THE INITIAL PUBLIC OFFERING

A Guidebook for Executives and Boards of Directors

Second Edition

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Wilson Sonsini Goodrich & Rosati, Professional Corporation

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About the Authors

WILSON SONSINI GOODRICH & ROSATI, PROFESSIONAL CORPORATION is the premier legal advisor to technology and growth business enterprises worldwide, as well as the investment banks and venture capital firms that finance them. Over the last 5 years, the firm has completed more than 350 public offerings, representing issuers and underwriters in more public equity offerings in the U.S. than any other law firm. Over the past four decades, Wilson Sonsini Goodrich & Rosati has established its reputation by having unmatched knowledge of its clients' industries, as well as deep and long-standing contacts throughout the technology sector. The firm's legal expertise serves clients at all stages of growth, from venture-backed start-up companies to multi-billion dollar global enterprises. The firm's clients include some of the most recognized names in the technology, retail, life sciences, venture capital and finance sectors. The firm's broad range of services and legal disciplines are focused on serving the principal challenges faced by management and the board of directors of the business enterprise. The firm is nationally recognized as a leader in corporate governance, public and private offerings of equity and debt securities, mergers and acquisitions, securities class action litigation, intellectual property litigation, joint ventures and strategic alliances, and technology licensing and other intellectual property transactions. The firm, which is headquartered in Palo Alto, has offices in Austin, New York City, Reston, Salt Lake City, San Diego, San Francisco and Seattle. For more information about Wilson Sonsini Goodrich & Rosati, please visit the firm's web site at www.wsgr.com.

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Our former colleagues, Gail Clayton Husick and J. Michael Arrington, wrote the first edition of this guidebook, which was published in 1998. We acknowledge and thank Gail and Michael for establishing the basic framework of this guidebook, as well as for setting a standard of excellence that challenged us as we sought to write a book that addressed a business, financial and legal landscape that changed dramatically between 1998 and 2004. We only hope that this edition approaches the quality of theirs.

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Finally, we thank our families, who certainly felt the effect of the days, nights and weekends we spent writing this second edition.

Since the first edition of this guidebook was published in 1998, there have been numerous changes to the securities laws and the listing standards of the New York Stock Exchange and The Nasdaq Stock Market, as well as changes in the U.S. equity markets, affecting the initial public offering process and the post-offering requirements of a public company. Additionally, the Sarbanes-Oxley Act of 2002 has resulted in significant changes to the federal regulation of public company corporate governance and reporting obligations. The Sarbanes-Oxley Act has precipitated a volume and pace of new rulemaking that has fundamentally changed the standards for accountability of directors and officers of public companies and the auditors, securities analysts and counsel working with them. In the face of these changes, our goal with this second edition has been to present the current state of rulemaking from the SEC, the NYSE, the NASD and NASDAQ and, where appropriate, anticipate and present proposed rules. We do expect that rulemaking will continue and we will seek to update this guidebook regularly.

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Deciding to Go Public

What does it really mean to "go public?" Quite simply, "going public" refers to the process of registering shares of a company's stock with the U.S. Securities and Exchange Commission, or SEC, and offering the stock for sale to the public for the first time. This is called the initial public offering, or IPO. The process of going public and the consequences of being public, however, are anything but simple.

Brief Overview of the Legal Framework Governing the IPO Process

The Securities Act of 1933

In General

The offer and sale of securities in the U.S. is governed at the federal level by the Securities Act of 1933. The Securities Act has two basic objectives:

- require delivery to investors of financial and other significant information concerning securities being offered for public sale; and
- prohibit deceit, misrepresentations and other fraud in the sale of securities.

A primary means of accomplishing these objectives is requiring issuers of securities to disclose important and accurate business and financial information through the registration of securities offerings.

