

FREQUENTLY ASKED QUESTIONS ABOUT INITIAL PUBLIC OFFERINGS

Initial public offerings (“IPOs”) are complex, time-consuming and implicate many different areas of the law and market practices. The following FAQs address important issues but are not likely to answer all of your questions.

Understanding IPOs

What is an IPO?

An “IPO” is the initial public offering by a company of its securities, most often its common stock. In the United States, these offerings are generally registered under the Securities Act of 1933, as amended (the “Securities Act”), and the shares are often but not always listed on a national securities exchange such as the New York Stock Exchange (the “NYSE”), the NYSE American LLC or one of the NASDAQ markets (“NASDAQ” and, collectively, the “exchanges”). The process of “going public” is complex and expensive. Upon the completion of an IPO, a company becomes a “public company,” subject to all of the regulations applicable to public companies, including those of the Securities Exchange Act of 1934, as amended (the “Exchange Act”).

What are advantages of going public?

- The most obvious reason to go public is to raise capital. Unlike a private offering, there are no

restrictions imposed on a company with respect to offerees or how many securities it may sell. The funds received from the securities sold in an IPO may be used for common company purposes, such as working capital, research and development, retiring existing indebtedness and acquiring other companies or businesses.

- Going public creates a public market for a company’s securities. Liquidity is important for existing and future investors, and provides an exit strategy for venture and hedge fund investors.
- Following an IPO, a company should have greater access to capital in the future. Once a public market is created, a company may be able to use its equity in lieu of cash or more costly debt financings.
- Public companies have greater visibility. The media has greater economic incentive to cover a public company than a private company

because of the number of investors seeking information about their investment.

- Going public allows a company's employees to share in its growth and success through stock options and other equity-based compensation structures that benefit from a more liquid stock with an independently determined fair market value. A public company may also use its equity to attract and retain management and key personnel.

What are disadvantages of going public?

- The IPO process is expensive. The legal, accounting and printing costs are significant and these costs will have to be paid regardless of whether an IPO is successful.
- Once an IPO is completed, a company will incur higher costs as a public company, including the significant compliance requirements of the Sarbanes-Oxley Act of 2002 ("Sarbanes-Oxley") and the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 ("Dodd-Frank").
- There is much more public scrutiny of a company after an IPO. Once a company is public, certain information must be disclosed, such as compensation, financial information and material agreements.

How does the JOBS Act change the IPO process?

Since at least the dotcom bust of the early 2000s and accelerating after the passages of Sarbanes-Oxley and Dodd-Frank, business leaders and commentators have observed that the regulatory requirements to be met in order to finance companies in the United States have

become overly burdensome and discourage entrepreneurship. In the aftermath of the financial crisis of 2008, national attention shifted to job creation and the backlash against over-regulation brought about by Dodd-Frank. In April 2012, the Jumpstart Our Business Startups Act (the "JOBS Act") was enacted, which reflects many of the legislative initiatives that had been discussed for several years. The JOBS Act adopted the following provisions that affect capital formation:

- An "IPO on-ramp" for a new category of issuer, "emerging growth companies," that offers a number of benefits, including confidential SEC Staff review of draft IPO registration statements, scaled disclosure requirements, no restrictions on "test-the-waters" communications with qualified institutional buyers ("QIBs") and institutional accredited investors before and after filing a registration statement, and fewer restrictions on research (including research by participating underwriters) around the time of an offering (all of which will be discussed in greater detail below).
- An amendment to the Securities Act (informally referred to as Regulation A+) permitting companies to conduct offerings to raise up to \$50 million in any 12-month period through a "mini-registration" process similar to that provided for under Regulation A.
- Higher securityholder triggering thresholds for reporting obligations under the Exchange Act.
- Removal of the prohibition against general solicitation and general advertising in certain private placements.

- A new exemption under the Securities Act for crowdfunding offerings.

The JOBS Act offers an issuer new possibilities for structuring its capital raise.

What types of companies go public?

Any company seeking greater access to capital may decide to go public. Companies with revenues and profits or a shorter path to profitability are more likely to have successful IPOs than companies without revenues or that are in a development stage, particularly in difficult economic environments. A company seeking increased visibility and liquidity may also decide to go public. Depending on its size and business, a public company may have from two to 20 analysts covering its stock.

Research and development-based companies, including pharmaceutical and technology companies, with strong valuations but little current revenue may decide to go public to fund long-term, costly R&D. Later-stage R&D companies and companies with near-term milestones may also decide to access the public markets through an IPO.

There are a number of kinds of companies that do not yet have an operating history but may seek to go public in order to pursue their strategic plans, including:

- *Real estate investment trusts (“REITs”)*, including mortgage REITs, are formed to take advantage of opportunities to purchase distressed or undervalued mortgage-related securities and equity REITs that seek to acquire specific kinds of real estate.
- *Special purpose acquisition vehicles (“SPACs”)*, a more recent type of blind pool offering, are shell or blank-check companies that have no

operations but go public with the intention of merging with or acquiring a company with the proceeds of the IPO, subject to shareholder approval.

- *Business development companies (“BDCs”)* are entities that go public to fill the perceived need for capital for smaller businesses.

What is an “emerging growth company” or “EGC”?

The JOBS Act establishes a new process and disclosures for IPOs by a new class of companies referred to as “emerging growth companies” or “EGCs.” An EGC is an issuer (including a foreign private issuer) with total annual gross revenues of less than \$1.07 billion (adjusted from \$1 billion in March 2017, and subject to inflationary adjustment by the SEC every five years) during its most recently completed fiscal year.¹ The SEC Staff has stated in its General Applicability FAQs that asset-backed issuers and registered investment companies do not qualify as EGCs; however, BDCs can qualify as EGCs.

How long can an issuer maintain EGC status?

Status as an EGC is maintained until the earliest of:

¹ In its Frequently Asked Questions of General Applicability on Title I of the JOBS Act (issued on April 16, 2012, updated on May 3, 2012 and September 28, 2012, and collectively referred to herein as the “General Applicability FAQs”), the SEC Staff specified that the phrase “total annual gross revenues” means total revenues of the issuer (or a predecessor of the issuer, if the predecessor’s financial statements are presented in the registration statement for the most recent fiscal year), as presented on the income statement in accordance with U.S. generally accepted accounting principles (“GAAP”). If a foreign private issuer is using International Financial Reporting Standards (“IFRS”) as issued by the International Accounting Standards Board as its basis for presentation, then the IFRS revenue number is used for this test. Because an issuer must determine its EGC status based on revenues as expressed in U.S. dollars, the SEC Staff indicates that a foreign private issuer’s conversion of revenues should be based on the exchange rate as of the last day of the fiscal year.

- the last day of the fiscal year in which the issuer's total annual gross revenues are \$1.07 billion or more;
- the last day of the issuer's fiscal year following the fifth anniversary of the date of the first sale of common equity securities of the issuer pursuant to an effective registration statement under the Securities Act (for a debt-only issuer that never sells common equity pursuant to a Securities Act registration statement, this five-year period will not run);
- any date on which the issuer has, during the prior three-year period, issued more than \$1 billion in non-convertible debt; or
- the date on which the issuer becomes a "Large Accelerated Filer," as defined in the SEC's rules.

If an EGC loses its status as an emerging growth company, the status cannot be reestablished.

With regard to the \$1 billion debt issuance test, the SEC Staff clarified in the General Applicability FAQs that the three-year period covers any rolling three-year period and is not limited to completed calendar or fiscal years. The SEC Staff also noted that it reads "non-convertible debt" to mean any non-convertible security that constitutes indebtedness (whether issued in a registered offering or not), thereby excluding bank debt or credit facilities. The debt test references debt "issued," as opposed to "issued and outstanding," so that any debt issued to refinance existing indebtedness over the course of the three-year period could be counted multiple times. However, the SEC Staff also indicated in the General Applicability FAQs that it will not object if an issuer does not double count the principal amount from a private placement and the

principal amount from the related *Exxon Capital* exchange offer, as it views the subsequent exchange offer as completing the capital-raising transaction. An issuer also should count any debt securities offered by or through a securitization vehicle to the extent that the securitization vehicle is consolidated for accounting purposes.

What happens if an EGC loses its status as an EGC during its IPO?

The Fixing America's Surface Transportation Act (the "FAST Act") amends Section 6(e)(1) of the Securities Act in order to provide a grace period permitting an issuer that qualified as an EGC at the time it made its first confidential submission of its IPO registration statement and subsequently during the IPO process ceases to be an EGC to continue to be treated as an EGC through the earlier of: the date on which the issuer consummates its IPO pursuant to that registration statement, or the end of the one-year period beginning on the date the company ceases to be an EGC.

When should a company go public?

There is no right answer or right time. It depends on a company's need for cash or liquidity to pursue its strategic plans. There is a market consensus that there is a "window" when companies, often particular types of companies, can effect IPOs. Whether the window is open or closed depends on overall economic conditions and investor appetite for risk. For example, in the dotcom boom of the late 1990s, many technology companies had ideas but no revenues and certainly no profits. SPACs became popular in the 2000s because, unlike blind pools before them, public investors in the SPACs had rights to approve the proposed acquisitions and the IPO proceeds had to be returned if a suitable

investment was not found within a specified period, usually two years. After the dotcom bust and since the current economic downturn, investors are looking for companies with more revenues and actual profits or a relatively quick path to profitability.

What is the IPO process?

The public offering process is divided into three periods:

- *Pre-filing.* The pre-filing period is the period from the determination to proceed with a public offering to the filing of a registration statement with the SEC. This is also generally called the “quiet period,” and a company is usually subject to limitations on its public communications. See “*What is the quiet period?*” and “*What are ‘testing-the-waters’ communications by or on behalf of an EGC?*”
- *Waiting or pre-effective.* The waiting or pre-effective period is the period from the date of the filing of the registration statement to its “effective date.” During this period, a company may make oral offers and certain written offers, but may not enter binding agreements to sell the offered security. See “*What is the waiting period?*”
- *Pricing and post-effective.* The post-effective period is the period from the date the registration statement has been “declared effective” by the SEC to the completion of the offering. See “*What happens after the SEC has completed its review?*”

IPO Team

Who is involved in an IPO?

Going public requires retaining the proper external advisors. An IPO team will include a lead underwriter and potentially co-managing underwriters, an independent auditing firm with significant public company experience, outside legal counsel, a transfer agent and a financial printer. A company may also want to hire a public relations firm.

A company should also have an internal IPO team in place. Key members of this internal team will include the company’s president, CEO, CFO, general counsel, controller and an investor relations or public relations manager.

