side A coverage—the most important—covers directors and officers if the company can't indemnify them because of either legal prohibitions or cost.
- Side B coverage—covers directors and officers indirectly by reimbursing a company for settlements where the company indemnifies the directors and officers. This coverage can be viewed more as a financing device rather than true insurance.
- Side C coverage—sometimes called "entity" coverage—covers the company for claims made against it.

Directors should consider the effect of Side C coverage because Side C coverage provides direct coverage for the company with respect to claims against it. This means that when it comes to defense costs (which are always part of the policy limits in D&O policies) and limits available to pay a judgment or settlement, there is a greater risk of insufficiency to cover claims against all of these insureds because of the addition of another insured. If there is Side C coverage, a director should seek information as to whether the policy limits are adequate to assure protection for the directors and officers if the company cannot or will not provide indemnification. There are a number of ways to deal with this issue. One is to increase policy limits for Sides A, B and C. Another is to include an "order of payments" provision which requires that in the event of insufficiency, Side A claims are paid first. A third approach is to have a separate Side A excess policy which will have "drop down" coverage that will provide Side A coverage whether or not the Side A coverage in the main D&O policy is fully paid out.

Chapter 5—The IPO and the IPO Process

The company has decided go public, management is interviewing potential underwriters and the company is methodically working through pre-IPO considerations and action steps to get ready. But ready for what? What exactly is involved in the process of taking a company from being privately owned by its founders, investors and/or employees to being a company with a public trading market for its stock?

In a nutshell, the IPO process entails the company working with its underwriters and advisors—primarily company counsel, underwriters’ counsel and the company’s auditors—to:

- prepare a prospectus used for marketing the offering;
- conduct due diligence;
- file the prospectus and related registration statement with the SEC;
- respond to and satisfy the SEC’s comments to the registration statement;
- market the offering on a “road show” to potential investors;
- list the stock on a stock exchange;
- have the SEC declare the registration statement “effective”; and
- price and then close the sale of company stock in the initial public offering.

This chapter provides an overview of the registration process, the due diligence process, the registration statement and disclosure requirements and stock exchange listing.

During the process, a company must comply with the Securities Act, the Exchange Act and the applicable stock exchange rules. At the same time, the underwriters’ involvement with the IPO must comply with the rules of the Financial Industry Regulatory Authority (“FINRA”) (formerly, the National Association of Securities Dealers, or “NASD”).

Overview of the Registration Process— the Pre-Filing Period, the Waiting Period, Effectiveness and the Post-Effective Period

The IPO process centers on the registration of the company’s stock offering with the SEC. The registration process involves three stages: (1) the “pre-filing period”—the period prior to the initial filing of the registration statement with the SEC; (2) the “waiting period”—the period between the initial filing and the date that the SEC declares the registration statement “effective”; and (3) the “post-effective period”—the period in which the stock can actually be sold to the public.

The Pre-Filing Period

The pre-filing period is the most time intensive (outside of the time management spends on the road show) and the most sensitive to premature public disclosure. During the pre-filing period, the company decides to proceed with an IPO, selects the underwriters, holds an “organizational meeting” (described in more detail in Chapter 7), facilitates due diligence

and drafts the registration statement. The pre-filing period is also called the “quiet period,” because improper public disclosures concerning the company or the offering prior to filing the registration statement with the SEC could jeopardize the IPO. Chapter 6 provides guidance on this and other publicity and communication by the company.

After the organizational meeting, where the working group—the company, the underwriters, counsel for the company and underwriters, and the auditors—first meet as a group, the working group meets regularly over a period of time (typically between four and six weeks) to draft the registration statement. These drafting sessions culminate in the filing of the registration statement with the SEC.

The Statistics

“Beat the Clock?”: Time in Registration

It’s natural to be optimistic when targeting an offering date and considering how long it will take to work through the SEC review process once the registration statement is filed with the SEC. In many cases, the optimism is warranted, but sometimes it is wishful thinking. For domestic IPOs completed in 2007, it took on average 160 days from filing the initial registration statement with the SEC to completing the offering, with a very wide range in the number of days for each IPO. The shortest time to completion was 38 days, and the longest 820 days. Both of these cases probably involved unusual circumstances. So where does the average IPO fit in this range? Only four of 220 domestic IPOs were completed in less than 60 days, but 51, or 23%, were completed in less than 90 days. However, 48% of the IPOs took longer than 120 days. Bear in mind that this does not include the time necessary to prepare the registration statement before it is filed with the SEC. A registration statement is more likely to pass through the SEC comment process quickly if it is filed after it has been carefully prepared and well-drafted, rather than filed prematurely.

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The Waiting Period

Once the registration statement is filed with the SEC, the waiting period begins, and, as the name implies, the company waits for the SEC to review and comment on the registration statement. After completing its initial review, the SEC delivers a “comment letter” to the company outlining questions and issues concerning the registration statement. Among other things, the letter addresses the registration statement’s compliance with the Securities Act, certain aspects of the disclosure and accounting matters. The working group typically prepares and files one or more amendments to the registration statement and one or more written “comment letter responses” to the SEC and works with the SEC to address and resolve the issues. During the waiting period, the company and the underwriters also organize the marketing efforts, including the road show presentation, for the offering. The company also continues responding to due diligence questions from the underwriters’ counsel and preparing itself for life as a public company. Near the end of the SEC review process, the company and underwriters will go on the road to market the offering to potential investors. Later in this chapter, we provide an “Offering Roadmap” to give an overview of the timing of the SEC review process and the initial public offering stages.

Effectiveness and the Post-Effective Period

After the end of the road show, during which time the underwriters have solicited interest in the offering, the company requests that the SEC declare the registration statement effective so that its sales can be made pursuant to the registration statement. If all issues have been resolved, the SEC will declare the registration statement effective. Afterward, on the day effectiveness is declared, the underwriters and the company hold a pricing call where the underwriters recommend to the company the price at which the underwriters will purchase the stock from the company for resale to the public. Prior to or during the formal pricing call, the underwriters, to different degrees, provide the company with indications of the investors' interest and other relevant market data indicating the appropriate price range for the company's stock to ensure a successful offering. On the pricing call, a committee of the board, the Pricing Committee, formally approves the price at which the stock will be sold to the underwriters for resale to the public, usually giving significant consideration to the underwriters' recommendation. After the pricing call, the underwriting agreement is executed and, either that night or before the market opens the following day, a press release announcing the terms of the offering is issued. The next day the underwriters sell the company's stock to investors and trading in the company's stock begins. Chapter 9 provides a Pricing Schedule that highlights in more detail the concluding events to a successful IPO.

After the IPO, the company must comply with various governance and compliance requirements (whether from the SEC, NYSE or Nasdaq) and the reporting and other regulatory requirements of the Exchange Act. During the IPO process, the company will make arrangements in order to comply with these requirements, some of which must be met at the time of initial filing of the registration statement and others at the time the company goes public. Chapter 10 provides a more detailed discussion of these governance and compliance requirements, as well as the reporting and regulatory requirements.

Possible Dangers of Recent Private Placement

An issue can arise when a private offering occurs in close proximity to the filing of a registration statement for an IPO. The good news is that under the Securities Act a company can privately sell its stock to raise that last round of capital required to get the company to the IPO stage. The bad news is that the SEC may "integrate" the private placement, which would otherwise be exempt from SEC registration, with the IPO. Integration means that the two offerings are treated as one issuance, destroying the private placement's exemption from registration and subjecting the company to liability in connection with the private placement for violation of the disclosure and other legal requirements under the Securities Act.

Avoiding integration is essential if the company wants to conduct a private placement prior to or during registration of its initial public offering. There are two ways to avoid integration. First, the company may utilize a statutorily defined safe-harbor provision. Second, the company can structure the two offerings as two distinguishable separate plans of financing, and, therefore, not integrated.

Rule 502 under the Securities Act provides that exempt private offerings under Regulation D (the most often used exemption for private offerings) completed more than six months prior to the IPO will not be integrated with the IPO. In addition, if a company begins a private offering but abandons it to pursue an IPO, Rule 155 under the Securities

Act can provide a statutory safe harbor to preserve the legality of the IPO under certain conditions. Under Rule 155, a private offering will not be integrated with a later IPO if:

- no securities were sold in the private offering;
- the company and persons acting on its behalf end all of the private offering activity before filing the registration statement for the IPO;
- the preliminary and final prospectuses for the IPO include certain information about the abandoned private offering; and
- the IPO registration statement is not filed until at least 30 days after the end of the offering activity in the private offering, unless the private placement securities were offered only to accredited investors (or persons reasonably believed to be accredited investors) or persons who satisfy certain knowledge and experience standards under Rule 506 of Regulation D.

If a statutory safe harbor is unavailable, the determination as to whether separate offers and sales are part of the same offering and, therefore, integrated, will be a question of fact that depends on the particular circumstances of each case. The SEC has listed five questions that it would use to determine whether two ostensibly separate offerings should be integrated and treated as a single offering: (1) Are the offerings part of a single plan of financing? (2) Do the offerings involve issuance of the same class of securities? (3) Are the offerings made at or about the same time? (4) Is the same type of consideration to be received? (5) Are the offerings made for the same general purpose? Although the five-factor test provided by the SEC offers guidance on the integration issue, the factors are not exclusive and do not offer any “bright line” rules to resolve the issue. Each determination will turn on the unique facts and circumstances surrounding the offerings.

The nonexclusivity of the five factors is highlighted by the SEC’s position in *Black Box, Inc.*, where the SEC held that a private offering conducted subsequent to the filing of a registration statement would not be integrated with a public offering. Instead of citing one of the five factors to support its conclusion, the SEC appears to have based its determination on the nature and number of the offerees involved in the private placement.

If a company has recently issued securities prior to an IPO, or anticipates issuing securities during the IPO process but not as part of the IPO, the company should contact its legal counsel for advice. The “Black Box” analysis and determination concerning how the private offering can be structured to avoid integration takes time and should not be treated casually.

Trap for the Unwary *Stock Option Compliance—The Google Case*

Stock options are not just a form of employee compensation—they are securities, and the issuance of stock options and of common stock on exercise of the options are securities offerings regulated by federal and state law. The Exchange Act may require a company to register with the SEC if it has at least 500 option holders and over \$10 million in assets, even if the company’s stock or options are not publicly-traded. Sometimes a company inadvertently exceeds these thresholds, requiring SEC registration and causing it

Trap for the Unwary

Stock Option Compliance—The Google Case (cont'd)

to become a public company through the “trap door.” In addition, a company must either register the issuance of stock options and stock underlying the options under federal and state securities laws, or have an exemption from registration.

Google, like many start-ups, granted options to its employees when it was private. According to its SEC filings, at the end of 2003, Google had over \$870 million in assets and in excess of 500 option holders (as of March 31, 2004, Google had 1,900 employees all of whom purportedly owned Google equity).

Not only did Google not timely register its stock options with the SEC as was necessary because it had over 500 option holders and substantial assets, it also failed to comply with the requirements for an exemption from federal or state registration for the issuance of its stock options and the common stock underlying the options. Even after Google offered to allow its employees to rescind the issuances, the SEC and the State of California took enforcement action against Google, causing Google and its general counsel to accept a cease and desist order and settle civil claims by the State of California. In addition, the SEC made clear that company officers and counsel should report to the board noncompliance with the securities laws in connection with the option plan. These stock option travails were a time-consuming, unwelcome distraction from what was Google’s otherwise famously successful IPO.

Learn and Tell: Fundamentals of Due Diligence and Disclosure

Due Diligence: Getting a Head Start

Due diligence is vital to an initial public offering, even if unglamorous and painstaking. In the due diligence process, the underwriters, the company and their respective counsel carefully review information and background materials regarding the company. Due diligence takes many forms including listening to formal management presentations, asking numerous questions of management during prospectus “drafting sessions” to understand the company and ensure it is accurately portrayed, and examining a large volume of written materials about the company. The company compiles the written materials, usually in response to an extensive due diligence request list.

Broadly, due diligence assists in determining and verifying the information required to be disclosed in the registration statement for the IPO. Practically, due diligence achieves three main goals. First, it allows the company to ensure it accurately discloses the information technically required to be disclosed in the registration statement and helps the company to avoid material misstatements or misleading omissions in the registration statement for which it (and its officers and directors) could be liable. Second, it provides the underwriters a “due diligence defense” to liability under the securities laws. Underwriters can incur liability for material misstatements and omissions in the registration statement but can maintain a defense to liability if the underwriters establish that, after a reasonable investigation, they have reasonable grounds to believe the statements in the registration statement were true and there were no material omissions. The underwriters establish this defense through the due diligence process. Third, satisfactory due diligence is necessary

for counsel to render a required written statement to the underwriters at the closing of the offering to the effect that counsel is not aware of any material misstatement or omission in the registration statement or prospectus.

The underwriters' due diligence request list is usually very broad and covers the company's charter documents and corporate records, including option records; stockholder information; board minutes and records; information about ongoing or recent litigation or investigations; all permits and related citations; a wide range of personnel information; real and intellectual property documentation; finance and tax information and material agreements. Counsel will provide a detailed checklist of the due diligence materials required. The list should be coordinated between company and underwriters' counsel. Generally, one person at the company is the designated due diligence contact. Compiling the due diligence materials in an organized manner will enable the working group to draft the registration statement in a more efficient manner and will also reveal early on any issues that need to be resolved for a smooth, successful IPO.

Practical Tips *Electronic Data Room*

Electronic data rooms can help you manage the logistics of compiling due diligence documentation and responding to due diligence requests. Organizing paper due diligence files takes a significant amount of time. Delivering copies of due diligence documents and tracking what has been provided, and to whom, can quickly become complex. Electronic or "virtual" data rooms are hosted websites that provide secure access, via an online portal, to hundreds or thousands of documents in an organized, easy-to-navigate manner. Electronic data rooms have become popular in merger and acquisition transactions and can be an efficient means to handle the requests and keep control of the IPO due diligence process. For instance, an electronic data room provides a clear index and record of the documents being provided during due diligence and allows for easy access and viewing simultaneously by multiple parties 24 hours a day, avoiding the need to copy and distribute multiple copies of the same document. Automated alerts notify potential document reviewers each time a new document is added to the data room. Reviewers can post questions in the data room, within the documents, and the company can post answers online. In addition, the data room has tools to automatically track which documents have been reviewed, by whom, and at what time, so the company can gain insight into the document reviewers' area of focus or concern.

D&O Questionnaire

Any person buying part of a company would want to know quite a bit about the company's leaders and key owners. It is no surprise, then, that the federal securities laws require that detailed information about the directors, officers and major stockholders of the company be disclosed in the IPO registration statement. This information includes share ownership, compensation, biographical information and participation in certain transactions with the company. As part of the due diligence process, each director, officer and major stockholder completes and signs a relatively extensive questionnaire, referred to as the "D&O questionnaire," to elicit this information. In addition, each director, officer and major stockholder answers questions regarding affiliation with FINRA. Underwriters must supply FINRA with certain information about company insiders as part of obtaining FINRA approval of the compensation the underwriters will receive in connection with the offering.

Backing Up the Disclosure

As the IPO prospectus is drafted, underwriters' counsel will ask the company to provide documentation that supports the factual assertions in the prospectus. For instance, if a company states that it is the leading provider of a product, the company will have to provide written factual support for that claim. The SEC may also ask the company for this type of support. For organization, underwriters' counsel should provide a "circle-up" of all of the statements and items in the registration statement that the company is expected to back up. The company should respond with documentation that is organized and keyed to the request. This process and support is separate from financial information covered by a comfort letter from the company's auditors, discussed below.

Getting Comfort From the Auditors

As part of due diligence, the underwriters request "comfort" from the company's auditors regarding the financial data in the registration statement. The auditors respond by rendering a "comfort letter" to the underwriters on the date the registration statement becomes effective and the offering is "priced." The auditors issue a bring-down comfort letter several days later at the closing of the offering.

The comfort letter includes statements concerning the company's audit, compliance of the financial statements included in the registration statement with the securities law requirements, negative assurance regarding changes in financial results during interim periods, negative assurance as to pro forma adjustments (if pro forma financial statements are included in the registration statement), statements concerning the procedures performed by the auditors and confirmation of each item of financial data in the registration statement.

What is actually included in the letter depends on the underwriters' counsel's request and what information the auditors can document. The auditors will not necessarily give comfort on every number in the registration statement, because the nature of the company's internal accounting controls and records affect the auditors' ability to provide comfort on certain numbers. Generally, the auditors will give comfort on financial data that tie to the books and records of the company. However, what the auditors are willing or able to comfort can be a significant issue. By the same token, the underwriters will not likely tolerate a prospectus that contains financial data for which the underwriters do not obtain sufficient backup or due diligence, such as that contained in a comfort letter. Accordingly, underwriters' counsel and the auditors should communicate early in the process and identify any areas of concern that may need resolution. Also, the underwriters will require SAS 71 review of any interim financial statement included in the prospectus.

Underwriters' "Business" Due Diligence

Beyond a review of corporate documents, the underwriters will need to engage in "ground level" due diligence to understand the company's business. Underwriters typically want to visit significant facilities, participate in operational tours and speak with major suppliers and customers. The underwriters also spend significant time examining and assessing the company's financial results and projections with management to grasp the story behind the numbers and its implications for the offering. The underwriters will also conduct a due diligence call with the company's auditors outside the presence of management to obtain an independent view on the company's audit and accounting processes.

Practical Tips

“Winning the Paper Chase”: Preparing for Due Diligence

Preparing ahead for due diligence decreases the disruption caused by an IPO and increases management’s ability to “stick to business” during the offering. Here are some simple steps to prepare:

- Ask counsel for a detailed due diligence request list early in the IPO process.
- Designate one person at the company to be the point person for due diligence; make sure each business unit will be responsive to the point person.
- Organize documents gathered in response in a manner consistent with the request list, correlate the response to the numbered items on the request list.
- Consider winning the paper chase by eliminating the paper. Instead of organizing due diligence documents in paper form in boxes, set up an electronic data room, which maximizes the efficiency and effectiveness of due diligence review. (See “Practical Tips—Electronic Data Rooms” on page 38).
- Control the flow of documents and keep an organized record of responses and documents provided.
- Anticipate the recipient’s additional requests or questions by setting aside time to provide supplemental information.
- Obtain, organize and provide supporting documentation for factual assertions in the prospectus.
- Be patient—the due diligence process is tedious but underlies the integrity of the initial public offering.

Disclosure—Drafting, Filing and SEC Review

Full and fair disclosure of material information, enabling an investor to make an informed choice whether to invest in a company, is the bedrock legal principle underpinning the regulation of the U.S. securities markets. The same is true of the initial public offering process. The offering prospectus is drafted with great care and receives intense attention because it is the primary disclosure document in the IPO.

The offering prospectus is part of the registration statement and contains a detailed description of the company and its business. It serves multiple purposes. The underwriters and the company use the preliminary prospectus, as it is called until near the end of the process, to market the offering to potential investors. The underwriters will also base the initial investor presentations for the road show on the disclosure in the preliminary prospectus, and the road show presentation must be consistent with the preliminary prospectus. Although the company tells its “story” in the preliminary prospectus, it is also the disclosure document that disgruntled investors may base a securities law claim on if it contains inaccuracies or suffers from misleading omissions.

The company files with the SEC a complete registration statement, which includes the preliminary prospectus but excludes a limited set of information relating to the final offering price per share for the IPO. Typically, the majority of the SEC’s comments on the registration statement will concern aspects of the disclosure in the prospectus.