Registration Requirements of Section 5

Section 5 of the Securities Act requires an issuer to use the registration process for all offers and sales of its securities unless it can find an exemption under Section 3 or Section 4 of the Act. The registration process requires an issuer to file a registration statement (generally on Form S-1) covering the securities to be sold in the transaction before any offers are made. The SEC must declare the registration statement effective before any sales by the issuer can be made.

The Registration Process-The Pre-Filing, Waiting and Post-Effective Periods

The registration process is basically divided into three periods: (1) the pre-filing period; (2) the waiting period; and (3) the post-effective period. The three registration periods are discussed in greater detail in Chapter 5.

Exactly when the pre-filing period begins is not always clear; however, an issuer should consider itself as being in registration once it has reached an understanding with the investment banking firm that is to act as managing underwriter. The pre-filing period ends when the issuer files a registration statement with the SEC. A common misconception is that this period begins with the IPO organizational meeting. Typically, the issuer has reached an understanding with the managing underwriters to proceed with the IPO in advance of the actual date of the organizational meeting. In general, during the pre-filing period, no "offers" may be made, prospective purchasers cannot be contacted and underwriters may not be publicly disclosed. Chapter 5 provides greater detail with respect to what constitutes an "offer" for purposes of the Securities Act.

The waiting period begins when the issuer files a registration statement with the SEC and ends when the registration statement is declared effective. During this period, offers are permitted so long as they are made orally or by using a preliminary prospectus (commonly referred to as the "red herring"). Indications of interest are allowed, but sales are prohibited. In addition, the issuer must be careful that nothing in writing (including press releases and content posted on the issuer's web site) is construed as an illegal prospectus.

The post-effective period begins when the registration statement is declared effective and ends when broker-dealers are no longer required to deliver a prospectus by the Securities Act. During this period, sales are permitted and certain communications, such as sales material or literature (commonly referred to as "free writing"), are allowed and not deemed an illegal prospectus *if* accompanied or preceded by a final prospectus.

The Securities and Exchange Commission and Its Role in the IPO Process

The U.S. Congress established the SEC to administer and enforce the federal securities laws. The SEC is empowered to interpret and enforce the federal securities laws and to propose and amend rules and regulations to address changing market conditions.

The SEC's role in the IPO process is to ensure that the company provides investors with the information considered necessary to enable investors to make informed decisions about whether to purchase the company's securities.

Public offerings of securities must be made pursuant to an effective registration statement. All companies, both domestic and foreign, must file their registration statements electronically via the SEC's EDGAR system. The company's registration statement is then subject to examination by the SEC's Division of Corporation Finance, which reviews it for compliance with disclosure requirements. To meet the SEC's requirements for disclosure, a company issuing securities must make available all information, whether that information reflects positively or negatively on the company, that might be deemed material and relevant to an investor's decision to buy, sell or hold the security. The registration process is discussed in greater detail in Chapter 8.

State Securities Regulation

The offer and sale of securities in the U.S. is also regulated at the state level by each state's securities laws, which are commonly referred to as "Blue Sky" laws. State Blue Sky administrators typically assess not only the sufficiency of disclosure but also the fairness of the offering. However, the U.S. Congress enacted the National Securities Markets Improvement Act of 1996 (NSMIA) to specifically preclude the various states from requiring the registration of certain "covered securities," which include nationally traded securities, or securities listed or authorized for listing on the New York Stock Exchange (NYSE) or the American Stock Exchange (Amex) or included or qualified for inclusion on the Nasdaq National Market. In other words, the Blue Sky requirements generally will be relevant only with respect to those companies whose securities will not be listed on those stock exchanges or the Nasdaq National Market (for example, companies whose securities will be traded on the Nasdaq SmallCap Market).

Self-Regulatory Organizations (SROs) and Their Role in the IPO Process

A company must also comply with applicable rules and regulations of certain self-regulatory organizations (referred to as SROs), which include the NYSE, the National Association of Securities Dealers (NASD),

and Amex, among others. The SROs require that certain listing requirements be met before listing is approved on the exchange, or included or qualified for inclusion on the Nasdaq Stock Market.