What does the managing underwriter do?

A company will identify one or more lead underwriters that will be responsible for the offering process. A company chooses an underwriter based on its industry expertise, including the knowledge and following of its research analysts, the breadth of its distribution capacity, and its overall reputation. The company should know the answers to the following questions, at a minimum:

- Does the investment bank have strong research in its industry?
- Is its distribution network mainly institutional or retail?
- Is its strength domestic, or does it have foreign distribution capacity?

Depending on the size of the offering, a company may want to include a number of co-managers in order to

balance the lead underwriters' respective strengths and weaknesses.

A company should keep in mind that underwriters have at least two conflicting responsibilities—to sell the IPO shares on behalf of the company and to recommend to potential investors that the purchase of the IPO shares is a suitable and worthy investment. In order to better understand the company—and to provide a defense in case the underwriters are sued in connection with the IPO (*see “Who may also be liable under the Securities Act?”*)—the underwriters and their counsel are likely to spend a substantial amount of time performing business, financial and legal “due diligence” in connection with the IPO, and making sure that the prospectus and any other offering materials are consistent with the information provided.

The underwriters will market the IPO shares, set the price (in consultation with the company) at which the shares will be offered to the public and, in a “firm commitment” underwriting, purchase the shares from the company and then re-sell them to investors. In order to ensure an orderly market for the IPO shares, after the shares are priced and sold, the underwriters are permitted in many circumstances to engage in certain stabilizing transactions to support the stock. *See “What actions may underwriters take after pricing?”*

What do the co-managers do?

Co-managers are underwriters who agree to purchase a substantial portion of a company's shares and who are involved in drafting the prospectus and marketing the offering. Companies typically choose co-managers that have distribution capabilities or analyst coverage that is complimentary to those of the managing underwriter.

What do the auditors/accountants do?

Accountants prepare and audit the financial statements of a company or other entities or properties that must be included in an IPO registration statement. Other services provided by the accountants during the offering process include assisting a company in preparing the other financial portions of the prospectus, such as the summary financial information, selected financial information, capitalization and dilution tables, and any required pro forma financial statements, and working with the company to identify any problems associated with providing the required financial statements in order to seek necessary accommodation from the SEC. The accountants will also provide a “comfort letter” to the underwriters. *See “What financial information is required to be included in the registration statement?” and “What is a ‘comfort letter’?”*

What does legal counsel do?

A company's in-house and outside legal counsel play important roles in completing the IPO. A company's counsel:

- has principal responsibility for preparing the registration statement, prospectus, stock exchange application and any confidential treatment requests;
- communicates with the SEC and the stock exchanges on a company's behalf, responding to any comments they may have;
- negotiates an underwriting agreement with the underwriters and their counsel; and
- prepares various other documents, including stock option plans, a company's post-IPO certificate of incorporation and bylaws, committee charters, board minutes relating to

the IPO and any required consents, waivers and legal opinions.

Underwriters' counsel undertakes legal due diligence during the offering process and reviews the registration statement and prospectus with the company, its counsel and the underwriters. Underwriters' counsel also:

- negotiates the underwriting agreement with a company and its counsel;
- negotiates the "comfort letter" with a company's accountants; and
- submits the underwriting agreement, registration statement and other offering documents for review to the Financial Industry Regulatory Authority ("FINRA").

Company's counsel and underwriters' counsel will also coordinate the closing of the transaction.

What role do research analysts play?

Generally, research analysts will cover the company once it becomes public, increasing the company's visibility. The JOBS Act permits a broker-dealer to publish or distribute a research report about an EGC that proposes to register an offering under the Securities Act or has a registration statement pending, and the research report will not be deemed an "offer" under the Securities Act, even if the broker-dealer will participate or is participating in the offering. Since the dotcom bust of the early 2000s, the courts, the SEC and FINRA have imposed significant restrictions on the role of the research analyst and research's relationship with investment bankers. The JOBS Act now prohibits any self-regulatory organization ("SRO"), such as FINRA, and the SEC from adopting any rule or regulation that would restrict a broker-dealer from participating in certain meetings relating to EGCs. Further, no SRO or

the SEC may adopt or maintain any rule or regulation prohibiting a broker-dealer from publishing or distributing a research report or making a public appearance with respect to the securities of an EGC following an offering or in a period prior to expiration of a lock-up (see "*What types of provisions are contained in the underwriting agreement?*"). The JOBS Act also removes restrictions on who within an investment bank can arrange for communications between research analysts and prospective investors in connection with an EGC IPO, permitting investment bankers to be involved in those arrangements. Further, a research analyst is permitted to engage in communications with an EGC's management when other employees of the investment bank, including the investment bankers, are present.²

Depending on its size and type of business, a company can expect to have between two and 20 analysts covering its stock although smaller companies may not have any analyst coverage. The analysts will regularly publish recommendations with respect to the company based on their analyses of the company's financial condition and results of operations. Analyst coverage/publicity may result in introducing the company to potential customers and business partners, as well as reinforcing the company's advertising and product-branding initiatives.

What does the financial printer do?

A company's financial printer will print and distribute drafts of the prospectus to the working group as well as providing copies of the prospectus to the underwriters

² See "Frequently Asked Questions about Separation of Research and Investment Banking" at <http://www.mofo.com/files/Uploads/Images/Frequently-Asked-Questions-about-Separation-of-Research-and-Investment-Banking.pdf>.

for distribution to investors. The printer will also file (or confidentially submit) the registration statement and prospectus with the SEC through the SEC's EDGAR system. While the company should seek a financial printer with conference facilities, endless days at the printer are no longer as common as they were in the past because of the use of email, specialized websites and video and audio conference calls.

What does the transfer agent do?

A transfer agent coordinates the issuance and tracking of the company's stock certificates. Unlike a private company, a public company's outstanding stock can be traded many times during each business day. The agent also maintains a list of the individuals and entities to whom the shares are issued and some agents provide additional services that are useful to public companies, such as administering certain aspects of stock option plans and acting as inspectors of election at shareholder meetings.

What other professionals are involved in an IPO?

A company may hire a public relations firm for the IPO. The public relations firm will help to ensure that the company's communications with the general public as well as its target market during the offering period are consistent with the SEC's rules, while continuing to generate interest in the company and its business. In preparing for an IPO, the company should discuss with the public relations firm the nature of the communications planned during the offering period and identify any items that might constitute gun jumping. See "Pre-IPO Disclosures."

Pre-Filing Matters

What corporate steps should be taken to prepare for an IPO?

Most companies must make legal and operational changes before proceeding with an IPO and begin those changes well before the organizational meeting. A company cannot wait to see if its IPO is likely to be successful prior to implementing most of those changes.

- Many corporate governance matters, federal securities law requirements (including Sarbanes-Oxley) as well as applicable exchange requirements must be met when the IPO registration statement is filed, or a company must commit to satisfy them within a set time period. A company's certificate of incorporation and bylaws will likely need amendment as well. However, many corporate governance requirements are not applicable to foreign private issuers although home country requirements are often required to be disclosed.
- A company proposing to list securities on an exchange should review that exchange's financial listing requirements as well as its governance requirements before determining which exchange to choose.
- A company should consider adopting anti-takeover defenses, such as a staggered board of directors or a shareholder rights plan. The underwriters should be involved in these discussions so that the company avoids adopting any anti-takeover measure that might negatively affect the marketing of the offering.

- The company should analyze its capitalization to determine whether it will be appropriate after the IPO. For example, because of the risk of “market overhang” (the concern that a large number of shares may flood the public market and depress the market price of the shares), most underwriters advise companies to try to cause the conversion or exercise of outstanding convertible preferred stock, warrants and convertible debt into common stock prior to the IPO if the original documentation does not already require conversion or exercise. The underwriters may also advise the company whether a stock split or reverse stock split is appropriate in order for the company’s stock to trade at an attractive price for its industry and size after the IPO.
- A company must also address other corporate governance matters, including:
 - board structure;
 - recruiting directors;
 - board and management committees and member criteria;
 - whether to retain additional senior management;
 - identifying, disclosing and/or terminating related party transactions; and
 - directors’ and officers’ liability insurance.

Should a company review its compensation policies and principles prior to the IPO?

A company should undertake a thorough review of its compensation scheme for its directors and officers, particularly its use of equity compensation.

- *Systematizing compensation practices.* Compensation decisions should be made more systematically—doing so may require:
 - establishing an independent compensation committee of the board of directors, as required by Dodd-Frank and the exchanges;
 - using formal market information to set compensation; and
 - establishing a regular equity compensation grant cycle.
- *Confirming accounting and tax treatment.* A company should be sure that the Internal Revenue Code (“Code”) Section 409A valuation used to establish stock value for stock option purposes is consistent with that used for financial accounting purposes. The company should also consider whether to limit option grants as the IPO effective date approaches because option grants close to an IPO may raise “cheap stock” issues. *See “What is ‘cheap stock’?”*
- *Reviewing securities law compliance.* A company should confirm that equity grants were made in compliance with federal and state securities rules, including the limits of Rule 701 under the Securities Act, to avoid rescission or other compliance concerns.

- *Adopting plans.* Public companies are usually required by the exchanges to obtain shareholder approval for new compensation plans and material amendments. In order to obtain favorable “incentive stock option” (“ISO”) treatment under U.S. federal tax laws, the option plan must be approved by a company’s shareholders. An issuer will have greater flexibility to adopt compensation plans prior to its IPO. An issuer should adopt the plans it thinks it may need during its first few years as a public company (including an equity incentive plan, employee stock purchase plans, and Code Section 162(m) “grandfathered” bonus plans), and reserve sufficient shares for future grants.
- *Adoption of policies and clawback arrangements.* Particularly in light of the requirements of Dodd-Frank, a company should review or establish policies with respect to clawbacks of executive compensation, severance and post-employment benefits (“golden parachutes”) upon the occurrence of certain events.

What is the organizational meeting?

The IPO process usually starts moving rapidly beginning with an organizational meeting attended by representatives of the company, its accountants and counsel, the underwriters and their counsel. The meeting generally includes discussion of the timeline for the offering, the general terms of the offering and the responsibilities of the various parties. Also discussed is the timing of the audited financial statements to be included in the prospectus and any accounting matters or policies that may be of concern. The participants will

also discuss reasons for potential timing delays—for example, significant acquisitions or the need for financial statements relating to acquisitions or the need to retain additional executive officers.

The organizational meeting may also include presentations by the company’s management, some initial due diligence questions by the underwriters and their counsel and a general discussion of the scope and level of comfort that the accountants will be asked to provide with respect to the financial information included in the prospectus.

