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# The U.S. IPO Market: Market and Legal Developments

**April 2017**

# Agenda

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- Fewer U.S. IPOs; private companies choosing to stay private or choosing M&A exits
- The late-stage private placement market
- Recent IPO trends
- PE- and VC-backed IPOs
- Dual track processes
- Insider participation in IPOs
- Voting and governance issues
- What's next?

# Staying Private

# The JOBS Act and private offerings

- Although the aspect of the JOBS Act that has received the most attention relates to changes to the IPO process, in large measure, the JOBS Act related changes affecting the private market may be more significant.
  - Title V and Title VI changes to the Exchange Act Section 12(g) threshold
  - Changes to Rule 506
  - Legal certainty for matchmaking platforms
- Taken together, these measures have the effect of permitting companies to stay private longer and to rely on exempt offerings (while enabling companies to contact a broader range of potential investors) for their capital-raising.

# Reliance on private or exempt offerings

- Even pre-JOBS Act, based on various studies, it was already the case that more capital was being raised in reliance on Regulation D and Rule 144A (in aggregate) than in SEC-registered offerings—according to the SEC’s Division of Economic Research and Analysis (DERA), in 2014, for example, the total raised in registered offerings was \$1.35 trillion whereas the total raised through all private offerings was \$2.1 trillion
  - Amounts raised in private offerings are likely to be understated given that many issuers fail to file Form Ds and amounts raised in 4(a)(2) offerings are not reported
  - The amounts raised in registered offerings include debt offerings, whereas the majority of Reg D offerings involve equity or “new capital”

- These trends became more pronounced in 2015 and 2016
- Companies are choosing to defer their IPOs and rely on private financing for much longer than in the past
  - This is evident from various IPO reports
  - For example, based on statistics for the period from 1/1/12 through 12/31/16, the median market cap for IPO issuers was approximately \$384.9 million, and the average was \$1.3 billion
  - Fewer than 2.3% of IPO issuers have a market cap of \$50 million or less

*Source: IPO Vital Signs*

# Venture-backed Companies Delaying IPOs

- There are now at least 187 private companies valued by venture capital firms at \$1 billion or more. (CB Insights)
  - These companies, often referred to as “unicorns,” have a median valuation after their most recent investment in 2016 of \$2 billion. (CB Insights)
  - Uber has been able to raise significant amounts (reportedly \$5 billion) in private financings, giving it a value of close to \$62.5 billion.
- Venture-backed companies raised more in the private market (\$8.8B) than the public market (\$894M) in the second quarter of 2016 (National Venture Capital Association & Thomson Reuters).
- 2016 proved challenging for venture-backed technology IPOs. In the third quarter, 21 venture-backed tech companies went public, raising \$3.0 billion (Renaissance Capital).

- Venture-backed tech companies' total average funding (\$182M) and median funding (\$105M) are up 64% and 42% from last year (CB Insights).
- 56% of startups eyed acquisition by a larger company as the long-term goal compared to just 17% that still want to go public (*Newsweek/Silicon Valley Bank 2016 Survey*).

No U.S. Tech IPOs in First-Quarter – First Time in Seven Years

Technology stocks selloff may turn IPO chill into IPO freeze

*Tech Start-Ups Choose to Stay Private in I.P.O. Standoff*

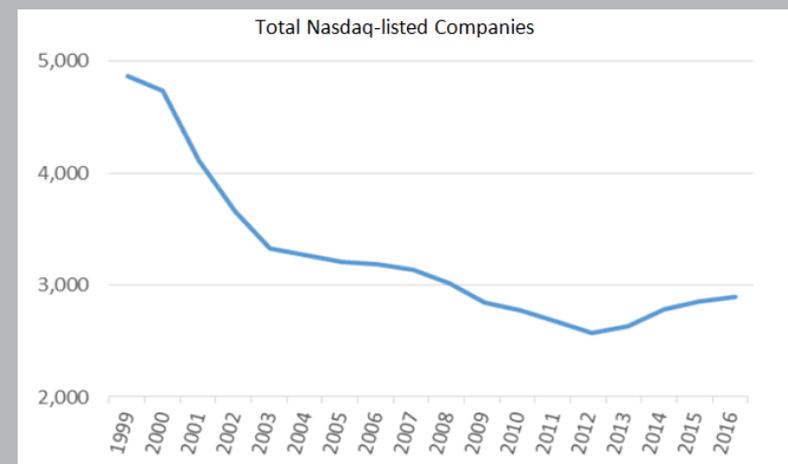
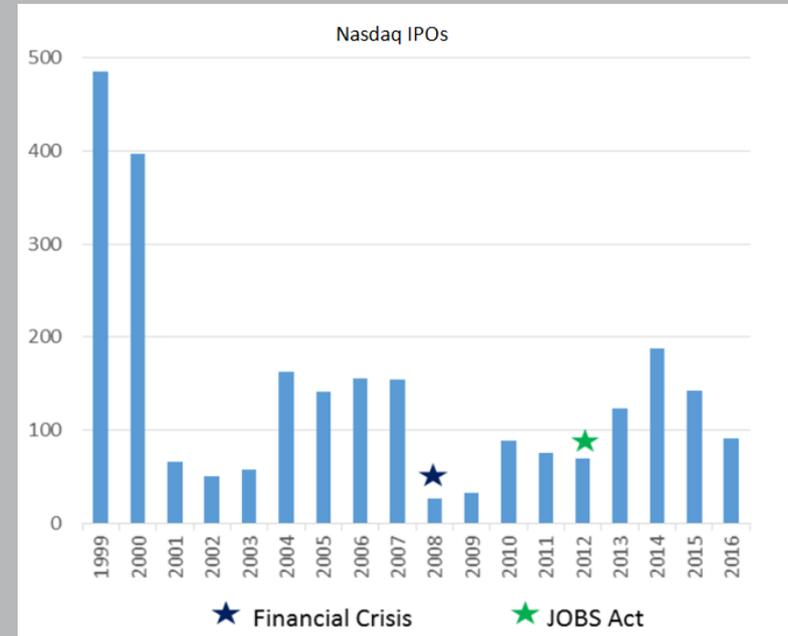
Tech group public-private funding gulf widens

# Effects on the IPO Market

- In a recent study based on work undertaken by the University of Florida, capital invested in private tech companies grew from \$11b billion in 2005 to \$75 billion in 2015 and almost tripled from 2013 to 2015.
- The median age of a tech company going public in 1999 was 4 years. Between 2004-2015, the median age grew to 9 years. Six companies between 2004 and 2015 reached valuations upwards of \$10 billion before going public.
- The market is “losing” IPO candidates as promising companies choose to stay private longer or pursue M&A exits.

Source: J. Ritter/University of Florida

Graph Source: Testimony of Edward S. Knight, Nasdaq, Inc. before the House Financial Services Committee Subcommittee on Capital Markets and GSEs



# Late-stage financings

# Late stage or pre-IPO privates

- There may be a variety of different motivations for a late stage or pre-IPO private placement
  - Company may want to defer IPO and need to raise additional capital prior to the IPO
  - Company may want to take out early friends & family and angel investors and “clean up” balance sheet or provide partial liquidity for longstanding holders
  - Company may want to bring in strategic investors
  - Company may be advised that it should prepare itself for the IPO by gaining support and validation from key sector investors that are opinion leaders
  - Company and bankers may want to “de-risk” the IPO by bringing in cross-over investors that will also invest in the IPO
  - Company may be advised that an up round will make higher IPO pricing easier for IPO investors to accept
  - May be quite sector dependent

# Recent High Profile Late Stage Private Financings

 **Palantir**  
\$500M

 **airbnb**  
\$1.5B

 **Spotify**  
\$526M

 **Pinterest**  
\$367M

 **Dropbox**  
\$350M

 **SPACEX**  
\$1.0B

 **Snapchat**  
\$1.81B

 **wework**  
\$300M

 **DOMO**  
\$366M

 **FanDuel**  
\$275M

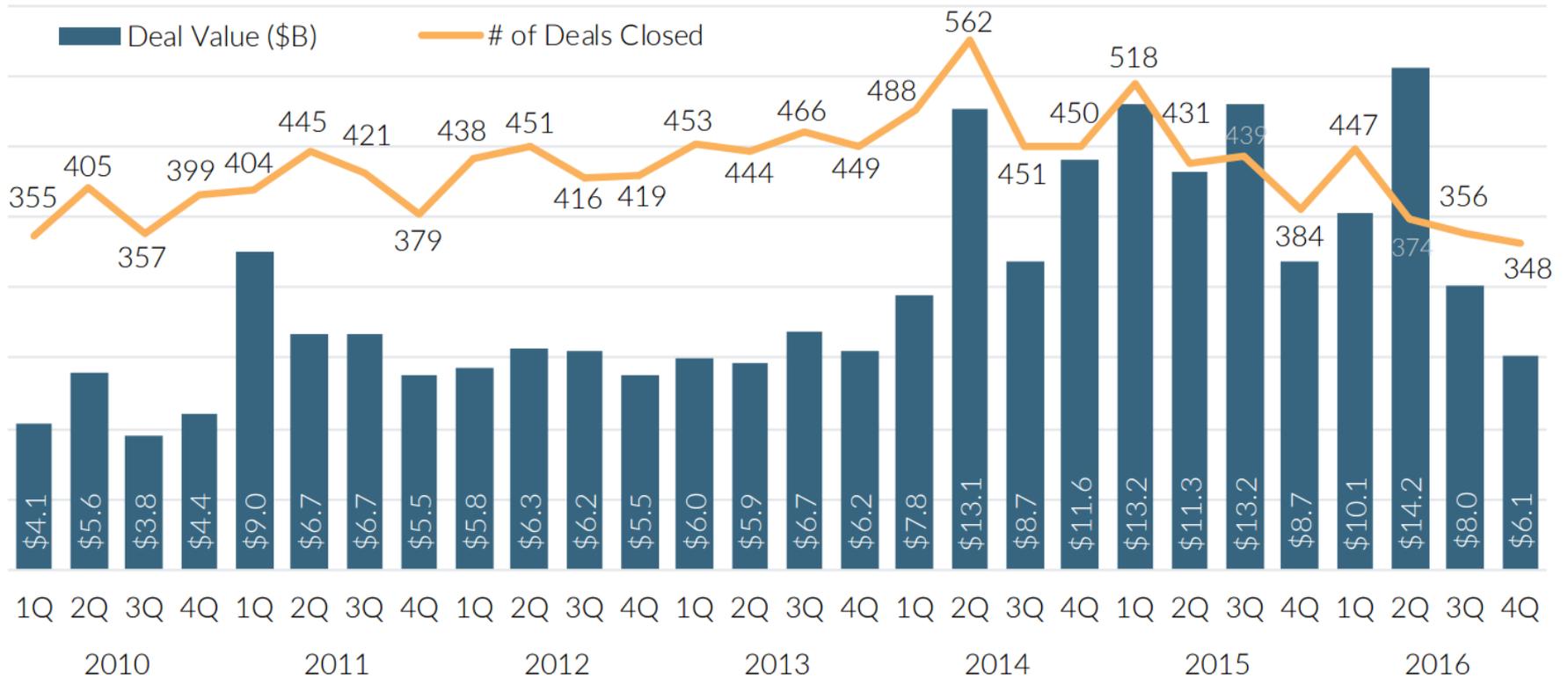
 **DRAFT KINGS**  
\$300M

 **magic leap**  
\$794M

 **UBER**  
\$5.6B

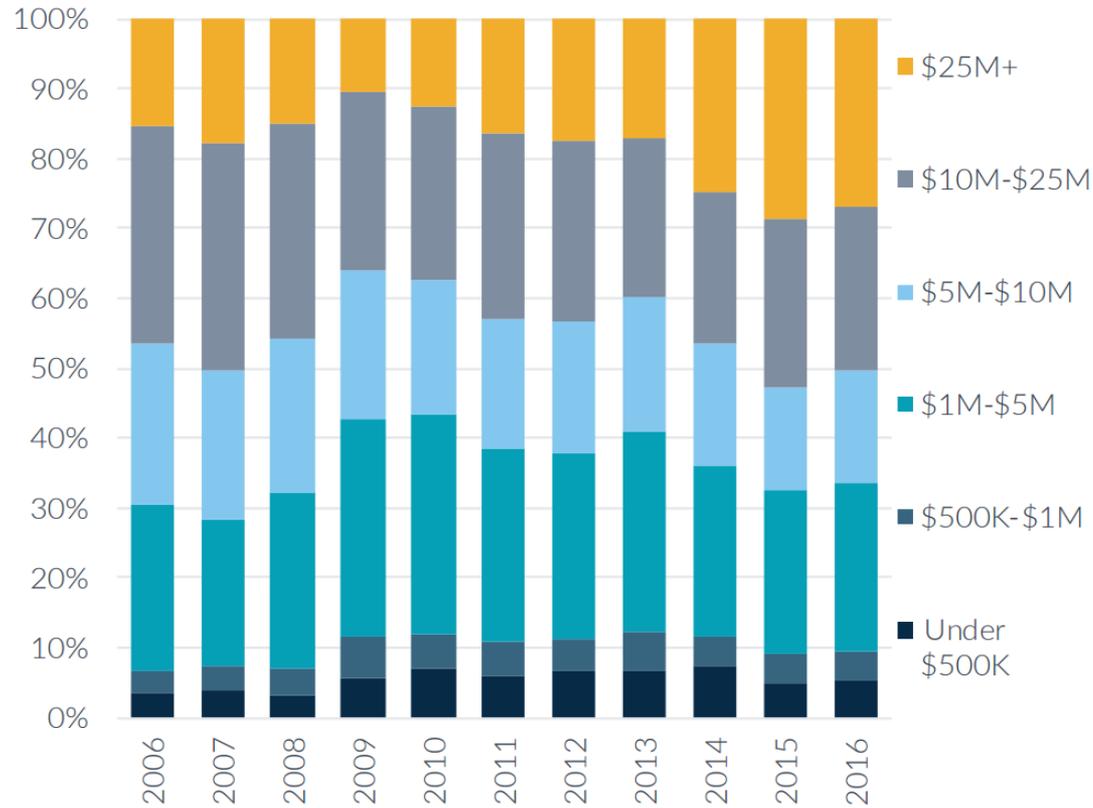
# Late Stage Financing Activity

US late-stage VC activity by quarter



Source: PitchBook. Note: Uber's financings in the first half of 2016 were collated into one super round in 2Q 2016 according to PitchBook methodology.