Not every company is a candidate to list on the NYSE or the Nasdaq National Market. The NYSE and the Nasdaq, in particular, maintain stringent quantitative and qualitative standards for their listed companies. If a company is unable to comply with these standards, it will not qualify to list. If a listed company falls below these standards, it is delisted. The listing requirements for the NYSE and the Nasdaq National Market are set forth on ***Appendix A.***

Benefits

There are several benefits to going public, which include the following:

Cash

A successful IPO can generate significant proceeds for a company, and the infusion of cash offers a company an opportunity to accelerate growth by hiring more people, building more infrastructure, conducting more research and development and delivering more products and services. And unlike debt, there are no payments of interest or principal that must be made.

Public offerings can range from $10 million or less to $1 billion or more. Of the 278 IPOs, completed from the beginning of 2001 through the end of 2003, the average deal size was approximately $316 million and the median size was approximately $106 million.*

Liquidity for employees

Many companies, particularly technology and life sciences companies, provide incentives to employees through the use of stock options. Underlying this benefit is the hope that someday the company will go public (or experience some other liquidity event, such as a sale of the company) that will enable the employees to realize the appreciation in the value of the underlying stock. Liquidity for employees generally will not be simultaneous with effectiveness of the IPO because the company's underwriters will insist that employees observe a "lock-up," typically for

* Source: © 2004 Corporate Finance Institute.

180 days, following the company's IPO. After the lock-up is removed, additional restrictions under the securities laws and under the company's insider trading policy may continue to limit the opportunities for employees, and particularly executive officers, to sell shares of the company's stock. Nevertheless, one of the significant benefits of an IPO is the fact that it creates a public market for the company's stock that eventually will result in liquidity for the company's employees. The Company can use its stock option and employee stock purchase plans to increase employee commitment and recruiting power.

Companies that are considering going public, however, should be aware that the landscape for the use of stock options and other forms of equity compensation for executives and employees is undergoing significant change. Perceived excess levels of executive compensation, in particular equity-based compensation, in the wake of the Enron debacle and the burst of the so-called Internet bubble has led to enhanced scrutiny, and a general negative perception, of the broad use of stock options and other equity compensation programs. This sentiment is reflected not only in increased rulemaking by the SEC, the NYSE and the NASD (discussed below), but also through stockholder advocacy groups, such as Institutional Shareholder Services, which are actively recommending to their institutional clients "no" votes with respect to equity compensation plans which they determine to be too generous to executives and too dilutive to existing stockholders. Moreover, the Financial Accounting Standards Board has recently issued pronouncements that may result in mandatory expensing of equity compensation. Companies should consult with counsel in advance of the IPO process to understand the recent developments affecting equity compensation and how they will impact the way in which companies will be able to compensate their employees once they are public.

Liquidity for investors

Many investors in private companies invest with a view to earning a sizable return upon a liquidity event. An IPO is one such event. A public market for a company's stock provides an opportunity for investors to realize appreciation in the value of their investment that is typically much more difficult to monetize while a company is private. For example, even if a private company's stock may be sold, the illiquid nature of private

company stock generally results in a discount on its valuation. Thus, the IPO allows the investors to realize more of the accrued appreciation than they otherwise would.

The exact timing of this liquidity depends upon a variety of factors. If an investor has contractual registration rights entitling the investor to include its shares in the IPO, or is otherwise permitted to participate in the IPO as a selling stockholder, liquidity can be immediate. If an investor's shares are not included in the offering, and are subject to a lock-up restriction or are subject to holding period requirements under the federal securities laws, liquidity may be delayed. Nevertheless, a public company's stock is generally more liquid than that of a private company.