What do Sarbanes-Oxley and Dodd-Frank require?

The requirements of Sarbanes-Oxley, as augmented by Dodd-Frank, include:

- a prohibition on most loans to officers and executive directors;
- limitations on the use of non-GAAP financial measures;
- disclosure of material off-balance sheet arrangements;
- “material correcting adjustments” identified by the company’s accountants must be reflected in all periodic reports containing GAAP financial statements;
- potential compensation disgorgement upon a restatement of financial results attributable to misconduct;
- auditor independence;
- certifications by the company’s CEO and CFO of each periodic report containing financial statements;
- adoption of a code of business conduct and ethics for directors, officers and employees;

- whistleblower protections for employees who come forward with information relating to violations of federal securities laws;
- the creation of audit, nominating and compensation committees that comply with certain independence requirements; note that the independence requirements for compensation committees were strengthened by Dodd-Frank; and
- shareholder approval of equity compensation plans.

When does Sarbanes-Oxley apply to an issuer?

Certain provisions of Sarbanes-Oxley become applicable immediately upon the filing of the registration statement by a company, even before the registration statement is declared effective, and other provisions of Sarbanes-Oxley apply to a company as soon as its registration statement becomes effective. Accordingly, the company must familiarize itself with Sarbanes-Oxley requirements early in the offering process and take necessary steps to comply prior to filing the registration statement or prior to effectiveness. However, the company will not have to comply with the requirements of Section 404 of Sarbanes-Oxley regarding internal control over financial reporting until the second fiscal year following its IPO (and potentially after the fifth fiscal year for an EGC).

What is the "due diligence" process?

Underwriters have a defense to Securities Act liability if they exercise "due diligence," which is the practice of reviewing information about an issuer in an effort to mitigate liability and reputational risk. After the organizational meeting and during the quiet period, the

underwriters and their counsel will likely spend a substantial amount of time performing business, financial and legal due diligence in connection with the IPO. The process is usually started with a "due diligence request" prepared by the underwriters and their counsel. The company's key management personnel will generally make a series of presentations covering the company's business and industry, market opportunities, and financial matters. The underwriters will use these presentations as an opportunity to ask questions and establish a basis for their "due diligence" defense. The presentations will also aid the company and the underwriters in determining how the prospectus will describe the company, its business, strategies and objectives and risk factors, and provide information for drafting the underwriting agreement.

The company's directors and officers will be provided with a directors' and officers', or "D&O," questionnaire to complete. The purpose of the questionnaire is to identify any facts about those individuals, and the relationships that they have with the company, its affiliates or business partners, that must be disclosed in the prospectus. The D&O questionnaire usually tracks the specific SEC and FINRA disclosure requirements. In some cases, holders of more than 5% of the company's equity will also be asked to execute a D&O questionnaire.

Typical areas of concern include:

- *Business*, including management presentations and discussions, customer and supplier calls or meetings, trips to company facilities, in-depth review of financial positions and results and general discussions with the company's accountants;

- *Accounting*, including audits, changes in accounting policies, critical accounting policies and tax issues, cheap stock issues, capital structure and comfort letters and the level of comfort to be provided;
- *Legal*, including outstanding and even closed claims and litigation, loan agreement restrictions, third-party consents, FINRA issues, intellectual property, labor, environmental, regulatory or other issues and legal opinions; and
- *Management and corporate governance*, including composition of the board, director independence, senior management team changes, related party transactions and board actions relating to the IPO.

What is “insider trading”?

Federal securities laws impose significant restrictions, and may impose civil and criminal liability, on the company’s personnel who trade securities on the basis of material non-public information. While this is not a significant issue until a company completes its IPO, when the company’s securities begin to trade in the public market, there likely will be risk that the company’s officers, directors and employees will have confidential information that, if used, could enable them to make profitable trades in those securities.

Even though this type of insider trading would violate the employee’s legal obligations, and not necessarily the company’s obligations, insider trading violations are the type of publicity that all companies seek to avoid. Accordingly, it is an important part of the offering process for a company to adopt an insider trading policy. A typical policy will bar trading in the

company’s securities (and the securities of any other company with which the company does business) during any period in which the individuals covered by the policy possess material non-public information about the issuer, and most policies impose mandatory restrictions (“blackout periods”) during the period between the time that the company begins to compile its financial results for a quarter and one or two business days after the release of the financial information to the public in the form of an earnings release.

What third-party consents are needed?

Prior to an IPO, a company may have entered into agreements that impose restrictions on its ability to complete the IPO, including:

- Shareholder agreements that may require consents to share issuances or that require the company to register the shareholders’ shares as part of the IPO (“registration rights”);
- Loan or credit agreements that restrict share issuances or the use of proceeds from the offering; or
- Operating agreements with significant business partners that contain broad “change of control” provisions that may be triggered by the IPO.

A company, with the help of its counsel, should review all of its agreements to identify these provisions and negotiate for necessary consents or waivers with the other parties involved so that they do not jeopardize the timing of the IPO. Companies will want to avoid any last minute hold-up by a shareholder, creditor or supplier or customer that could delay the offering or require the issuer to pay a consent fee or make other concessions.

Reviewing Management Structure

Are independent board members required?

A company must comply with significant corporate governance requirements imposed by federal securities laws and regulations and the regulations of the applicable exchanges, including with regard to the oversight responsibilities of the board of directors and its committees. A critical matter is the composition of the board itself. All exchanges require that, except under certain limited circumstances, a majority of the directors be “independent,” as defined by both federal securities laws and regulations and exchange regulations. In addition, boards should include individuals with appropriate financial expertise and industry experience, as well as an understanding of risk management issues and public company experience. In addition, the exchanges require that the independent directors have regularly scheduled executive sessions.

A company should begin its search for suitable directors early in the IPO process even if it will not appoint the directors until after the IPO is completed. The company can turn to its large investors as well as its counsel and underwriters for references regarding potential directors and also designate a committee of the board to undertake the director search.

What board committees are required?

The exchanges all require listed companies to have an audit committee, consisting only of at least three independent directors who meet certain standards. At least one of the audit committee members must be a “financial expert.” The passage of Sarbanes-Oxley in 2002 resulted in a significant enhancement of the independence and expertise requirements for audit

committees. At the same time, the SEC and the exchanges began to exert pressure to ensure that compensation and nominating or corporate governance committees become more independent. The NYSE also requires a compensation committee and a nominating/corporate governance committee consisting only of independent directors. NASDAQ also now requires, subject to certain phase-in rules, a compensation committee of independent directors but does not require a nominating committee. The functions of a nominating committee can be performed either by a committee consisting solely of independent directors or by a majority of the company’s independent directors operating in executive session. Pursuant to Dodd-Frank and the SEC’s implementing rules, exchanges must require that listed companies’ compensation committees, among other things, be composed entirely of independent directors.

Do board committees need charters?

Yes, under the rules of the exchanges, the audit, compensation and nominating/corporate governance committee charters must contain specific responsibilities and provisions, including the committee’s purpose, member qualifications, appointment and removal, board reporting and performance evaluations. If any of the responsibilities of these committees are delegated to another committee, the other committee must be comprised entirely of independent directors and must have its own charter. In addition, the NYSE and best practices require that the company make its charters available on or through its website, and disclose in its proxy statement (or annual report on Form 10-K if it does not file a proxy statement) that the charters are available on or through its website, including the address.

Does a company need to hire new senior management in connection with an IPO?

The need to hire new senior management is a company-specific determination. Some companies contemplating an IPO may feel the need to have chief executive officers who have public company experience but who may not necessarily have the industry experience. In many ways, it may even be more critical that the company have a chief financial officer with public company experience as the financial reporting requirements are extensive and unrelenting. Often, underwriters will identify new or replacement officers that the underwriters believe will make the company more attractive to investors. Because finding such officers is time-consuming and expensive, it is best for the company to identify the management gap as early in the process as possible.

Well before its IPO, an issuer should begin to approach executive compensation like a public company. The IPO registration statement requires the same enhanced executive compensation disclosures that public companies provide in their annual proxy statements, including a discussion of compensation philosophy, an analysis of how compensation programs implement that philosophy and a discussion of the effects of risk-taking on compensation decisions. An EGC will have reduced compensation disclosure requirements. See *“What disclosures may an EGC omit from its registration statement?”*

Listing

What are the benefits of listing a class of securities on an exchange?

Listing its stock on an exchange is one of the most important steps a company can take to achieve liquidity. Certain kinds of investors may only invest in exchange-listed issuers. Liquidity and an active market should help establish a widely recognized value for the company’s stock, which will help the company use its stock instead of cash for acquisitions and other significant transactions. Listing on an exchange cannot guarantee liquidity or investor interest and there are many companies that have liquid markets even though they are traded in the over-the-counter (“OTC”) markets such as OTCQX and OTCPink. However, particularly since the rise of the alternative trading markets, such as “dark pools,” it is usually beneficial for a company to list on an exchange.

What are exchange requirements to list a stock?

Exchange listing requirements may be generally described as “quantitative requirements” and “qualitative requirements.” Quantitative requirements are financial criteria for listing and include a minimum number of shareholders of the company, a minimum market capitalization, a minimum share price and financial tests. Qualitative requirements are standards relating to the company’s business and corporate governance, including the nature of the company’s business, the market for its products, its regulatory history, as well as the election and composition of the board of directors and audit committee, issuance of earning statements and the company’s shareholder approval requirements. Especially since the passage of

Sarbanes-Oxley and Dodd-Frank, there has been significant convergence of the exchanges' corporate governance requirements, some of which are already discussed in these FAQs.

What is the listing process?

To list its securities on an exchange, a company must meet the quantitative and qualitative requirements and submit an application to the exchange. The NYSE and the NYSE American LLC require that the company participate in a confidential pre-application eligibility review in order to determine whether the company meets its listing criteria. NASDAQ offers a similar preliminary listing eligibility review. In order for shares to be listed on the exchange, in addition to filing a registration statement for the IPO itself under the Securities Act, the issuer must also file a registration statement under the Exchange Act that acts as the continuing registration statement for the company after the IPO is completed. If the exchange listing is in conjunction with the IPO, the Exchange Act registration statement is a brief filing consisting primarily of cross-references to the Securities Act IPO registration statement. The exchange will review the application and supporting documentation and once the listing is approved, the shares will be admitted for trading after the Exchange Act and, if applicable, Securities Act registration statements have been declared effective by the SEC and the shares have been offered and sold if there is a concurrent IPO. A company cannot state in its preliminary prospectus that its shares have been approved for listing, subject to official notice of issuance, unless it has actually received such approval. As listing is often critical to the success of an IPO, it is best practice to get such approval before the preliminary prospectus has been printed.