## US late-stage VC activity (#) by size



Source: PitchBook

Late Stage Financing Activity,  
cont'd.

# Valuation

- In addition to the fact that there are many more investors willing to invest in private companies (i.e., sovereign wealth funds, family offices, cross over funds, etc.), often the valuations available to attractive privately held companies may be quite compelling
- How are the shares of privately held companies valued and who is responsible for valuations?
  - The IPO prices for many companies that have gone public have been lower than the prices at which these companies had last raised capital privately and lower than the prices at which secondary private transactions were completed
  - Private companies also have been able to raise money at higher premiums than their direct competitors who are public
  - What does this suggest, if anything?
    - Are investors no longer applying a “liquidity discount”?
    - Is the premium associated with the liquidation preference that typically accompanies preferred stock rounds only?
  - In IPOs, investment banks in pricing the IPOs and IPO investors demand an “IPO discount” (“IPO underpricing”)

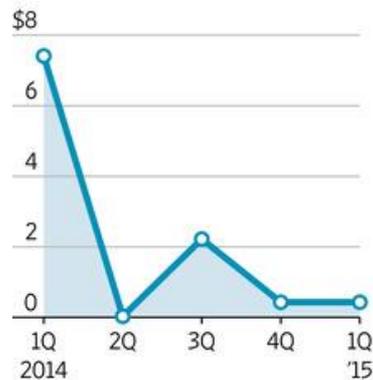
- When VCs or “cross over investors” participate in successive private financing rounds, often they can negotiate for themselves downside protection, including protection should the company go public at a lower valuation—but what about participants in secondary private markets?
- Many analysts also have noted that the fact that few unicorns are being purchased in M&A transactions suggests some skepticism regarding valuation levels

## All Over the Place

Three examples of how mutual funds valued their shares in private technology companies

### Peixe Urbano

Online retailer's valuation by T. Rowe Price New Horizons Fund was topsy-turvy.



Sources: Morningstar; the mutual funds

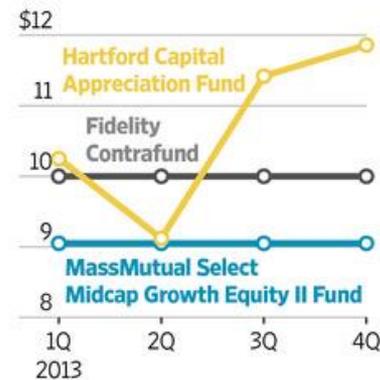
### Cloudera

Three mutual funds valued the software startup at different prices on June 30, 2014.



### Dropbox

Two funds kept their price constant all year, but another changed it.



THE WALL STREET JOURNAL.

Valuation, cont'd

# Preparing for the IPO

- The timing between the late stage private placement and the IPO
  - Are expectations aligned between the late stage investors and the company?
  - What if the timeline for the IPO is extended?
  - Will the late stage investors need liquidity? Will other existing stockholders of the company or employees require liquidity before the IPO?
- Valuation issues
  - As discussed, many late stage private placements include provisions providing for IPO price protection
  - How does this work in a volatile market? What if the IPO price is almost certainly less than the private price?
  - How is the new valuation determined?

- Well recognized cross-over investors may be helpful in promoting the issuer's interests when dealing with the IPO bankers
- Will cross-over investors participate in the IPO?
  - Ideally, the pre-IPO round investors will be the “anchor orders” in the IPO
  - No ability in the U.S. to obtain and secure cornerstone investors
  - Only two options: either obtain an indication of interest from the cross-over investor that can be disclosed in the IPO prospectus, or do a concurrent private placement to the cross-over investor at the IPO price concurrent with the IPO
  - Maybe more uncertainty with the indication of interest option if the market remains volatile and IPOs price below stated ranges
- Did the cross-over investors receive confidential information during the pre-IPO process? Has that information been disclosed in the IPO prospectus? Are they cleansed of material nonpublic information?

# The Future of Pre-IPO Financings

- To the extent that investors in pre-IPO rounds are investing because they believe that an IPO will be occurring within 12 to 18 months, will there continue to be interest when the IPO market becomes volatile and when the IPO exit is delayed?
- Are we already experiencing a shift in the late-stage or pre-IPO market?
- Will this affect the IPO market?

# The State of the IPO Market

# Making use of the JOBS Act

- An emerging growth company or “EGC” is defined under the JOBS Act as an issuer (including a foreign private issuer) with total annual gross revenues of less than \$1 billion (subject to inflationary adjustment by the SEC every five years—in fact, the SEC just amended the rule to increase the threshold modestly) during its most recently completed fiscal year.
- An EGC may confidentially submit a draft registration statement for an IPO for non-public review, provided that the initial confidential submission and all amendments are publicly filed with the SEC no later than 15 days prior to the issuer’s commencement of a road show.
- An EGC can engage in “test the waters” communications. Testing the waters with institutional accredited investors and QIBs provides valuable information about the presentation of the company’s business, the valuation that institutional investors would ascribe to the offering, and their interest in the offering. All of this will inform the company’s and the underwriters’ views.

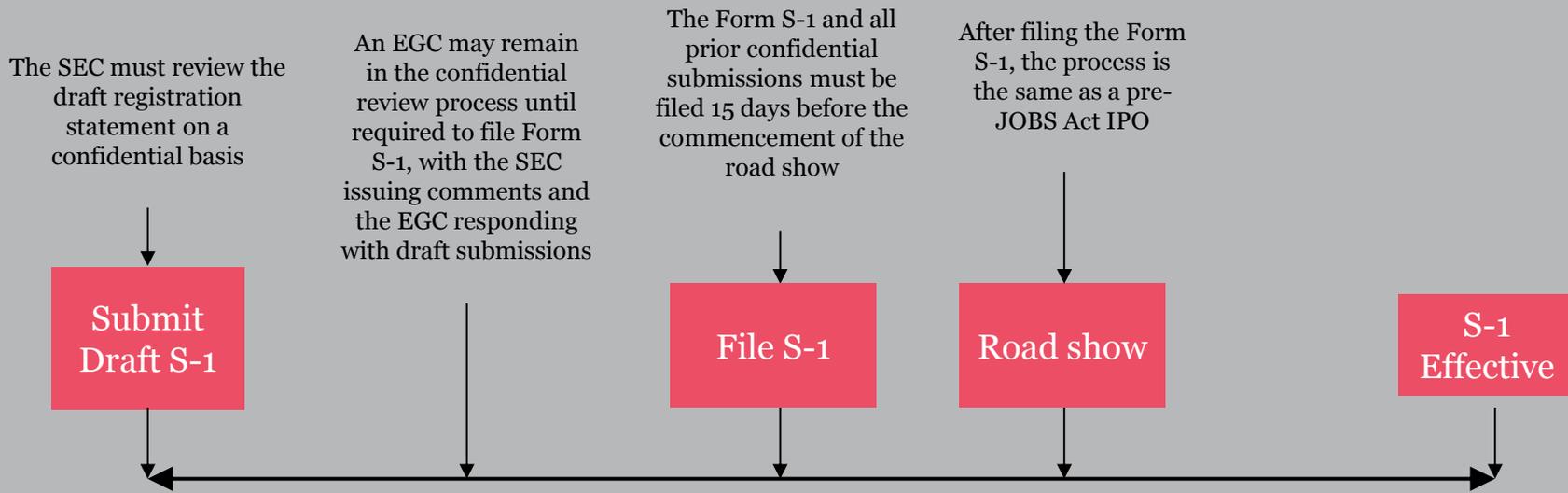
# The JOBS Act at 5

- Has the JOBS Act made a difference?
- The vast majority of EGCs that priced an IPO since the JOBS Act took effect (over 90%) have confidentially submitted at least one draft registration statement prior to publicly filing and the majority of EGCs have submitted at least two draft registration statements prior to making their first public filing.
- Taking advantage of the scaled financial disclosures has gained some market acceptance, with approximately half of all EGCs electing to provide only two years of audited financial statements rather than three years.
- EGCs are not required to comply with new or revised GAAP accounting pronouncements until those pronouncements apply to private companies, however, the majority of EGCs have not taken advantage of this extended transition period for compliance with new or revised GAAP accounting pronouncements.

- The vast majority of EGC IPO issuers in 2014, 2015 and 2016 that otherwise would have been required to include traditional executive compensation disclosures elected to take advantage of the reduced disclosure, with many omitting the CD&A section and including only a Summary Compensation Table and Outstanding Equity Awards Table covering three rather than five named executive officers and limiting the tabular disclosures to two years.
- Almost all EGCs have indicated that they intend to take advantage of (or reserve the right to do so in the future) the exemption from providing the auditor attestation report under Sarbanes-Oxley Act Section 404(b).

# Testing The Waters

- The JOBS Act added a more formal structure for pre-offering Company / Investor meetings via the Testing The Waters process, designed originally as a viability assessment.
- This procedure has evolved in the last five years to include a variety of additional goals beyond seeking feedback on viability.
- Management teams have gained additional benefits from this process included earlier exposure and presentation honing.
- The Testing The Waters process is still most often used in biotech and medtech IPOs.



*An EGC or any other person authorized by the EGC can “test the waters” in communications with QIBs and institutional accredited investors before or during the IPO*

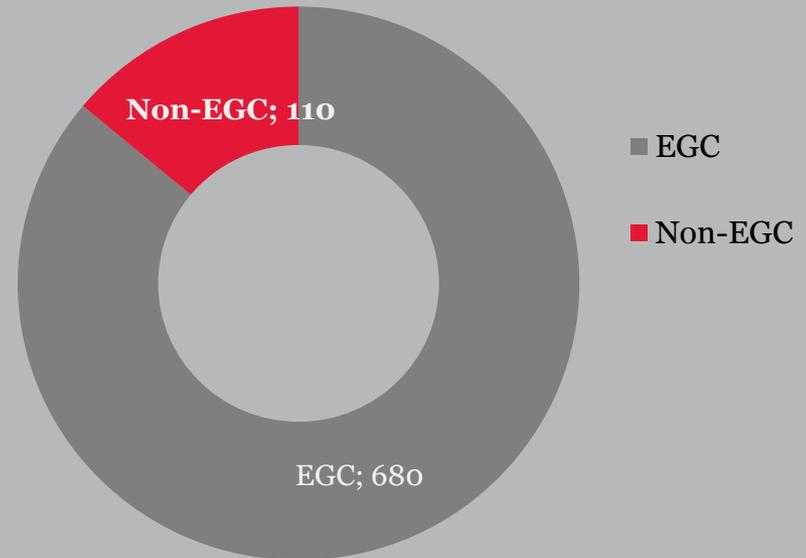


*Broker-dealers, including those participating in the IPO, can publish research before, during or after the IPO without the research being deemed an “offer” under the Securities Act*

# EGC Versus Non-EGC Filings

- Out of 834 issuers that went public in the period from January 1, 2013 through December 31, 2016, 680 filed as an EGC.