Creation of a currency that can be used for acquisitions

Once a liquid market exists for a company's stock, the stock may be just as valuable as cash for acquiring other businesses. In fact, it may be better. Under certain circumstances, a stock-for-stock acquisition is eligible for favorable tax treatment that is unavailable in the case of a cash acquisition. Also, stock provides an acquisition currency that enables the target company stockholders to participate in the anticipated upside of the combined company (and share in the risks related to those anticipated future results), without having to monetize future potential benefits at the time of closing the acquisition. It is important to note, however, that shares issued by a company in connection with an acquisition are not automatically freely tradeable just because the company is public. If the specific shares issued in the acquisition are not registered with the SEC, the shares will be restricted stock under the securities laws, and the resale will need to be registered or benefit from a specific exemption from registration.

Access to the public market for future financings

A company that has completed its initial public offering may return to the public market to raise additional cash in follow-on offerings. A follow-on offering often can be completed in a significantly shorter time frame than an initial public offering. This is due in part to the fact that a company that is already public has relationships with underwriters who are familiar with its business, an established valuation, and a following among analysts and investors who understand the company's business and market.

A registration statement on Form S-1 is generally used for an IPO. A company that has been public for at least 12 months and that meets certain other requirements is eligible to register shares for a follow-on offering on an abbreviated form of registration statement, known as Form S-3. The Form S-3 allows the company to incorporate large amounts of information by reference from documents previously filed with the SEC, such as the company's recent Form 10-K and Form 10-Q filings. Using this abbreviated form significantly reduces the burden and cost of the drafting process for a follow-on offering as compared to the drafting process for an IPO (unless the company and the underwriters choose to include IPO-level disclosure for marketing reasons). Even if the short-form registration statement may not be used (for example, if the IPO was within 12 months prior to the follow-on offering), significant efficiencies can be obtained by being able to leverage the drafting in the IPO prospectus and subsequent public reporting filings.

While the SEC reviews and comments on IPO registration statements almost without exception, it sometimes chooses not to review and comment on a registration statement for a follow-on offering, and generally does not if it has recently reviewed another filing of the same company. Whether or not the SEC reviews the registration statement used by a company for a follow-on public offering is entirely within the SEC's discretion. Should a company be lucky enough to receive no review from the SEC, it can reduce the offering timetable by another five or six weeks.

In recent years, companies have increasingly used shelf registrations as a means to raise capital in the public markets opportunistically during perceived narrow market windows. In fact, in 2003, nearly 63% of all equity follow-on public offerings were undertaken through the use of a shelf registration statement. In effect, a shelf registration enables a company which is eligible to use Form S-3 to register securities, both equity and debt, that it does not intend to presently offer to the market. Once effective, a company is in a position to access the markets rapidly through a take-down of securities from the shelf and issue such securities in a public offering without the delays and uncertainties of an SEC review process. By way of example, it is not uncommon in the context of follow-on offerings involving the use of a shelf registration statement for the offering process, from organizational meeting through pricing, to be completed in one week or less.

Shelf registrations, however, are not without their drawbacks, principal among them being that institutional shareholders may disfavor their use, and the perceived overhang of the securities available through the shelf registration statement may have a depressant affect on the company's stock price. Moreover, companies should consult with counsel early in the shelf registration process to map out a strategy for effective due diligence in the face of offerings completed in such compressed time frames.

Public companies are also in a better position to consider debt financing. The transparency that comes from the public reporting requirements applicable to public companies makes them more attractive candidates for lending, all other things being equal. Also, the cash proceeds of an IPO make for a stronger balance sheet, which can make debt financing easier to obtain on more favorable terms. Convertible debt financing transactions are made possible by having liquid common stock with a readily ascertainable market value into which the convertible bonds can convert.

Enhancement of the company's stature, perceived stability and competitive position

An important consideration for many companies contemplating an IPO is the effect that being public will have on the company's stature, perceived stability and competitive position. Private companies often face sales resistance from potential customers who have doubts about the company's staying power. For some companies, an IPO's effect on credibility with customers is even more important than the cash generated by the offering. Suppliers and lenders may perceive a company to be a better credit risk after its IPO, and therefore may be more inclined to extend favorable terms to the company. In addition, the public offering process itself may generate publicity that raises the company's profile with potential customers. For example, newspapers and magazines may be more likely to cover public companies than private ones. The perceived stature and stability that accrues to public companies may also be an advantage in attracting top tier management talent to the organization.