Underwriting Arrangements

What kinds of underwriting arrangements are possible?

In a typical IPO, the underwriters will have a "firm commitment" to buy the shares once they sign the underwriting agreement, meaning they will purchase all of the offered shares if the conditions specified in the underwriting agreement are satisfied. However, other underwriting arrangements exist, including a "best-efforts" underwriting, in which the underwriters agree to use their best efforts to sell the stock as the company's agents. If purchasers are not found, the stock will not be sold. A best-efforts underwriting may provide that no shares will be sold unless purchasers can be found for all of the offered shares but other arrangements provide that shares may be sold as long as a specified minimum is reached (sometimes known as a "min-max best efforts offering"). The SEC imposes certain escrow and other requirements on a min-max best efforts offering. The nature of the underwriters' commitment will also affect the ability of the underwriters to engage in certain stabilizing transactions to support the stock price following the IPO.

How much will the underwriters' compensation be?

The underwriters will be paid a fixed percentage of the total dollar amount of securities sold, usually about 7%. The percentage varies depending on a number of factors, such as the size of the company, its profitability, its industry, etc., but cannot exceed 10%. See "*What is FINRA and what are its requirements?*" While the underwriters will not receive their fee unless the IPO is successful, when they are paid, their fees are substantial.

What is an auction IPO?

In a traditional underwriting, the underwriters set the initial offering price based on their understanding of non-binding indications of interest from potential investors. In an auction, also sometimes called a “Dutch auction,” potential investors put in bids for the shares at the prices they deem appropriate. The shares are then sold at the highest price that results in all of the offered shares being sold. Unlike a traditional auction where the price starts out low and rises, in a Dutch auction, the price starts out high and decreases until all shares are allotted to investors, and all investors pay that lowest price. The Google IPO in 2004 is the most famous example of a Dutch auction IPO. They are still rare occurrences.

What types of provisions are contained in the underwriting agreement?

An underwriting agreement is the agreement pursuant to which a company agrees to sell, and the underwriters agree to buy, shares and then sell them to the public. Until this agreement is signed, the underwriters do not have an enforceable obligation to acquire the offered shares (in a firm commitment offering) or to use their best efforts to place the shares (in a best efforts offering). The underwriting agreement is executed after the offering price is agreed upon, which is typically shortly after the Securities Act registration statement is declared effective by the SEC.

In addition to being a securities purchase agreement, an underwriting agreement may serve to protect the underwriters from liability under the Securities Act in connection with an offering. Part of underwriters’ due diligence is making sure that the representations of the issuer in the underwriting agreement are true and

accurate. In addition, the underwriters’ defenses are bolstered by the receipt of opinions of counsel about specific matters relating to the company as well as “comfort letters” from the company’s auditors and in some circumstances, receipt of similar letters from other experts such as engineers and oil and gas experts.

The most important provisions of an underwriting agreement are:

- *Description of the nature of the underwriters’ obligation.* The opening paragraphs describe the offering, whether the underwriters have a firm commitment or best efforts obligation and the underwriters’ compensation.
- *Representations and warranties.* The company makes statements about its business, finances and assets, the offered stock and the accuracy of the registration statement.
- *Conditions to closing.* Conditions usually include the continued effectiveness of the registration statement and the absence of material adverse changes.
- *Required deliverables.* The company will need to provide opinions of counsel and other experts, certificates confirming the accuracy of the representations and warranties, the initial accountants’ comfort letter delivered at the time of pricing the offering and the bring-down letter delivered at closing and other closing documents.
- *Division of expenses.* The underwriting agreement will specify which expenses of the offering are paid by the company.
- *Lock-ups.* The underwriting agreement will prohibit the company as well as directors and

executive officers from selling equity, except for certain limited purposes, during a period of up to 180 days following the IPO without the managing underwriter's consent. This "lock-up" will also often extend to all or certainly the largest shareholders of the issuer. The exceptions from the lock-up provisions can be highly negotiated.

- *Indemnification.* The indemnification section is probably the most important part of the underwriting agreement other than the payment provisions. Arguably, the balance of the agreement is a due diligence exercise designed to ensure that the company provides sufficient information to the underwriters to satisfy the underwriters' liability obligations under the Securities Act. In the indemnification section, the company (and sometimes, the primary shareholder) agrees to indemnify and be responsible for the underwriters' damages and expenses in the event of any litigation or other proceedings regarding the accuracy of the registration statement and prospectus. The indemnification section will also provide that the underwriters will be liable to the company for misstatements in the prospectus attributable to the underwriters, which information is typically limited to the underwriters' names and the stabilization and similar disclosures. Each underwriter has its own form of indemnification provision and, in light of the importance of this section, underwriters are usually reluctant to make changes to that provision. It should be noted

that the SEC has a long-standing position that indemnification for Securities Act liabilities is unenforceable and against public policy.

What are lock-up agreements?

To provide for an orderly market and to prevent existing shareholders who may have owned the shares long enough to have freely tradable shares from dumping their shares into the market immediately after the IPO (and indicating a lack of trust in the future of the company), underwriters will require the company as well as directors, executive officers and large shareholders (and sometimes all pre-IPO shareholders) to agree not to sell their shares of common stock, except under certain limited circumstances, for a period of up to 180 days following the IPO, effectively "locking up" such shares. Exceptions to the lock-up include issuances of shares in acquisitions and in compensation-based grants. Shareholders may be permitted to exercise existing options (but not to sell the underlying shares), transfer shares to family trusts, and sometimes to make specified private sales, provided that the acquiror also agrees to be bound by the lock-up restrictions. Lock-up exceptions can be highly negotiated.

What is FINRA and what are its requirements?

FINRA is the largest non-governmental regulator for all securities firms doing business in the United States. It was created in July 2007 through the consolidation of the National Association of Securities Dealers and the member regulation, enforcement, and arbitration functions of the NYSE. FINRA determines whether the terms of the "underwriting compensation" and arrangements relating to "public offerings" are "unfair and unreasonable."

Underwriters' counsel will submit the underwriting agreement, the registration statement, and other offering documents for review to FINRA. FINRA reviews the terms of the offering and the underwriting arrangements to determine whether they are "fair and reasonable." FINRA will focus on the compensation to be paid to the underwriters, which could also include certain items of value received in the six months before the IPO. An IPO cannot proceed until the underwriting arrangement terms have been approved by FINRA.

Can a company "go public" without an underwriter?

There are two ways a company can go public without an underwriter: (i) through a Form 10 filing and (ii) by self-underwriting.

A registration statement on Form 10 registers a company's stock pursuant to Section 12(b) or (g) of the Exchange Act, so that the company can become a reporting company under the Exchange Act. It requires many of the same disclosures as would be required in an IPO under the Securities Act that typically uses a registration statement Form S-1, including risk factors, financial information and statements and descriptions of the company's business and its management.

Technology and the Internet have made self-underwriting a more feasible prospect for even small companies. Through the Internet, companies can reach a wider audience of investors without an underwriter. Some companies have even conducted auction IPOs, in which the company solicits bids through a website.

Three considerations for companies considering going public without an underwriter are:

- *Locating investors:* If the offering is of a significant size, it may be difficult for a

company to find enough investors for its shares.

- *Independent scrutiny:* In addition to the discipline of responding to underwriters' comments based on their diligence, underwriters may have a better and broader understanding of the company's industry and markets and will have access to more investors, particularly institutional investors.
- *Research coverage:* An IPO without underwriters may not have any or sufficient research coverage after the offering, often resulting in an inactive, and therefore, illiquid, post-offering market.

Financial Information

What financial information is required to be included in the registration statement?

The SEC requires the following information in the prospectus of an issuer:

- Audited balance sheets as of the end of the issuer's last two fiscal years;
- Audited statements of operations, statements of cash flows, statements of comprehensive income and statements of changes in shareholders' equity of the company's last three fiscal years, or two years in the case of an EGC;
- Depending on the length of time from the end of the last fiscal year and the date of filing, an unaudited balance sheet for the most recent fiscal interim period and statements of operations, statements of cash flows and

statements of changes in shareholders' equity for the interim period and for the corresponding period of the prior fiscal year; and

- Selected historical financial data for the last five fiscal years (or since the company's incorporation, if the company has not been in existence for five fiscal years) and for the period since the end of the last full fiscal year and the corresponding period of the prior fiscal year; while the JOBS Act was unclear, the General Applicability FAQs clarify that an EGC may limit the selected historical financial data in its IPO prospectus to the same number of years as the audited financial statements presented in the registration statement.

These statements must be prepared in accordance with U.S. GAAP, and they will be the source of information for "Management's Discussion and Analysis of Financial Condition and Results of Operations" ("MD&A").

In addition, a prospectus may contain audited and unaudited financial statements relating to acquisition of assets and companies as well as pro forma financial information indicating what the issuer's financial statements would look like following the acquisition.

Can an EGC omit any other financial information in its confidential submissions?

The FAST Act also amended the financial information requirement for EGCs. As a result of the FAST Act amendments, an EGC may omit historical financial information for certain periods otherwise required by Regulation S-X at the time of filing or confidential submission, if the EGC reasonably believes the

information will not be required to be included at the time of the contemplated offering. By way of example, this change would allow an EGC to omit 2013 financial statements in a December 2015 filing if it does not intend to consummate the offering until its year-end 2015 audited financial statements are available (at which point 2014 and 2015 financial statements will be included in the registration statement). In December 2015 and subsequently superseded in August 2017, the SEC Staff provided guidance on this change, clarifying that the accommodation applies to all historical financial information required to be presented pursuant to Regulation S-X, including, for example, financial statements for an acquired company.

As noted above, in August 2017, the SEC Staff provided updated guidance on this topic. In this guidance, the SEC Staff notes that, "Under Section 71003 of the FAST Act, an Emerging Growth Company may omit from its filed registration statements annual and interim financial information that "relates to a historical period that the issuer reasonably believes will not be required to be included...at the time of the contemplated offering." Interim financial information that will be included in a longer historical period relates to that period. Accordingly, interim financial information that will be included in a historical period that the issuer reasonably believes will be required to be included at the time of the contemplated offering may not be omitted from its filed registration statements. However, under Staff policy, an Emerging Growth Company may omit from its draft registration statements interim financial information that it reasonably believes it will not be required to present separately at the time of the contemplated offering."