Drafting the prospectus and the registration statement takes a tremendous and patient effort from the working group, as well as various parties whose input may be required to make the disclosure accurate and complete. Company counsel and management typically collaborate on the first draft of the registration statement during the weeks leading up to the first drafting session of the IPO working group and distribute it in advance of the first working group meeting so that members have an opportunity to read, analyze and formulate a response to it. The IPO working group (management, underwriters and counsel) then meets in drafting sessions to discuss, and provide comments to, the draft registration statement. The drafting sessions are usually held weekly in the beginning and then more often toward the end of the process as the time for filing of the initial registration statement with the SEC approaches. Revising the registration statement involves a substantial time commitment from the working group, who must frequently negotiate language to reconcile the sometimes countervailing goals of accurate, balanced disclosure (legal protection) and wording that will enable the underwriters to successfully convey the company's compelling attributes to potential investors (marketing).

Once the drafting process is complete, the company files the registration statement with the SEC. The SEC reviews the business, legal, accounting and other aspects of the registration statement to determine if it complies with the applicable disclosure requirements set forth in federal securities laws and regulations. The SEC provides initial written comments to the company approximately 30 days after receiving the registration statement. The working group then discusses proposed responses to the comments and prepares a comment response letter. The registration statement and prospectus typically are amended and re-filed to update information and reflect the changes required in response to the SEC's comments. This comment and comment response process may go through several iterations before the SEC is satisfied that its concerns have been met.

Once the revisions are complete, the company is in a position to print copies of the preliminary prospectus contained in the registration statement for use in the marketing road show with potential investors. When the road show concludes, the company asks the SEC to declare the registration statement "effective" and the underwriters and the company agree on a price at which the company's stock will be sold to the public. The company adds the pricing information and any other necessary updates to the prospectus (including any changes that may have resulted from the actual offering price varying from the anticipated price set forth in the preliminary prospectus). The resulting document is the final prospectus that the company files with the SEC.

Peek at the Process

"From Pen to Paper to IPO Proceeds": An Offering Roadmap

The following outline identifies key steps from the initial drafting of the registration statement through the IPO closing, along with some time estimates (the actual time for these steps can vary widely). The outline below is a summary; a multitude of additional steps must be completed in an IPO. Company counsel should provide a thorough, detailed time and responsibility list, setting forth the actions required and parties responsible for their completion from the start to the finish of the process. (See "Appendix 2: Sample Time and Responsibility Schedule for an IPO.")

1. Draft registration statement, including the preliminary prospectus that describes the company's business (four to six weeks, meeting at least weekly).

Peek at the Process

“From Pen to Paper to IPO Proceeds”: An Offering Roadmap (cont’d)

2. File the registration statement with the SEC.
3. Receive written comments to the registration statement from the SEC (approximately 30 days after filing).
4. Respond to the SEC comments through a letter to the SEC and by revising, where appropriate, the disclosure in the registration statement (5 to 15 days).
5. File the comment response letter with the SEC, with an amendment to the registration statement containing the disclosure that has been revised in response to SEC comments.
6. Receive written comments to the amended registration statement and response letter from the SEC (approximately 5 to 10 days, depending on the initial SEC comments, the company’s response and how many filings of other companies the SEC is concurrently responding to).
7. Respond to the SEC’s second round of comments through a written response letter and a second amendment to the registration statement (3 to 7 days).
8. File the second amendment and response letter.
9. Complete any additional rounds of comments and responses that may occur depending on the type and number of comments and the level of issues raised by the SEC. Frequently, at this stage, more open dialogue with the SEC by phone occurs to resolve comments without continuing rounds of amended disclosure and written responses.
10. With resolution of major SEC comments, print the preliminary prospectus and launch the road show.
11. At the end of the road show, ask the SEC to declare the registration statement effective. Establish the price of the company’s stock to the public and finalize and file the final prospectus with the SEC.
12. Stock begins trading the day after pricing.
13. Close the IPO (4 trading days after the day of pricing, 3 days after the stock begins trading).

Source of Disclosure Requirements—Form S-1, Regulation S-K and Rule 10b-5

For most initial public offerings, the company files its registration statement on Form S-1. For most nonfinancial disclosure items, Form S-1 refers to the substance of disclosure called for by Regulation S-K. For financial-related disclosure items, including the financial statements to be included in the registration statement, Form S-1 refers to the substance of financial disclosure called for by Regulation S-X. In sum, Form S-1, Regulation S-K and Regulation S-X are the regulations that set forth in detail the items of disclosure to be included in the IPO registration statement. But a company’s disclosure obligations don’t begin and end there—the disclosure in the registration statement must comply with the basic antifraud tenets of the federal securities laws. These tenets, embodied in Section 10(b) of the Exchange Act and related Rule 10b-5 and certain other sections of the Securities Act and rules of the SEC, establish liability for material misstatements and mislead-

ing omissions in the registration statement. While not dictating any particular disclosure content, the potential liability for material misstatements or misleading omissions is an overarching driver of the quality and content of the information presented in the IPO offering prospectus.

Breaking Down the Registration Statement and Prospectus

The first part of an IPO registration statement on Form S-1 is the prospectus, which discusses the company's business and financial condition. The second part of the registration statement on Form S-1 and the exhibits contain additional information that is not required to be included in the printed prospectus but is publicly available. The additional information includes details concerning indemnification for securities law liability, expenses of the offering, recent company sales of unregistered securities and certain undertakings by the company required by the SEC.

The "glossy" prospectus will be distributed to potential investors as the primary basis upon which investors will decide whether to buy stock in the IPO. Here is an overview of the main sections of the prospectus.

Prospectus Summary

Near the start of the prospectus is the prospectus summary, also known as the "box" due to the border that typically surrounds this section. The prospectus summary includes a condensed description of the company and its business, the company's key strategies, financial information and basic information about the offering. Many underwriters consider the summary the most important section of the prospectus because it is the first (and sometimes the only) part of the prospectus potential investors read to determine their interest in the company. Consequently, the company, the underwriters and counsel often labor intensively over the summary's content and wording to convey accurately the key company information an investor would find important to its investment decision.

Risk Factors

Immediately following the prospectus summary are risk factors that identify the company's key risks and challenges, and key risks of an investment in the company. This section describes risks specific and unique to the company, as well as risks relating to the company's industry. Carefully drafted risk factors give investors a full picture of the investment profile of a company and can offer the company protection if its stock price declines and stockholders sue alleging that they were not provided with adequate information about the challenges facing the company and its industry. The SEC frowns upon "boilerplate" risk factors; rather risk factors should be tailored to the company's particular circumstances. While some companies bristle at inclusion of risk factors, or the breadth of the factors covered, investors are used to seeing them as part of an offering prospectus, and the benefits risk factors provide in the event of stockholder litigation typically significantly outweigh concerns over the effect they may have on marketing the IPO.

Although tempting, a company should not disclose a risk factor on the one hand and then seek to minimize it on the other hand by including so-called "mitigating" language. For example, in a risk factor about a pending patent infringement lawsuit against the company, mitigating language would be a statement declaring that the company expects to prevail or expects that damages awarded will be immaterial. Mitigating language effectively undercuts the benefit of including the risk factor in the first place and may draw a comment from the SEC in its review of the registration statement.

Breaking Down the Registration Statement and Prospectus (cont'd)

Selected Financial Data

The prospectus contains a table of selected financial data, which generally includes five fiscal years of income statement and balance sheet data, along with data for the latest interim period and the corresponding comparative period from the prior fiscal year. Frequently, the table will require an explanatory introduction and footnotes.

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

In the "MD&A," management provides a discussion of its financial results over its most recent three fiscal years and any interim period. In addition, management discusses its financial position, including its cash flows and liquidity. The financial result comparison is presented as a narrative comparison of the changes in results on a year-over-year (or period-over-period) basis, typically on a major line item basis. MD&A is meant to allow investors to look at the company's financial results through management's eyes—in other words, to help investors understand not just the "numbers," but what management thinks are the causes underlying the company's financial results. MD&A thus focuses on factors underlying changes in results, and known trends, commitments and uncertainties that may reasonably likely have a material effect on the company's financial condition or results. An important goal of the MD&A is to provide potential investors with an ability to analyze whether past performance is indicative of future performance. For instance, if a major portion of revenue comes from a customer that will not repeat the business in the succeeding financial period, that fact should be discussed.

Business

The business section provides a complete picture of the company, frequently including an industry overview, a summary of the business generally and details on the company's products and services, customers and customer relationships, facilities, marketing strategies, intellectual property, research and development and personnel. The business section should present a balanced view of the company. Recall that a prospectus cannot contain any material misstatements or misleading omissions.

Management

The "management" section of the prospectus provides biographical information about each of the executive officers and directors. This section also provides substantial information about executive compensation and benefits and transactions with the company. Recently, the SEC began requiring inclusion of a "compensation discussion and analysis," which focuses on the material principles underlying the company's executive compensation policies and decisions and the most important factors relevant to analysis of those policies and decisions. The "compensation discussion and analysis" section provides investors material information necessary to understand the company's compensation policies and decisions regarding its executive officers.

Other Information

In addition to the sections of the prospectus highlighted above, the company will have to provide significant information about the company and the offering, including information related to the use of proceeds, major stockholders, related party transactions, dilution, underwriting arrangements and the company's capital, among others.

Breaking Down the Registration Statement and Prospectus (cont'd)

Financial Statements

The prospectus requires audited financial statements that include three years of income statements and two years of balance sheets, accompanied by the audit report. The company will also have to include unaudited financial statements for any interim financial period required to be included in the registration statement. The financial statements must meet the requirements of GAAP and Regulation S-X. If the company is required to present pro forma information, pro forma financial statements may also be required. Each time the company files with the SEC a registration statement or an amendment to it containing the auditor's report, the company must obtain the auditors' consent to the filing. The auditor's consent is filed as an exhibit to the registration statement.

Graphics

Frequently, the underwriters will want to include "artwork" inside the front, and sometimes back, cover of the glossy prospectus. Typically, this takes the form of pictures or drawings, with the goal of illustrating the company's products, services or facilities.

Regulation G: Beware of the Use of Non-GAAP-Based Financial Disclosure in the Registration Statement

During the late 1990s, the use of non-GAAP financial disclosure in securities disclosure documents became increasingly prevalent. The SEC became concerned that the use of such non-GAAP financial measures, while supposedly used to provide more meaningful disclosure, was often resulting in inconsistent, confusing or misleading financial disclosure and financial metrics. The SEC adopted Regulation G in response. Regulation G requires primarily uniform, GAAP-based disclosure of financial results and forecasts in securities filings, including IPO registration statements. In those situations where Regulation G permits the use of non-GAAP financial information, it requires additional disclosure to help make that information understandable and meaningful. For example, if permissible non-GAAP disclosure of financial information is included in a registration statement, it must also include:

- a presentation of the most directly comparable GAAP measure as prominently as the non-GAAP measure;
- an understandable reconciliation of the non-GAAP measure to the most comparable GAAP measure;
- an explanation of why management believes the non-GAAP measure provides useful information to investors; and
- any additional purposes, if material, for which management may use the non-GAAP financial measure.

Exhibits and Confidential Treatment

SEC rules require the company to file certain documents as exhibits to the registration statement, including the company's certificate of incorporation and bylaws, the underwriting agreement, opinions related to the offering, certain debt instruments and "material" contracts.

What constitutes a material contract under the SEC rules is not necessarily intuitive. Determining whether a contract must be filed with the registration statement turns on whether it is made in the ordinary course of business. Contracts made in the ordinary course of business are generally defined as those which ordinarily accompany the kind of business conducted by the company.

Any contract made outside the ordinary course of business that is material must be filed as an exhibit to the registration statement. In this context, the term “material” may refer to either the dollar amount involved or to any other factor that makes the contract a significant one for the company.

If a contract is one made in the ordinary course of business, it does not have to be filed with the registration statement, except in certain situations. The following categories of contracts must be filed, even if made in the “ordinary course,” unless they are immaterial in amount or significance:

- Contracts to which a director, officer, security holder named in the registration statement or underwriter is a party;
- Contracts on which the company is substantially dependent;
- Contracts involving the acquisition or sale of any property, plant or equipment for consideration exceeding 15% of the company’s fixed assets; and
- Material leases that relate to part of the property described in the registration statement.

In addition, the following management contracts or compensatory arrangements must be filed as exhibits:

- Management contracts or compensatory plans, contracts or arrangements in which any directors or any of the principal executive officer, principal financial officer or three other most highly compensated executive officers participate—unless the compensatory plan, contract or arrangement by its terms is available to all employees, officers or directors and does not discriminate between management and nonmanagement positions regarding allocation of benefits;
- Any other management contract or other compensatory plan, contract or arrangement in which any other executive officer participates unless immaterial in amount or significance; and
- Any compensatory plan, contract or arrangement adopted without stockholder approval that provides for the award of equity or equity rights, such as stock options, unless immaterial in amount or significance.

Any contract filed as an exhibit to the registration statement will be publicly available. However, public disclosure of some information in contracts, particularly competitively sensitive commercial or financial information, could hurt the company. Examples of information that raise concerns for companies include pricing terms, technical specifications or milestone payments contained in material contracts. To address this problem, the SEC will permit confidential treatment to be granted to narrowly tailored parts of material contracts. As the company identifies contracts that must be filed as exhibits, it should consider whether to request the SEC to grant confidential treatment to any portions of the contracts.

A company's request for confidential treatment must set forth its analysis as to why confidential treatment should be granted. The SEC typically only grants confidential treatment on a narrow basis, so a company should specify as narrowly as possible the portions of the contract for which it seeks confidential treatment. The SEC will not grant confidential treatment simply because the company must get consent of the counterparty to disclose a contract's terms publicly. Obtaining confidential treatment can be time consuming, so the company should file its confidential treatment request at the time that it initially files its registration statement or soon in the process after the initial filing. A complete contract will need to be submitted to the SEC in addition to a version redacting the information for which confidentiality is sought. If confidential treatment is granted for a contract, the company must refile a confidential request on the contract every three years to maintain confidentiality.

Third-Party Consents

Third-party consents may be required in connection with filing the registration statement. For example, if the company must file a material contract as an exhibit to the registration statement, and the contract contains confidentiality provisions, the company may need the other party to the contract to consent to its filing.

Consent is also required for the use of any expert's name in the registration statement. This would include the company's auditors with respect to the audit opinion included in the registration statement. It may also include industry experts who provided information or data included in the registration statement.

Listing on the Exchange

One critical component of the IPO is the exchange listing process. Having the company's stock listed on an exchange such as the NYSE or one of the Nasdaq markets creates a (hopefully) liquid market in the company's stock. Choosing the market on which the company will list its stock will depend on a number of factors, and companies should consult with their underwriters and counsel to determine which market is the best fit. A company will also have to determine whether it can satisfy the listing requirements of the exchange on which it wants to list. Appendix 3 sets forth a summary of the initial listing requirements for each of the NYSE, the Nasdaq Global Select Market, the Nasdaq Global Market and the Nasdaq Capital Market. Additionally, on a going-forward basis, the exchange rules subject listed companies to extensive corporate governance requirements, which we discuss in greater detail in Chapter 10.

Exchange Act Registration

During the IPO effort, most of the document preparation focuses on the registration statement on Form S-1, which registers the initial offering of common stock to the public under the Securities Act. However, in order for the stock to be traded on an exchange from and after the IPO, the company must also file a registration under the Exchange Act to register the class of security to be listed on the exchange. Registration under the Exchange Act is accomplished by filing a short registration statement on Form 8-A. This form is relatively simple for a company concurrently registering for an IPO. Form 8-A requires disclosure of general characteristics of the company's securities being listed, including dividend rights and voting rights, and any anti-takeover provisions in the company's charter documents.

Chapter 6—Publicity and Communications

Many companies embarking on an initial public offering are surprised to learn that the federal securities laws place limitations on the kinds of publicity and communications the company may engage in leading up to, during and after the IPO. A company needs to continue business, after all, and most companies need to engage in publicity, marketing and communications to promote their products and services, reach customers and generate sales. In tension with this practical goal is the desire of the SEC to regulate the information provided to potential investors to generate interest in the company's public offering. Recently, the SEC reformed certain of its regulations governing communications during an IPO to help decrease some of the tension between a company's need to communicate information for business purposes and the SEC's regulation of information provided to investors.

The federal securities laws regulate the kind of information a company may use to offer stock in its initial public offering and the manner in which the company may provide the information. To ensure that the company conveys information about the IPO primarily through a written prospectus meeting federal disclosure requirements, the SEC closely regulates the kinds of communications a company may make leading up to the filing of its registration statement, between the filing and the time the registration statement is declared effective, and after effectiveness. Consequently, the types of communication a company conducting an IPO may make will vary at different stages of the IPO process. In 2005, the SEC adopted the Securities Offering Reform rules, which clarified, and in some cases significantly changed, the communications permitted during the IPO process.

The Pre-Filing Period—Don't Jump the Gun

During the pre-filing period of the IPO, a company may not make a written or oral offer to sell, or solicit an offer to buy, its securities. The "pre-filing period" is the period after the company becomes "in registration" and before the company has filed its registration statement. There is no bright line as to when a company first becomes "in registration" but, at latest, a company is in registration once it reaches an understanding with a managing underwriter to lead its public offering.

A company's publicity or other business communications can inadvertently constitute a prohibited written or oral offer of its stock during the pre-filing period. The reason is that the SEC has broadly interpreted what constitutes a written or oral "offer" to include communications that "condition the public mind or arouse public interest in particular securities." For example, company-generated publicity touting the company could be viewed as conditioning the market to be receptive to its stock in the IPO. As a result, the SEC could view company-generated publicity during the pre-filing period as an illegal "offer" prior to the filing of the registration statement, a problem known as "gun-jumping." The recent Securities Offering Reform, however, has created a number of safe harbors that help clarify what kinds of business communications before and during an IPO would not be considered illegal "gun-jumping."

Rule 163A provides a safe harbor with respect to company communications more than 30 days before the filing of the registration statement. Company communications made more than 30 days prior to the filing of a registration statement will not violate the gun-jumping provisions of the Securities Act, if (1) the communication does not refer to a

securities offering that will be covered by a registration statement, (2) the communication is made by or on behalf of the company going public, and (3) the company takes reasonable steps within its control to prevent redistribution or republication of the communication during the 30 days before filing the registration statement.

The first two requirements are straightforward, but what does it mean for a company to take “reasonable steps within its control” to prevent dissemination of the communication during the 30-day pre-filing period? There is no recipe for what actions would constitute reasonable steps, but the SEC did offer some helpful guidance in a few areas:

Website information. Is a company required to remove all its website information 30 days before filing to avoid gun-jumping? The SEC does not expect a pre-IPO company to necessarily remove information from its website, so long as the information is appropriately dated, otherwise identified as historical material and not referred to in the offering activities.

Timing of Publication of Interviews. While the SEC does not expect a company to be able to control the republication or accessing of press releases that were issued before the 30-day pre-filing period, it does expect the company to control its own involvement in communications that may be distributed or published during the 30-day period. For example, the SEC has made it clear that a company that gives an interview to the press prior to the 30-day period cannot rely on the Rule 163A safe harbor if it is published during the 30-day period.

Practical Tips

“Caution on Communication”: Keeping Pre-Filing Communications Safe

To make use of the Rule 163A safe harbor on permissible communications more than 30 days prior to filing a registration statement, develop a process with the company’s internal and external communications team several months before the IPO. Appoint a communications “czar,” an employee who will oversee the company’s communications practices. The communications czar should ensure that leading up to the IPO the company has authorized all press releases or other corporate communications. This practice will help satisfy the Rule 163A requirement that communications are made “by or on behalf” of the company.