EGC Versus Non-EGC IPO Filings  
(By Frequency)



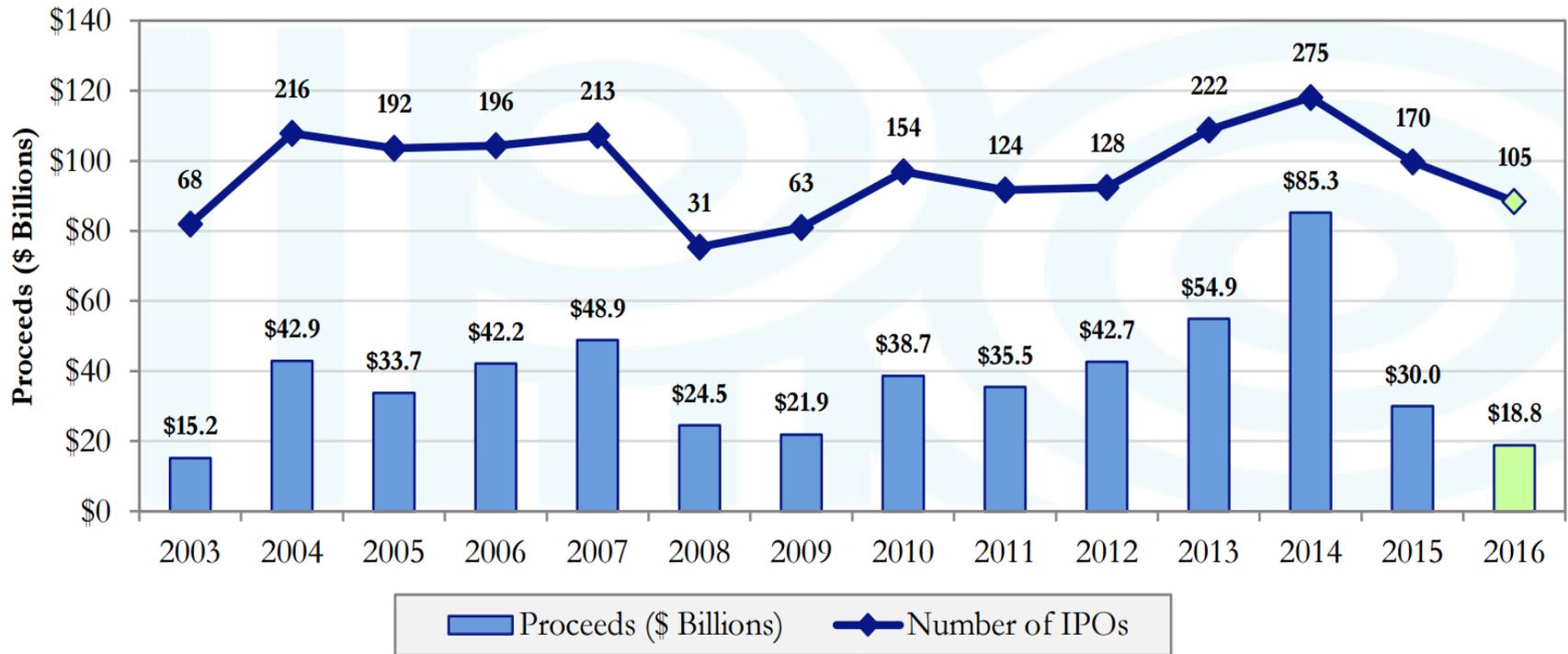
# What Hasn't Changed?

- The JOBS Act isn't a panacea. Prospective IPO candidates still express concerns regarding:
  - The IPO timeline
  - IPO costs, which haven't changed
  - The lack of research coverage
  - The disadvantages associated with being public
    - Short-term focus
    - Costs associated with corporate governance and reporting requirements
    - Increased scrutiny and liability

# The IPO Market

# IPO Activity

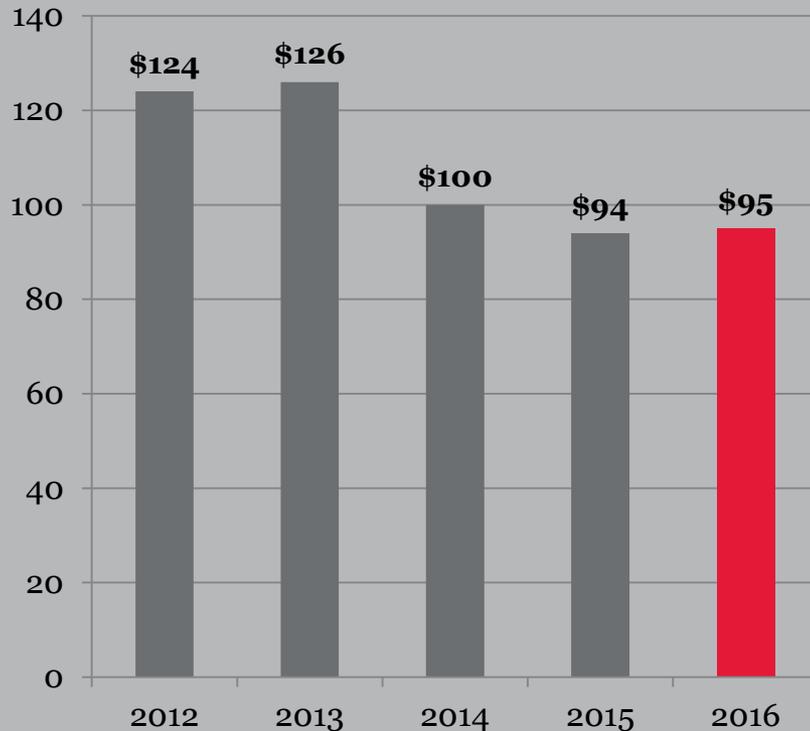
## US IPO Activity



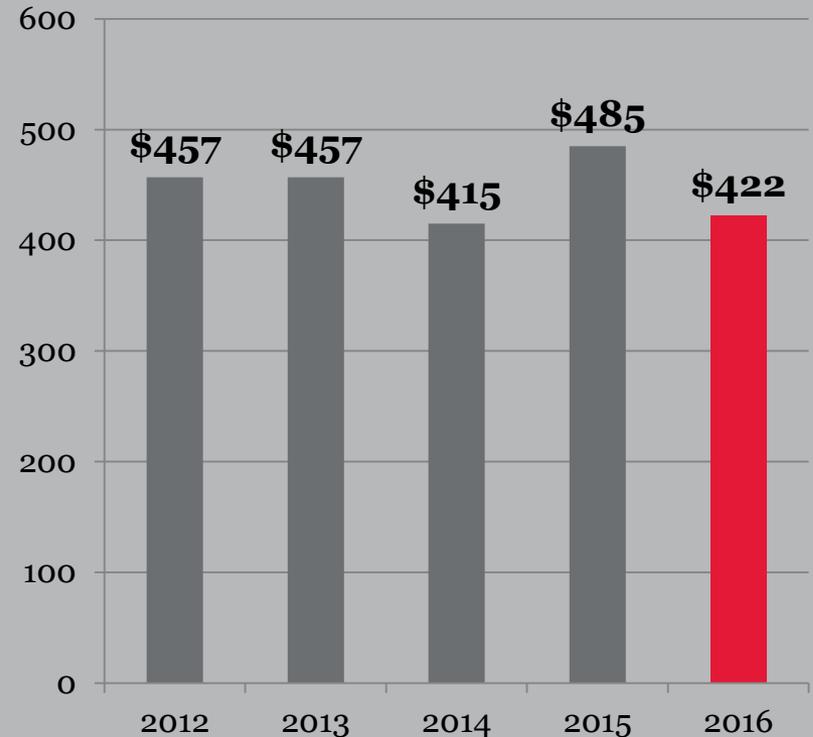
Includes IPOs with a market cap of at least \$50 million and excludes closed-end funds and SPACs. Data through 12/15/16. Source: Renaissance Capital.

- In 2017, to date, there have been 23 IPOs, raising approximately \$9.7 billion.

**Median Deal Size 2012-2016**  
in millions USD



**Median Market Capitalization 2012-2016**  
in millions USD

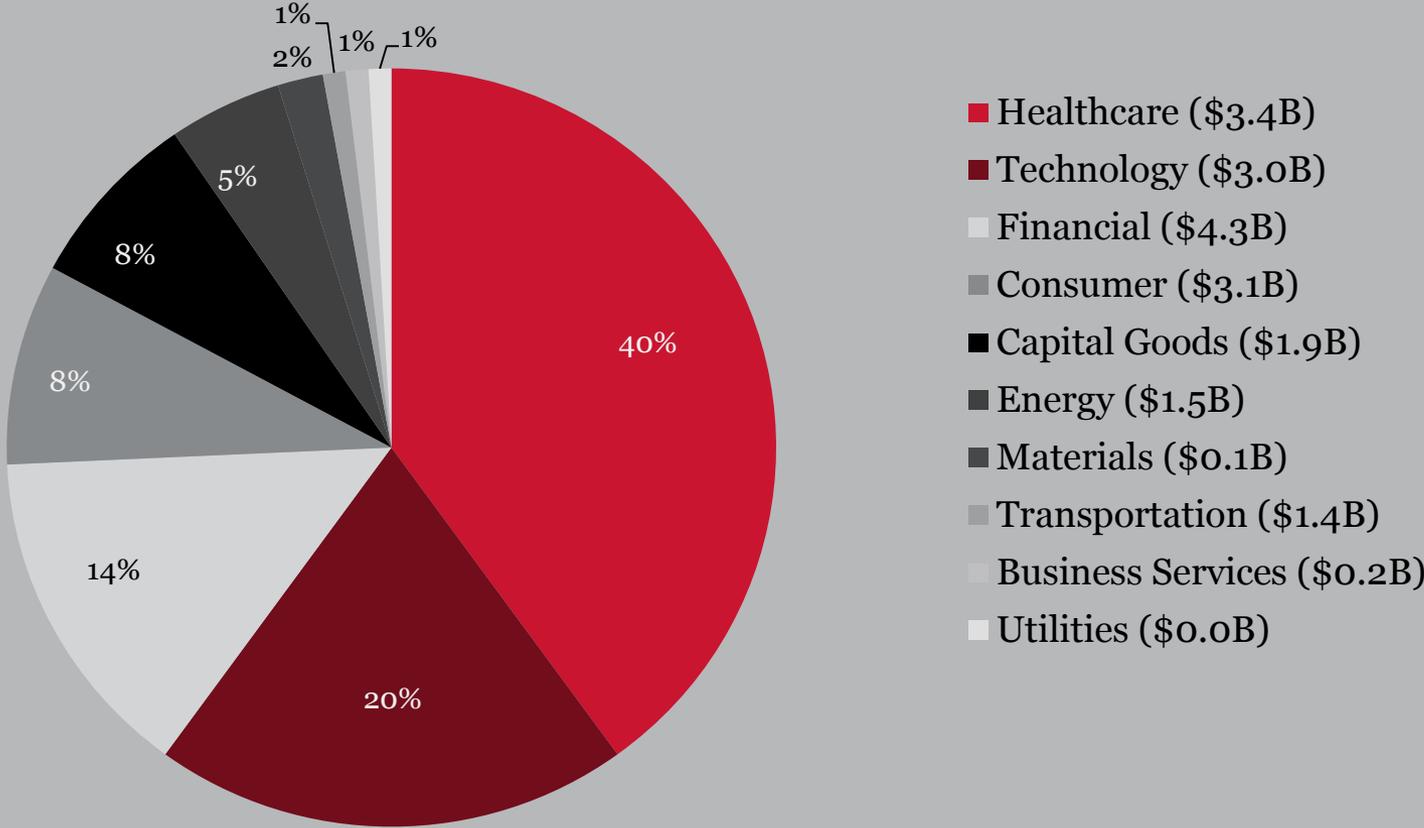


Source: Renaissance Capital

**IPO Activity, cont'd.**

# IPOs by Sector in 2016

in billions USD



Source: Renaissance Capital

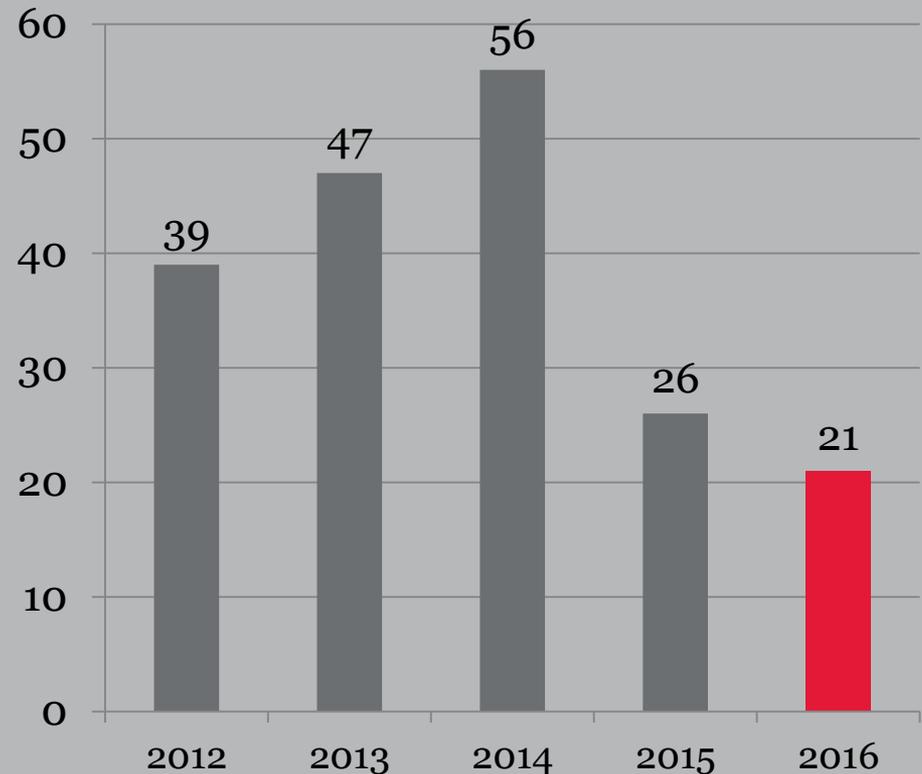
IPO Activity, cont'd.