The updated SEC Staff guidance includes a helpful example as well:

For example, consider a calendar year-end Emerging Growth Company that submits a draft registration statement in November 2017 and reasonably believes it will commence its offering in April 2018 when annual financial information for 2017 will be required. This issuer may omit from its draft registration statements its 2015 annual financial information and interim financial information related to 2016 and 2017. Assuming that this issuer were to first publicly file in April 2018 when its annual information for 2017 is required, it would not need to separately prepare or present interim information for 2016 and 2017. If this issuer were to file publicly in January 2018, it may omit its 2015 annual financial information, but it must include its 2016 and 2017 interim financial information in that January filing because that interim information relates to historical periods that will be included at the time of the public offering.

Can a non-EGC issuer that avails itself of the confidential submission process omit any financial information?

An issuer that is not an EGC that is relying on the confidential submission process may exclude certain financial information that the issuer believes will not be required at the time that the registration statement is publicly filed (as opposed to, in the case of EGCs, discussed above, at the time of the offering). Also, as discussed above, an issuer cannot omit from its confidential submission interim financial statements for a period that will be included within required financial

statements covering a longer interim or annual period at the time of its offering, even though the shorter period will not be required to be presented separately at that time. In the SEC Staff guidance issued in August 2017, the Staff provided an example set forth below

...[C]onsider a calendar year-end issuer that is not an Emerging Growth Company that submits a draft registration statement in November 2017 and reasonably believes it will first publicly file in April 2018 when annual financial information for 2017 will be required. This issuer may omit from its draft registration statements its 2014 annual financial information and interim financial information related to 2016 and 2017 because this information would not be required at the time of its first public filing in April 2018.

What are auditors' consents and why are they necessary?

The SEC requires that auditors consent in writing to the inclusion of their audit reports in the prospectus. Under the Securities Act, auditors have liability as experts. Further, a positive audit report is viewed by the market as critical to an IPO. Therefore, in order to ensure that the auditors have reviewed the prospectus that includes their audit report and to protect the auditors from companies falsely including audit reports in the auditors' names, the SEC requires the company to include an executed auditor's consent as an exhibit to its filed registration statement.

Does the SEC comment on the financial statements?

The SEC will review and comment on the financial statements and the MD&A. The SEC's areas of particular concern are:

- revenue recognition;
- business combinations;
- segment reporting;
- financial instruments;
- impairments of all kinds;
- deferred tax valuation allowances; and
- compliance with debt covenants, fair value and loan losses.

Companies and their auditors should review their accounting policies and potential areas of concern before filing the registration statement. The SEC encourages discussions with its accounting Staff of accounting concerns early in the preparation process, thus avoiding potential problems once the registration statement is filed and publicly available.

What is “cheap stock”?

Many offerings involve grants of options to officers, directors and employees before the IPO process begins. The impact of any option grant on the company’s financial statements in the prospectus and in subsequent SEC filings should be discussed with the company’s accountants, underwriters and counsel before any action is taken as these grants raise accounting issues that can result in less attractive financial results. In addition, under IRS regulations, stock options that are not priced at their fair market value as of the date of the grant may subject the option holder to an excise tax on this component of compensation.

“Cheap stock” describes options granted to employees of a pre-IPO company during the 18-24 months prior to the IPO where the exercise price is deemed (in hindsight) to be considerably lower than the fair market

value of the shares at grant date. If the SEC determines (during the comment process) that the company has issued cheap stock, the company must incur a compensation expense that will have a negative impact on earnings. The earnings impact may result in a significant one-time charge at the time of the IPO as well as going-forward expenses incurred over the option vesting period. In addition, absent certain limitations on exercisability, an option granted with an exercise price that is less than 100% of the fair market value of the underlying stock on the grant date will subject the option holder to an additional 20% tax pursuant to Code Section 409A.

The dilemma that a private company faces is that it is unable to predict with any certainty the eventual IPO price. A good-faith pre-IPO fair market value analysis can yield different conclusions when compared to a fair market value analysis conducted by the SEC in hindsight based on a known IPO price range. There is some industry confusion as to the acceptable method for calculating the fair market value of non-publicly traded shares and how much deviation from this value is permitted by the SEC. A company will often address this “cheap stock” concern by retaining an independent appraiser to value its stock options. However, it now appears that most companies are using one of the safe-harbor methods for valuing shares prescribed in the Section 409A regulations.

What is a “comfort letter”?

During the waiting period, underwriters’ counsel and the company’s independent auditor will negotiate the auditor’s “comfort letter.” In the “comfort letter,” the auditor affirms (1) its independence from the issuer, and (2) the compliance of the financial statements with

applicable accounting requirements and SEC regulations. The auditor will also note period-to-period changes in certain financial items. These statements follow prescribed forms and are usually not the subject of significant negotiation. The underwriters will also usually require that the auditor undertake certain “agreed-upon” procedures in which the auditor compares financial information in the prospectus (outside of the financial statements) to the issuer’s accounting records to confirm its accuracy. These procedures can be the subject of significant negotiation as certain information for which the underwriters seek comparison may not be in the issuer’s accounting records. These are called “comfort letters” as they offer cold comfort because of the number of caveats and exceptions taken by the auditors, including use of negative assurance language (for example, “nothing has come to our attention that the relevant information is not true”). There may be more than one comfort letter if the financial statements included in the registration statement are audited by more than one auditor, and the allocation of agreed-upon procedures between the different auditors may also require negotiation. Agreed-upon procedures may also uncover errors in the prospectus. Therefore, it is best practice to finalize the agreed-upon procedures prior to printing the preliminary prospectus for any road show.

Pre-IPO Disclosures

Why are there limitations on public statements by a company in proximity to its IPO?

Section 5(c) of the Securities Act prohibits offers of a security before a registration statement is filed. Section 5(b)(1) prohibits written offers other than by

means of a prospectus that meets the requirements of Section 10 of the Securities Act, such as a preliminary prospectus. The bans are designed to prohibit inappropriate marketing, conditioning or “hyping,” of the security before all investors have access to publicly available information about the company so that they can make informed investment decisions. Generally, a company contemplating an IPO does not have much publicly available corporate information and none of that information has been subject to regulatory review. Until 2005, the Section 5 bans were quite prohibitive, created significant uncertainty about the effects of ordinary business communications and did not address the explosion of new communication technologies since the 1930s. In 2005, in order to modernize the offering process, the SEC adopted the “Securities Offering Reform,” which included adding a number of communication safe harbors from enforcement of Section 5.

What is the quiet period?

Section 5(c) of the Securities Act prohibits offers or sales of a security before a registration statement has been filed. The pre-filing period begins when a company and the underwriters agree to proceed with a public offering.

From the first all-hands organizational meeting forward, all statements concerning the company should be reviewed by the company’s counsel to ensure compliance with applicable rules. Communications by an issuer more than 30 days prior to filing a registration statement are permitted as long as they do not reference the securities offering. Statements made within 30 days of filing a registration statement that could be considered an attempt to pre-sell the public offering

may be considered an illegal prospectus, creating a “gun jumping” violation. This might result in the SEC delaying the public offering or requiring prospectus disclosures of these potential securities law violations. See “What is ‘gun jumping’?” Press interviews, participation in investment banker-sponsored conferences and new advertising campaigns are generally discouraged during this period.

In general, at least four to six weeks will pass between the distribution of a first draft of the registration statement and its filing with or confidential submission to the SEC. To a large extent, the length of the pre-filing period will be determined by the amount of time required to obtain the required financial statements to be included in the registration statement.

What are “testing-the-waters” communications by or on behalf of an EGC?

The JOBS Act provides an EGC, or any other person, such as its underwriter, that it authorizes to act on its behalf, with the flexibility to engage in oral or written communications with QIBs and institutional accredited investors in order to gauge their interest in a proposed offering, whether prior to (irrespective of the 30-day safe harbor) or following the first filing of any registration statement, subject to the requirement that no security may be sold unless accompanied or preceded by a Section 10(a) prospectus. An EGC may utilize the testing-the-waters provision with respect to any registered offerings that it conducts while qualifying for EGC status. There are no form or content restrictions on these communications, and there is no requirement to file written communications with the SEC. In their comment letters on registration statements, the SEC Staff typically requests to see any

written test-the-waters materials, which can also provide it with guidance about information that should be included in the prospectus.

What is the waiting period?

The SEC targets 30 calendar days from the first registration statement filing or confidential submission date to respond with comments. It is not unusual for the first SEC comment letter to contain a significant number of comments that the issuer must respond to both in a letter and by amending the registration statement. After the SEC has provided its initial set of comments, it is much easier to determine when the registration process is likely to be completed and the offering can be made. In most cases, the underwriters do not begin the formal offering process and distribute a preliminary prospectus until the SEC has reviewed at least the first filing and all material changes suggested by the SEC Staff have been addressed.

Marketing generally begins during the waiting period although an EGC can make test-the-waters communications even before filing the registration statement. Section 5(b)(1) of the Securities Act requires that written offers must include the information required by Section 10. The only written sales materials that may be distributed during this period are the preliminary prospectus and additional materials known as “free writing prospectuses,” which must satisfy specified SEC requirements. See “What is a free writing prospectus?” While Section 5(a) of the Securities Act prohibits binding commitments during the period before the registration statement becomes effective, the underwriters will receive indications of interest from potential purchasers that should allow the underwriters to determine the final price and number of shares to be

offered. Once SEC comments are resolved, or it is clear that there are no material open issues, the issuer and underwriters will undertake a two- to three-week “road show,” during which company management will meet with prospective investors. Once SEC comments are cleared and the underwriters have assembled indications of interest for the offered securities, the company and its counsel will request that the SEC declare the registration statement “effective” at a certain date and time, usually after the close of business of the U.S. securities markets on the date scheduled for pricing the offering. For more information, see “Marketing the IPO.”

What is “gun jumping”?

“Gun jumping” refers to written or oral offers made before the filing of the registration statement and written offers made after the filing of the registration statement other than by means of a Section 10 prospectus, a free writing prospectus or a communication falling within a safe harbor from the gun jumping provisions. While gun jumping can be a serious concern, the 2005 safe harbors created by Securities Offering Reform have provided considerable guidance to companies about this issue. Further, the ability of EGCs to test-the-waters prior to filing the registration statement, together with the elimination of the ban on general solicitation in connection with certain private placements also effected by the JOBS Act (see “How does the JOBS Act change the IPO process?”), have significantly reduced concerns about gun jumping.

There are several safe harbors from the gun jumping provisions applicable to IPOs, including:

- *Rule 134 – Communications Not Deemed a Prospectus.* Rule 134 provides a safe harbor for

certain limited information about an offering such as the name and address of the issuer, the title and amount of the securities being offered, a brief indication of the issuer’s business and the names of the underwriters.