If the company or its representatives give media interviews before the 30-day pre-filing period, the company should take reasonable steps to prevent republication of that interview during the 30-day pre-filing period. For example, the company could enter into a written agreement with the news or media company not to publish or disseminate the interview during the period that the company reasonably believes will include the 30-day pre-filing period. Make sure that the period covered by the agreement is long enough—sometimes market conditions can cause a company to delay its registration statement filing at the last moment.

Ongoing Communication of “Factual Business Information”

A company needs the flexibility to make ordinary business communications, such as announcing new products or corporate developments, during the 30 days prior to filing and the entire IPO process without constantly being concerned that the communications might constitute market-conditioning rising to the level of an illegal securities “offer.” Rule 169 provides a safe harbor for ongoing communications “by or on behalf of an issuer” of “factual business information” intended for use by persons receiving the information other than in their capacity as investors or potential investors, such as clients, customers or suppliers. “By or on behalf of an issuer” means that the company, or an agent or representative of the company (other than offering participants like underwriters), authorizes or approves the release of the information. “Factual business information” means:

- Factual information about the company, its business or financial developments or other aspects of its business, and
- Advertisements, or other information, about the company’s products or services.

To rely on the safe harbor, the company must satisfy a few additional conditions:

- The company must have previously regularly released this type of factual business information in the ordinary course of business.
- The timing, manner and form in which the information is released must be consistent in material respects with similar past releases.
- The company must intend that the information be used by persons, such as customers and suppliers, not acting in an investor capacity.
- The information must be released by the company’s employees or agents who have historically released such information.

Peek at the Process *Regularly Released Requirement*

There is no minimum time period to satisfy the “regularly released” condition, but the company must have some “track record” of releasing the particular type of information at issue, which can include only once previously. The SEC does warn that releasing a new type of financial information or projection just before or during the offering will likely not pass muster. By the same token, if a company regularly releases information on a periodic basis, such as news about product releases each quarter, it would likely fail to meet this condition if it accelerated the release of such information to a weekly basis on the cusp of its initial public offering. But the SEC has made it clear that the “regularly released” requirement does not apply solely to regularly scheduled releases of information but can include episodic communications, such as product advertising, if the issuer has previously provided such communications in that manner.

There are two important exceptions to the safe harbor of Rule 169. First, it does not apply to information about the IPO, or information released as part of the offering activities in the IPO. For example, while the safe harbor may be available for issuance of a press release consistent with past practice, it would not cover the distribution of that press release as part of the marketing activities to potential investors in the IPO. Second, the safe harbor does not apply to forward-looking information.

Practical Tip
Create a “Track Record”

Don’t wait until the last minute to establish a practice of regularly releasing business information. If a company is contemplating an IPO, it should establish a regular pattern and manner of releasing important business information, such as corporate developments or product updates. If the company waits until shortly before the IPO to do so, it will be difficult to establish that it has regularly released the information and consequently will cast doubt on whether dissemination of these types of information during the IPO process should enjoy the protection of the Rule 169 safe harbor.

Post-Filing—Written Offering-Related Communications

Prior to the Securities Offering Reform, a company had three ways to communicate matters relating to the IPO after filing the registration statement and before the SEC declared it effective (the so-called “waiting period”): (1) the “red-herring” preliminary prospectus (so-named for the red legend printed on the cover of the prospectus stating that offers cannot be accepted until the registration statement is effective), (2) a press release or tombstone advertisement that provided very limited information identifying the offering pursuant to Rule 134 of the Securities Act, and (3) road show meetings with potential investors. Recent reforms relaxed the restrictions on written offering-related communications that can be made after the registration statement is filed in two ways. The first is incremental—expansion of the types of information permitted to be included in a press release or similar publications under Rule 134. The second is more radical—the permitted use of “free-writing prospectuses.”

Press Releases and Other Offering Notices

A press release has typically been used by companies to publicly announce the IPO after the registration statement is filed, and to tell potential investors from whom a prospectus can be obtained. Rule 134 substantially limits the information a company may include in the release. As a result of the reforms, however, the release may now include more information about the company and its business, the mechanics and anticipated schedule of the IPO, procedures for account opening and for submitting indications of interest and conditional offers to buy the offered securities, and procedures for directed share plans and other participation in the IPO by officers, directors and employees. This notice may be in the form of a press release, an email or a website posting.

Free-Writing Prospectus

The changes regarding the use of “free-writing prospectuses” ushered in by the Securities Offering Reform rules are significant for IPOs. Prior to the reforms, once a company filed a registration statement, only one kind of written offer of the stock was permitted—a prospectus meeting the requirements of the statute (typically the preliminary prospectus). The reform rules allow a new kind of written offer to be used post-filing—the free-writing prospectus.

A free-writing prospectus is any written or graphic communication, other than a statutory prospectus, that constitutes an offer to sell, or a solicitation of an offer to buy, securities that are the subject of a registration statement. The term “written communication” is broadly defined to include communication that is written, printed or broadcast on television or radio. Graphic communications include communications via any form of electronic media, such as emails, websites, audio tapes, video tapes, faxes and CD-ROMS.

An IPO company or an underwriter may use a free-writing prospectus only after the registration statement has been filed, and it must be accompanied or preceded by the most recent statutory prospectus containing a price range. For a free-writing prospectus in electronic form, such as an email, the company can satisfy the requirement to accompany it with the statutory prospectus by including a hyperlink in the email that links to the most recent statutory prospectus. A free-writing prospectus may contain information not included in the registration statement, so long as the information does not conflict with anything in the registration statement. Free-writing prospectuses are offers and are therefore subject to liability for material misstatements or material misleading omissions if the person making the offer through the free-writing prospectus cannot sustain a due diligence defense.

A company undertaking an initial public offering is generally required to file with the SEC, on or before the date it is first used,

- A free-writing prospectus prepared by or on behalf of the company, or used or referred to by the company;
- Material information about the company or its securities that has been provided by or on behalf of the company and that is included in a free-writing prospectus prepared by or on behalf of, or used by, any other IPO participant, such as an underwriter; and
- Any part of a free-writing prospectus that describes the IPO’s final terms or the stock offered.

An underwriter is generally required to file a free-writing prospectus if the underwriter distributes it in a manner reasonably designed to lead to broad, unrestricted dissemination, such as posting the free-writing prospectus on an unrestricted website. By contrast, no filing is required if an underwriter posts the free-writing prospectus to a website with access restricted to its customers, or includes it in an email by the underwriter to its customers, regardless of the number of customers.

Updating Website and Consistency With Disclosure

Many companies now use their websites to communicate general business, marketing and financial information to customers, the general public and potential investors. A company might also use its website to supply information from third parties, either by publishing the information on its website or by hyperlinking to the third party's site. Because all online disclosures must comply with federal and state securities laws, they pose legal risks for the company. The SEC has made it clear that information available on a corporate website constitutes a "written communication" subject to the SEC's antifraud rules.

Trap for the Unwary

"Keep it Clean": Scrubbing the Website to Avoid Gun-Jumping

Although a company may think it acceptable to promote itself and laud corporate developments on its website, the SEC may view website content as an "offer," a "general solicitation" or even as a "nonconforming prospectus." As a result, a company planning for an IPO should take precautions regarding its online disclosure:

- Carefully review the company website and any information on third-party websites to which it hyperlinks.
- Work with counsel to understand the SEC's strict rules regarding what kind of information may be disseminated when and to whom, which depend in part on the nature of the content and the timing of its availability before, during and after the registration process.
- "Scrub" the website before an offering to possibly remove company or product hype, links to third-party sites and other nonverifiable information.
- Avoid establishing a new website, or launching a new image campaign, immediately before or during the registration period. The SEC may view such efforts as an attempt to condition the public to be receptive to the IPO and therefore as an illegal "offer" before or during the IPO.
- Use the website in a manner consistent with the company's past practice, for ordinary-course corporate communications (including press releases).
- Do not mention website addresses in the prospectus other than as a statement of fact.
- Limit references, if any, to an offering according to the "tombstone" and related rules of the SEC.

Chapter 7—Kick-off: The Organizational Meeting

Prepare, Prepare, Prepare: The Strategic Advantage of the Over-Prepared Issuer

Once the company has selected the managing underwriters for the offering and wants to begin the IPO process in earnest, the company and managing underwriters will schedule an organizational meeting with management, the underwriters, counsel and possibly the auditors. The meeting's purpose is to discuss the offering process and economics, the proposed offering schedule, allocation of responsibilities and any potential issues that may be encountered during the offering process. Company management typically gives presentations at the meeting to educate the working group on the company's business, history and industry. In addition to the business overview, the group will discuss a number of "house-keeping" matters such as due diligence issues. An organizational meeting typically lasts from a half to a full day. The underwriters customarily provide an agenda, working group list and basic offering timeline.

The company and its counsel should prepare for the organizational meeting due to the breadth and depth of information presented and discussed. The meeting should be organized and efficient. It will set the tone for a well-coordinated, thoughtful and business-like approach to the IPO, which will help the company conduct an IPO that proceeds effectively and on time.

Agenda for the Organizational Meeting

The underwriters and company should tailor the agenda for an organizational meeting to the particular circumstances of the company and the initial public offering contemplated. Below are some common items on an organizational meeting agenda:

1. Introduction

- Introductions of company management team and its legal counsel and auditors, and the underwriting group and its legal counsel

2. Structure of offering

- Size of offering, including amount, primary and secondary shares, and the over-allotment option (a/k/a the "Green Shoe" option)
- Number of shares outstanding and overhang (i.e., shares that will be issuable pursuant to the exercise of options and warrants after completion of offering)
- Recapitalization of company (e.g., stock split or reverse stock split) that might be required prior to offering
- Anticipated use of proceeds
- Selling stockholders, if any
- Lockup agreements

- Distribution objectives and syndication (institutional and retail; domestic and international; directed share program)
- Selection of listing exchange
- Directed share “friends and family” program for employees or others

3. Timetable for offering

- Drafting and due diligence
- Availability of audited and interim financial statements
- Target filing date for S-1
- Road show schedule and coverage (e.g., U.S. only, or U.S. and Europe)
- Target offering and closing date
- Potential timing conflicts

4. Accounting and financial issues

- Presentation of financial statements
- Accounting issues, including any cheap stock charges
- Tax issues

5. Legal, regulatory and disclosure issues

- Pending or anticipated material transactions, including mergers and acquisitions
- Outstanding legal issues, such as current litigation and labor relations
- Anticipated FINRA or blue sky problems and desirability of pre-filing conference with the SEC, blue sky authorities and/or FINRA
- Regulatory issues and any necessary legal opinions
- Related party transactions and insider loans
- Restrictions on publicity and press releases, including company website
- Corporate governance, including board and committee composition and Sarbanes-Oxley compliance
- Arrangements with stockholders, including registration rights
- Circulation of D&O questionnaires

6. Printing the prospectus and miscellaneous topics

- Selection of financial printer
- Discussion of use of color, pictures and logo
- Selection of transfer agent
- Selection of stockholder relations advisor
- D&O insurance

7. Assignment of responsibilities for tasks and next steps
8. Presentations by company management

Practical Tips

“Getting Organized for the Organizational Meeting”: Recommended IPO Actions Prior to Organizational Meeting

In addition to preparing to address the items on the meeting agenda, the company should consider taking the following actions to prepare for the organizational meeting:

1. **Twelve Pre-IPO Action Items.** Consider the 12 Pre-IPO Action Items discussed in Chapter 3, page 14, before the meeting, many of which may be touched upon in an organizational meeting. The underwriters will not expect the company to have resolved all the matters on that list before the meeting. However, the organizational meeting process will proceed more crisply, and the underwriters will gain more confidence in the company’s command of the IPO process, if the company identifies the issues and matters on that list and offers a solution or timetable for resolution.
2. **Financial Statements.** The company should identify any material accounting or internal control problems to be addressed before the IPO. In addition, the parties will discuss which financial statements, including interim periods, should be included in the registration statement. The company should consider the timing and ability to complete work on any interim accounting periods, and what level of auditor review will be required for interim periods.
3. **Management Presentations.** Management should prepare summary presentations, which will begin to shape the company’s “story” and guide the drafting of the prospectus. This item is discussed in detail in “Management Presentations and Discussion of Issues” below.
4. **Initial Draft of Prospectus.** The company and its counsel should begin preparation of an initial draft of the prospectus prior to the meeting. The process of drafting the “Business” section of the prospectus will aid the company’s preparation of its management presentations for the organizational meeting. Participants will expect an initial draft of the prospectus soon after the meeting, so starting early will increase the quality of the draft and likely reduce the time required for subsequent group drafting. To accelerate the process further and make a strong initial impression on the underwriters, consider having a full draft of the prospectus ready for distribution at the organizational meeting.

Offering Schedule

If nothing else, the organizational meeting attendees will be keenly interested in discussing the offering schedule and responsibility checklist. The underwriters will present at least a high-level offering timeline, with important targets for registration statement filing, road show commencement and offering conclusion. A sample offering schedule and time and responsibility checklist can be found in Appendix 2. This schedule allows for multiple drafting sessions; the underwriters’ completion of their due diligence review; the filing of the registration statement with the SEC; the waiting period for the company to receive its first round of comments from the SEC (approximately 30 days); the revision of the registration statement in response to the SEC’s comments (which may require one

or several amendments); the road show presentations; and the pricing and closing of the offering. In some circumstances, the company may want to compress this time period to take advantage of market opportunities, such as favorable news regarding the company's industry or confidence in the public markets. While the working group may work furiously to accelerate the offering schedule to meet the company's and underwriters' optimal offering schedule, SEC review time and resolution of open issues, especially accounting issues, may significantly delay the offering. Companies that are thoroughly prepared will be in the best position to accelerate the process. Chapter 5 also provides an overview of an offering roadmap.

Management Presentations and Discussion of Issues

Presentations by the CEO, CFO and other executive officers about the company are an important aspect of the organizational meeting, and quality, well-prepared presentations can significantly advance the IPO. Be aware that different participants in the process will have varying levels of knowledge about the company and its industry. As a result, the presentations should provide a clear and complete picture of the company. The presentations typically cover the company's history, its products, services and technology, financial results, the industry and the company's key strategies and any other information relevant to gaining a solid grasp of the company and its prospects. The goal is to educate the participants about the company and enable them to proceed with reviewing the registration statement and preparing the company for the offering. The discussion of the company's business at the organizational meeting will also help the underwriters begin to think through the framework of the company's road show presentations later in the process.

The management team should meet well in advance of the organizational meeting to discuss their presentations so that each member of the team is thoroughly prepared. Typically, the company's CEO presents general information about the company and its industry; the company's CFO presents historical financial information, as well as current projections and relevant accounting issues; and other management team members present information related to their role with the company (for example, the company's vice president of sales presents an overview of the company's sales methodology, customers, targets and trends).

The organizational meeting also presents an opportunity for management and the company's legal counsel and auditors to highlight any potential issues the group may face in completing the offering on the offering schedule. As mentioned above, management should meet with the company's legal counsel and auditors prior to the organizational meeting and discuss potential issues so that any problems can be identified and resolved, or a plan for their resolution prepared. Management should inform the underwriters of any potential issues early in the process to give the offering team plenty of time to solve them effectively. Frank and thorough disclosure of potential issues will also foster a relationship of trust between the company and the underwriters, which is a key component of a successful offering. Disclosure of material issues later in the process could delay, or permanently derail, the offering.

Selecting a Printer

As the company begins drafting the prospectus and orchestrating organizational meeting matter, it should also select a financial printer. The company's financial printer serves multiple functions in an offering. These include not only typesetting and printing but also providing administrative and word processing services, document management, hosting meeting spaces for drafting sessions, coordinating the circulation of each registration statement draft, converting the registration statement into EDGAR format and filing the registration statement with the SEC. Using an inexperienced printer, or a printer with inadequate services, can increase offering expenses and contribute to costly delays.

The company should obtain recommendations for a printer from its legal counsel, and the company's legal counsel and the underwriters can assist the company with obtaining bids from those printers. Bids from each printer should be as detailed as possible and include the number of prospectuses to be printed and an estimate of the number of pages for the prospectus, artwork for the prospectus, charges for revisions and distribution, filing fees, conference room fees and related charges (such as food and beverages) and overtime service. It is also advisable for the company to obtain references from each financial printer. When choosing a financial printer, the company should consider using a financial printer with a local office, if possible, to save on travel expenses.

Even though the company will choose the printer based, in part, on the bid received from the printer, the final cost for printing services will depend on how often each page is revised, how many amendments have to be filed and whether holiday, weekend, overtime or rush services are required. The bulk of financial printing costs are incurred in the categories of "alterations" and "blacklining." Consider ways to factor these into the bid request to minimize the risk that the actual cost of printing might end up substantially higher than the bid amount. The company can also expect to incur out-of-pocket expenses for postage, freight and other services.

The company's financial printer may provide services after the offering is completed in addition to those provided during the IPO. For example, after the IPO the company will be required to file annual and quarterly reports with the SEC, as well as other periodic reports. Initially, a public company uses its financial printer to format and file these periodic reports. Thus, as part of its selection process the company should also consider the potential relationship between the company and its financial printer after completion of the offering.

Chapter 8—Raising the Capital: Underwriting and Distribution

The underwriting and distribution of the company's stock to the public lie at the heart of the initial public offering transaction. This chapter describes the way in which the underwriting and distribution arrangements between the underwriters and the company work.

In an IPO, one or more investment banks will agree to “underwrite” the offering, an arrangement memorialized in the “underwriting agreement.” The agreement typically provides for the underwriters to purchase common stock from the company and effect the distribution and resale of the stock to the public. This process is known as a “firm commitment” underwriting because the underwriters commit to purchase all of the offered stock at a fixed price directly from the company, and then resell the stock to the public, either directly or through dealers.

An alternative is a “best efforts” underwriting, sometimes used for higher risk stock offerings. Underwriters in a “best efforts” underwriting agree only to use their best efforts to sell the offered stock to investors on the company's behalf, but the underwriters do not purchase the stock from the company and therefore do not assume the risk for any portion of the offering not sold to the public. Because most IPOs are done on a “firm commitment” basis, this chapter discusses the key considerations and characteristics of a “firm commitment” underwriting and distribution.

Timing the Sale

Underwriters and the company both have an incentive to “time” the initial public offering to maximize the chance of its success. The market cycle for securities of companies in similar industries or with similar businesses can influence the price and success of the offering as much as the strength of the company. The perception that the securities markets are favorable, or even “hot,” for companies in a particular industry or business supports a strong offering with high demand and naturally influences the company's and underwriters' willingness to invest the time, money and resources for an IPO. Both the underwriters and the company will want to time the offering so that it coincides with a strong or strengthening securities market. The underwriters often push or slow the registration process depending on their view of the market “window” for the company's stock.

Peek at the Process

“Opening Windows”: Recent Trends in the Market Window for Venture-Backed Companies

The so-called stock market “window” of opportunity to get a favorable price in an IPO is frequently referred to in terms of the type of issuer and its industry. Often, peaks and valleys occur for particular stock market niches regardless of general market conditions. However, the biggest window closing probably happened to all companies, especially emerging growth companies, at the end of 2000. Coming off the phenomenal year of 1999, when there were 250 IPOs by venture-backed companies, the first quarter of 2000 continued the pace with 69 venture-backed IPOs, and then in the second quarter

Peek at the Process

“Opening Windows”: Recent Trends in the Market Window for Venture-Backed Companies (cont’d)

Nasdaq had a substantial drop when IPOs dropped off to 43. Not to be undone, the market rebounded in the third quarter and 71 venture-backed IPOs made it out, only to have the market decline precipitously in the fourth quarter when only 18 IPOs squeezed through. This was followed by only 22 IPOs in all of 2001. The window for emerging growth companies took until 2004 to start to reopen, but it still is not nearly as wide open as it was in any year in the late 1990s.