# Sector Focus: Tech IPOs

- The tech sector has seen a decline in the past few years, which can be attributed at least in part to the late-stage private placement market dynamics discussed earlier:

- There were 21 Tech IPOs, raising \$3.0 billion, in 2016;
- 26 Tech IPOs, raising \$4.2 billion, in 2015;
- 56 Tech IPOs, raising \$32.3 billion, in 2014 (including the \$25 billion Alibaba IPO);
- 47 Tech IPOs, raising \$10.0 billion, in 2013; and
- 39 Tech IPOs raising \$20.9 billion, in 2012.

**Tech IPOs 2012-2016**

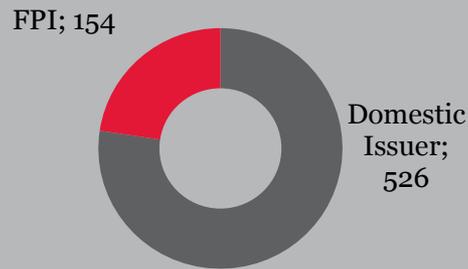


Source: Renaissance Capital

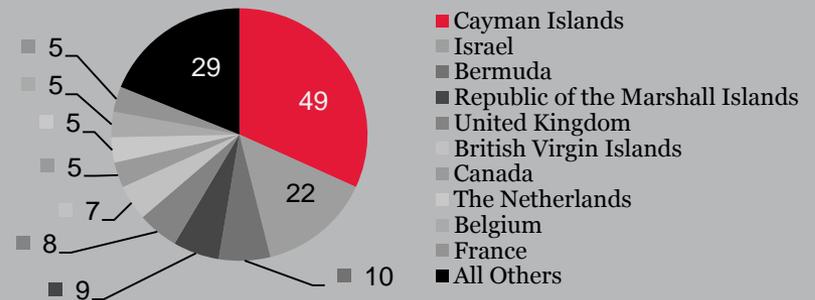
# Additional Trends

- Of the 680 EGCs that completed their IPOs in the period from January 1, 2013, through December 31, 2016, 154 were foreign private issuers (“FPIs”).

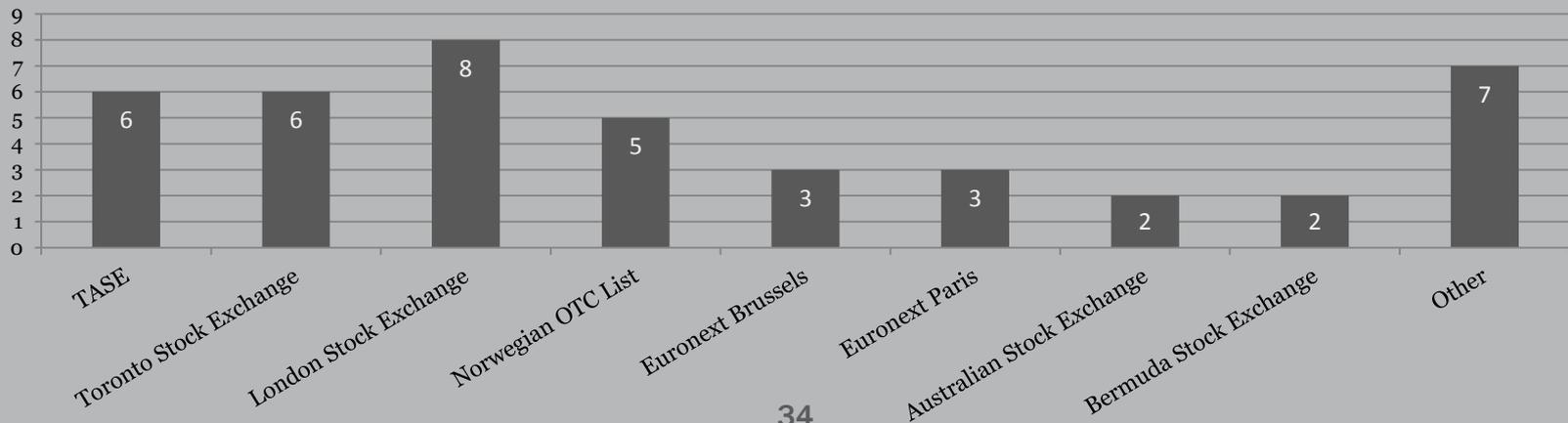
**Domestic Issuers Versus FPIs**  
(By Frequency)



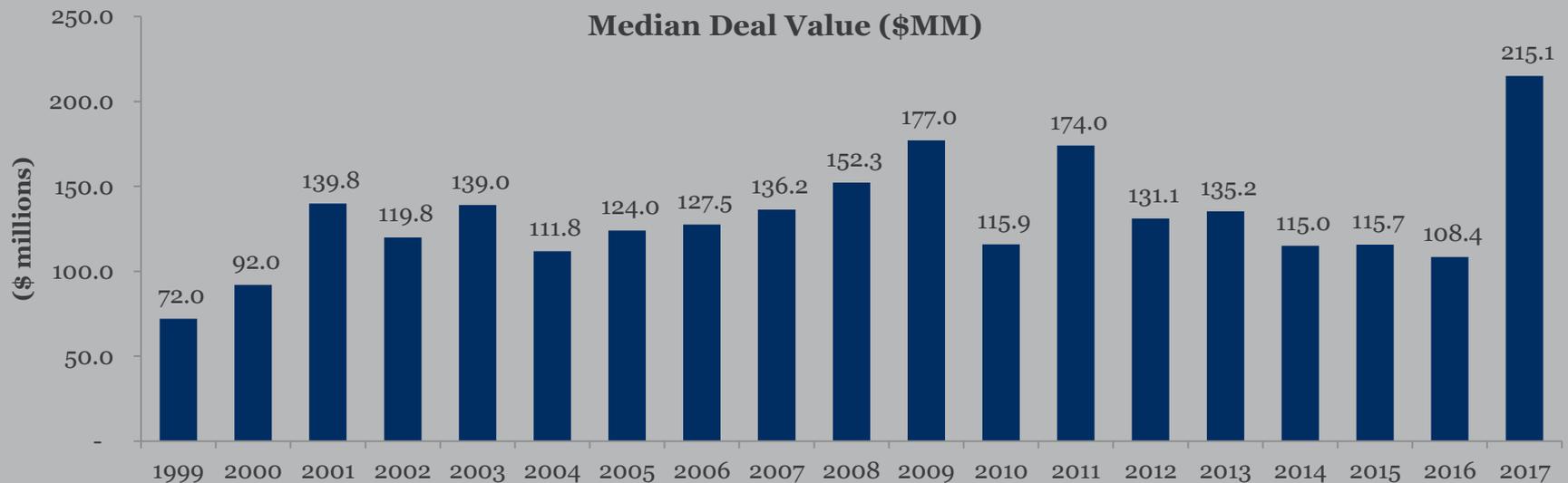
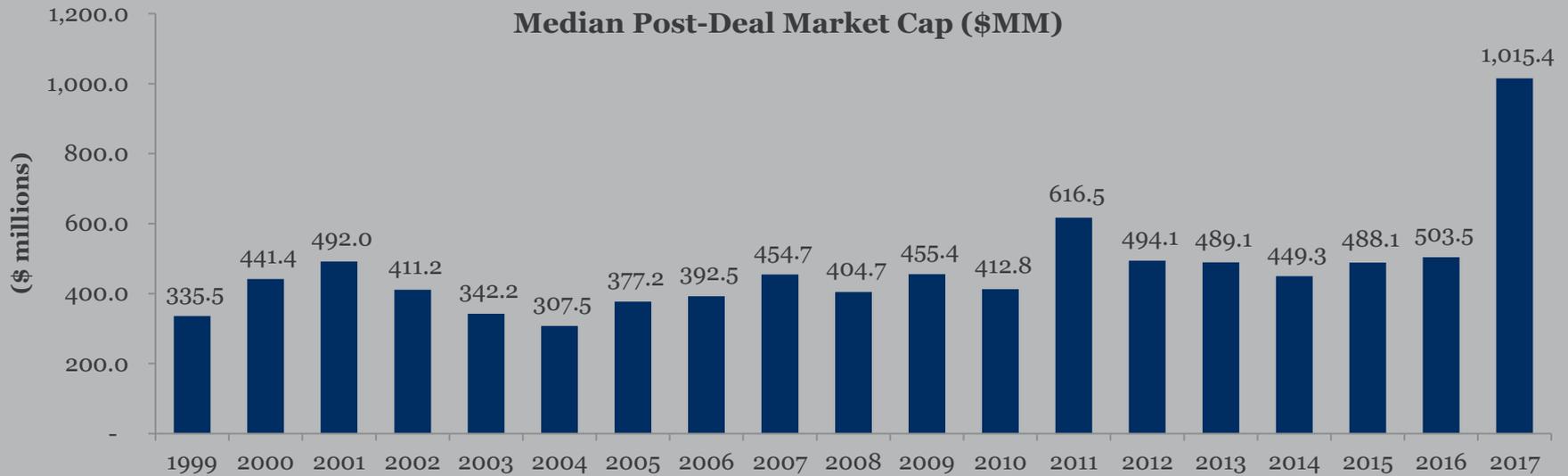
**FPI Country of Incorporation**  
(By Frequency)