- *Rule 135 – Notice of Proposed Registered Offerings.* Rule 135 provides a safe harbor for even more limited notices of proposed offerings that do not include the names of the underwriters.
- *Rule 163A – Exemption from Section 5(c) of the Act for Certain Communications Made by or on Behalf of Issuers More than 30 days Before a Registration Statement is Filed.* Rule 163A provides a safe harbor for all issuers, provided that the communication is made more than 30 days before the filing of a registration statement and does not reference the securities offering that is or will be the subject of a registration statement.
- *Rule 169 – Exemption from Sections 2(a)(10) and 5(c) of the Act for Certain Communications of Regularly Released Factual Business Information.* Rule 169 provides a safe harbor for communications by all issuers containing regularly released factual information.

The consequence of gun jumping is that investors would have the right to rescind the transaction for the return of their original investment. In addition, the SEC may demand a delay of the offering and additional disclosure regarding potential liability as a result of the violation.

What is the effect on marketing of an issuer's ability to submit its IPO registration statement confidentially?

As discussed below (see “Can an issuer submit its draft IPO registration statement for confidential review by the SEC?”), an EGC may submit its draft registration statement to the SEC on a confidential basis and have it reviewed without public scrutiny. However, the EGC must publicly file the registration statement and any revisions thereto at least 15 days before it begins a “road show” (see “What are road shows and what materials are permitted in a road show?”). The JOBS Act required that an EGC publicly file 21 days prior to commencement of its roadshow; however, the FAST Act amended this requirement and reduced the 21-day period to a 15-day period. Certain foreign issuers may also submit a draft registration statement confidentially before filing publicly, although they do not have the obligation to file at least 15 days before a road show unless they are filing as EGCs.³ Further, the JOBS Act does not amend Section 5(b)(1) of the Securities Act, which requires that written offers must include the information required by Section 10. Therefore, in order to make written offers, an EGC or a foreign private issuer must first file (not just submit) its registration statement with the SEC and have a preliminary prospectus available, irrespective of the expected commencement of the road show. In June 2017, the SEC’s Division of Corporation Finance announced a new policy to make the confidential submission process for registration statements more broadly available. Since July 10, 2017, all companies, including foreign private issuers and Canadian issuers that rely on the Multijurisdictional Disclosure System,

³ See “Frequently Asked Questions about Foreign Private Issuers” at <https://media2.mofo.com/documents/100521faqforeignprivate.pdf>.

may submit draft IPO registration statements for confidential review. Foreign private issuers may elect to benefit from this new guidance, the procedures available to EGCs (if they so qualify) or the Division of Corporation Finance staff guidance issued on May 30, 2012 for certain foreign private issuers. As is the case for EGC IPO issuers, any issuer that avails itself of the confidential submission process for its IPO must publicly file its registration statement at least 15 days before the date on which the issuer conducts a road show. A foreign private issuer that relies on the accommodations available to EGCs or on this new policy will have to comply with the requirement to file publicly at least 15 days prior to commencement of its roadshow, which would not apply under the Staff’s 2012 guidance. The SEC did not extend any of the other JOBS Act benefits (*i.e.*, the ability to test the waters or reduced disclosure requirements) to non-EGC IPO issuers.

Filing Requirements

What must be filed with the SEC?

The company must file a registration statement with the SEC. The registration statement will usually be on Form S-1 (or Form F-1, if it is a foreign private issuer). Real estate companies, including REITs, will file on Form S-11, which requires specific real estate-related disclosures, and BDCs file on Form N-2 (which is also a form under the Investment Company Act of 1940), which requires detailed information about their investment strategies and policies and investments. The registration statement consists of two parts. Part I is the prospectus, which contains information about the company’s business and financial condition, including

the company's audited financial statements. Part II includes information that is not required to be included in the prospectus that is delivered to investors, such as information about the offering expenses and fees, indemnification of officers and directors and a description of recent sales of the company's unregistered securities. Part II also contains the company's legal undertakings and the exhibits to the registration statement.

Separately from the Form S-1, the company typically must file a registration statement on Form 8-A to register its common stock under the Exchange Act. The Form 8-A is required because the company will be subject to the Exchange Act's reporting requirements after the IPO. The Form 8-A is a simple, typically one-page registration statement and is filed via the EDGAR system.

What is included in a prospectus?

A prospectus describes the offering terms, the anticipated use of proceeds, the company, its industry, business, management and ownership, and its results of operations and financial condition. Although it is principally a disclosure document, the prospectus is also crucial to the selling process.

SEC regulations require certain disclosures in a prospectus. The principal sections of the prospectus are identified below ("smaller reporting companies" (as defined by the SEC), EGCs and foreign private issuers have less burdensome disclosure obligations, particularly with respect to executive compensation):

- *Summary.* The summary is a short overview of the more important aspects of the offering and the company. The summary will cover the type of security offered, a brief description of

the company, the amount of securities offered, the trading market for the securities and the use of the proceeds. Generally, the summary section should not exceed three pages.

- *Financial Statements.* The prospectus will include audited financial statements of the company, including balance sheets for each of the last two completed fiscal years and income statements for each of the last three (two for an EGC) completed fiscal years. The prospectus must also include unaudited financial statements for any interim periods subsequent to the last completed fiscal year.
- *MD&A.* The MD&A section describes the company's liquidity, capital resources and results of operation. It also includes a discussion of known trends and uncertainties that may have a material impact on the company's operating performance, liquidity or capital resources. The SEC has identified three principal objectives of the MD&A section: (i) to provide a narrative explanation of the company's financial statements enabling investors to view the company through management's eyes; (ii) to enhance the overall financial disclosure and provide context within which the company's financial information should be analyzed; and (iii) to provide information about the quality of, and potential variability of, the company's earnings and cash flow, so that investors can assess the company's future performance.
- *Risk Factors.* The risk factors section usually includes three types of risks: risks pertaining to the offering; risks pertaining to the issuer;

and risks pertaining to the issuer's industry. The SEC requires that the risk factors section include only risks specific to the company.

- *Business.* The business section describes the company's business, including its products and services, key suppliers, customers, marketing arrangements and intellectual property.
- *Management.* Officers and directors must be identified in the management section and brief biographical descriptions must be included.
- *Executive Compensation.* The company must disclose the executive compensation of its five highest paid executive officers, which must include the CEO and CFO. Most of this disclosure is presented in tabular format. The executive compensation section must also include directors' compensation and employee benefit plans. The SEC requires a compensation disclosure and analysis ("CD&A") in which the company discloses the company's executive and board compensation matters. An EGC will have reduced compensation disclosure requirements. See "What disclosures may an EGC omit from its registration statement?"
- *Related Party Transactions.* This section must include any material business transaction between the issuer and its executive officers, directors, significant shareholders and other key personnel.
- *Security Ownership.* This section includes a tabular presentation of the company's officers' and directors' beneficial share ownership as well as the beneficial ownership of each holder

of more than 5% of the company's outstanding stock.

- *Plan of Distribution.* The plan of distribution section describes the underwriting arrangements, including the underwriters' plans for distributing the shares in the offering.
- *Counsel and Experts.* These two sections identify counsel to the company and the underwriters and the accountants who have audited the company's financial statements. "Experts" will also identify anyone else who has "expertized" any information in the prospectus.

A good prospectus sets forth the "investment proposition." As a disclosure document, the prospectus functions as an "insurance policy" of sorts in that it is intended to limit the issuer's and underwriters' potential liability to IPO purchasers. If the prospectus contains all SEC-required information, includes robust risk factors that explain the risks that the company faces, and has no material misstatements or omissions, investors will not be able to recover their losses in a lawsuit if the price of the stock drops following the IPO. A prospectus should not include "puffery" or overly optimistic or unsupported statements about the company's future performance. Rather, it should contain a balanced discussion of the company's business, along with a detailed discussion of risks and operating and financial trends that may affect its results of operations and prospects.

SEC rules set forth a substantial number of specific disclosures required to be made in a prospectus. In addition, federal securities laws, particularly Rule 10b-5 under the Exchange Act, require that documents used to sell a security contain all of the information material to

an investment decision and do not omit any information necessary to avoid misleading potential investors. Federal securities laws do not define materiality; the basic standard for determining whether information is material is whether a reasonable investor would consider the particular information important in making an investment decision. That simple statement is often difficult to apply in practice. An issuer should be prepared for the time-consuming drafting process, during which the issuer, investment bankers, and their respective counsel work together to craft the prospectus disclosure.

What disclosures may an EGC omit from its registration statement?

The JOBS Act created an “on-ramp” of scaled disclosure requirements for EGCs. Generally, an EGC has flexibility to choose the scaled disclosures with which it will comply, except with respect to the timing of compliance with new or revised accounting standards.

- *Financial Statements and MD&A.* An EGC is required to present only two years of audited financial statements in its initial public offering registration statement. An EGC may also limit its MD&A to cover only those audited periods presented in the audited financial statements. The SEC will also not object if an EGC presenting two years of audited financial statements limits the selected financial data included in its initial public offering registration statement to only two years. As noted earlier, the FAST Act amended the financial information requirement for EGC submissions and filings. An EGC should consider, together with its advisors, whether it

makes strategic sense to include additional years of financial information.

- *Executive Compensation.* An EGC may comply with the executive compensation disclosures applicable to a “smaller reporting company,” which means that an EGC need provide only a Summary Compensation Table (with three rather than five named executive officers and limited to two fiscal years of information), an Outstanding Equity Awards Table, and a Director Compensation Table, along with some narrative disclosures to augment those tables. EGCs are not required to provide a Compensation Discussion and Analysis, or disclosures about payments upon termination of employment or change in control.
- *Compliance with New or Revised Accounting Standards.* An EGC may elect an extended transition to compliance with new or revised accounting standards. However, if an EGC chooses to comply with such standards to the same extent that a non-EGC is required to comply with such standards, the EGC must (1) make such choice at the time it is first required to file a registration statement, periodic report, or other report under the Exchange Act and notify the SEC of such choice; (2) comply with all such standards to the same extent that a non-EGC is required to comply with such standards; and (3) continue to comply with such standards to the same extent that a non-EGC is required to comply with such standards for as long as the company remains an EGC.