Source: Dow Jones VentureSource

Perceptions about market windows customarily have been subject to seasonal fluctuations, too. As a general rule, underwriters shy away from conducting road shows around traditional long holidays, particularly Thanksgiving and Christmas, and the last half of August, when much of Europe and many Americans take vacations. In recent years, however, this resistance appears to have softened, and offerings have been brought to market in these traditional holiday and vacation periods.

Amount to Be Raised; Price Per Share

The company, with the advice of the underwriters, will need to determine the total minimum dollar amount it may seek to raise in the IPO before it files the registration statement. This amount can be increased later in the process. It appears on the cover of the registration statement and will be used to calculate the SEC filing fee, which will also include any additional amounts for common stock that the underwriters will have an option to purchase to cover over-allotments (discussed below). Later in the process, the company and underwriters will determine (and file with the SEC) the optimal price range at which the stock will be offered and the number of shares that will be offered. Frequently, the total offering amount, the acceptable amount of dilution to existing stockholders and the target offering price per share are determined, and then the company backs into the right number of shares by considering the company’s proposed valuation and undertaking a stock split or similar recapitalization to achieve that number.

The offering prospectus must also disclose the intended principal uses of the offering proceeds. Underwriters sometimes prefer that the offering proceeds are allocated to particular purposes, e.g., to finance specific items or to repay indebtedness, rather than simply to working capital and other general corporate purposes. Investors presumably view specifically identified intended uses of proceeds more favorably than uses subject to a large degree of management discretion.

Distribution of the Shares

Underwriters have different account bases that constitute the primary sources of potential resales of the company’s stock in the IPO. Most investment banks that serve as managing underwriters focus primarily on selling to institutional accounts. Other, often

regional, underwriters focus primarily on selling to retail customers. Companies often opt to include both types of underwriters in the underwriting syndicate for the offering, so that both institutions and individual investors participate.

The optimal mix of institutional and retail investors is a subject of much debate. Institutional investors typically will hold large blocks of common stock. They are generally considered more sophisticated stockholders than retail investors and better able to comprehend a company's financial and operational complexities. On the other hand, an institutional investor can more easily influence the market for a company's common stock through its purchase and sale decisions. Institutional investors also typically take a more activist approach to corporate governance matters. Conversely, retail investors can provide liquidity and stability for a company's common stock, and sales or purchases by a single retail investor rarely cause market movement in the company's common stock.

Peek at the Process

“Get the Show on the Road”: Understanding the Road Show

A lot of excitement, a bit of mystery and an expectation of long days usually surround the “road show” for a management team undertaking its first initial public offering. The amount of emotion and focus invested in the road show is warranted, since a well-done road show is critical to a successful IPO.

During the road show, representatives from the company meet with prospective investors, generally institutional investors such as mutual funds, pension funds and the like, in various cities and make presentations about the company.

During the SEC review process, the underwriters and the company will prepare an investor presentation consistent with, and limited to the content of, the disclosure in the prospectus. When the preliminary prospectus is complete, the financial printer will print and deliver the preliminary prospectuses as instructed by the underwriters for ultimate delivery to potential investors. While the prospectuses are being delivered to potential investors and prior to going on the road, the company will meet with the underwriters' sales forces to educate them on the company and the offering (and hopefully create enthusiasm).

During the road show, the company's top management will give 20- to 30-minute presentations, followed by 10 to 15 minutes of Q&A, to investor groups or with individual investors one-on-one, usually multiple times a day for two weeks or so and covering 10 or more cities in the United States and possibly some cities in Europe. Sometimes, particularly in very large offerings, the underwriters will ask for a second team to give presentations so that more investors can be covered, and may rent a private airplane to better facilitate travel. (Make sure to clarify up front who will pay for that plane.) Increasingly, road show presentations are given electronically so that not all investors are met face to face. The 2005 Securities Offering Reform rules increased certainty and clarified rules about electronic road shows, facilitating electronic road shows to an even greater degree.

The underwriters will introduce the company and may make a few general comments, but otherwise do not participate in the presentation. Only the preliminary prospectus is handed out to potential investors. The slide presentation is not handed out because doing so will make the material a “free-writing prospectus,” subjecting the presentation to a number of SEC rules.

Peek at the Process

“Get the Show on the Road”: Understanding the Road Show (cont’d)

Management’s performance on the road show is one of the most critical aspects of the IPO within the company’s control. It enables investors to assess management up close and personal and gain confidence in the leadership of the company. Heightening the importance of the presentation is the fact that investors often only glance at the prospectus summary prior to attending the presentation. A strong, smooth presentation focused on the key, compelling aspects of the company and industry can make a tremendous difference in investors’ interest in the company. Because of this, the underwriters will strongly encourage “dry runs” of the presentation before the road show. The price per share for the IPO is typically set the day the road show ends, so that the underwriters can capitalize on the momentum of the road show and offering efforts.

Selling Stockholders

Existing stockholders may wish, and in fact may have contractual registration rights, to sell shares of company common stock they own in the IPO. The company and the underwriters should address this issue, which can be quite sensitive, early in the registration process. Some founders and officers may have a substantial portion of their net worth in company stockholdings. Often they have sacrificed for years to build a successful company and understandably may wish to “take some chips off the table” by selling some stock to raise cash. Underwriters may be concerned that allowing stockholders, especially officers or founders, to sell in the IPO may be perceived as insiders “bailing out” because of doubts about the company’s prospects. However, if the company is willing to permit existing stockholders to sell and the underwriters are eager to please both the company and the selling stockholders, and particularly if the market for the issue is “hot,” selling stockholders may be included in the offering, in some cases as the seller of the shares subject to the underwriters’ over-allotment option.

Participation of selling stockholders in the IPO requires additional offering arrangements. To ensure a smooth process, the selling stockholders will be asked to sign a power of attorney assigning to at least one attorney-in-fact the authority to negotiate and sign the underwriting agreement on behalf of the selling stockholders. Selling stockholders will also be asked to surrender their stock certificates to a custodian, who will deliver the certificates for transfer at the closing of the offering.

Lockups

Underwriters use “lockup” agreements as a means to help stabilize trading in the company’s common stock following the IPO. Typically, the underwriters will require the company and its directors, officers and stockholders to enter lockup agreements in which they agree not to sell, transfer or otherwise dispose of any common stock they own for a period of time, typically ending 180 days after the closing, without the underwriters’ consent. If the company and underwriters agree to offer a directed share or “friends and family” program (discussed below), participants in the program also will be required to sign a lockup agreement. The underwriters will require that most, if not all, of the lockup agreements be

signed before the preliminary prospectus is printed, after which the underwriters' leverage to obtain the lockups declines. Lockup agreements will contain various exceptions to the prohibition against selling company common stock. With respect to the company, these exceptions typically include:

- the sale of the common stock to the underwriters;
- the issuance of shares upon exercise of outstanding options or warrants; and
- the issuance of options or warrants to purchase shares under the company's stock incentive plans.

With respect to the company's directors, officers and stockholders, depending on the circumstances, the lockup exceptions may include:

- open market acquisitions of shares;
- transfers of shares, or securities convertible into shares, to the underwriters, to limited partners or stockholders of the party subject to the lockup, or as a bona fide gift;
- transfers to trusts for the benefit of the party subject to the lockup; and
- transfers by will or laws of descent.

Lockup agreements may provide for an extension of the time period for which transfers are prohibited if the company issues, or announces that it will issue, a release about earnings, or if material news or events relating to the company occur, during a period close to the date that the lockup expires. This period usually is just over 15 days before and just over 15 days after the lockup expiration date. The agreement typically provides that if such a release or material news or event occurs the lockup period will be extended for a period usually ending at least 15 days after the release or occurrence.

The extension provision is a reaction to a FINRA rule that was adopted as part of the Global Research Analyst Settlement resulting from the SEC's lengthy investigation into the role of research analysts in the securities industry beginning in 1999. The SEC's investigation found that a number of favorable analyst reports on companies that had recently completed an initial public offering had been issued at or near the time the post-offering lockup period expired, presumably boosting the price of the company's stock at precisely the time that management and others subject to the lockup could begin to sell their shares into the market. The FINRA rule combats these "booster shot" reports by providing that no member of the underwriting group may publish a research report concerning the company whose securities were offered during a period beginning 15 days before and ending 15 days after the expiration or termination of the lockup agreement. A key exception to this prohibition, however, is that a member of the underwriting group may publish a report concerning the effects of significant news or a significant event if that member's legal or compliance personnel authorize the publication of the report.

Directed Share or “Friends and Family” Programs, and Other Variations

The excitement of an IPO, the potential value of an investment in the company and relationship concerns often lead a company to request that the underwriters reserve a portion, usually no more than 5% to 10%, of the shares to be purchased by the underwriters for sale at the IPO price to the company’s directors, officers, employees, business associates and other interested parties. This type of arrangement is known as a “directed share program.” The program permits “friends and family” of the company to participate as direct purchasers in the offering when they otherwise might not have the opportunity to do so. The underwriters will require direct share program participants to sign lockup agreements and the company to indemnify the underwriters for any liabilities arising out of the program. In addition, detailed disclosure will need to be provided to the SEC about the program. Many underwriters do not care for the additional burden caused by these programs or the reserve of shares they could otherwise allocate, but usually will accommodate a program if the company has sufficient interest in it.

The Statistics	
<i>“Going Direct”: Information About Directed Share Programs</i>	
Interested in getting shares in the IPO at the IPO price? This can be done by participating in a directed share program, without relying on your broker’s ability to have shares allocated to you. In 2007, however, nearly 60% of IPOs did not have a directed share program. Of the 40% that did, the company most frequently had 5% of the IPO shares allocated to the program.	
Percentage of IPO Shares Reserved for Directed Share Program	Percentage of IPOs With That Percentage of Shares Reserved
10.0% or greater	9%
7.5 - 10.0%	7%
5.0 - 7.5%	7%
5.0%	46%
2.5 - 5.0%	27%
Less than 2.5%	4%
Source: www.IPOVitalSigns.com, © 2008 CCH, a Wolters Kluwer Company. Used by permission.	

The Underwriting Agreement

The underwriting agreement sets forth the terms and conditions that govern the underwriters’ purchase of common stock from the company and any selling stockholders, and the rights and obligations of the company, the underwriters and any selling stockholders. Each lead managing underwriter maintains its own form of underwriting agreement. Although the underwriters may seek to have the company and participating selling stockholders sign with few changes, the document as a practical matter is negotiated.

Forms of underwriting agreements are updated periodically to address changes in the law, exchange rules and other concerns. Investment banks have revised their form of underwriting agreement in reaction to the 2005 Securities Offering Reform rules, the Sarbanes-Oxley Act of 2002 and recent concerns about potential violations of the Foreign Corrupt Practices Act of 1977 and the Currency and Foreign Transactions Reporting Act of 1970.

The underwriters and the company negotiate the underwriting agreement long before the registration statement becomes effective. Underwriters prefer to have a virtually final form of the agreement completed before printing the preliminary prospectus, with only pricing information to be filled in later. The company files this final form of underwriting agreement as an exhibit to the registration statement, usually by amendment. After the SEC declares the registration statement effective, the company and the underwriters will (it is hoped) agree on pricing terms and then finalize and sign the underwriting agreement.

Purchase and Sale of Shares—Basics and the “Green Shoe”

The underwriting agreement sets forth the price at which the underwriters agree to purchase the company’s or any selling stockholders’ common stock. The pricing terms, which are negotiated after the underwriters have built the “book” in the course of the road show, provide that the underwriters will pay a price per share that reflects a discount to the price at which the underwriters will offer the shares to the public. The purchase terms provide that the company or selling stockholders, if any, will agree to sell an additional number of shares to the underwriter, typically an amount equal to 15% of the total number of original shares to be sold in the offering, on the exact same terms, to permit the underwriters to cover resales they make in excess of the number of original shares. This option, commonly called the “over-allotment option” or the “Green Shoe” (after the practice putatively pioneered by The Green Shoe Manufacturing Company (now Stride Rite Corporation)), usually expires 30 days after the date of the underwriting agreement.

Underwriting agreements may also provide for online and international offers. Online offers generally permit a paperless transaction. The company and its counsel should clearly understand whether and how these types of offers will be conducted.

The Statistics

“Paying the Piper”: The Underwriters’ Discount

The underwriters of the IPO get paid by buying the company’s stock from the company at a discount, then selling the stock to the public at a higher price. The front page of the prospectus will list the “price to the public” (the price at which the underwriters will sell the stock to the public) and the amount of the underwriters’ discount, which is generally, but not always, 7%. The table below shows a breakdown of the underwriters’ discount in IPOs completed in 2007. (The table excludes one IPO with a discount above 10% and one below 2%).

The standard of a 7% underwriters’ discount, however, might be more pervasive for operating companies going public than the table below suggests. For instance, some specialty or niche issuers, such as certain oil and gas issuers, have a lower standard discount. In addition, discounts may be lower for “blank check” companies, or special purpose acquisition companies (“SPACs”). A relatively recent trend, blank check companies are formed for the purpose of acquiring other businesses or assets in the future. Unlike a typical company going public, blank check companies have no operating history or material

The Statistics		
<i>“Paying the Piper”: The Underwriters’ Discount (cont’d)</i>		
financial results at the time of the IPO. Because blank check companies are essentially “empty vessels,” the disclosure and due diligence burdens, and attendant risks of material misstatements or omission, and the underwriters’ role in shaping the “story,” are significantly diminished compared to traditional IPOs. The diminished burdens and risks might be reflected in a smaller payment, on a percentage basis, to the underwriters.		
IPO Discount	Number of IPOs	Percent of IPOs
7+ to 8%	8	2.8%
7%	180	63.8%
6+ to 6.9%	32	11.3%
5+ to 6%	31	11.0%
4+ to 5%	7	2.5%
3+ to 4%	11	3.9%
2+ to 3%	6	2.1%
Average		6.5%
Median		7.0%
Source: www.IPOVitalSigns.com, © 2008 CCH, a Wolters Kluwer Company. Used by permission.		

Representations and Warranties

The underwriting agreement contains a number of company representations and warranties. These representations and warranties address customary corporate governance matters and more offering-specific concerns, particularly the accuracy and sufficiency of the registration statement and the other items noted above. If selling stockholders are participating in the offering, they will make various representations and warranties concerning title to, and the ability to sell, their shares.

Covenants

In addition to agreeing to sell shares to the underwriters, the company agrees in the underwriting agreement to comply with federal and state securities laws and exchange rules before and after the sale of the shares. The company also agrees to the lockup terms described above and terms addressing the use of free-writing prospectuses. In addition, and somewhat painfully, the company typically agrees to pay virtually all fees and expenses associated with the offering, except for specified underwriters’ costs and expenses (including legal fees), which the company will nonetheless be obligated to pay if the offering fails to close for any reason other than underwriter default and limited other exceptions.

Closing Conditions

Under the underwriting agreement, the underwriters typically are not obligated to close the sale of the shares until:

- the registration statement has been declared effective;
- legal opinions have been delivered by the underwriters' counsel and counsel for the company and any selling stockholders;
- the company's independent auditors deliver a "comfort" letter on the date the underwriting agreement is signed and as of the closing; and
- the company has certified the continuing accuracy of its representations, warranties and covenants, particularly those concerning compliance with securities laws and exchange rules, made in the underwriting agreement.

The underwriters also typically are not required to close the IPO if the company has suffered any materially adverse change. In addition, the underwriters' obligation to close typically terminates if events like the following occur before closing:

- trading in securities on the major U.S. exchanges has been suspended;
- a general moratorium or material disruption in U.S. commercial banking or securities settlement activities has occurred; or
- war has been declared by the United States, hostilities involving the United States have broken out or escalated, or any other calamity has occurred, and the underwriters determine, in their judgment, that proceeding with the offering would be "impracticable or inadvisable."

Although these conditions are remote, underwriters staunchly resist any attempt to eliminate any of them from the agreement.

Indemnifying the Underwriters

In the underwriting agreement, the company typically agrees to indemnify the underwriters for all damages the underwriters may suffer as a result of any material misstatement or omission in the registration statement or prospectus. One narrow exception to this obligation is for material misstatements or omissions based on information provided by the underwriters, for which the underwriters will indemnify the company for any resulting damages. Any selling stockholder will also provide indemnification based on material misstatements or omissions of the stockholder. The underwriters' and the selling stockholders' liability for indemnification to others often is capped at the underwriters' discount, in the case of the underwriters, and the net proceeds resulting from the sale of the selling stockholders' shares, in the case of the selling stockholders. The broad indemnification obligations of the company represent a significant allocation of risk to the company, and reinforce the importance of thorough due diligence and careful review of each offering document before it is used in the IPO.

Underwriter Default

If an underwriter that is part of the underwriting syndicate defaults on its obligation to purchase shares it had agreed to purchase in the IPO, the underwriting agreement typically gives the managing underwriter a short period of time (usually 36 hours) to either agree to fill in or find a replacement for the defaulting underwriter. If the managing underwriter does not agree to step in for the defaulting underwriter or is unsuccessful in finding a replacement, the company generally has an additional short period of time (again, usually 36 hours) to find one or more new purchasers. If the managing underwriter steps up to

the plate, or replacement underwriters are located, then the closing of the offering may be delayed for a short time (usually up to seven days) to make the necessary changes to the offering documents. If the necessary arrangements are made and more than a small number of shares (around 10%) remain unsold, however, the underwriting agreement typically terminates.

Peek at the Process

“Going Dutch”: The Use of Dutch Auctions

The “Dutch auction” is an innovation used in a small number of IPOs, including the Google IPO. In a Dutch auction, the underwriter manages a bidding process for the shares to be resold to investors. A potential investor submits a bid that includes the number of shares the investor is willing to purchase and the per share price the investor is willing to pay for the offered shares. The auction ends after the registration statement is declared effective. The underwriter then determines the highest bid price, the “clearing price,” that will sell all the shares in the offering based on bids received at or above that price. The company and the underwriter then agree whether to sell the shares at the clearing price or a lower price. If the public offering price is lower than the clearing price, and thus the offering is oversubscribed, the underwriter allocates the shares on a pro rata basis.

Chapter 9—Price, Close and Trade

Conclusion of the Road Show and Effectiveness of the Registration Statement

The initial public offering process culminates in the company's stock trading on the stock exchange on which the stock is listed. Before the company and the underwriters can agree on the price at which the stock will be offered to the public, the offering participants must work in coordination to complete the SEC review process, FINRA's review of the underwriting arrangements and the stock exchange's review of the company's listing application. The goal is to make sure that these processes conclude before or during the wind-down of the road show. The company and the underwriters work hard to build interest during the road show and hope to price the offering as soon as the road show is completed in order to take advantage of the interest generated.

Events Leading to Pricing

The SEC must declare the company's registration statement effective in order for pricing and trading to occur. Generally, on the day the road show concludes, the company and the managing underwriters ask the SEC to declare the registration statement effective and, once effective, the company sets the price for the IPO.

The SEC's rules require the company and managing underwriters to request in writing, at least 48 hours in advance of the desired effective time, that the SEC declare the registration statement effective. In addition, FINRA must confirm that it has no objection to the underwriting arrangements before the SEC will declare the registration statement effective. If acceleration is requested at least 48 hours in advance, and the company has addressed the SEC's comments on the registration statement to the SEC's satisfaction, the SEC is generally willing to accommodate the requested effective time. Effectiveness orders, the official SEC document declaring the registration statement effective, are now posted on the SEC's EDGAR website. The company's registration statement under the Exchange Act—typically a short-form registration statement Form 8-A in the case of an IPO—will become effective at the same time as the Securities Act registration statement.