**FPI Dual-Listing by Exchange**  
(By Frequency)

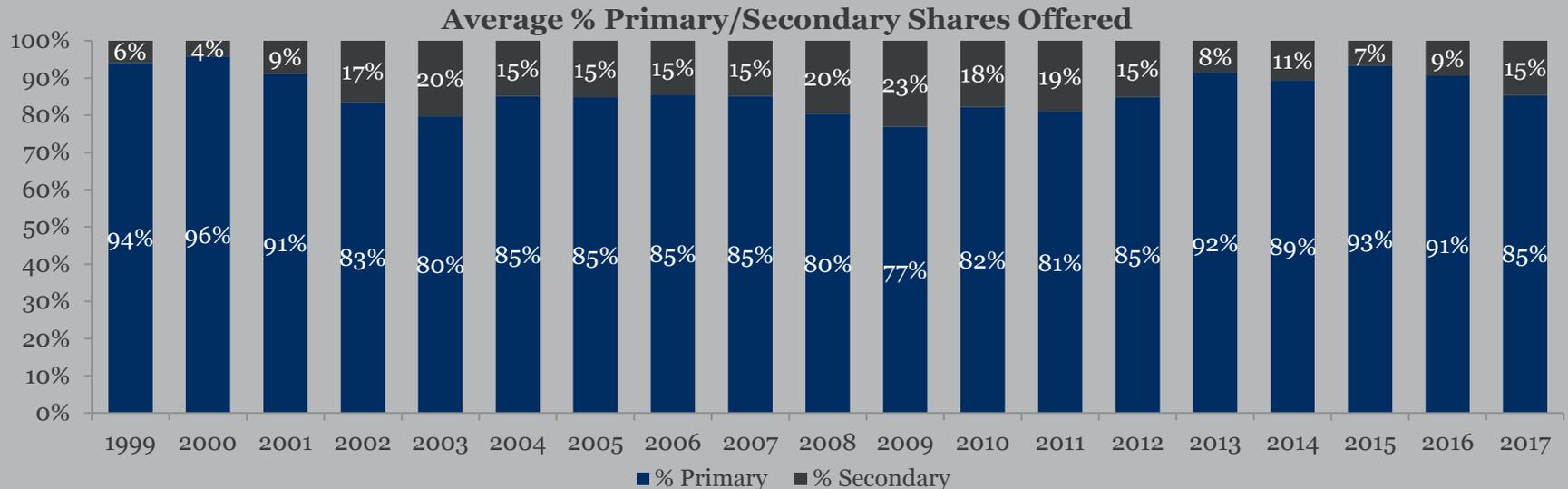


# IPO Median Market Cap



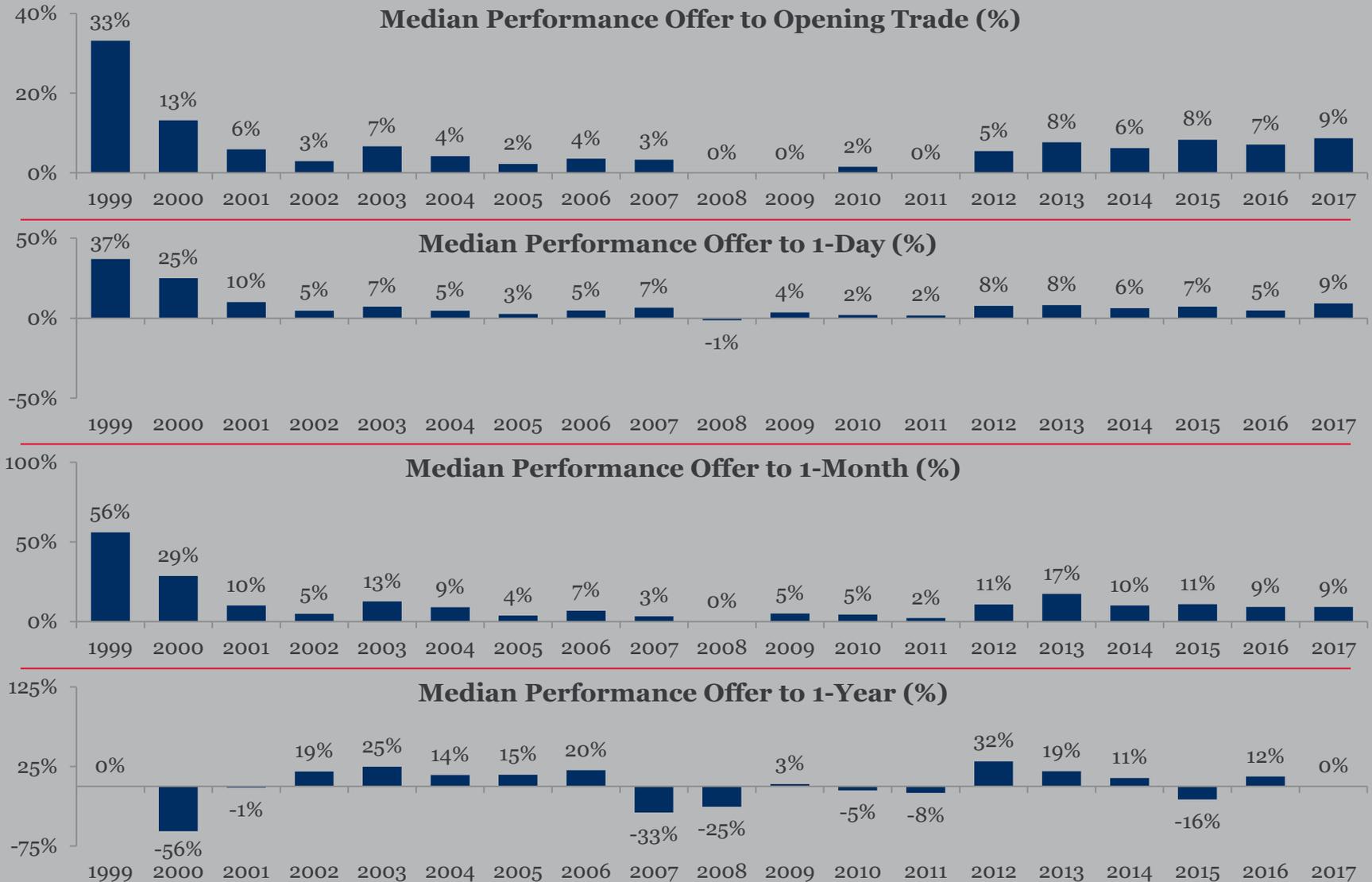
Source: Dealogic. Includes US IPOs with a market cap of at least \$50mm and excludes CLEFs and SPACs. Data Through 04/24/17.

# IPO Percentage of Shares Offered



Source: Dealogic. Includes US IPOs with a market cap of at least \$50mm and excludes CLEFs and SPACs. Data Through 04/24/17.

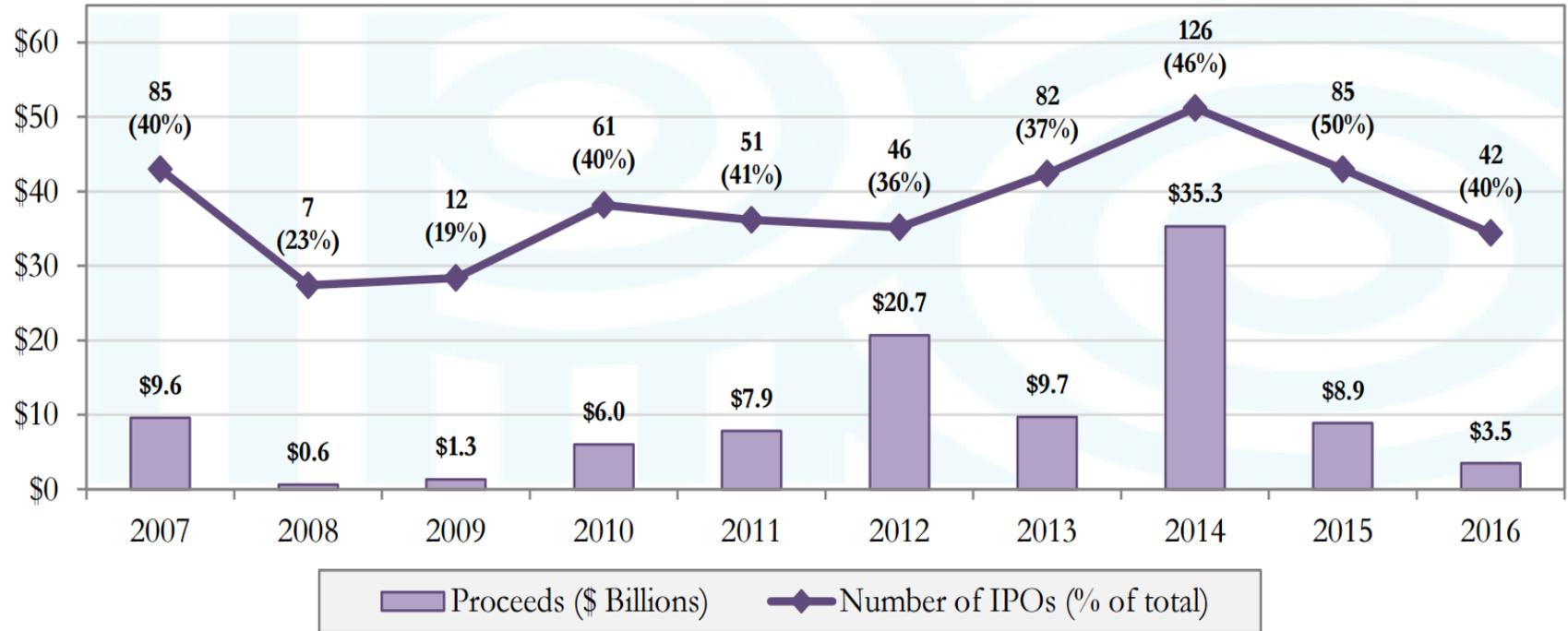
# IPO Post-Market Performance



Source: Dealogic. Includes US IPOs with a market cap of at least \$50mm and excludes CLEFs and SPACs. Data Through 04/24/17.

# VC- and PE-backed IPOs

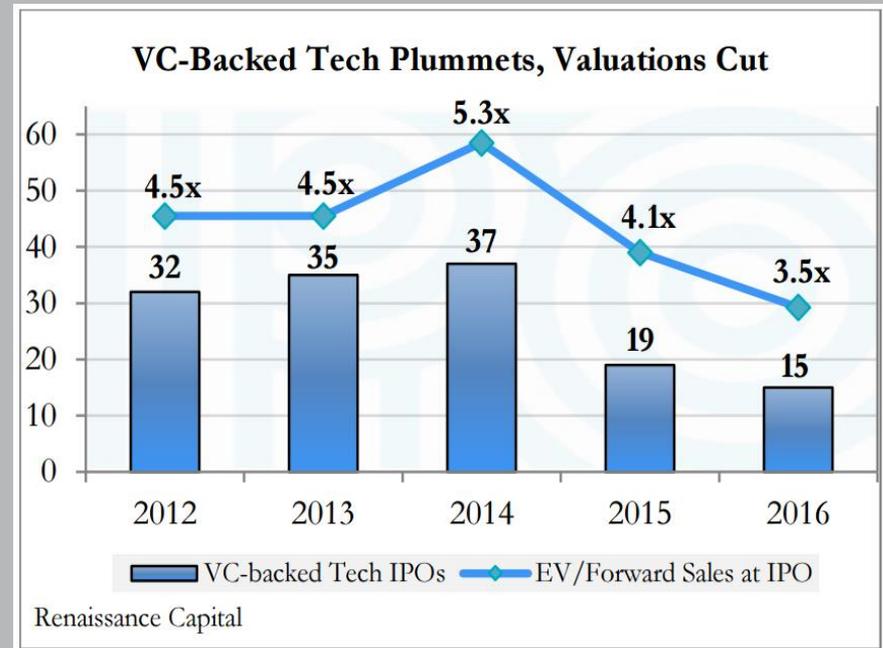
## US IPO Activity – Venture Capital-Backed IPOs



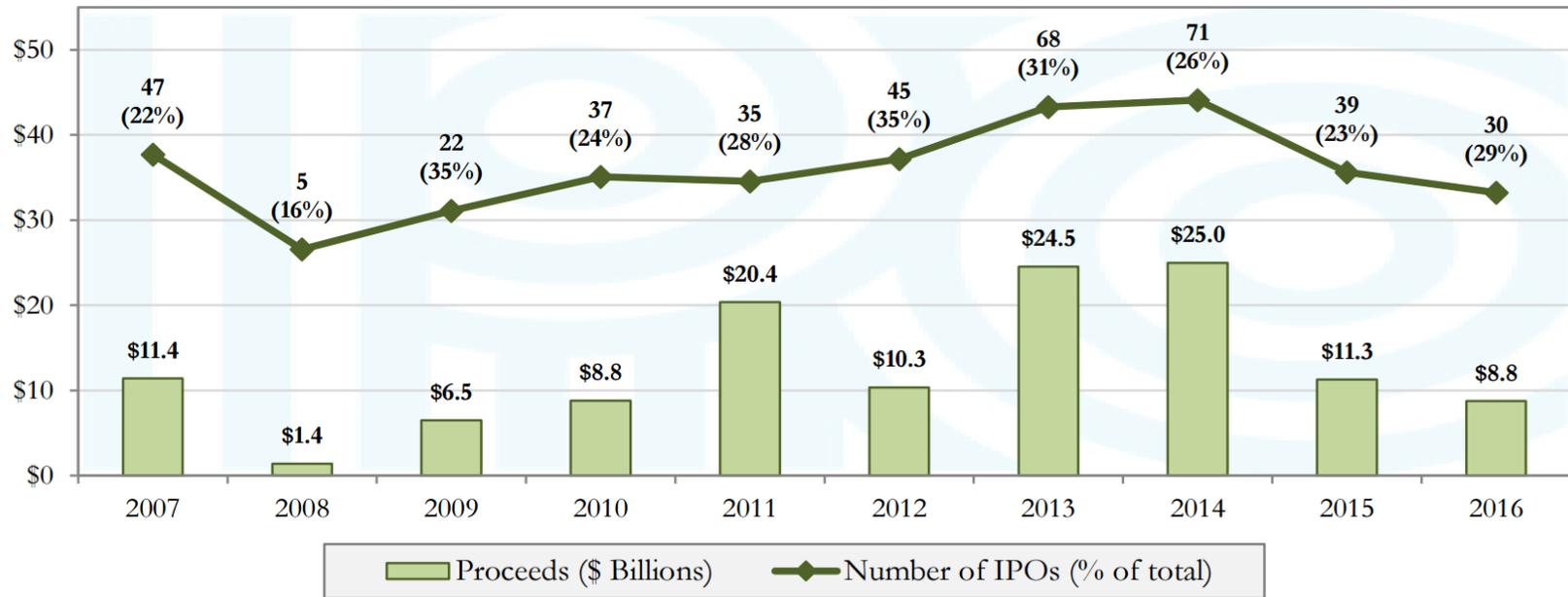
Source: Renaissance Capital.

IPO Activity, cont'd.

- The number of VC-backed technology IPOs fell in 2016 due to a public-private valuation disconnect.
- Many pre-IPO companies remained private and relied upon private financings.
- Only a select few conducted an IPO down-round
- VC-backed tech IPOs produced a 48% average return.



## US IPO Activity – Private Equity-Backed IPOs



Source: Renaissance Capital.

# Syndicate Structure

# Syndicate Structure



Source: Dealogic. Includes US IPOs with a market cap of at least \$50mm and excludes CLEFs and SPACs. Data Through 04/24/17.

# Lock-Up Trends

# Lock-Up Trends

- Very little break from the traditional 180 day IPO lock up.
- However, early release of that lock up to facilitate organized First Follow-ons has become more frequent.

## First Follow-ons by Execution Timing



Source: Dealogic. Includes first follow-ons for US IPOs with a market cap of at least \$50mm and excludes CLEFs and SPACs. Data Through 04/24/17.

# Return of the SPAC

# SPACs

- Evolved and more investor friendly structures have reinvigorated the SPAC IPO market, pulling in investor dollars and removing potential IPOs from the backlog.



Source: Dealogic. Includes US SPAC IPOs with a market cap of at least \$50mm and. Data Through 04/24/17.