- *EGC Status.* The SEC Staff has explained in the General Applicability FAQs that an EGC must identify itself as an EGC on the cover page of its prospectus. In addition, SEC Staff comments on EGC registration statements have requested the following disclosures: (i) a description of how and when a company may lose EGC status; (ii) a brief description of the various exemptions available to an EGC, such as exemptions from Sarbanes-Oxley Section 404(b) and the Say-on-Pay/Say-on-Golden Parachute provisions; and (iii) the EGC's election for extended transition to new or revised accounting standards. The SEC Staff requests that if the EGC has elected to opt out of the extended transition period for new or revised accounting standards, then it must include a statement that the election is irrevocable. If the EGC has elected to use the extended transition period, then risk factor disclosure must explain that this election allows an EGC to delay the adoption of new or revised accounting standards that have different effective dates for public and private companies until those standards apply to private companies. The SEC Staff requests that the EGC state in the risk factors that, as a result of this election, the EGC's financial statements may not be comparable to issuers that comply with public issuer effective dates. A similar statement is also requested in the EGC's critical accounting policy disclosures in MD&A.

What is included in the registration statement?

A registration statement contains the prospectus, which is the primary selling document, as well as other

required information, written undertakings of the issuer and the signatures of the issuer and at least a majority of the issuer's directors. It also contains exhibits, including basic corporate documents and material contracts. U.S. companies generally file a Form S-1 registration statement. Most non-Canadian foreign private issuers use a Form F-1 registration statement, although other forms may be available. There are special forms available to certain Canadian companies.

How is the registration statement filed and what is EDGAR?

A registration statement is filed electronically with the SEC through its Electronic Data Gathering, Analysis and Retrieval (EDGAR) system. Before the company can file via the EDGAR system, it must create an account with the SEC by obtaining a Central Index Key ("CIK") number and associated security codes. The CIK number is a unique number assigned to individuals and companies who file reports with the SEC. Once the company files the registration statement via the EDGAR system, it becomes publicly available.

Can an issuer submit its draft IPO registration statement for confidential review by the SEC?

The JOBS Act permits an EGC to submit its initial public offering registration statement confidentially for nonpublic review by the SEC Staff, 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" (as defined in Securities Act Rule 433(h)(4)). The SEC Staff will also require EGCs to submit via the EDGAR system all of the responses to Staff comment letters on the confidential draft registration statements at the time the registration statement is first filed. The SEC Staff also

asks that the draft registration statement be accompanied by a transmittal letter confirming the issuer's status as an EGC. The Staff expects that any registration statement submitted for confidential review will be substantially complete at the time of initial submission, including a signed audit report and the required exhibits (however, the registration statement itself is not required to be signed or to include the consent of auditors and other experts). The SEC Staff has noted that it will defer review of any draft registration statement that is materially deficient.⁴

Certain foreign private issuers also may submit their registration statements confidentially for nonpublic review.⁵

As discussed above, since July 10, 2017, all companies, including foreign private issuers and Canadian issuers that rely on the Multijurisdictional Disclosure System, may submit draft IPO registration statements for confidential review. Foreign private issuers may elect to benefit from this new guidance, the procedures available to EGCs (if they so qualify) or the Division of Corporation Finance staff guidance issued on May 30, 2012. As is the case for EGC IPO issuers, any issuer that avails itself of the confidential submission process for its IPO must publicly file its registration statement at least 15 days before the date on which the issuer conducts a road show. A foreign private issuer that relies on the accommodations available to EGCs or on this new policy will have to comply with the

⁴ See Frequently Asked Questions: Confidential Submission Process for Emerging Growth Companies, issued by the SEC Staff on April 10, 2012, revised December 21, 2015.

⁵ See "Frequently Asked Questions about Foreign Private Issuers" at <https://media2.mofo.com/documents/100521faqforeignprivate.pdf> for a discussion of the circumstances under which a foreign private issuer that is not an EGC may submit its draft registration statement confidentially.

requirement to file publicly at least 15 days prior to commencement of its roadshow, which would not apply under the Staff's 2012 guidance. The SEC did not extend any of the other JOBS Act benefits (*i.e.*, the ability to test the waters or reduced disclosure requirements) to non-EGC IPO issuers. In connection with announcing this policy, the SEC Staff provided additional guidance regarding the process. Although the process for submission of draft registration statements through the EDGAR system will be the same for submissions made in reliance on the new procedures, the SEC Staff noted that issuers may seek confidential treatment when submitting responses to SEC Staff comments on draft registration statements. An issuer should consider requesting confidential treatment under Rule 83 for its draft registration statements and comment letters.

Can any other information or agreement be kept confidential?

In addition to a registration statement, a company is required to file certain exhibits with the registration statement, including its certificate of incorporation, bylaws, material agreements (including the underwriting agreement) and consents of experts. Since information filed via the EDGAR system with the SEC will be publicly available, if the company wants to keep any information confidential, it must request confidential treatment of the information from the SEC and file redacted versions of the exhibits with the SEC. Requests for confidential treatment may involve trade secrets or commercial or financial information that could harm the company competitively if disclosed to the public. However, the SEC will not grant confidential treatment requests if it believes the information is necessary to protect investors. As a result, requests should be as narrow as possible. The

confidential treatment request process can be lengthy and initial requests should be submitted with or as soon as possible after the initial filing of the registration statement as the SEC will not declare the registration statement for the IPO effective if there is an outstanding confidential treatment request.

What is the SEC review process?

The SEC's review of the registration statement is an integral part of the IPO process. Once a registration statement is filed, a team of SEC Staff members is assigned to review the filing. The team consists of accountants and lawyers, including examiners and supervisors. The SEC's objective is to assess the company's compliance with its registration and disclosure rules. The SEC review process should not be viewed as a "black box" where filings go in and comments come out—rather, as with much of the IPO process, the comment process is a collaborative effort.

The SEC's principal focus during the review process is on disclosure; although the nature of some comments shade into substantive review. In addition to assessing compliance with applicable requirements, the SEC considers the disclosures through the eyes of an investor in order to determine the type of information that would be considered material to an investor. The SEC's review is not limited to just the registration statement. The SEC Staff will closely review websites, databases, and magazine and newspaper articles, looking in particular for information that they think should be in the prospectus or that contradicts information included in the prospectus.

The review process is time-consuming. While there was a time when the review process could be completed in roughly two months, now, given the length of many

prospectuses and the complexity of the disclosure, it can take three to five months. The review depends on the complexity of the company's business and the nature of the issues raised in the review process. Initial comments on Form S-1 are provided in about 30 days—depending on the SEC's workload and the complexity of the filing, the receipt of first-round comments may take longer. The SEC's initial comment letter typically includes about 15 to 30 comments, with a majority of the comments generally addressing accounting issues. The company and counsel will prepare a complete and often lengthy response. In some instances, the company may not agree with the SEC Staff's comments, and may choose to schedule calls to discuss the matter with the SEC Staff. The company will file (or confidentially submit) an amendment revising the prospectus, and provide the response letter along with any additional information. The SEC Staff generally tries to address response letters and amendments within 10 days, but timing varies considerably. This timing is the same whether the registration statement is filed publicly or submitted confidentially.

The SEC makes comment letters and responses from prior reviews available on its website, so it is possible to determine the most typical comments raised during the IPO process and, if appropriate, to anticipate them in the first filing. Overall, the SEC Staff looks for a balanced, clear presentation of the information required in the registration statement. Some of the most frequent comments raised by the SEC Staff on disclosure, other than on the financial statements, focus on whether the risk factors are specific to a company and devoid of mitigating language, whether the MD&A addresses known trends and events that affect the company's financial statements, operations and liquidity, and

whether the description of the company's market position is supportable by third-party data. The SEC will even review artwork based on the theory that "a picture is worth a thousand words."

What is the difference between registration under the Securities Act and registration under the Exchange Act?

It has been said that if the Exchange Act had been passed first, the Securities Act would never have been enacted. Both acts seek to protect investors in "public" companies and make sure that public investors have the material information they need to make an informed investment in public companies. The Securities Act generally addresses offerings of particular kinds of securities and requires disclosure for a particular offering or, once a company is public, perhaps a number of offerings. The Exchange Act addresses whether a company should be seen as "public" because of its intention to list its securities on an exchange or because of the size of its ownership base and the amount of its assets, and requires periodic and ongoing public disclosure about the company. Companies may become subject to the Exchange Act without a "public" offering.

Marketing the IPO

Can an issuer make offers before filing a registration statement?

No. Once a company decides to go public, it is "in registration" and the quiet period begins. See "What is the quiet period?" However, communications made by the company more than 30 days before the filing of the registration statement will not be deemed to be attempts to condition the market if they do not reference the offering. Similarly, test-the-waters communications by

or on behalf of EGCs will not be treated as an illegal conditioning of the market.

Can an issuer make offers during the SEC review process?

Yes. During the SEC review process, an issuer can make offers to the public through distribution of a preliminary prospectus, free writing prospectuses and live oral presentations. Thus, an EGC cannot make offers to the public until it files the registration statement publicly. Generally, a preliminary prospectus, while available on the EDGAR system, will not be distributed to investors until after the initial filing has been revised to address any significant issues raised in the SEC's comments.

What are road shows and what materials are permitted in a road show?

"Road shows" or "dog and pony shows" are presentations where the company's representatives (usually the CEO, CFO and possibly an investor relations professional) and the underwriters meet with potential significant investors to market the offering. For an IPO, the road show will begin after the preliminary prospectus has been printed and distributed. Depending on the size of the offering and the company's business, the road show may include meetings in cities outside the United States. The road show typically takes two to three weeks. The offering will be priced following the completion of the road show and the effective date of the registration statement.

Can an issuer hold an electronic road show?

Yes. Securities Offering Reform allows greater use of the Internet to distribute electronic road shows. A

preliminary prospectus must be made available to investors before or at the same time when the investors access the electronic road show.

What is a free writing prospectus?

In the 2005 Securities Offering Reform, the SEC adopted the concept of a “free writing prospectus.” Rule 405 defines a free writing prospectus as any written communication that constitutes an offer to sell or a solicitation of an offer to buy securities relating to a registered offering that is used after the registration statement is filed (there is more latitude for certain issuers that are already public) that is made by means other than an actual prospectus or preliminary prospectus meeting SEC requirements and certain other written communications. While free writing prospectuses are often used in debt transactions to describe the specific terms of the debt securities, they are less often used in IPOs. However, they do have a very useful IPO function. Prior to 2005, if there were a material change in the offering, the deal team—issuer, underwriters and counsel—would debate whether the change was so material that oral advice of the change was insufficient and a revised prospectus needed to be prepared, filed and circulated to investors (called a “recirculation”). Since 2005, the deal team has the ability to provide a simple updating document to potential investors no later than the time when the investors have to make their investment decision (and file it within the time required by SEC rules). The free writing prospectus does not have a required format and will reflect transaction needs. Not all information released by an issuer needs to be in the form of a free writing prospectus, and the deal team may need to determine the value of filing specific information.