Peek at the Process

“Book It”: Building the Book

The level of interest in the IPO that potential investors indicate to the underwriters is perhaps the most fundamental factor affecting the price at which the shares are offered to the public. “Building the book” is the common phrase used to describe the underwriters' process of obtaining indications of interest, and specific price and quantity information, from potential investors. During the road show, as management makes presentations to spur interest in the IPO, the underwriters' sales desks or syndicate groups call potential investors to gauge interest in the offering. The underwriters record the number of shares each investor would be willing to purchase and the potential price the investor would be willing to pay. Recall that no sales may be made at this point, because the registration statement is not effective before the end of the road show. At the road show's conclusion, the underwriters understand the level of investor demand for the offering and, therefore,

Peek at the Process

“Book It”: Building the Book (cont’d)

the number of shares that can be sold (including the over-allotment option) and at what price. This information, along with the underwriters’ view of current market, industry and economic conditions and developments, shapes the underwriters’ recommendation to the company’s pricing committee on the “pricing call” of the price per share to the public that the company should select for its IPO.

The underwriters may not actually sell stock during the book-building process. If stock market or industry conditions deteriorate, or jarring events occur at the company or affect the broader economy, even a book that had been strong may fall apart. As a result, underwriters like to minimize the time between the end of the road show and pricing and having the registration statement declared effective. Once the registration statement becomes effective on the date of pricing and the prospectus is completed, the underwriters may confirm the “orders,” committing the investors to purchase the stock from the underwriters.

What Is Pricing and What Happens

IPOs usually are priced after the stock markets close, and the stock begins trading on the next day. Pricing ideally occurs on the last day of the road show while interest in the offering is strong. A “bring-down” due diligence call is held prior to pricing to ensure that all of the information in the preliminary prospectus is still accurate and complete. After the registration statement has been declared effective, the underwriters and the company, represented by senior management, and a pricing committee of the company’s board of directors, frequently made up of the CEO and one or two outside directors, confer by telephone to determine the price at which the stock will be offered to the public. If stockholders are selling in the IPO, a representative of the selling stockholders may sometimes also participate in the pricing call.

The underwriters on the pricing call present their recommendation regarding the price at which they believe the offering should be priced and provide data and other information to support that recommendation, including the “book” of indicated interest, recent performance of the stock markets, performance of recent IPOs and other matters. When an agreement is reached on the price of the stock, the pricing committee formally approves the number of shares to be sold by the company to the underwriters, the public offering price for the shares, and the price to be paid by the underwriters (which is a function of the underwriting discount, typically 7%). The pricing committee also approves the underwriting agreement, reserves the shares for issuance and directs the officers of the company to apply the proceeds received from the sale of the shares as set forth in the registration statement. The company’s auditors will then deliver a comfort letter to the underwriters, confirming the company’s audited financial statements and other financial information in the prospectus. Once these steps have been taken, the underwriting agreement will be signed.

After pricing, the company typically issues a press release announcing the terms of the offering. This release usually consists of basic information about the offering that complies with the SEC’s requirements under Rule 134 so that it does not need to be filed as a “free-writing prospectus.” Chapter 6 discusses Rule 134 and free-writing prospectuses in more

detail. The parties will also prepare a final prospectus—which includes the pricing-related information (i.e., number of shares, public offering price, underwriting discount and commissions and net proceeds) and final information about the composition of the underwriting syndicate. The final prospectus must be filed with the SEC within two days of pricing or its first use.

Peek at the Process

“Time to Price”: Overview of the Pricing Schedule

Below is a schedule of pricing-related events for a typical initial public offering:

- Two days before the expected completion of the road show and pricing → confirm date of pricing and no remaining issues with the SEC, and file acceleration requests with the SEC
- Confirm SEC obtained FINRA no objection letter and stock exchange authorized listing
- Morning of pricing day → hold “bring-down” due diligence call
- Afternoon of pricing day → SEC declares registration statement effective
- After market on pricing day → hold pricing call and price offering
- After pricing, auditors deliver comfort letter, the company and managing underwriters execute the underwriting agreement and the final prospectus is completed
- Night of pricing day or pre-market the next day → issue press release
- Day after pricing → stock trades
- Fourth trading day after pricing → close initial public offering and receive proceeds from the underwriters

Upsizing the Offering

The SEC’s rules provide a simple mechanism for “upsizing” an initial public offering if the demand for IPO shares exceeds the number of shares initially registered with the SEC. Under the SEC’s Rule 462(b), a short-form registration statement can be filed immediately after the effectiveness of the original registration statement to register up to 20% more stock for offering in the IPO. This “462(b) registration statement” merely registers the additional securities and incorporates them into the original registration statement. It is effective immediately when filed. Registration statements filed under Rule 462(b) are subject to the same requirements with respect to opinions and auditors’ consents, so new opinions and consents will need to be prepared and filed with the 462(b) registration statement. The Rule 462(b) process is a quick, handy way of increasing the size of the offering (up to the 20% maximum) without having to go through a formal SEC clearing or amendment process.

Peek at the Process

“Finally, Paperless”: Access Equals Delivery of the Final Prospectus

Prior to the SEC’s adoption of the Securities Offering Reform rules in 2005, a company completing its initial public offering would print a large number of hard copies of the final prospectus. The final prospectuses were then delivered to all purchasers of the company’s stock in the initial public offering. Recognizing that this was largely a legal formality, and that the investment decision was previously made based on the preliminary prospectus, the SEC adopted Securities Offering Reform in 2005 that, among other things, implemented the “access equals delivery” rule. As a result, issuers and their underwriters are no longer required to deliver hard copies of the final prospectus unless requested, so long as the company has filed the final prospectus with the SEC, and it is publicly available “electronically” via EDGAR.

Closing and Closing Documents

Although a company’s stock usually begins trading the day after the IPO is priced, closing does not occur until a few days after trading commences. Assuming that pricing occurs on the trading day immediately preceding the day on which trading actually begins, the closing of the offering takes place on the fourth trading day after pricing. At the closing, the underwriters pay for the shares they have purchased to resell to the public, and the shares are delivered by the company’s transfer agent to the underwriters. With modern securities transfer procedures, shares are not physically delivered by the company’s transfer agent to the underwriters; instead they are registered electronically on the books of The Depository Trust Company, a clearing agency for the securities industry.

Prior to closing, the company’s counsel and underwriters’ counsel prepare various closing documents, including officers’ certificates, legal opinions and cross-receipts, for execution and delivery at the closing. Underwriters’ counsel typically prepares a checklist—or closing memorandum—ahead of time to make sure that none of the documents to be delivered at closing or other steps to be taken at or prior to closing fall through the cracks. The offering participants do another “bring down” due diligence call prior to closing, and company counsel confirms with the SEC that no “stop orders” are in effect with respect to the registration statement.

At closing, the company’s counsel delivers a legal opinion to the underwriters regarding the legality of the securities offered in the offering to the underwriters, as well as certain corporate matters including the due authorization, execution and delivery of the underwriting agreement. In addition, the company’s counsel renders a “cold comfort” opinion regarding the completeness of the registration statement and prospectus. If the offering includes shares from selling stockholders, counsel to the selling stockholders also delivers a legal opinion regarding certain legal matters relating to the selling stockholders. The company’s auditors provide a “bring-down” comfort letter dated as of the closing to reaffirm the comfort letter delivered at the time the underwriting agreement was executed and to update it, if necessary, regarding any developments that may have occurred between that time and the actual closing. At closing, the company’s management delivers executed certificates confirming the accuracy and completeness of the registration statement and

the representations and warranties in the underwriting agreement. The delivery of IPO proceeds is confirmed, and the company's counsel coordinates the release of shares by the transfer agent.

Exercise of Over-Allotment Option

If the underwriters choose to exercise their over-allotment option (discussed in Chapter 8), a second closing is typically required to settle the sale of the additional shares. The mechanics, as well as the closing deliveries, for the second closing are similar to those for the first closing. In the case of IPOs for which high demand exists, the underwriters may exercise the over-allotment option immediately after pricing, in which case closing of the over-allotment occurs at the same time as the main offering.

Post-IPO Reporting and Compliance Responsibilities

Once the IPO is completed, the company becomes subject to public reporting and other requirements under the Exchange Act. Among other things, each year the company must file an annual report on Form 10-K, quarterly reports on Form 10-Q for the first three fiscal quarters, and current reports on Form 8-K with respect to a wide variety of “triggering events,” including disclosure of material financial information about a completed fiscal period (i.e., earnings releases), significant acquisitions or dispositions, entry into material contracts, resignations of directors and certain executive officers, and creation of financial obligations. In addition, the company will be subject to the SEC's proxy rules that govern proxy statements used to solicit proxies in connection with annual and special stockholders' meetings and related matters. The company's directors, executive officers and greater than 10% stockholders will also have new obligations—they must report their beneficial ownership of the company's stock, as well as changes in such beneficial ownership, under the Exchange Act Section 16 rules. Pre-IPO stockholders who beneficially own more than 5% of the company's stock must report such holdings under the Exchange Act Section 13(d) rules, typically on a Schedule 13G.

Chapter 10 provides a more detailed overview of the post-IPO reporting and compliance responsibilities of a public company and its officers, directors and significant stockholders.

Trap for the Unwary

“Whither the Money?”: Don't Forget to Report Use of IPO Proceeds in 10-Ks and 10-Qs

After the company completes its initial public offering, each post-IPO annual report on Form 10-K and quarterly report on Form 10-Q will need to describe the use of the proceeds the company received in the IPO. The company must make this disclosure in these reports until it has disclosed how all the proceeds have been applied. For some companies, this may take several years or more.

Chapter 10—So Now You Are Public: Navigating the New Environment

Private companies emerge from their initial public offerings with access to all the benefits of public company life, but those benefits come with obligations. Private companies also emerge from their IPOs in the intense spotlight of public company life—their new responsibilities to their public stockholders and the various constituencies (the SEC, NYSE, Nasdaq and stockholder representatives) that demand robust governance and transparency regarding the company's business and financial condition. This chapter provides a practical overview of public company corporate governance and disclosure requirements.

Maintaining a Public Company Boardroom

Chapter 4 provides details on assembling an independent board of directors. A majority of a public company's directors must be “independent”—individuals who can exercise judgment as a director independent of the influence of company management and meet the standards required by SEC and stock exchange rules. (One exception to this requirement is if the public company is a majority owned subsidiary of another company.) The SEC and stock exchanges prescribe independence standards, as explained in Chapter 4. In addition to independence, a well-functioning board has the following:

- **Board Leadership.** Board leadership rests primarily with the chair and, if appropriate, a lead independent director. In response to scrutiny from public stockholders and at the suggestion of corporate governance advisors such as ISS, boards generally either designate an independent director as chair or ask an independent director to share board leadership with an internal chair/CEO (often referred to as the lead independent director).
- **Executive Sessions.** Both NYSE and Nasdaq require nonmanagement and independent directors to meet in executive sessions—meetings without management or other nonindependent directors present. These must be held “regularly” for NYSE companies and at least twice a year for Nasdaq companies. Most companies adopt a practice of routinely holding executive sessions of independent directors at each board meeting. An ideal format is to schedule an executive session as the final agenda item at each regularly scheduled board meeting.

Board Committees: Requirements Generally and Under NYSE and Nasdaq

As discussed in Chapter 4, all public companies will have an Audit Committee. NYSE requires, and Nasdaq suggests, a Compensation Committee composed of independent directors. NYSE requires a Nominating & Governance Committee, while Nasdaq requires either a Nominating & Governance Committee or that independent directors meet in executive session to deal with director nominations.

Audit Committee

Purpose and Authority. The Audit Committee fulfills the board's oversight responsibilities related to the company's internal controls, financial reporting and audit functions. The Audit Committee is directly responsible for the appointment, compensation and oversight of the company's outside auditor.

Duties. An Audit Committee has four areas of responsibility, which it defines in a publicly available written charter:

- Assessment of the independent auditor
- Review of financial statements
- Internal controls and disclosure practices
- Whistleblower process

Composition and Independence. NYSE and Nasdaq require that the Audit Committee consist of at least three members. With a few exceptions, all members of the Committee must be independent and financially literate. Audit Committee members must meet two overlapping independence standards, one established by Sarbanes-Oxley, the other by NYSE or Nasdaq. The critical issue is independence from management of the company. Sarbanes-Oxley (and implementing SEC rules) have only two criteria for Audit Committee independence: (1) a Committee member may not receive any compensation other than for board service, and (2) a Committee member may not be an affiliated person of the company.

Financial Literacy. Audit Committee members must be able to read and understand fundamental financial statements, including balance sheets and cash flow statements.

Audit Committee Financial Expert. SEC rules require that a public company disclose the names of one or more members of the Audit Committee who qualify as "audit committee financial experts." If a company does not have an audit committee financial expert, it must disclose why it does not.

NYSE and Nasdaq Financial Expertise Requirements. NYSE and Nasdaq rules require that the Audit Committee have a member with accounting and financial management expertise (NYSE) or employment experience or other comparable experience resulting in financial sophistication (Nasdaq). A director who meets the audit committee financial expert requirements under SEC rules is presumed to satisfy the NYSE and the Nasdaq requirements.

Compensation Committee

Purpose and Authority. A Compensation Committee develops criteria and goals for, and then reviews and approves, the compensation of the company's senior management.

Duties. The Compensation Committee will have the following duties as set forth in a written charter:

- Set goals and objectives for executive compensation
- Establish and oversee equity and benefit plans

- Recommend stock plan approval

Composition and Independence. NYSE requires a Compensation Committee of all independent directors (at least three), and Nasdaq requires either a Compensation Committee of exclusively independent directors (with a limited exception) or that a majority of independent directors on the board meet in executive session to perform Compensation Committee duties. (These requirements are the same for the Nominating & Governance Committee discussed below.)

Nominating & Governance Committee

Purpose and Authority. The Nominating & Governance Committee takes the lead in selecting directors, committee members and chairs or lead directors.

Duties. The Nominating & Governance Committee will set forth these duties in a written charter:

- Select the director slate
- Oversee board governance
- Develop meeting procedures
- Evaluate effectiveness of board

Phase-In of Committee Independence Requirements

A newly public NYSE or Nasdaq company will be allowed to phase in its independent core board committees over a 12-month period, with the following limitations:

- One member of each core board committee (Audit, Compensation and Nominating & Governance) must be independent generally at the completion of the IPO process;
- A majority of the members of the core board committees must be independent within 90 days of listing; and
- All members of the core board committees must be independent within one year of listing.

Key Public Company Governance Policies

A fundamental aspect of a public company's good governance framework is the adoption and public disclosure of its key corporate governance policies.

Corporate Governance Guidelines (NYSE)

The "Corporate Governance Guidelines" required of each NYSE company allow the board and senior management to publicly set out the key tenets of their company's governance values. Prominently featured on the "Corporate Governance" page of NYSE companies' websites, the guidelines should address (1) director independence standards, (2) director orientation and continuing education, (3) management succession, and (4) annual self-evaluation of the board.

Code of Business Conduct and Ethics

NYSE and Nasdaq require a public company to adopt and post on its website a practical set of ethical requirements for its officers, directors and employees. At a minimum, the code will address:

- Conflicts of interest, corporate opportunities and fair dealing
- Confidentiality and protection and proper use of company assets
- Compliance with laws, rules and regulations
- Proactive reporting of any illegal or unethical behavior (with protections against retaliation)

The Code of Conduct required by Nasdaq must comply with the “code of ethics” from Section 406 of Sarbanes-Oxley. Item 406 of SEC Regulation S-K requires disclosure of a company’s “code of ethics” for its CEO and senior financial officers, and if no such code exists, the company must disclose why it does not.

Whistleblower Procedures

SEC Rule 10A-3 adopted under Sarbanes-Oxley requires an Audit Committee to establish “whistleblower” procedures for the receipt, retention and treatment of complaints received by the company regarding accounting, internal accounting controls or auditing matters. Although public disclosure of the procedures is not required, “best practices” suggest at least disseminating the portions of the procedures that describe how to submit complaints. A company’s website and employee intranet are logical places where this information could be made available.

Practical Tips

“Transparency in the Internet Age”: Website Postings of SEC and Corporate Governance Materials

SEC rules and regulations require website posting of periodic and current reports, Section 16 reports and other information.

Periodic Reports on Forms 10-K and 10-Q and Current Reports on Form 8-K. The SEC requires “accelerated filers” and “large accelerated filers” to post their annual reports, quarterly reports, current reports and amendments to each on their corporate websites and to make them available free of charge to the public (or explain in their annual reports why they do not do so). Companies may provide timely access by posting a hyperlink to the EDGAR database on the SEC’s website or to third-party service providers.

Section 16 “Insider” Reports. Companies must post their Section 16 reports (Forms 3, 4 and 5, including all exhibits and attachments) by the end of the business day after the date the report is filed with the SEC. If a company posts a hyperlink to its Section 16 reports, it must post a separate, direct link to the Section 16 filings only. A company must satisfy even more conditions if it decides to post these reports with a hyperlink to a third-party service provider.

Practical Tips

“Transparency in the Internet Age”: Website Postings of SEC and Corporate Governance Materials (cont’d)

SEC rules and regulations and NYSE and Nasdaq corporate governance rules permit and sometimes require public companies to post corporate governance materials and information on their corporate websites.

Director Nomination and Stockholder/Board Communication Information. Under SEC rules, if the company’s nominating committee has a charter, the charter must either be disclosed through the company’s proxy statement at least once every three years or be posted on the company’s website (as long as the availability of the charter and website address are noted in the proxy statement). The same requirement applies to the company’s stockholder/board communication policies and procedures.

SEC Code of Ethics Disclosure. A company is required to disclose in its annual report whether it has adopted a Code of Ethics and, if so, to make it publicly available by, among other methods, posting a copy on the company’s website and indicating that fact along with its URL address in the company’s annual report on Form 10-K.

New York Stock Exchange Corporate Governance Rules. NYSE corporate governance rules require listed companies to have and maintain a publicly accessible website and to adopt and post on their websites (a) charters for the “most important” committees of the board of directors, (b) Corporate Governance Guidelines and (c) a Code of Business Conduct and Ethics for directors, officers and employees.

Nasdaq Corporate Governance Rules. Nasdaq requires listed companies to adopt and publicly disclose charters for the Audit and Nominating & Governance committees and a Code of Conduct that complies with the SEC Code of Ethics requirements. A company can satisfy these requirements by posting the charters and Code of Conduct on its website and stating in its annual report the website address and availability of the documents.

Public Company Reporting and Disclosure

A public company must comply with extensive ongoing disclosure requirements. Under SEC, NYSE or Nasdaq rules, a public company will make certain mandatory disclosures throughout the fiscal year. Voluntary disclosure, however, is also an important method in communicating the state of the business to the public.

Periodic and Current Reporting

A public company files annual, quarterly and current reports with the SEC. The reports regularly update and supplement information that the company has made available to the public in its IPO and other registration statements and Exchange Act filings. Companies file the reports within a specified number of days after the end of each reporting period or after certain material events. Each of these reports is described below.

Annual Report on Form 10-K. A public company must file an annual report on Form 10-K following the end of each fiscal year. Form 10-K is the most comprehensive periodic report filed with the SEC. It includes much of the same information that is required in the IPO registration statement. The heart and soul of Form 10-K is MD&A—management’s

discussion and analysis of the company's financial condition and results of operations. Like the MD&A included in the IPO prospectus, this disclosure requires a discussion of the liquidity, capital resources, results of operations and other information necessary to an understanding of the company's financial condition, change in financial condition and results of operations.

Form 10-K also requires extensive disclosure regarding executive compensation and various corporate governance matters, but this information is normally included in the company's annual proxy statement and incorporated by reference into the Form 10-K. (We discuss the annual proxy statement below.)