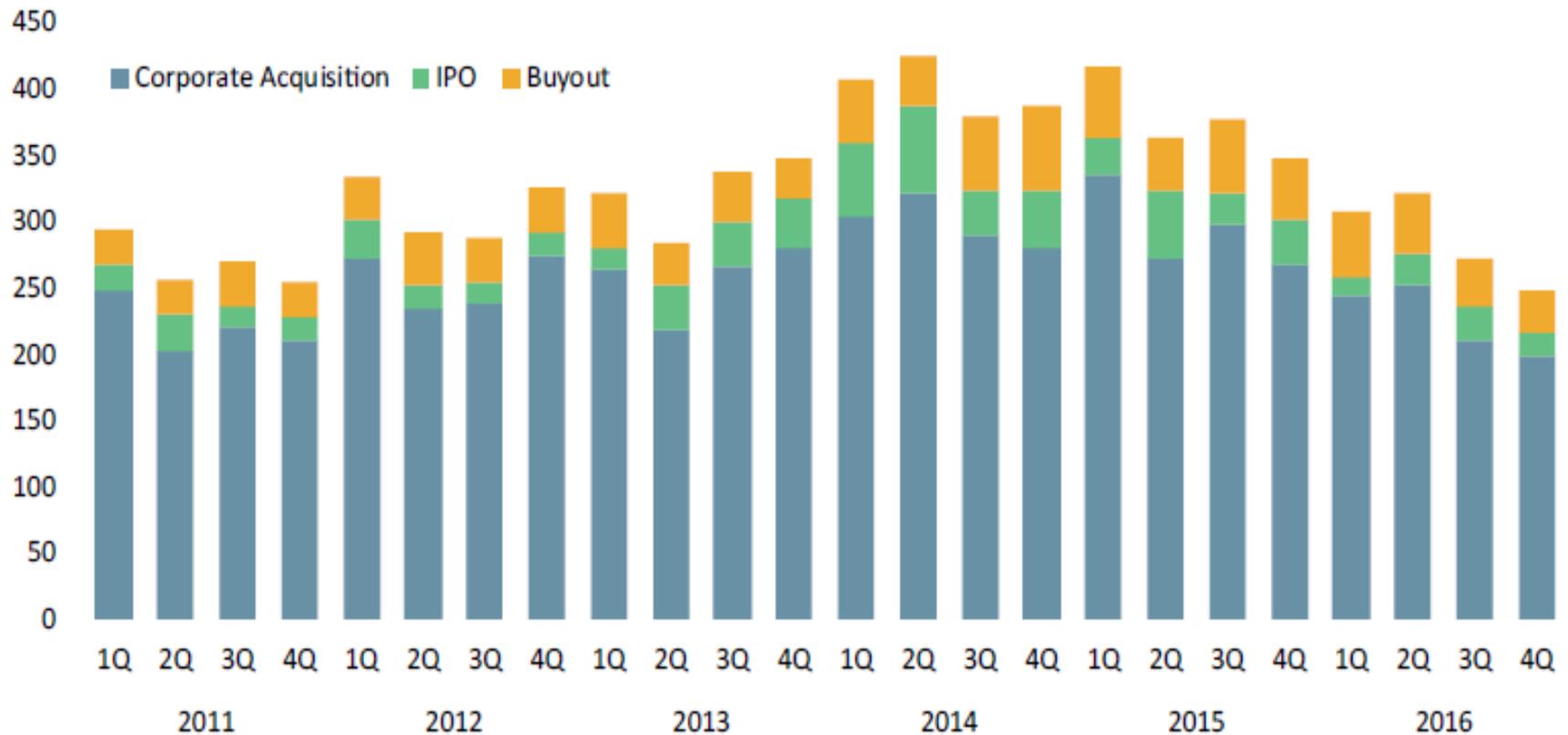
# Dual Track Processes

# Dual Track Processes

- Perhaps given the uncertain market conditions, and perhaps in part due to the view that an IPO is no longer as attractive, many more US IPO candidates are pursuing dual track processes
- In a recent study, Bloomberg reports that 14 out of 52 companies (27%) withdrew their IPO registration statements in 2016 and were acquired within six months of doing so. This compares to approximately 14% in 2015. These numbers are understated given that many more IPO candidates abandon the IPO process before they file publicly with the SEC
- This trend is more pronounced if you consider the VC- and PE-backed IPO candidates who appear more amenable to an M&A exit
- However, few unicorns are being acquired

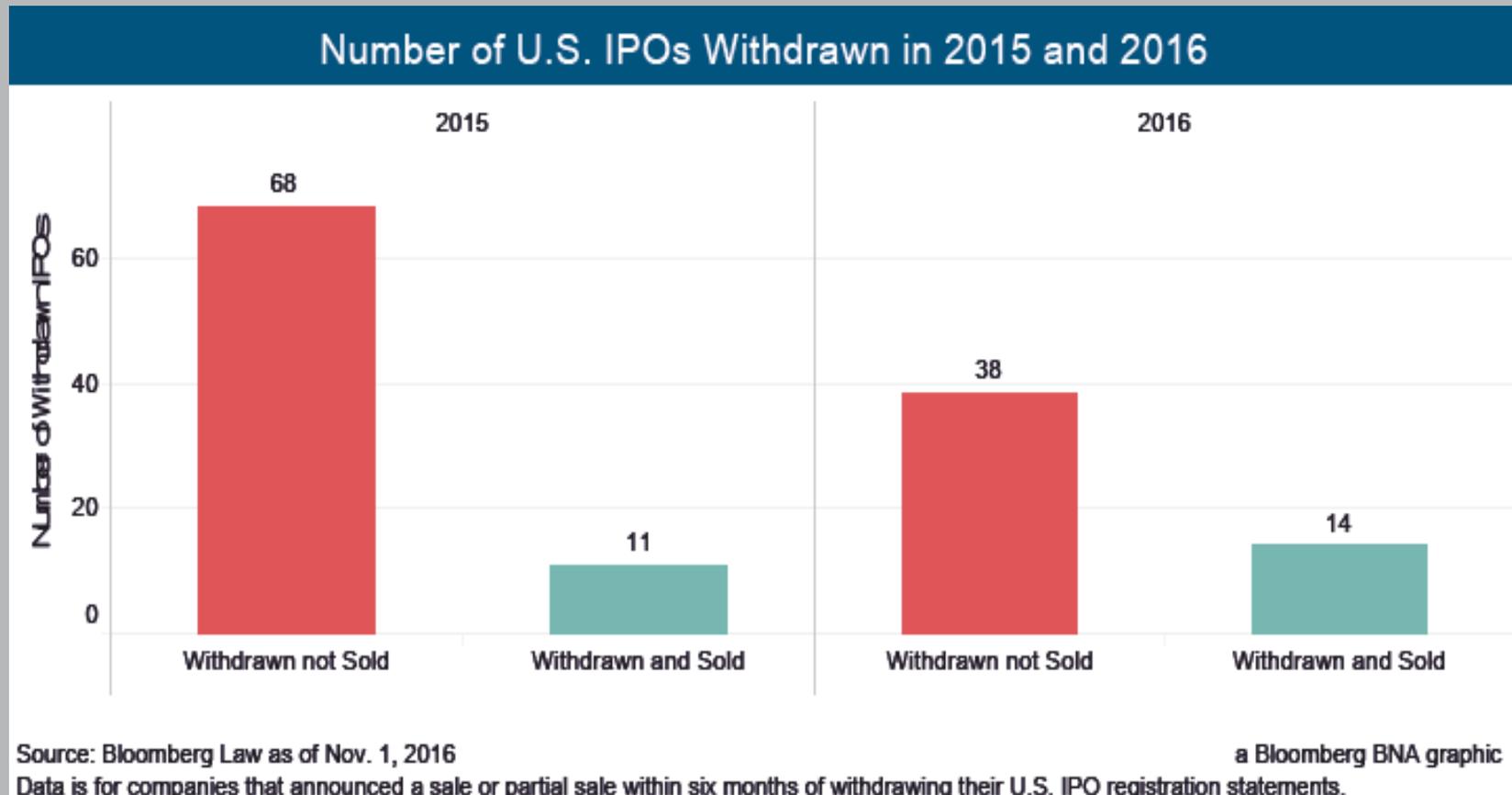
# M&A Exits

As the number of IPOs has waned, corporate buyers play a proportionally greater role  
VC-backed exits (#) by type



Source: PitchBook

- The below table provides some additional data:



- Issuers sometimes will pursue an IPO concurrently with an M&A sale transaction, or a “dual-track process.” A dual-track process can be very useful during periods of heightened market volatility in which the IPO market is uncertain.
- Recent high profile dual-track processes leading to M&A exits include:

**APPDYNAMICS**

**\$3.7 Billion**

**Moly-Cop**

**\$1.2 Billion**

**SENSUS**

**\$1.7 Billion**

**LanguageLine  
Solutions®**

**\$1.5 Billion**

**MAUSER**

*Excellence in Industrial Packaging Solutions*

**\$2.3 Billion (Expected)**

**Dual track process, cont'd.**

# Dual track process

## Advantages and Disadvantages

### Advantages

**Better pricing.** Pursuing both paths (i) creates price tension that could produce a more robust competitive process and (ii) insures maximum exposure and uncovers prospective buyers; 22% to 26% premium over companies acquired without a concurrent IPO (James C. Brau, Ninon K. Sutton & Nile W. Hatch, Dual-track versus single-track sell-outs: An empirical analysis of competing harvest strategies, 25 Journal of Business Venturing 389-402 (2010))

**Less dependence on market conditions and greater flexibility.** Dual track allows seller to keep its options open until it becomes clear which route will yield the highest value, thus preserving flexibility and hedging against deal uncertainty and market volatility (e.g., M&A process can provide a valuable backstop in the event that markets turn against seller during the relatively lengthy IPO process)

**Creates leverage for sale process.** IPO creates a credible alternative which increases the leverage of the seller in its M&A negotiation (particularly important when there is a limited set of suitors); prospective purchasers in the sale process will be incentivized to bid higher than each other but also to provide an attractive alternative to an IPO value

**Creates higher degree of urgency.** Prospective buyers (i) may be more inclined to act in the face of a credible possibility of an IPO and (ii) will be encouraged to close their bid on a timeline dictated by seller prior to any hard deadlines in the IPO process

**Complementary strategies.** Legal and process requirements of an IPO can assist, and be complementary to, the M&A process - e.g. (i) IPO data room can be used, with minimum additional work, as a sale process data room; and (ii) if the company ends up being sold to a buyer who requires financing, the IPO registration statement offers a significant head start on a debt offering memorandum

### Disadvantages

**Public Disclosure.** Unless the issuer can avail itself of the JOBS Act, public filing of registration statement may result in undesirable public disclosures; amount and type of information required to be disclosed in IPO registration statement frequently includes information that management would rather not hand over to regulators, competitors, customers and the general public in the absence of an IPO

**Adverse effect on efficiency of outcome.** May be perceived as lack of strategic direction or limited acquisition interest, which may lead key participants to misread market signals, negatively impacting final result (e.g., potential buyers in sale process might determine that IPO process is more likely route and elect not to spend time and money necessary to pursue acquisition)

**Diversion of management resources.** Each process on its own creates significant distractions; attempting to orchestrate both an IPO and a sale process at the same time will limit the amount of time and attention that management can spend running the business. However, (i) diversion can be reduced by leveraging similarity of many required processes (e.g., detailed forecasting and gathering diligence materials) and (ii) dual-track approach is far less disruptive for management than a series of unsuccessful sales attempts

**Market risk exposure.** A failed IPO attempt could harm the company's reputation and potentially the value of its business and assets; JOBS Act confidential submission, if applicable, could alleviate this concern

**Substantial additional costs.** Running two significant and complicated work streams in tandem, especially where the IPO track is pursued for several rounds of SEC comments or to completion, is likely to involve substantial costs. However, the dual-track costs are significantly lower when compared to costs that would result from a failed single-track exit transaction followed by later effort to obtain liquidity

## Timing and Structure

Timeline and structure of dual-track process often depend on which option is more promising

### **IPO is the more promising exit**

- File or submit the registration statement with the SEC and work through one or more rounds of SEC comments before starting the M&A process; more flexibility presented by JOBS Act confidential submission process
- M&A process can be used as backstop of IPO exit if IPO exit doesn't live up to expectations, or can result from inbound interest

### **Neither track is more promising**

- File or submit the registration statement with the SEC at about the same time as initiating M&A sale process
- “Classic” dual-track process; contemplates filing of IPO registration statement and simultaneous commencement of solicitation of interest from potential buyers

### **M&A sale is the more promising exit**

- Start M&A auction process and delay the filing of a registration statement for as long as possible, but prepare a complete and ready-to-file registration statement; more flexibility presented by JOBS Act confidential submission process
- Existence of the registration statement is used to inform potential buyers that company has a credible alternative and drive potential bids higher; registration statement may never be filed with SEC

## Other Timing Issues

**Management of timeline of dual-track process is of paramount importance;** if timeline for the IPO and M&A process are not coordinated, company may be forced to make a decision in connection with one process that has unintended negative consequences – For example:

- If after the end of SEC review process for the IPO (when the company is almost ready to launch its road show), the offering is postponed to continue acquisition discussions, favorable market conditions may disappear.
- Delay caused by ongoing acquisition discussions can result in need to update company's IPO registration statement with more recent financial statements.

### **Time to choose between the two tracks**

- The choice can be delayed until after the IPO road show to immediately before signing underwriting agreement.
- However, in practice, the choice is usually made before start of IPO road show (because of significant cost of running a road show). If an attractive acquisition offer does not seem imminent, the sale process is ordinarily shut down when the road show begins.

## Other Considerations

### **Confidentiality**

- Confidentiality of information disclosed in the sale process is absolutely crucial if the IPO process is not to be compromised
  - Particular attention should be paid to putting in place and enforcing comprehensive confidentiality agreements with prospective buyers.
  - A limited auction/sale process to a select few prospective purchasers is well suited to a dual-track process.
- Advisable to include a standard public company standstill provision in the confidentiality agreements
  - Highly undesirable for a former potential buyer to make a hostile offer for the company during the period immediately following its IPO.
  - Sidesteps making a determination as to whether prospective buyers will be restricted from trading in the company's securities following the IPO by virtue of being in possession of inside information.