Can an IPO issuer use free writing prospectuses?

Yes. A company may use free writing prospectuses in addition to a preliminary prospectus as long as the preliminary prospectus precedes or accompanies the free writing prospectus. In addition, certain free writing prospectuses must be filed with the SEC and contain a required legend. Underwriters may also use free writing prospectuses, and the underwriting agreement for an IPO will contain mutual restrictions on the use of issuer free writing prospectuses and underwriter free writing prospectuses. BDCs and other investment companies may not use free writing prospectuses. However, they may file similar information as sales material or a term sheet pursuant to Rule 497 under the Securities Act.

What is a “family and friends” or “directed share” program?

In connection with an IPO, an issuer may want the option to “direct” shares to directors, officers, employees and their relatives, or specific other designated people, such as vendors or strategic partners. Directed share (or “family and friends”) programs (“DSPs”) set aside stock for this purpose, usually 5-10% of the total shares offered in the IPO. Participants pay the initial public offering price. Shares not sold pursuant to the DSP, usually within the first 24 hours after pricing, are then sold by the underwriters in the IPO. Generally, directed shares are freely tradable securities and are not subject to the underwriter’s lock-up agreement, although the shares may be locked up for some shorter period. Each underwriter has its own program format. There are, however, guidelines that must be followed. The DSP is not a separate offering by the company but is part of the

plan of distribution of the IPO shares and must be sold pursuant to the IPO prospectus.

Does an issuer need to disclose ownership by shareholders and/or management?

In addition to information about the issuer itself, federal securities laws are concerned with trading by “affiliates” of the issuer and public disclosure of affiliate ownership of the issuer’s securities. The SEC has a simple definition of affiliate that is often hard to understand and apply to specific situations. An affiliate is any entity or person that, directly or indirectly, controls or is controlled by or under common control with the specified entity. While there is much written about affiliates, Congress in Section 16 of the Exchange Act has determined that directors, officers and holders of 10% or more of the issuer’s equity securities are persons likely to be affiliates. Therefore, under the Exchange Act, directors, officers and 10% shareholders must report their holdings of a company’s securities as well as their purchases and sales. The initial statement of ownership is on Form 3, which must be filed with the SEC on or prior to the effective date of the registration statement. Subsequent changes in ownership are filed on Form 4, or for certain transactions, on Form 5, all of which are available on the EDGAR system. In addition, under Section 13 of the Exchange Act and its rules, certain existing holders who will own 5% or more of the post-offering shares will be required to file a short-form Schedule 13G within 45 days after the end of the calendar year, since the holder will not have “acquired” securities triggering the long-form Schedule 13D; however, any subsequent transactions in the securities may require an amendment using Schedule 13D.

Pricing

What happens after the SEC has completed its review?

Once a registration statement has been declared effective and an offering has been priced, the issuer and the managing underwriters execute the underwriting agreement and the auditor delivers the executed comfort letter. This occurs after pricing and before the opening of trading on the following day. The company then files a final prospectus with the SEC that contains the final offering information. On the third or fourth business day following the pricing transaction (T+3 or T+4), the closing occurs, the shares are issued, and the issuer receives the proceeds. The closing completes the offering process. Then, for the next 25 days, aftermarket sales of shares by dealers must be accompanied by a final prospectus or a notice with respect to its availability. If during this period there is a material change that would make the prospectus misleading, the company must file an amended prospectus.

How is an offering priced?

In most IPOs, after the road show, representatives of a company and the underwriters will meet to price the offering. The initial public offering price will be determined based on the demand for the stock, current market conditions and the price range stated in the preliminary prospectus. This is referred to as the book building process. If the number of shares will be significantly increased or decreased or the offering will not be priced within the range, a free writing prospectus is often issued at this point to make sure that investors have the necessary information before deciding to purchase the shares. Additional information will also be determined at this time, including the underwriters’

fees and commissions and the members of the underwriting syndicate. The company will issue a press release to announce the IPO price before the stock market opens the following day.

What is a “syndicated offering”?

In a syndicated offering, at the time of pricing, the managing underwriter(s) will invite additional underwriters to participate in the offering. Each member of the underwriting syndicate will agree to underwrite, that is, purchase, a portion of the shares to be sold and will enter the existing general agreement among underwriters that governs their relationship.

What is a “green shoe” or “over-allotment option”?

Most “firm commitment” equity public offerings include an “over-allotment option” or “green shoe” (the latter name references a case about these kinds of options). This option enables the underwriters to purchase additional shares (usually 15% of the “firm” shares purchased by the underwriters) from the company if there is substantial demand for the offered shares. The option is typically exercisable for 30 days after the pricing of the IPO and the underwriters may purchase the additional shares at the same price per share as those sold in the IPO.

What happens at a closing?

The closing of the offering usually takes place three or four business days (T+3 or T+4) after the pricing of the IPO, typically T+4 because offerings are usually priced after the close of the market at 4 p.m. Eastern time.⁶ Immediately prior to the closing, the underwriters will also hold a bring-down diligence call with the company

to confirm that no material changes in the company’s business or finances have occurred since the date of pricing and that the statements in the prospectus remain accurate. At the closing, the company will deliver the documents required by the underwriting agreement, including a bring-down comfort letter, certificates of officers and one or more opinions of counsel. Upon satisfaction of the closing conditions, the underwriters will wire transfer the net proceeds of the offerings to the company and upon receipt, the company will instruct its transfer agent to release the shares to the underwriters. A final prospectus must accompany or precede the delivery of the securities after their sale.

What actions may underwriters take after pricing?

After pricing and during the offering itself, the underwriters may purchase and sell shares of common stock in the open market. These transactions may include short sales, purchases to cover positions created by short sales and stabilizing transactions.

Short sales involve the sale by the underwriters of a greater number of shares than they are required to purchase in the IPO. Covered short sales are sales made in an amount not greater than the underwriters’ option to purchase additional shares of common stock from the company in the IPO. The underwriters may close out any covered short position by either exercising their option to purchase additional shares or purchasing shares in the open market. In determining the source of shares to close out the covered short position, the underwriters consider, among other things, the price of shares available for purchase in the open market compared to the price at which they may purchase shares through the over-allotment option.

⁶ The standard settlement period will be changing from a T+3 to a T+2 period.

Naked short sales are any sales in excess of the over-allotment option. The underwriters must close out any naked short position by purchasing shares in the open market. A naked short position is more likely to be created if the underwriters are concerned that there may be downward pressure on the price of the shares in the open market prior to the completion of the offering.

Stabilizing transactions consist of various bids for or purchases of the company's common stock made by the underwriters in the open market prior to the completion of the offering.

The underwriters may also impose a penalty bid. This occurs when a particular underwriter repays to the other underwriters a portion of the underwriting discount received by it because the sole book-running manager has repurchased shares of the common stock sold by or for the account of that underwriter in stabilizing or short covering transactions.

Purchases to cover a short position and stabilizing transactions may have the effect of preventing or slowing a decline in the market price of the common stock. In addition, these purchases, along with the imposition of the penalty bid, may stabilize, maintain or otherwise affect the market price of the common stock. As a result, the price of the common stock may be higher than the price that might otherwise exist in the open market. These transactions may be effected on the relevant exchange, in the over-the-counter market or otherwise.

What liability can a company face in an IPO?

Civil and criminal liability may arise under the Securities Act from material misstatements or omissions in a registration statement when it becomes effective or in a preliminary prospectus upon which a contract for sale of shares of a company's stock is based. Liability can also arise from the failure to comply with registration requirements or to supply or make available a final prospectus to investors. Purchasers of a company's stock in a registered public offering have a right of action under Section 11 of the Securities Act for an untrue statement of material fact or an omission to state a material fact in a registration statement. Section 11 imposes liability on the issuer, each person who signs the registration statement, each director, the company's accountants (and certain other experts) and the underwriters. Purchasers also have a right of action under Section 12(a)(2) for false or misleading statements that are material in a prospectus and in oral statements. The SEC may bring actions under Section 17 of the Securities Act and Section 10(b) and Rule 10b-5 under the Exchange Act.

Under the Securities Act, the company is absolutely liable for material misstatements or omissions in the registration statement, regardless of good faith or the exercise of due diligence. Directors and officers of the company, however, may have certain due diligence defenses, as do underwriters, the company's accountants and other experts and controlling persons.

Who may also be liable under the Securities Act?

If a company's registration statement contains an untrue statement of a material fact or omits to state a material

fact required to be stated in it (or that is necessary to make the statements not misleading), any purchaser of the company's stock can sue the issuer and the following persons:

- anyone who signed the registration statement (the registration statement is signed by the company's chief executive, principal financial and accounting officers, and at least a majority of the company's directors);
- anyone who was a director of the issuer (or anyone who consented to be named as a director) at the time the registration statement was filed;
- every accountant, engineer, appraiser or other expert who consented to be named as having prepared or certified the accuracy of any part of the registration statement, or any report or valuation used in the registration statement (but liability is limited to that information); and
- every underwriter.

A purchaser of a security can also sue any person who:

- offered or sold the company's stock to that purchaser in violation of Section 5 of the Securities Act; and
- offered or sold the company's stock to that purchaser by means of a prospectus or oral communication that included an untrue statement of a material fact or omitted to state a material fact necessary to make a statement, in light of the circumstances under which it was made, not misleading.

Every person who controls (through share ownership, agreement or otherwise) any other person that is liable

under Section 11 or 12 of the Securities Act is jointly and severally liable with that other person, unless the controlling person had no knowledge of, or reasonable grounds to believe in, the existence of the facts that resulted in the alleged liability.

Is directors' and officers' insurance needed?

Yes. Anyone who signs the company's registration statement and anyone who is or was a director of the company or who consented to be named as a director of the company at the time the registration statement was filed may be sued by any purchaser of the company's stock. These officers and directors have several potential defenses to liability, including a due diligence defense. No person will serve as a director or officer without indemnification from the company and appropriate directors' and officers' insurance, and a company usually represents that it has such insurance in the underwriting agreement.

What is the SEC's position on indemnification for Securities Act liabilities?

Since its early history, the SEC has consistently stated that indemnification of directors, officers and controlling persons for Securities Act liabilities is against public policy and is therefore unenforceable. Every registration statement is required to set forth the SEC's position. Nonetheless, companies have always provided such indemnification and courts have upheld such contract rights.

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