Quarterly Report on Form 10-Q. Public companies file a quarterly report on Form 10-Q after the end of each of their first three fiscal quarters. The Form 10-Q provides an update on the most recently completed fiscal quarter, including unaudited interim financial statements, MD&A for the quarter, a description of new material legal proceedings or material developments to ongoing legal proceedings and information regarding other specified events that occur during the quarter (such as the results of stockholders' meetings held during the quarter).

A company that goes public must file a Form 10-Q that covers the entire quarter in which the IPO registration statement becomes effective, except that if it went public in its fourth fiscal quarter, it must file an annual report on Form 10-K, described below. The first Form 10-Q after the company's IPO will include information regarding the status of the offering. If the company held a special stockholders' meeting immediately prior to the IPO, the results of that meeting will also appear in the first Form 10-Q.

Form 10-K and 10-Q Filing Deadlines. For newly public companies, the first Form 10-K is due 90 days after the end of the first fiscal year in which the IPO is completed. Until the company has been subject to the Exchange Act reporting requirements for at least 12 calendar months and filed at least one annual report on Form 10-K, the Form 10-Qs are due 45 days after the end of the fiscal quarter.

After these initial filings, Form 10-K and 10-Q filing deadlines depend on the size of the company, based on public equity float. For large accelerated filers (public float of at least \$700 million) the Form 10-K is due within 60 days after the fiscal year and each Form 10-Q is due within 40 days after quarter end. For accelerated filers (public float of at least \$75 million but less than \$700 million) the Form 10-K is due within 75 days after the fiscal year and each Form 10-Q is due within 40 days after quarter end. For non-accelerated filers (public float of less than \$75 million) the Form 10-K is due within 90 days after the fiscal year and each Form 10-Q is due within 45 days after quarter end.

CEO and CFO Certifications, Disclosure Practices and Internal Controls. Public company CEOs and CFOs will certify each annual report on Form 10-K and quarterly report on Form 10-Q. These certifications, which are referred to as the Sarbanes-Oxley Sections 302 and 906 certifications, are submitted as exhibits to each periodic report. The certifications cover two main areas: (1) the accuracy of the report, including the financial statements and related information and (2) the existence and adequacy of, and the responsibility of the CEO and CFO with respect to, the company's disclosure controls and procedures and internal control over financial reporting. To ensure that a disclosure system is in place to backstop these certifications, each public company will maintain disclosure controls and procedures, or "DC&Ps," and internal control over financial reporting.

Disclosure Controls and Procedures. DC&Ps are controls and procedures designed to ensure that the company records, processes, summarizes and discloses on a timely basis information required to be disclosed in Exchange Act filings. These are broad in scope and extend beyond financial matters to cover all controls and procedures relating to required disclosures. Most widely traded public companies have followed an SEC recommendation to establish a nonboard “Disclosure Practices Committee” of officers and employees with responsibility to oversee the DC&Ps that support the CEO and CFO certifications.

Internal Control Over Financial Reporting. Internal control over financial reporting includes policies and procedures that track transactions in assets, control receipts and expenditures and protect assets. The most costly and controversial aspect of Sarbanes-Oxley is the internal control requirement of Section 404. Section 404 and related SEC rules require each public company to include in its Form 10-K a management report on the effectiveness of the company’s internal control over financial reporting. The company’s independent auditor is then required, in a separate audit-like analysis, to attest to, and report on, management’s assessment.

The Annual Proxy Statement and Annual Report to Stockholders

A public company’s proxy statement for its annual meeting of stockholders, along with its annual report to stockholders, plays an increasingly important public disclosure role. These documents provide an annual, formal communication from management to the company’s stockholders. They also serve as an annual corporate governance check-up—not only for compliance with Sarbanes-Oxley, but also for other governance and disclosure mandates, including extensive disclosure regarding executive compensation.

The Proxy Statement. During the first several months of each year, a public company’s senior management and professional advisors will expend significant energy preparing for the company’s annual meeting of stockholders. Much of this time will be spent preparing the company’s proxy statement. The proxy statement informs stockholders about the agenda for the stockholders’ meeting and solicits a proxy from each stockholder to vote his or her shares at the meeting in the manner specified in the proxy card.

Regulation 14A of the Exchange Act governs any communication by a public company reasonably calculated to cause a stockholder to grant, withhold or revoke a proxy. The SEC’s Schedule 14A outlines the information that a company must include in its annual proxy statement. This includes information relating to the meeting and proposals to be acted upon, which normally includes the election of directors, but also goes beyond that information to include extensive corporate governance and executive compensation disclosure. The proxy statement will include detailed information regarding the board, including the independence of directors and the composition and function of the board committees.

The proxy statement will also include detailed tabular and narrative disclosure of executive and director compensation. This will include a Compensation Discussion and Analysis section aimed at providing a plain English discussion of the objectives and implementation of executive compensation programs and the underlying reasons for the programs (basically, MD&A for executive compensation).

Under certain conditions described in Rule 14a-8 under the Exchange Act, a public company must include in its proxy materials “qualifying” proposals from a stockholder

at no expense to that stockholder. These rules provide a means for stockholders to seek stockholder consideration of action not otherwise proposed by the board. If the proposal does not meet the procedural and substantive requirements outlined in Rule 14a-8, the company may exclude the proposal from its proxy materials.

The Annual Report to Stockholders. The SEC requires an annual report to stockholders to accompany or precede a company's proxy statement for any stockholders' meeting at which stockholders will elect directors. Unlike the corporate governance focus of the annual proxy statement, the annual report conveys information regarding the company's business, management and operational and financial status. The annual report has similar content requirements to Form 10-K but serves a different purpose. Form 10-K fulfills the year-end reporting requirement to the SEC and is not necessarily designed to communicate with stockholders. The annual report is intended principally as a communication device—the most direct message from the company to its stockholders—and is generally issued in an attractive format to facilitate this purpose.

Practical Tips

“Wrap It Up at Low Cost”: Fulfilling the Annual Report Requirement With the “10-K Wrap”

Rules 14a-3 and 14c-3 under the Exchange Act specify the minimum content requirements for the annual report to stockholders, which include financial information and MD&A, stock and dividend information, operation and industry segment information and director and officer information. Because the content requirements of the Form 10-K satisfy most of the minimum annual report content requirements, an increasingly common and practical format is the Form 10-K “wrap” annual report: eight or so glossy pages of company message and materials (e.g., president's or chairman's letter, photographs of company, management or products) that simply wrap around the Form 10-K. This avoids duplication between the annual report to stockholders and the 10-K, reduces costs and gets a valuable SEC-filed report into stockholders' hands.

Voluntary Public Disclosure Under Regulation FD

The periodic reports and other filings described above relate to public company disclosures that are mandatory—they are required by SEC, NYSE or Nasdaq rules. Virtually all other communications by a public company, both formal and informal, are voluntary. These communications include earnings releases and calls, analyst conferences, one-on-one discussions with analysts and press interviews. Though voluntary, these communications are critically important as senior executives strive to maintain a dialogue with professional analysts, the financial press and major stockholders to help market professionals follow the company's stock and to provide stockholders with access to management. Yet private discussions with analysts and major investors can create an imbalance of information—and, prior to Regulation FD, institutional stockholders and professional analysts often had more information than other investors. The SEC issued Regulation FD to correct this situation.

Regulation FD (short for Fair Disclosure) requires a company to inform the public when the company, or a person acting on its behalf, voluntarily discloses material nonpub-

lic information to securities market professionals or security holders when it is reasonably foreseeable that the holders will trade on the basis of that information. The timing of the company's public disclosure depends on whether the voluntary selective disclosure was intentional or unintentional. If intentional, the company must make public disclosure of material information simultaneously with any selective disclosure (in practice, this generally means prior to the nonpublic disclosure). If unintentional, the company must make public disclosure promptly after the inadvertent disclosure of material information—meaning within 24 hours after the inadvertent disclosure or by the next opening of the NYSE.

Practical Tips

“Good Policy Makes for Good Disclosure”: Adopting a Disclosure Policy

To help the company comply with Regulation FD and other public disclosure regulations, including Regulation G (see page 45) and Regulation M-A (requiring targets and acquirers in mergers and acquisitions to file all their written communications on the date of first use), adopt a corporate disclosure policy. Some key elements of a disclosure policy include:

- **Designate spokespersons.** Designate only specific persons (e.g., the chairman, chief executive officer, chief financial officer and chief investor relations officer) as spokespersons.
- **Limit timing of one-on-one calls and meetings.** Whenever practicable, limit the timing of conversations with analysts and/or investors to the period following an earnings conference call up to the blackout period.
- **Limit subject matter of one-on-one meetings.** The spokespersons should limit their responses in these conversations to elaboration of previously disclosed or generally known information. Ensure that the analyst or investor understands that the company does not intend to disclose material information selectively.
- **Do not comment on analysts' projections or previous earnings guidance.** The company generally should not comment on or confirm previous earnings guidance or individual analyst projections, nor should it refer to or distribute individual analyst projections.
- **Do not comment on transactions and unusual market activity.** Unless required by law, the company should not respond to inquiries regarding potential financings, restructurings, acquisitions, mergers or other transactions or unusual market activity.
- **Be cautious in interviews with news media.** Treat the media as if communications were subject to Regulation FD.

Insider Reporting and Trading Restrictions

The directors, executive officers and significant stockholders of a public company are subject to a number of limitations and reporting obligations in their ownership and trading of the company's securities. Compliance with these rules requires strong procedures for both the company and the insider.

Section 16 Reporting Obligations of Directors, Executives Officers and 10% Beneficial Stockholders

Section 16(a) of the Exchange Act requires directors and executive officers of a public company to publicly report their beneficial ownership of the company's stock to the SEC. Each insider first files a Form 3 as the initial report with the SEC listing all of the insider's holdings of the company's securities, including equity awards. Generally, the Form 3 is due within ten days of the event triggering compliance—for example, within ten days after a person becomes an officer, director or greater than 10% stockholder of a public company. Insiders of newly public companies file a Form 3 on the date the company becomes a reporting company under the Exchange Act.

Generally, any change that occurs in an insider's beneficial ownership of the company's securities is reported on Form 4. Insiders must file a Form 4 within two business days after a change in beneficial ownership. The two-day reporting period begins when a transaction is executed, not when it settles. Insiders may also be required to file a Form 5 within 45 days after the end of the company's fiscal year. Form 5 is required unless the insider either had no reportable transactions during the year or had already filed one or more Form 4s during the year covering all transactions required to be reported on Form 4 or 5.

Failure to timely file a Form 3, 4 or 5 can result in substantial penalties to the insider. In addition, a public company must disclose in its proxy statement any insiders who reported transactions late or failed to file required reports during the fiscal year.

Section 16(b)—Short-Swing Profit Liability

Another aspect of Section 16 is the short-swing profit liability provisions of Section 16(b) of the Exchange Act. This provision makes an insider of a public company liable to the company for “short-swing trades”—that is, for any profits the insider receives from the purchase and sale (or sale and purchase) of securities of the company within a period of less than six months. The insider is liable for profits realized in both cash and noncash form, such as securities. The test for Section 16(b) liability is purely objective. It does not matter whether the insider was aware of confidential information, whether confidential information was material, whether the insider relied on the information in making a transaction or whether the insider acted in good or bad faith.

Schedules 13D and 13G Reporting Requirements for 5% Stockholders

Entirely apart from any Section 16(a) reporting obligations they may have, stockholders who beneficially own more than 5% of a public company's stock must report their stock ownership to the SEC on Schedule 13D or Schedule 13G. Within 45 days following the end of the calendar year in which a company completes its IPO, every person (including directors and officers) that beneficially owned more than 5% of the company's stock at the time of the IPO must report that ownership to the SEC on a short-form 13G. These initial 5% stockholders are referred to as “exempt stockholders” because their shares were acquired prior to the company's IPO.

After a company is public, any exempt stockholder who acquires more than 2% of the company's stock in a 12-month period, or any other stockholder who acquires 5% or more of the company's stock (following its IPO), may be required to file a Schedule 13D, which is longer than Schedule 13G.

Rule 144 Restrictions on Trading Restricted and Control Securities

The Securities Act requires that a sale of a security be registered with the SEC, unless the security or transaction qualifies for an exemption. Rule 144 provides the most frequently used exemption for the resale in market transactions of restricted and control securities. "Restricted securities" are generally securities that have been issued in a private placement exempt from registration. "Control securities" are any securities owned by any person who is an "affiliate" of the issuer. An "affiliate" is a person that controls, is controlled by or is under common control with, the issuer, including directors, executive officers and major stockholders of the issuer.

Under Rule 144, which was amended effective February 15, 2008, the following conditions must generally be met by affiliates of a reporting public company before restricted stock acquired in a private transaction may be sold to the public:

- There must be adequate "current public information" available concerning the issuer (typically all SEC-required reports filed for 12 months preceding proposed sale);
- The seller must have held the restricted stock for at least six months;
- The seller may not sell in any three-month period restricted and control stock of the same class exceeding the greater of (1) 1% of that class; or (2) the average weekly trading volume in such stock during the preceding four calendar weeks;
- The securities must be sold in unsolicited brokers' transactions or in transactions directly with a market maker; and
- The seller must file Form 144, "Notice of Proposed Sale of Securities," if the seller intends to sell more than 5,000 shares or expects proceeds over \$50,000 within a three-month period.

SEC amendments to Rule 144 adopted in February 2008 changed some of the requirements of Rule 144, particularly for the sale of restricted securities of public companies by nonaffiliates as compared to affiliates. The following table summarizes the conditions applicable to the resale under Rule 144 of restricted stock of a company that has been public for at least 90 days held by affiliates as compared to those held by nonaffiliates.

Affiliate or Person Selling on Behalf of an Affiliate	Nonaffiliate (and Has Not Been an Affiliate During the Prior Three Months)
<ul style="list-style-type: none">• During six-month holding period—no resales under Rule 144 permitted.• After six-month holding period—public resales permitted in accordance with all Rule 144 requirements including:<ul style="list-style-type: none">◆ Current public information,◆ Volume limitations,◆ Manner of sale requirements for equity securities, and◆ Filing of Form 144.	<ul style="list-style-type: none">• During six-month holding period—no resales under Rule 144 permitted.• After six-month holding period but before one year—unlimited public resales under Rule 144 permitted except that the current public information requirement still applies.• After one-year holding period—unlimited public resales under Rule 144 permitted; there is no need to comply with any other Rule 144 requirements.

Insider Trading and Rule 10b-5

The antifraud provisions contained in Rule 10b-5 under the Exchange Act prohibit directors, officers, employees and others who are aware of material nonpublic information from trading while being aware of that information. Disclosing material nonpublic information to others who then trade while aware of such information is also a violation of Rule 10b-5, and both the person who discloses the information and the person who trades while being aware are liable. These illegal activities are commonly referred to as “insider trading.” In the context of insider trading, the term “insider” covers all employees and anyone else who is aware of the material nonpublic information, such as consultants, in addition to Section 16 insiders.

Potential penalties for insider trading violations include imprisonment for up to 20 years, civil fines of up to three times the profit gained or loss avoided by the trade and criminal fines of up to \$5,000,000. The company, as well as directors and officers, may be subject to controlling person liability if the company or the director or officer knew, or recklessly disregarded, that a person directly or indirectly under the company’s or the responsible person’s control was likely to engage in insider trading and the company or person failed to take appropriate steps to prevent such trading.

The best way to protect a company and its insiders from potential liability under the insider trading laws is to adopt, implement and enforce a clear policy that defines insider trading and prohibits employees and insiders from trading while aware of material nonpublic information. The insider trading policy should apply to all directors, officers, employees and consultants of the company.

Chapter 11—IPO as an Exit: Special Considerations for Private Equity and Venture Capital Investors

Time to Exit, Part I—Is an IPO Right for You? An Overview

Private equity and venture capital funds have multiple factors to consider when analyzing an exit strategy. Chapter 1 discusses many of these factors related to an IPO as an exit. In addition, a fund will need to consider, among other things, the strategy for liquidating its position; the time it will take to fully liquidate; the aggregate price it will receive for its investment when selling over time at prevailing market prices; the multiple it would receive in a public offering compared to a private sale; the fund's continued ability (or inability) to control the company; ongoing disclosure, including disclosure of affiliated relationships and transactions; and the heightened scrutiny of compliance with fiduciary duties by fund representatives on the board. Ultimately, it may be more difficult to exit a significant investment through the public offering process than a private sale, and the fund will have less control and more disclosure requirements. However, often the public will pay a higher price than a private buyer for a company with strong growth potential.

One way to approach the IPO exit decision is to first determine whether to gain liquidity through an IPO exit strategy or through a sale of the company. If through an IPO, then determine a post-IPO liquidity strategy—secondary sales to the public; distribution to fund investors; or private sales or a sale of the company following the IPO. Analysis of the post-IPO liquidity strategy, and related issues, may affect the threshold exit decision. While this chapter does not address in detail the threshold IPO versus sale decision, it provides guidance on analyzing a variety of liquidity options.

Time to Exit, Part II—IPO as Stalking Horse, or the Only Way Out

While many funds may want to exit an investment through a straightforward sale process to gain immediate liquidity, funds face situations where an exit is ripe, but a typical sales process may not appear to yield significant or timely demand for the company. One strategy to stimulate demand is to begin or even complete an IPO while still seeking a private sale. A strategic buyer may become more interested in a company if, in a competitive situation, it believes the company will gain resources or momentum through the public offering process. Regardless of whether the company is a competitor, a buyout will become more expensive and difficult after the target is public.

Going public also can be seen as an alternative to a sale, so it can effectively serve as another bidder in an exit process. If a sale is not completed and the company goes public, the company may increase its visibility and essentially market itself through public disclosure of its business, strategies and financial results. In some cases, a “two-step” sale—partial liquidity through an IPO at a short-term market peak, followed by a negotiated sale of control—could extract total higher value for a fund than a straight sale or complete liquidity through secondary sales to the public.

An IPO is expensive and consumes significant management time, so an IPO should not be used lightly to facilitate a complete exit through a private sale process. However, if an exit is appropriate and an IPO is otherwise a reasonable strategy, it may be worthwhile to consider.

The Statistics

“Choosing the Exit Door”: Comparison of Private Equity and Venture-Backed IPOs to Private Sales

Venture-Backed IPOs. Traditionally, IPOs have been viewed as a preferred exit strategy for venture capital funds. Among other reasons, public offerings frequently result in the highest valuation and showcase successful investments. The table below summarizes the number of IPOs of venture-backed companies from 1992 to 2007.

However, exit by private sale (in both number and dollars) has outpaced exit by IPO in the United States. Since 2001, the number of private exits with disclosed values exceeded the number of IPO exits by approximately 9 to 1. Only at the 1999-2000 height of the public market bubble did the number of IPO exits begin to approach the number of private sale exits. During 2000, there were approximately 201 IPOs of venture-backed companies, compared with 462 private sale exits.

Year	Number of Venture-Backed IPOs
2007	75
2006	56
2005	43
2004	67
2003	23
2002	18
2001	22
2000	201
1999	250
1992-1998	141 average per year

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Private Equity-Backed IPOs. Even with the increased popularity of “secondary buyouts”—one private equity fund selling to another private equity fund—private equity-backed IPO exits have seen a dramatic increase since 2004. In 2006, 27% of U.S. IPOs (34% by proceeds) involved companies purportedly backed by private equity funds, according to Global IPO Trends Report 2007 by Ernst & Young. Nevertheless, private sales still dominate IPOs as an exit strategy for private-equity-backed companies. For instance, for 2006 it has been reported that there were 120 sales of private equity-backed companies to other private equity funds alone, compared to 65 IPOs of private equity-backed companies. Note that statistics vary significantly with respect to the number of IPOs of companies that were backed by private equity sponsors.