## **Complying with securities laws communication restrictions**

- Although an IPO registration statement filed by a domestic U.S. company will be publicly available on the SEC's website and can (and invariably will) be viewed by any potential buyer, there are limitations on the ability to use the registration statement prior to the effective date.

## **Other disclosure issues**

- Absent a leak, the sale process usually does not need to be publicly disclosed prior to an acquisition announcement, but disclosure may be required in certain circumstances (e.g., if an acquisition deal is reached and then falls apart, company must consider whether the reasons for the busted deal must be disclosed in the registration statement).

## **M&A sale terms**

- If an acceptable acquisition offer emerges from a dual-track process, company (i) may seek to style the definitive agreement as if the transaction were a “public-public” merger, with limited representations and no indemnities or escrows following the closing, or (ii) may try to make the disclosure in IPO registration statement an exception to representations and warranties in a private sale agreement, permitting company to prepare shorter disclosure schedules.

## Unwinding the IPO Registration

- Assuming an acquisition agreement is signed after the IPO registration statement has been filed, the registration statement will need to be withdrawn prior to closing the sale. However, it is usually advisable to keep the IPO registration statement and the exchange listing application on file until shortly before the closing to mitigate disruption if the M&A deal doesn't close.

## Valuation impact

- A dual track can create tricky valuation issues, if seller pursues an IPO after receiving one or more acquisition offers
  - Company must consider the impact of acquisition offers on its subsequent determinations of fair market value for option grants made prior to the IPO.
  - Company will need to evaluate whether the amount of any acquisition offers should—or must—be disclosed in response to “cheap stock” comments from the SEC.

# Insider Participation

# Insider participation in U.S. IPOs

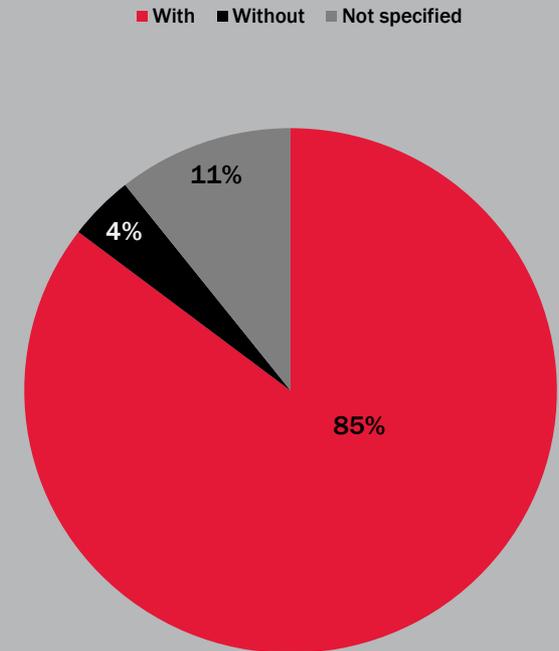
- The dynamics of U.S. IPOs, especially those in particular industry sectors, has changed in recent years in a number of important respects:
  - There are more institutions willing to invest in private companies, despite the lack of liquidity
  - More of the growth in emerging companies is being experienced while these companies are private rather than in the years immediately following their IPOs
  - Cross-over funds, SWFs, family offices and other institutional investors want to benefit from this growth
- In part, as a result of a soft U.S. IPO market there is a desire to “de-risk” the IPO, which often means that:
  - IPO bankers will encourage the company to undertake a late-stage private placement immediately prior to the IPO
  - Cross-over investors are expected to be the “anchor” investors in the company’s IPO
  - Other insiders or “friends of the company” are expected to participate in the company’s IPO as well
  - From a marketing perspective, this has a strong signaling effect

- IPO bankers advising a VC-backed or PE-backed IPO candidate often expect that:
  - The VC or PE firm will not sell in the IPO, but it is understood that if the stock performs well following the IPO, the VC or PE firm will want to dispose of some of its stake through a follow-on offering
  - These types of sales in follow-ons where the IPO stock has performed well are not viewed negatively
  - Cross-over investors that have come in during late-stage private placements and in the IPO usually will hold for some period of time or may buy/sell in small amounts in the market in regular way transactions over a period of time
- In certain sectors, the success (or failure) of an IPO has become dependent on insider support.
- We looked at the life sciences sector as a case study in order to assess the trends regarding insider participation
- In the life sciences sector the majority of IPOs involved insider participation, which has involved a late-stage private placement, buying in the IPO, or buying in a private placement concurrent with the IPO
- In the United States, the securities laws restrict the way in which these transactions can be structured
- First, we will review some statistics

# Insider participation in private placements preceding IPOs

- In a recent survey<sup>1</sup>, we reviewed whether insiders<sup>2</sup> participated in the last private placement of a life sciences-focused company shortly prior to their IPO.
- Approximately 85% (64/75) of companies that conducted a late-stage private placement that preceded an IPO had insider participation. Approximately 11% (8/75) of the companies did not disclose whether they had insider participation in their last private placement shortly prior to the IPO. Three companies did not have insider participation in their last private placement shortly prior to the IPO.

## Insider Participation in Last Private Placement



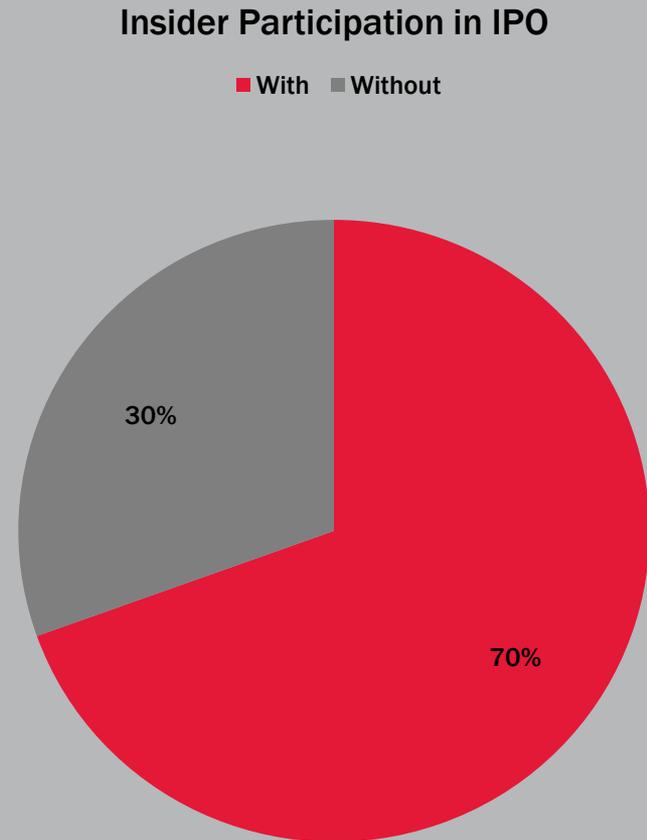
<sup>1</sup> Data refers to Morrison & Foerster study of late-stage private placements that preceded life sciences IPOs undertaken in 2015 and in 2016 (through June 30).

<sup>2</sup> “Insiders” refer to directors, executive officers, officers or employees with policy-making functions, and 10% beneficial holders.

- Of those companies that had insider participation in their last private placement:
  - The amount invested by insiders relative to the gross proceeds of the last private placement was on average approximately 62%.
  - The amount invested by insiders relative to the gross proceeds of the last private placement ranged from 1% to 100%.

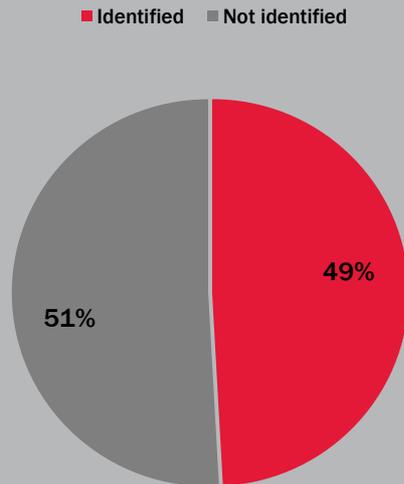
# Insider participation in IPOs

- Approximately 70% (57/82) of the IPOs had insider participation and approximately 30% (25/82) did not.
- Insiders participating in the IPOs generally were 10% beneficial holders, including through an affiliation with a director or officer.

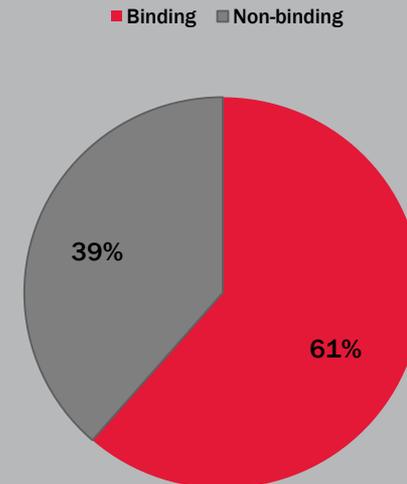


- Approximately 51% (29/57) of the IPO prospectuses did not disclose the names of those insiders participating in the IPO and approximately 49% (28/57) identified those insiders participating in the IPO.
- Approximately 61% (35/57) of the IPO prospectuses disclosed a binding agreement of insiders to participate in the IPO and approximately 39% (22/57) disclosed a non-binding agreement to participate in the IPO.

Type of Insider Participation



Binding Versus Non-Binding Participation

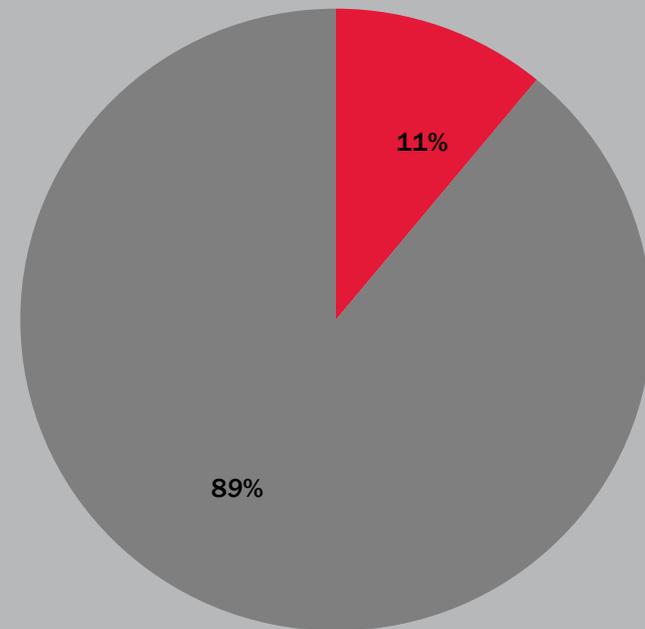


- For those IPOs with identified insider participation, the *range* of the amount of insider investment as a percentage of the gross proceeds of the IPO was approximately 1% to 80%
- For those IPOs with identified insider participation, the *average* of the amount of insider investment as a percentage of the gross proceeds of the IPO was approximately 34%.
- There typically was a jump in valuation for life sciences companies from the last private placement to the IPO. This jump was slightly higher in 2015 (an average of approximately over 150%) compared to 2016 (an average approximately under 110%).

- Approximately 11% (9/82) of the IPOs had a concurrent private placement. Of those companies with a concurrent private placement, eight also had insiders indicating an interest in participating in the IPO.
- For those IPOs that had a concurrent private placement, the *range* of the gross proceeds of the concurrent private placement relative to the gross proceeds of the IPO was approximately 8% to 36%
- For those IPOs that had a concurrent private placement, the *average* of the gross proceeds of the concurrent private placement relative to the gross proceeds of the IPO was approximately 22%

### Insider Participation in IPO

■ Occuring ■ Not Occuring



Insider participation in  
IPOs, cont'd.