Time to Exit, Part III—Getting Liquidity Post-IPO

Often the most important issue a fund will need to analyze in a going public exit strategy is how to actually liquidate its position in the portfolio company. A number of factors come into play, including market demand, the terms of any registration rights agreement, lockup agreements, insider trading policies and securities laws restrictions, including those prohibiting sales while in possession of material, nonpublic information. The following are several post-IPO paths to liquidity.

Sale of Shares to the Public (Secondaries)

Sales of shares by the fund to the public in a portfolio company's initial public offering or through subsequent registered offerings is a fundamental liquidity strategy. When analyzing this strategy, a fund should consider how the following factors would affect its ability to achieve liquidity:

- An IPO is primarily a capital-raising event—current investors may be limited in the amount they can sell in the IPO.
- Market demand for secondary offerings will affect the amount and timing of sales by the fund. If the public market float and trading volume are small, the fund may not be able to sell sizable blocks of its shares to the public.
- While the public market may value the shares at a higher multiple, the market price may deteriorate over time and sales by officers, directors and other significant stockholders could further depress the trading price.
- Registration rights agreements almost always contain restrictions on forcing the company to register shares, including provisions allowing the underwriters and company to cut back the amount of shares sold by an investor in an offering.
- Significant investors are typically locked up, or restricted from selling shares, for 180 days following an IPO and may be locked up for various periods after later public offerings.

Funds can take a number of steps to assess whether an IPO of a portfolio company will achieve satisfactory liquidity for its equity in the company through secondary offerings. First, a fund should evaluate the company's business prospects and ability to deliver operating results after the IPO that will maintain or increase public stockholder value. This would include consideration of how the company will report results under SEC guidelines and which results public investors and analysts would find important. Second, a fund should analyze its rights under the portfolio company's organizational agreements and any registration rights and other agreements relating to the fund's rights to participate in public offerings. Third, the fund should talk with investment banks specializing in the company's particular industry about the probable strength and depth of the market for secondary offerings after the IPO. The market for secondary offerings will depend, in part, on the size of the company and offering; the level of public interest in the company; the strength of the company's industry or sector; the company's growth plan and strategies; and the outlook for the stock market generally. All of these matters can affect whether the fund may be able to liquidate its position quickly through a small number of large sales or more slowly through a large number of small sales.

Distribution of Shares to Investors

As an alternative to a fund handling the liquidation of portfolio company shares, a fund should analyze the possibility of distributing the shares of the company to its investors following the IPO. This approach has several advantages. For instance, distributions shortly after the IPO may “lock-in” the return on investment that is otherwise subject to the volatility of the company’s trading price. This would provide a fund certainty as to its carried interest and its track record for investment performance. In addition, assuming the fund can distribute the shares tax-free, distribution allows each investor to choose whether to sell or hold the shares based on the investor’s own view of the company’s long-term prospects and its preferences regarding the timing of taxable gains. A fund may also prefer to distribute the shares if the time needed to dispose of the shares (without adverse price consequences) will exceed the fund’s life and expected wind-down period.

On the other hand, a fund’s distribution of shares to its investors would cause it to lose control of the timing and method of liquidating the investment. If the fund anticipates the trading price will increase over time, or if it expects an acquisition of the public company at a premium, the fund would have a lower investment return by prematurely distributing the shares. In addition, certain investors may not want to hold the shares directly or make subsequent disposition decisions themselves.

As an initial step in determining whether liquidating or distributing the portfolio company shares is a viable strategy, a fund should review its investment agreement. In particular, the fund should examine the terms and conditions of any requirements in the investment agreement about distributing public portfolio company shares and distribution allocations, including valuations for carried interest purposes.

Sales of Shares Outside of Public Offerings or Sale of the Whole Company

After a company is public, a fund will likely have the ability pursuant to a registration rights agreement to require a portfolio company to register the fund’s shares to facilitate a sale to the public. However, a privately negotiated sale by a fund can have advantages over a direct sale to the public through a registered offering. Registered public offerings consume a lot of time and can distract management’s attention from the important task of running the company. The filing of a registration statement may also signal to the public that significant sales are about to occur, which can depress the market price for the company’s stock.

As a result, a fund seeking liquidity might evaluate selling shares of a public company in a privately negotiated transaction. A portfolio company having shares registered with the SEC does not preclude a private sale if the transaction meets certain exemptions under the securities laws. A privately negotiated sale would typically take the form of a large block sale transaction to one or more sizable institutions. The sale either would be pursuant to a registration exemption, where the buyer might receive the shares subject to transfer restrictions, or would be registered with the SEC for a direct sale to the institution.

A fund may also sell unregistered, or restricted, stock to the public pursuant to Rule 144, with certain limitations that vary depending on whether the fund is an “affiliate” or “nonaffiliate” of the company. We describe Rule 144 limitations in greater detail in Chap-

ter 10 under “Rule 144 Restrictions on Trading Restricted and Control Securities.” A fund will likely be deemed an affiliate if it owns greater than 10% of the company.

Of course, a publicly traded company may also be sold in its entirety to a private acquirer or another public company. Even if the fund had drag-along rights before the IPO, enabling the fund to cause other stockholders to vote in favor of a sale, the drag-along rights customarily would have terminated at the time of the IPO. As a result, a sale of the publicly traded company would require a proxy solicitation of all of the voting stockholders, including the fund. Because lawsuits challenging a public company sale are, unfortunately, all too common, a sale typically involves extensive board meetings and process and almost always includes a fairness opinion. A substantial portion of the lawsuits result in a relatively quick settlement.

What Happens to My Control?

Venture and private equity investors often obtain certain kinds of control regarding significant company actions and the board through contracts and charter provisions negotiated with the company at the time of their investment. In the event of an IPO meeting certain specifications, however, many of these controls and contractual rights — such as preemptive rights to acquire stock in future financings, rights of first offer and co-sale, or tag-along, rights, drag-along rights, and protective provision “blocking rights” with respect to key corporate actions — will terminate. One exception is registration rights, which typically continue in force for several years after the IPO.

Most often, the company’s IPO also terminates or substantially reduces the fund’s rights to board seats, and the company becomes subject to director independence requirements. Both NYSE and Nasdaq require a majority of the board, as well as certain committees of the board, to be independent. Under certain circumstances, a representative from a fund can be considered independent under stock exchange rules; however, Sarbanes-Oxley has stricter audit committee standards for an “affiliate” of the company. Chapter 4 provides further detail on director independence requirements. In addition to independence requirements and the loss of contractual rights to a board seat, institutional stockholders may apply pressure to limit control of the board by pre-public investors.

Even if the fund’s contractual right to a board seat terminates in the IPO, the company and fund may consider nominating one or more directors for election or reelection to the board. Nothing precludes the fund from voting in favor of the slate of directors nominated by the company, and company stockholders typically vote in favor of the director slate proposed by the company.

Dealing With the Underwriters

An IPO requires the involvement of a number of parties, and the level of a fund’s participation may vary depending on whether it is selling in the IPO and the extent of its equity stake in the company. Generally, a fund with a significant stake in the portfolio company will want to have input on the investment bank’s selling strategies and the “story” told in the prospectus used to sell the offering. Accordingly, representatives of a lead investor frequently participate in the drafting of the offering prospectus. In addition, certain information about the fund’s holdings and involvement with the company will be disclosed in the prospectus.

If the fund is not selling shares in the IPO, its direct involvement may be limited to being a party to a lockup agreement restricting the sale of any of its shares for 180 days after the IPO and to filling out a questionnaire confirming matters that are required to be disclosed in the prospectus.

If the fund sells shares in the IPO, the underwriters will also expect the fund to become a party to the underwriting agreement and to provide representations and indemnification related to the fund's shares. In some IPOs, the underwriters request indemnification for securities law violations (mainly material misstatements and omissions in the prospectus) from major stockholders, but typically financial sponsors do not provide indemnification for broad securities law violations.

In some cases, the underwriters may ask the fund to execute powers of attorney and other documents prior to the marketing of the offering that commit the fund to transfer the shares it agrees to sell in the offering, if the offering is successful. This assures the underwriters that the fund will not change its mind or interfere with the pricing of the offering after the underwriters are publicly marketing the offering. If the fund effectively controls the final decision as to the price and terms of the sale, the underwriters may not require these documents. A fund should look to its own counsel, and not rely on company counsel, to review any requirements relating to its sale of stock and entrance into the underwriting agreement in connection with the IPO.

Board Duties and Watching Those Relationships

Following an IPO, board members' fiduciary duties become subject to greater scrutiny. While a board member always needs to consider the interests of all stockholders, regardless of whether the company is private or public, a director's risk and level of exposure for liability for failing to do so increase once a company is public. The reasons for this are several, including that public reporting and compliance make the workings of the company and its board more transparent once it is public and that the effect of board decisions on company value is more readily determined through movements in the public company's stock price. Chapter 4 discusses board member considerations.

Public companies are required to report transactions with related parties and possibly obtain approval of these transactions by disinterested directors. Accordingly, prior to going public, a company and fund should consider any arrangements between an affiliated portfolio company and the fund or directors representing the fund, including those related to management fees. Those arrangements should be formalized and disclosed in the IPO prospectus to avoid approval issues and post-IPO claims that they are inappropriate.

SEC Filing Requirements

Any stockholder beneficially owning more than 5% of a public company's stock must report its stock ownership to the SEC on Schedule 13D or 13G. Funds generally report ownership on Schedule 13G, which must be filed within 45 days following the end of the calendar year in which the company completes its IPO. Schedule 13G must be amended annually for any changes in beneficial ownership. The longer form Schedule 13D may be required in certain cases.

In addition to the rules requiring a Schedule 13D or 13G, executive officers, directors and 10% stockholders (considered “insiders”) are subject to Section 16 of the Exchange Act and must file statements of their beneficial ownership on Forms 3, 4 and 5. Section 16 also prohibits insiders from taking short-swing profits by buying and selling securities within a six-month period. Chapter 10 provides an overview of Schedules 13D and 13G and Section 16 reports.

Appendix 1: “Talk the Talk”— Glossary of Common IPO Terms

The initial public offering has a distinct lexicon. Here is a list of common IPO terms that can help you navigate discussions about the IPO process.

10b-5 Reference to Rule 10b-5 of the Exchange Act, which establishes liability for fraudulent activities in a securities offering and for material misstatements or omissions in the offering materials, such as the offering prospectus.

Blue line, digital blue (or similar terms) References to the financial printer’s providing a final, type-set version of the preliminary or final prospectus for final approval before printing the prospectus in quantity.

Book runner The managing or lead underwriter.

Building a book The underwriters’ process of building interest in the initial public offering and obtaining indications of interest, and specific price and quantity information, from potential investors.

Cheap stock Securities, commonly stock options or other equity awards, granted with an exercise price less than fair market value.

Comfort letter (or cold comfort letter) The letter from the company’s auditors to the underwriters regarding the financial data and financial statements in the registration statement, which is delivered at pricing.

Comment letter A letter from the SEC commenting in detail on the registration statement filed with the SEC, after its review of the initial registration statement or amendments to the filing.

D&O questionnaire A questionnaire that the company’s directors, officers and major stockholders will be required to complete concerning matters that may be required to be disclosed in the registration statement.

Directed share (or friends and family) program A program in which certain persons close to the company (so called “friends and family”) can purchase a certain amount of shares in the offering.

Drafting sessions Meetings with the IPO working group in-person or by conference call to discuss in detail the drafting of the prospectus.

Due diligence defense The defense the underwriters have to liability for material misstatements or omissions in the offering documents, which is established by the conduct of reasonable due diligence as prescribed in the securities laws.

Electronic road show A road show presentation given over the Internet or other electronic means, where the participants listen to the oral presentation and remotely view the slide presentation.

Exchange Act (or ’34 Act) The Securities Exchange Act of 1934, as amended, and associated rules and regulations of the SEC.

FINRA The Financial Industry Regulatory Authority (formerly, the National Association of Securities Dealers, or “NASD”), which is the self-regulatory organization governing the conduct of the underwriters and broker-dealers in the IPO.

Free-writing prospectus Any written or graphic communication, other than a prospectus that meets the statutory requirements of the Securities Act, that constitutes an offer to sell, or a solicitation of an offer to buy, securities that are or will be the subject of a registration statement.

Gun-jumping Any publicity or other activity that might be considered an illegal offer to sell the company's securities prior to the filing of the registration statement.

Lockups An agreement by the company, directors, officers and certain stockholders to not sell any company securities for a prescribed period of time after the IPO, typically 180 days.

Over-allotment option (or Green Shoe, “shoe”) An option that gives the underwriters the option to purchase up to 15% additional shares, on the same terms that they purchased the original shares, for a period up to 30 days after the initial public offering.

Pre-filing period The period after the company becomes “in registration” and before the company has filed its registration statement. There is no bright line as to when a company first becomes “in registration,” but, at the latest, a company is in registration once it reaches an understanding with a managing underwriter to lead its public offering. During the so-called “pre-filing period” of the IPO, the company and underwriters may not solicit offers to buy the company's securities to be offered in the IPO.

Price range The range of prices per share stated in the preliminary prospectus as the range in which the company expects it will ultimately price its stock for sale to the public.

Pricing The determination by the company of the per share price at which the company will offer its stock to the public, after consultation with the underwriters following the road show and effectiveness of the registration statement.

Pricing committee A board committee, usually comprised of the CEO, CFO and one or two independent directors, that will determine at pricing the final offering price and approve the underwriting agreement.

Prospectus The “glossy” portion of the registration statement given to prospective investors.

Red herring or “reds” The preliminary prospectus, printed with a red legend on the side of the cover stating that the prospectus is subject to completion.

Response letter A letter from the company or counsel for the company, responding to the SEC's comments on the registration statement.

Road show Representatives from the company meet with prospective investors (generally, institutional investors such as mutual funds, pension funds and the like) in various cities and make presentations about the company.

Road show presentation The slide show presentation (and related remarks) prepared for investor presentations on the road show.

Sarbanes-Oxley (or Sarbox, Sox) The Sarbanes-Oxley Act of 2002, which was the source of a great number of securities reforms increasing the legal compliance requirements of public companies.

SEC The U.S. Securities and Exchange Commission.

Securities Act (or '33 Act) The Securities Act of 1933, as amended, and associated rules and regulations of the SEC.

Summary (or Box) The summary of the company and offering contained in the front of the prospectus, usually surrounded by a box border.

S-1 The Form S-1 is the registration statement filed with the SEC to register securities for an offering. It includes the prospectus.

S-K Regulation S-K includes and describes items of disclosure required to be included in the nonfinancial portion of the registration statement on Form S-1.

S-X Regulation S-X includes and describes items of disclosure required to be included in the financial portion of the registration statement on Form S-1.

Window The theoretical period in which the company may optimally sell, or may only be able to sell, its stock in the IPO.

Appendix 2: Sample Time & Responsibility Schedule for an IPO

[COMPANY]

Time and Responsibility Schedule

Participants	Abbreviation
Company	CO
Company Counsel	CC
Managing Underwriter(s)	UW
Underwriters' Counsel	UC
Auditors	A
Transfer Agent and Registrar	TA

Date	Event
Day 1	Preliminary Organizational Meeting
Week One	First Draft of Registration Statement Distributed by Company Counsel
Week Two	First Drafting Session
Week Three	Revise and Distribute Registration Statement
Week Four	Second Drafting Session
Week Five	Third Drafting Session
Week Six	Final Drafting Session, at Printer
Week Seven	File Registration Statement With SEC
30 days from filing	Receive Comments From SEC
Week Eleven / Twelve	Respond to SEC Comments and Print Preliminary Prospectus
Week Thirteen	Begin Road Show
Week Fourteen	Complete Road Show
	Company and Underwriters Agree on Price
	Stock Begins Trading
Week Fifteen	Closing

[COMPANY]

Initial Public Offering

Sample Time and Responsibility Schedule

Date	Activity	Participants
WEEK ZERO	Prepare and distribute “publicity” memorandum for distribution to officers and directors of Company regarding informational restrictions in connection with offering	CC CO, CC
	Begin drafting Registration Statement	
	Meetings between Company and Company Counsel concerning “corporate cleanup.” The following matters should be discussed:	CO, CC
	(a) Amendments to Certificate of Incorporation and Bylaws	
	(b) Adjustment of individual stockholders’ holdings in Company, if desired	
	(c) Creation of, or revisions to, employment agreements	
	(d) Creation of stock option, stock purchase and other desired employee benefit plans	
	(e) Revision of existing employee benefit plans to comply with securities law requirements	
	(f) Verification that all existing employee benefit plans comply with requirements of ERISA and other applicable laws	
	(g) Determination of status after offering of stockholders’ and voting trust agreements and other restrictions on voting and transfer of stock	
	(h) Examination of covenants in loan agreements, leases and other contracts that restrict or limit use of proceeds of a public offering, or that restrict dividend payments	
	(i) Discussion of stockholders’ rights plans	
	(j) Collection of exhibits to Registration Statement and conversion to electronic form	
	Preliminary negotiation of terms of offering	CO, UW
	Meeting between Company and Auditors concerning need for change in accounting procedures (e.g., instituting necessary procedures and controls to produce reports required under the Exchange Act) when Company is a public company	
	Negotiate letter of intent or term sheet, if applicable	CO, CC, UW, UC

Date	Activity	Participants
WEEK ONE	<p>Organizational meeting, at which the following matters should be discussed:</p> <ul style="list-style-type: none"> (a) Terms and structure of offering <ul style="list-style-type: none"> 1) size; primary and secondary shares 2) over-allotment option ("Green Shoe") 3) Distribution objectives (institutional and retail, domestic and international, directed shares) (b) Timetable (c) Assignment of responsibilities for tasks (d) Selection of financial printer (e) Selection of banknote company (f) Selection of transfer agent (g) Selection of stockholder relations advisor (h) Appropriateness of certain "corporate cleanup" matters (e.g., employment agreements, stockholders' rights plans) in light of marketing considerations (i) Stock exchange listing (j) Discussion of required financial statements and of any special accounting issues or tax issues (k) Discussion of legal or regulatory issues (l) Discussion of any anticipated disclosure problems (m) Discussion of anticipated FINRA or blue sky problems (n) Arrangements with stockholders who have registration rights (o) Potential directed share program (p) Use of proceeds (q) Recapitalization of Company (e.g., stock split or reverse stock split) that will be required prior to offering (r) Discussion of any desired stockholder concessions, such as lockup agreements (s) D&O insurance (t) Discussion of press release under Rule 135 of the Securities Act 	CO, CC, UW, UC, A

Date	Activity	Participants
WEEK TWO	Distribute first draft of Registration Statement	CO, CC
	Distribute list of participants (including direct lines and home phone numbers)	CC
	Draft and distribute a time and responsibility schedule, including specific assignments of responsibilities	UW, UC
	Review each item of Form S-1 and appropriate items of Regulation S-K and Regulation C	CC
	Examine Company's charter, bylaws, minute books, loan agreements, stockholder agreements, etc., to determine, among other things, the following	CC
	(a) Due incorporation	
	(b) Good standing (consider sending for long form certificate from Secretary of State with certified copies of all charter documents and requesting a tax paragraph or separate tax certificate)	
	(c) Due qualification to do business in the jurisdictions required (consider obtaining certificate from Company's Secretary showing each jurisdiction in which Company has property or operations)	
	(d) Existence of preemptive rights and whether they have been honored, cumulative voting provisions, restrictions on issuance or transfer of stock, declaration and payment of dividends or issuance of debt and prior compliance therewith, and any other material limitations on Company's operations	
	(e) Compliance with corporate requirements of Company's state of incorporation relating to Company's outstanding securities	
	(1) Corporate authority to issue stock and proper corporate action	
	(2) Minimum capitalization	
	(3) "Fully paid and nonassessable" (consider obtaining certificate of Company's Treasurer or auditors regarding full payment)	
	(4) Adequate consideration	
	(5) Form of stock certificate	
	Transmit due diligence document request list to Company	UC
	Commence drafting necessary "corporate cleanup" documents (e.g., charter and bylaw amendments, employment agreements, stock option plans), documents necessary to effect any recapitalization and board resolutions necessary to authorize the public offering	CC, reviewed by UC

Date	Activity	Participants
	Continue business due diligence and commence legal due diligence review of material contracts, litigation, claims and contingent liabilities, past corporate action (minute books, stock records, charter, bylaws, etc.), financial statements, documentation with regard to outstanding securities, etc.	UW, UC
	Send bid letters to appropriate financial printers	CC
	Send Officers', Directors' and 5% Stockholders' Questionnaires to officers, directors and 5% or more stockholders of Company	CO or CC
	Begin preparation of initial report of beneficial ownership of equity securities (Form 3) required under Section 16(a) of the Exchange Act for officers, directors and 10% or more stockholders of Company (required to be filed by the effective date of Exchange Act registration)	CO, CC
	Commence preparation of Underwriting Agreement, Agreement Among Underwriters, Underwriters' Questionnaire, Underwriters' Power of Attorney ¹ and Preliminary Blue Sky Survey	UC
	If secondary offering is involved, prepare Selling Stockholders' Questionnaire and other Selling Stockholder documents, including a Custody Agreement and a Power of Attorney, if necessary	CC (or Selling Stockholders' Counsel, if different), reviewed by UC
	Analyze whether confidential treatment of any material contracts required; if so, begin preparation of confidential treatment request	CO, CC
	Commence preparation of necessary financial statements	CO, A
	Draft powers of attorney for Registration Statement and amendments thereto, if needed (these will typically be contained in signature page of Registration Statement)	CO, CC
	Select banknote company to print stock certificates	CO, CC
	Advise banknote company of schedule and arrange for printing of stock certificates	CO
	Select Transfer Agent and Registrar	CO
	Select financial printer	CO, CC
	If desired, exchange letter of intent with Issuer	CO and UW, reviewed by CC and UC

¹A separate Agreement Among Underwriters, Underwriters' Questionnaire and Underwriters' Power of Attorney will not be required if a Master Agreement Among Underwriters is applicable to the offering. Different underwriters have different forms of these agreements. Consult with the lead underwriter as to the proper form(s).

Date	Activity	Participants
	If desired, draft and distribute press release announcing proposed offering (see Rule 135 and appropriate SEC Releases)	CO and UW, reviewed by CC and UC
	Determine potential directed share program, possible reservation of securities for employees and business associates of the Company	CO, UW
	File Form ID with SEC to reserve electronic filing codes	CO or CC
	Determine availability and reserve desired stock exchange trading symbol	CO, CC
WEEK THREE	First meeting to discuss Registration Statement	CO, CC, UW, UC, A
	Distribute underwriting documents	UW, UC
	Commence negotiations with lenders and lessors concerning necessary consents and revisions of covenants that would restrict offering, use of proceeds thereof or dividends	CO, CC
	Contact stock exchange regarding preclearance; file stock exchange application	CC
	Revise and distribute Registration Statement	CO, CC
WEEK FOUR	Revise and distribute Registration Statement	CO, CC
	Distribute drafts of financial statements ²	CO, A
WEEK FIVE	Second meeting to discuss Registration Statement and Underwriting Agreement	CO, CC, UW, UC, A
	Discuss comfort letter content and procedures	UC, UW, A
	Review and approve proofs of stock certificates	CO, CC
	Obtain completed Questionnaires and Powers of Attorney, if any, from officers, directors and 5% or more stockholders of Company	CO or CC
	Obtain completed initial reports of beneficial ownership (Form 3) from officers, directors and 10% or more stockholders of Company	CO or CC
	Revise and distribute Registration Statement	CO, CC
	Assemble exhibits and deliver electronic version to printer	CO, CC

²The timing of the release of the financial statements will vary depending on the proximity of the commencement of preparation of the Registration Statement to the end of the fiscal quarter for which financial statements are to be included in the Registration Statement.

Date	Activity	Participants
WEEK SIX	Third meeting to discuss Registration Statement and Underwriting Agreement	CO, CC, UW, UC, A
	Draft of Registration Statement to printer	CC
	Draft of Underwriting Agreement to printer	UC
	Finalize and circulate “corporate cleanup” and recapitalization documents	CO, CC
	Ensure that Company has obtained the necessary authorizations and approvals of the offering from regulatory agencies, if any	CO, CC
	Circulate draft of comfort letter	A
	Prepare Form 8-A for Exchange Act registration	CO, CC
	Arrange to have execution copies of the signature pages printed and signed by necessary officers and directors (these pages may, if acceptable to the persons signing, include designations of certain individuals to sign amendments to the Registration Statement as attorneys-in-fact on their behalf)	CO, CC
	Arrange to have execution pages for accountant’s opinions and consents delivered, executed and returned in time for filing	CC, A
	Arrange for consents of persons about to become directors, if required (see Rule 438 under the Securities Act)	CC
	Finalize and execute Powers of Attorney and Custody Agreements and arrange for placement of Selling Stockholders’ stock certificates with Custodian prior to filing with SEC, if necessary (Custodian is often the Transfer Agent and Registrar)	CO, CC
	Confirm approval from stock exchange	CO, CC
WEEK SEVEN	Meetings at printer to discuss and finalize Registration Statement	CO, CC, UW, UC, A
	Circulate revised proofs of Registration Statement and Underwriting Agreement	CC, UC
	Meeting of board of directors of Company to approve financing program and “corporate cleanup” matters, including adoption of resolutions relating to:	CO, CC
	<ul style="list-style-type: none"> (a) Authorizing issuance, sale and delivery of stock (b) Participating Selling Stockholder(s), if applicable (c) Approving form of Underwriting Agreement and authorizing execution and delivery thereof (d) If necessary, appointing a special committee of the board of directors to establish the price of stock to the Underwriters and the initial public offering price 	

Date	Activity	Participants
	(e) Approving Registration Statement and prospectus and authorizing execution and filing of Registration Statement and all amendments thereto	
	(f) Authorizing listing of stock on stock exchange	
	(g) Appointing transfer agent and registrar	
	(h) Approving all necessary “corporate cleanup” matters	
	(i) Approving recapitalization, if necessary	
	(j) Calling a special meeting of stockholders, if necessary	
	(k) Approving form of stock certificates	
	(l) Blue sky matters	
	Special meeting (or written consent in lieu of meeting) of stockholders of Company, at which resolutions are adopted approving any recapitalization and all “corporate cleanup” matters that require stockholder approval	CO, CC
	File charter amendments necessary to effect recapitalization, if applicable	CO, CC
	Finalize financial statements	CO, A
	Finalize Underwriting Agreement	CO, CC, UW, UC
	Notify stock exchange at least two business days prior to expected filing date for stock exchange approval	CC
	Give instructions to printer with respect to the mailing of preliminary materials	UW
	Determine quantities of preliminary offering materials required and give printer instructions re same	CO, UW, UC
	Finalize compilation and preparation of exhibits to Registration Statement	CO, CC
	Obtain approval letter from stock exchange	CO, CC
	Prepare transmittal letter to FINRA	UC
	Complete Blue Sky Survey	UC
	Finalize comfort letter	UW, A, UC
	Arrange for wire transfer of SEC filing fee	CO
	Arrange for FINRA and stock exchange filing fees	CO, CC
	File Registration Statement with SEC via EDGAR	CC
	File confidential treatment request with SEC, if applicable	
	File Form 8-A with SEC via EDGAR and with stock exchange on which listing is sought	CC
	File Registration Statement and related materials with FINRA and stock exchange	UC

Date	Activity	Participants
	Notify parties that filing is accomplished and specify the SEC Registration Number	CC or UC
	If appropriate, issue brief press release re filing of Registration Statement (See Rule 134)	CO, UW
WEEK EIGHT	Have signed copies of Registration Statement distributed to Company, Company Counsel, Auditors, Underwriters and Underwriters' Counsel	CO or CC
	Prepare application for CUSIP number, apply for CUSIP number for stock; send copy of Registration Statement to CUSIP Service Bureau	CO, CC
	Send copies of Registration Statement to FINRA and stock exchange	CO, CC
WEEK NINE	File documents and otherwise finalize arrangements with Transfer Agent and Registrar necessary for its initial appointment	CO, CC
	Obtain CUSIP number for stock	CO, CC
	Approve final proof of stock certificates	CO, CC
	Order closing documents with long lead times	CC
	Resolve outstanding issues with FINRA and blue sky administrators	UC
	Resolve issues with stock exchange	CO, CC
WEEK ELEVEN AND TWELVE	Receive comments from SEC ³	CC
	Review SEC comments and draft changes to Registration Statement in response thereto; clear responses to comment letter and schedule for filing of amendment to, and effectiveness of, Registration Statement (and Form 8-A) with SEC (SEC may require one or more amendments containing changes to be filed prior to the final amendment)	CO, CC, UW, UC, A
	Print preliminary prospectuses in quantity	CO
	Commence information meetings ("Road Show")	CO, UW
WEEK THIRTEEN	If the amended preliminary prospectus incorporates substantial changes from prior distributed preliminary prospectus, consider recirculating preliminary prospectus	CC, UC

³Estimated time frame for receipt of SEC comments. To the extent that the SEC's comments are received significantly before or after the assumed date, the subsequent dates would be adjusted accordingly.

Date	Activity	Participants
	Obtain FINRA clearance of underwriting arrangements	UW, UC
	Prepare requests for acceleration of effective date of Registration Statement (see Rule 461) and Form 8-A	CO, CC, UW, UC
	Obtain letter from Underwriters joining in Company's request for acceleration of effectiveness of Form 8-A	CO, CC
	Distribute initial draft of closing memorandum	UC
	Notify stock exchange of expected effective date of Registration Statement no less than 72 hours prior to anticipated effectiveness	CO, CC
	File acceleration request of Company to SEC at least two business days in advance of desired effective date, together with letter of Managing Underwriter(s) joining in such request and providing information concerning distribution of preliminary prospectuses (see Rule 15c2-8 under the Exchange Act and Release No. 33-4968)	CC, UC
	File letter with SEC and stock exchange requesting acceleration of effective date of Form 8-A	CC
WEEK FOURTEEN Pricing Day	Complete Road Show	CO, UW
	Registration Statement declared effective by SEC (5:00 p.m., New York time) ⁴	CC
	Form 8-A declared effective (5:00 p.m., New York time)	CC
	Underwriter notified of effectiveness	CC
	Notify stock exchange of effectiveness of Registration Statement and Form 8-A	CC
	Notify syndicate of effectiveness	UW
	Meeting of Company's board of directors (or special committee of the board of directors) to establish the price of stock to the Underwriters and the initial public offering price thereof and to approve final form of Underwriting Agreement	CO, CC
	Give printer labels and mailing instructions for final prospectus to the extent of hard copy delivery	UW
	Deliver comfort letter (5:00 p.m., New York time)	A
	Sign Underwriting Agreement (5:30 p.m., New York time)	CO, UW
	File initial reports of beneficial ownership (Form 3) on behalf of officers, directors and 10% or more stockholders of Company as of the date of effectiveness (may be pre-filed)	CC

⁴Earlier effective time may be requested. If so, times listed above and time of effectiveness of Form 8-A should be appropriately adjusted.

Date	Activity	Participants
Offering Day (day after pricing)	Prepare final prospectus containing pricing information (Rules 424(b) and 430A)	CC, UC
	Issue press release re effectiveness of Registration Statement and price of stock	CO, UW
	File final prospectus with SEC pursuant to Rule 424(b)	CC
	Deliver copy of final prospectus to FINRA	UC
	Deliver copy of final prospectus to stock exchange	CC
	Release “tombstone”	UW
	Begin market-making activities	UW
	Distribute revised draft of closing memorandum	UC
	Commence preparation of legal opinions, certificates and other closing documents	UC, CC, TA
	Contact banknote company to arrange for printing in quantity of stock certificates	CO
	Print final prospectus in quantity	CO
	File Form S-8 to register stock issuable pursuant to employee benefit plans	CO, CC
Day after Offering Day	“Tombstone” advertisement appears	UW
	Notify syndicate of closing date and give instructions re payment	UW
WEEK FIFTEEN		
3 days prior to Closing	Furnish Company and Transfer Agent and Registrar with names and denominations in which stock certificates are to be registered	UW
	Company Counsel opinion and instructions for certificates to Transfer Agent and Registrar	CO, CC
1 day prior to Closing	Preliminary closing (2:00 p.m., New York time)	CO, CC, UC
	Stock certificates packaged for closing	UW, TA
Closing Day	Closing (9:00 a.m., New York time)	CO, CC, UW, UC, TA
Post-Closing, as appropriate	Monitor undertakings in Registration Statement for compliance	CC
	Prepare bound volumes	CC
Within 45 days from the end of the first fiscal quarter ending after effective date of Registration Statement	File report on Form 10-Q with SEC	CO, CC, A

Date	Activity	Participants
Within 90 days from the end of the fiscal year ending after the effective date of the Registration Statement	File report on Form 10-K with SEC re offering expenses and use of proceeds	CO, CC, A
Various dates subsequent to effective date of Registration Statement	Provide Underwriters with copies of filings as agreed upon in Underwriting Agreement	CO, CC

Appendix 3: Listing on the Exchange— NYSE vs. Nasdaq Requirements

NYSE Initial Listing Requirements

Distribution and Size Standards (must satisfy each of these three criteria)		Requirements
1. Stockholders		
<i>A. Companies listed in connection with an IPO; affiliated companies; and companies following emergence from bankruptcy</i>		
Round-lot (generally 100 shares) holders, including beneficial owners of “street name” shares		400
<i>B. Companies listed in connection with a transfer or quotation</i>		
Round-lot (generally 100 shares) holders, including beneficial owners of “street name” shares		400
OR		
Total stockholders		2,200
<i>together with</i>		
Average Monthly Trading Volume (for the most recent six months)		100,000 shares
OR		
Total stockholders		500
<i>together with</i>		
Average Monthly Trading Volume (for the most recent 12 months)		1,000,000 shares
2. Public Shares		1,100,000 shares
3. Market Value of Public Shares		
Public companies		\$100,000,000
IPOs, spin-offs, affiliated companies		\$60,000,000
If a company either has a significant concentration of stock or changing market forces have adversely impacted the public market value of a company that otherwise would qualify for NYSE listing, such that its public market value is no more than 10% below the minimum, the NYSE will consider stockholders’ equity of \$60 million or \$100 million, as applicable, as an alternate measure of size.		

Financial Standards (must satisfy one of the following three criteria)		Requirements
<hr/>		
1. Earnings		
Aggregate pretax earnings, adjusted for items listed in the NYSE Listed Company Manual, for last three fiscal years (two most recent years must be a minimum of \$2,000,000 and third year must be positive) . .		\$10,000,000
OR		
Aggregate pretax earnings, adjusted for items listed in the NYSE Listed Company Manual, for last three fiscal years (most recent fiscal year must be at least \$5,000,000 and next most recent fiscal year must be at least \$2,000,000)		\$12,000,000
OR		
<hr/>		
2. Valuation/Revenue Test		
<i>Valuation/Revenue With Cash Flow Test:</i> For companies with not less than \$500 million in global market capitalization and \$100 million in revenues in the last 12 months:		
Aggregate operating cash flow for the last three years (each year must report a positive amount)		\$25,000,000
Operating cash flow is net cash provided by operating activities excluding the changes in working capital or in operating assets and liabilities, as adjusted for items listed in the NYSE Listed Company Manual.		
OR		
<i>Pure Valuation/Revenue Test:</i> For companies with not less than \$750 million in global market capitalization:		
Revenues during most recent fiscal year		\$75,000,000
OR		
<hr/>		
3. Affiliated Company Test		
Global market capitalization (with (i) at least 12 months of operating history and (ii) the company's parent or affiliate company is a listed company in good standing and retains control over the company or is under common control with the company)		\$500,000,000
<hr/>		

Nasdaq Initial Listing Requirements

Nasdaq Global Select Market

(must meet all of the criteria under at least one of the standards)

Financial and Qualitative Requirements	Standard 1	Standard 2	Standard 3
Tax income from continuing operations	(i) \geq \$11 million aggregate in prior 3 fiscal years AND (ii) \geq \$2.2 million in each of 2 most recent fiscal years AND (iii) each of prior 3 fiscal years \geq \$0	N/A	N/A
Cash flow	N/A	(i) \geq \$27.5 million aggregate in prior 3 fiscal years AND (ii) each of prior 3 fiscal years \geq \$0	N/A
Market capitalization	N/A	Average \geq \$550 million over prior 12 months	Average \geq \$850 million over prior 12 months
Total revenue	N/A	\geq \$110 million in previous fiscal year	\geq \$90 million in previous fiscal year
Minimum bid price	\$5	\$5	\$5
Market makers	3	3	3
Compliance with corporate governance standards	Yes	Yes	Yes
Liquidity Requirements	IPOs and Spin-Offs	Seasoned Companies	Affiliated Companies
(A) Beneficial stockholders (round-lot) OR	450	450	450
(B) Beneficial stockholders OR	2,200	2,200	2,200
(C) Beneficial stockholders AND	N/A	550 AND	550 AND
Average Monthly Trading Volume over past 12 months		1.1 million	1.1 million

Publicly held shares (shares outstanding less any shares held by officers, directors, or beneficial owners of 10% or more)	1.25 million	1.25 million	1.25 million
Market value of publicly held shares	\$70 million	\$110 million	\$70 million
OR			
Market value of publicly held shares		\$100 million	
AND		AND	
Stockholders' Equity		\$110 million	

Nasdaq Global Market
(must meet all of the criteria under at least one of the standards)

Requirements	Standard 1	Standard 2	Standard 3
Stockholders' equity	\$15 million	\$30 million	N/A
Market value of listed securities	N/A	N/A	\$75 million
OR BOTH (for latest fiscal year or for 2 of last 3 fiscal years)			
Total assets			\$75 million
AND			
Total revenue			\$75 million
Tax income from continuing operations (in latest fiscal year or 2 of last 3 fiscal years)	\$1 million	N/A	N/A
Publicly held shares (shares outstanding less any shares held by officers, directors or beneficial owners of 10% or more)	1.1 million	1.1 million	1.1 million
Market value of publicly held shares	\$8 million	\$18 million	\$20 million
Minimum bid price	\$5	\$5	\$5
Round-lot stockholders (100-share block holders)	400	400	400
Market makers	3	3	4
Operating history	N/A	2 years	N/A
Compliance with corporate governance standards	Yes	Yes	Yes

Nasdaq Capital Market

(must meet all of the criteria under at least one of the standards)

Requirements	Standard 1	Standard 2	Standard 3
Stockholders' equity	\$5 million	\$4 million	\$4 million
Market value of publicly held shares	\$15 million	\$15 million	\$5 million
Operating history	2 years	N/A	N/A
Market value of listed securities	N/A	\$50 million	N/A
Net income from continuing operations (in latest fiscal year or 2 of last 3 fiscal years)	N/A	N/A	\$750,000
Publicly held shares (shares outstanding less any shares held by officers, directors or beneficial owners of 10% or more)	1 million	1 million	1 million
Minimum bid price	\$4	\$4	\$4
Round-lot stockholders (100-share block holders)	300	300	300
Market makers	3	3	3
Compliance with corporate governance standards	Yes	Yes	Yes

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