# Voting and Control Issues

# Dual class capital structures

## Summary

Recap company's common stock into two classes of common – existing shareholders get high-vote stock and low-vote stock is sold in the IPO and thereafter

Maintains control in a founder, family or small group regardless of dilution created by further stock issuances (for acquisitions or otherwise)

Charters typically provide that high-vote shares lose high-voting rights if transferred and receive same consideration in a merger as low-vote shares

## Advantages

Well-established structure

Allows for continued focus on core values and objectives

Particularly useful where founders have long-term vision for the company that creates value; less distraction by short-term considerations such as quarterly earnings, takeover offers and activist investors

## Disadvantages

May be disfavored by some institutional shareholders (although empirical evidence is unclear whether companies with dual class structures tend to underperform their peers)

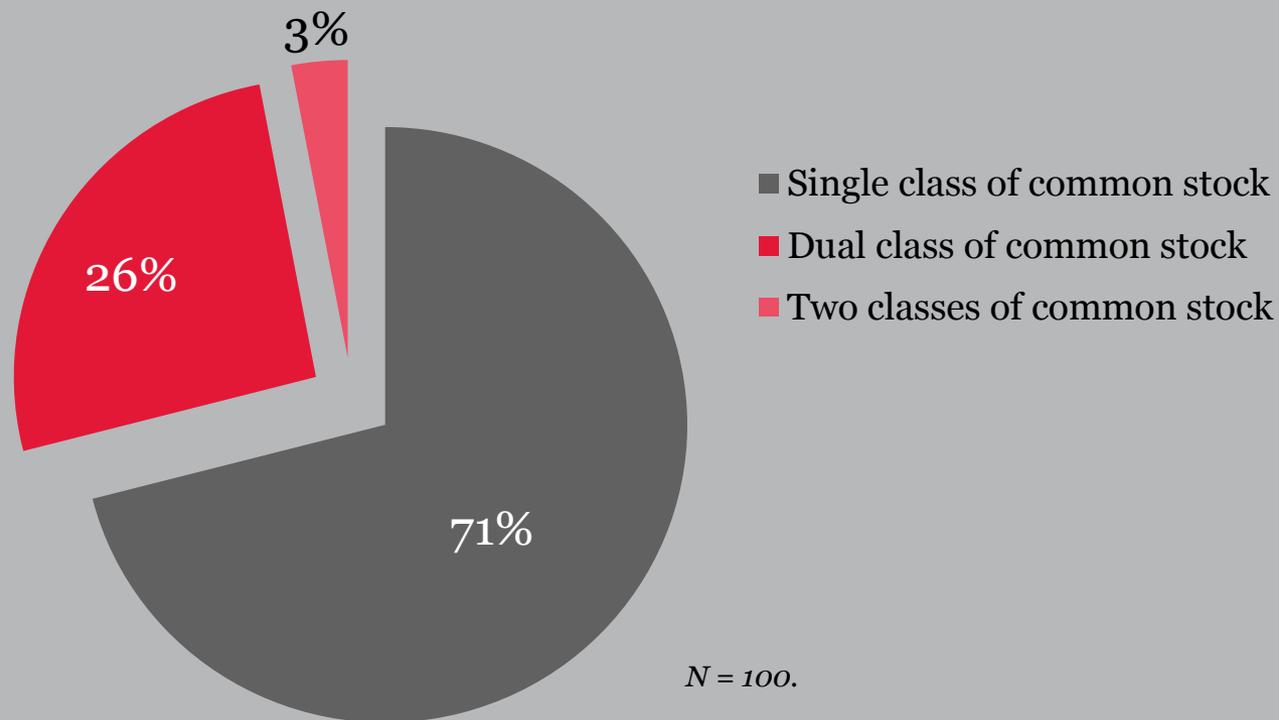
Decisions by control group are subject to “entire fairness” review unless special committee and minority approval are employed

IPO pricing may be discounted for risk inherent in low-vote shares

Diminished liquidity may lead to greater stock price volatility

- In the period from January 1, 2016 through December 31, 2016, twenty-six EGCs had dual classes of common stock, including three issuers that had more than two classes of common stock. Eleven of the dual-class EGCs were FPIs.

### Dual class capital structures.



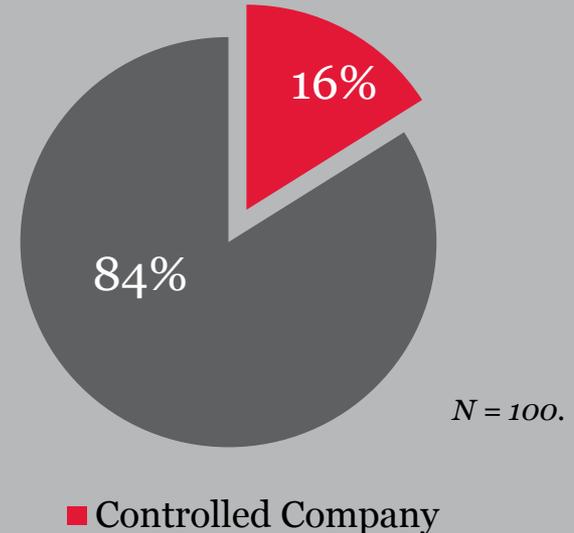
Dual class capital structures,  
cont'd.

# Controlled companies

- A “controlled company” is a company of which more than 50% of the voting power for the election of directors is held by an individual, a group, or another company. The calculation of voting power held by a group can include shares covered under voting agreements between or among shareholders relating to the election of directors.
- A company elects to be controlled company in its initial listing application to an exchange and discloses in its filings that it relies on certain exemptions. A “controlled company” is not required to comply with the following exchange requirements:
  - A company’s board of directors is required to have a majority of independent directors.
  - Independent directors must determine the compensation of the CEO and other executive officers.
  - Independent directors must select or recommend nominees for directors

## Frequency of Controlled Companies

(January 1, 2016 through December 31, 2016)



# Direct-to-Consumer Offerings

# Direct-to-Consumer Offerings

- Offerings to an IPO issuer's customers is not a new phenomenon but it seems to have renewed interest
- Boston Beer (a/k/a Sam Adams) was one of the first IPO issuers to undertake an offering of shares in its IPO to its beer consumers
- Since late 2013, at least 18 companies, including four billion-dollar-valued startups, have included consumer offerings in their IPOs
- Rationale for direct-to-consumer offerings:
  - Customers gain a sense of ownership in the companies they support
  - Companies demonstrate gratitude and appreciation for continued support
  - Expands the IPO investor pool beyond large funds and wealthy brokerage clients
  - Increases shareholder retention; investors less likely to sell shortly after IPO

# Invite your customers into your IPO

- You can undertake a consumer offering as part of your IPO. You can do this seamlessly by using a retail broker or a specialty firm, like Loyal3. Since its inception in 2013, Loyal3 has participated in 15 IPOs, facilitating the sale of equity to 54,000+ participants and raising \$205M for issuers, including:



# Examples

- Sample free writing prospectuses (FWPs) inviting consumers to participate in the IPO.
  - **Square, Inc.** (11/9/15):  
<https://www.sec.gov/Archives/edgar/data/1512673/000119312515371912/d68668dfwp.htm>
  - **Blue Buffalo Pet Products** (7/8/15):  
<https://www.sec.gov/Archives/edgar/data/1609989/000119312515248081/d13593dfwp.htm>
  - **Virgin America** (11/3/14):  
<https://www.sec.gov/Archives/edgar/data/1614436/000119312514393025/d814828dfwp.htm>
  - **Dave & Buster's** (9/29/14):  
<https://www.sec.gov/Archives/edgar/data/1525769/000119312514357385/d735753dfwp.htm>
  - **AMC Entertainment Holdings** (12/3/13):  
[https://www.sec.gov/Archives/edgar/data/1411579/000110465913088187/a13-18601\\_12fwp.htm](https://www.sec.gov/Archives/edgar/data/1411579/000110465913088187/a13-18601_12fwp.htm)

# **JOBS Act 2.0**

# The Financial Choice Act

- The Financial Choice Act of 2016 (the “Choice Act”) is viewed as the first major concerted effort to provide an alternative to the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (the “Dodd-Frank Act”) as a way to end “Too Big to Fail.”
- As currently drafted, the Choice Act would impact U.S. securities laws by:
  - Repealing a number of the specialized disclosure provisions contained in the Dodd-Frank Act; and
  - Subsuming various “JOBS Act 2.0” capital formation measures that have largely been presented as standalone bills.
  - Essentially, many of the securities law related provisions in the Choice Act have as their objective making being public more attractive by reducing the burdens on newly public companies and smaller public companies

# The Choice Act

## Reforms to Title IX of the Dodd-Frank Act:

<b><i>Fiduciary Duty Rule</i></b>	<ul style="list-style-type: none"><li>• Requires the SEC to report to the House Committee on Financial Services and the Senate Committee on Banking, Housing, and Urban Affairs on certain matters before promulgating a heightened standard of conduct for broker-dealers.</li></ul>
<b><i>Asset-Backed Securities and Credit Rating Agencies</i></b>	<ul style="list-style-type: none"><li>• Eliminates the risk retention requirements for certain asset-backed securities.</li><li>• Repeals the Franken Amendment.</li></ul>
<b><i>Relief for Smaller Issuers</i></b>	<ul style="list-style-type: none"><li>• Modifies threshold for ability to rely on the exemption from Section 404(b) of the Sarbanes-Oxley Act of 2002 (“Sarbanes-Oxley”).</li></ul>
<b><i>Executive Compensation, Incentive-Based Compensation, and Pay Ratio Disclosure</i></b>	<ul style="list-style-type: none"><li>• Repeals the Dodd-Frank Act provisions relating to incentive-based compensation and pay ratio disclosures.</li></ul>

# Reforms to Capital Formation

- ***Simplification of Small Business Mergers, Acquisitions, Sales, and Brokerage.*** Amends Section 15(b) of the Exchange Act to exempt an “M&A broker” from Exchange Act registration.
- ***Encouraging Employee Ownership.*** Increases the threshold for disclosures relating to compensatory benefit plans.
- ***Simplification of Small Company Disclosure Requirements.*** EGCs and issuers with less than \$25 billion in total annual gross revenues would be exempt from Extensible Business Reporting Language requirements for financial statements and other periodic reporting.
- ***SEC Overpayment Credit.*** New mechanism for the refunding or crediting of overpayment of fees paid in connection with Section 31 of the Exchange Act.

- ***Fair Access to Investment Research.*** Expands the safe harbor for investment fund research provided by Rule 139 under the Securities Act.
- ***Accelerating Access to Capital.*** Expands the eligibility for use of a registration statement on Form S-3.
- ***Establishment of an SEC Small Business Advocate.*** Amends Section 4 of the Exchange Act by establishing within the SEC an “Office of the Advocate for Small Business Capital Formation.”
- ***Small Business Credit Availability.*** Requires that the SEC promulgate regulations to codify the terms of an exemptive application already issued to a business development company (“BDC”) allowing the BDC to own interests in an investment adviser.
- ***Foster Innovation Through Temporary Exemption for Low-Revenue Issuers.*** Provides a temporary exemption for “low-revenue issuers” from Section 404(b) of the Sarbanes-Oxley Act.

- ***Enhance Small Business Capital Formation.*** Amends Section 503 of the Small Business Investment Incentive Act by requiring the SEC to review the findings and recommendations of the Government-Business Forum on Capital Formation.
- ***Revisions to the Prohibition Against General Solicitation and Advertising.*** Requires the SEC to revise Reg D to reflect the guidance contained in the *Michigan Growth Capital Symposium* no-action letter.
- ***Venture Exchanges.*** Amends Section 6 of the Exchange Act by enabling a national securities exchange to elect to be treated as a “venture exchange.”
- ***Safe Harbor for Micro Offerings.*** Provides a safe harbor from Section 4 of the Securities Act for certain micro offerings.
- ***Improvements to Private Placements.*** Amends Reg D in an attempt to ensure that the proposed amendments released by the SEC in July 2013 would be foreclosed from being adopted.

- ***Investor Limitations for Qualifying Venture Capital Funds.*** Amends Section 3(c)(1) of the Investment Company Act by allowing a “qualifying venture capital fund” to maintain holders of up to 250 U.S. persons without having to register under the Investment Company Act.
- ***Adjustments to Crowdfunding Regime.*** Adds a new provision under Section 4(a)(6) of the Securities Act, which would provide an exemption for securities offered by certain issuers:
  - Public float less than \$75 million as of most recent semi-annual period;  
*or*
  - Where total public float is zero, annual revenues of less than \$50 million as of most recently completed fiscal year.
- ***Corporate Governance Reform and Transparency.*** Requires “proxy advisory firms” to register under the Exchange Act before providing proxy voting research, analysis, or recommendations to any client.

# The Choice Act: Repeal of Certain Specialized Public Company Disclosures

## Would repeal the following provisions of the Dodd-Frank Act:

<b>Section 1502</b>	<ul style="list-style-type: none"><li>• Requires certain persons to disclose annually whether any “conflict minerals” are necessary to the functionality or production of a product of the person originated in the Democratic Republic of the Congo or an adjoining country.</li></ul>
<b>Section 1503</b>	<ul style="list-style-type: none"><li>• Requires the SEC to promulgate rules that require an issuer that files reports pursuant to Section 13(a) or Section 15(d) of the Exchange Act and is an operator, or maintains a subsidiary that is an operator, of a coal or other mine to include, in each periodic report filed with the SEC, certain information for the time covered by the report.</li></ul>
<b>Section 1504</b>	<ul style="list-style-type: none"><li>• Requires that the SEC issue rules that require reporting issuers engaged in resource extraction activities, including the commercial development of oil, natural gas, or minerals, to disclose in their annual reports certain payments made to the U.S. federal government or a foreign government.</li></ul>

# Changes to the as-introduced Version of the Financial Choice Act

- The Choice Act 2.0 contains additional provisions that would:
  - Modernize Section 12(g) registration requirements for smaller reporting companies.
    - Eliminate annual verification of accredited investor status; and
    - Increase revenue and shareholder thresholds.
  - Increase the exemption from registration as an investment company for “qualified angel funds” from 100 to 500 investors.
  - Increase the SEC Rule 701 threshold from \$10 to \$20 million with an inflation trigger.
  - Extend the ability to “test the waters” to all companies (not just EGCs).
  - Confidential filings will be available to all companies registering shares for sale for the first time.
  - Increase the Reg A+ \$50 million threshold to \$75 million per year plus the addition of an inflation trigger.