Enhancement of the company's market value

While a company is private, investors typically apply a significant liquidity discount in determining the price they are willing to pay for the company's stock. A successful public offering will eliminate this penalty for illiquidity. A successful public offering also will expose the company to a broad base of investors who might otherwise be unaware of the company or not suited for an investment in a private company, thereby increasing demand for the company's stock.

Burdens

Going public has its disadvantages, too. Some of the burdens of the public offering process and of being a public company include the following:

Distraction of management from the operations of the company

One of the greatest frustrations expressed by executives of companies going through the offering process is that they "just can't seem to get anything else done." The offering process typically takes three to five months and consists of many time-consuming tasks that cannot be delegated. Investment bankers must be selected. Due diligence presentations must be made. Drafting sessions, which can range from a few hours to multi-day marathons, must be attended. SEC comments regarding disclosure and other items in the registration statement must be addressed and resolved. The offering process culminates with a road show, which typically consists of a multi-week, round-the-clock, national (and sometimes international) investor presentation tour for the CEO and CFO.

Restrictions on publicity and other marketing activities

The federal securities laws restrict the manner in which stock can be offered to the public, and any publicity that could be construed as hyping or conditioning the market for a company's stock could cause the SEC to impose a "cooling off" period to delay the company's offering. These restrictions are discussed in greater detail in Chapter 5. Companies often must make difficult decisions about curtailing certain marketing and public relations activities during the offering process.

Additionally, following the IPO, all publicity must be monitored with an eye toward securities law requirements and potential liability. Public statements made by company officials regarding the company's business may result in securities fraud liability. For example, prior to an IPO, a CEO may have few concerns about making public statements regarding the future financial performance of the company, but as a public company all such statements carry potential risk. There are also SEC rules relating to selective disclosure and Nasdaq and NYSE rules requiring public disclosure of certain events, as well as other disclosure requirements and restrictions. These rules are discussed in greater detail in Chapter 10. A new public company should work closely with its counsel to determine what the rules are, and put in place appropriate control structures to ensure that inadvertent violations do not occur.

Compliance with SEC disclosure and reporting requirements, the Sarbanes-Oxley Act of 2002 and recently adopted corporate governance listing requirements

Once a company goes public, it becomes subject to a host of SEC rules and regulations, including the SEC's periodic reporting requirements and Regulation FD (which is discussed in Chapter 10). For example, public companies are required to file quarterly reports on Form 10-Q, annual reports on Form 10-K, current reports on Form 8-K to announce certain major events, and proxy statements in connection with their meetings of stockholders. Preparation of these documents will consume a significant amount of time of company personnel, particularly the CFO and his or her staff. In addition, company insiders and large stockholders will become subject to the reporting requirements of Section 13 or Section 16 of the Exchange Act and will require the assistance of counsel in order to comply with these requirements.

The rules affecting IPOs and public companies in general are changing, particularly since the enactment of the Sarbanes-Oxley Act in July 2002. The SEC, the NYSE, the NASD and the Nasdaq Stock Market have issued new and amended rules (and listing standards) that affect public companies and the manner in which they govern themselves and make disclosures to their stockholders and the investment community at large.

These rules, among a variety of other matters, address the composition and responsibilities of a company's board of directors and board committees; impose new and more stringent standards of independence on directors and auditors; require new disclosures regarding a company's director nominating committee and nomination process; require the company to maintain formal disclosure controls and procedures; and mandate CEO and CFO certifications as to the accuracy of financial statements filed with the SEC. A public company's ability to comply with these new rules and regulations, as well as the periodic reporting requirements and the other public company burdens, will come at a cost – both in time and money. Accordingly, a company should plan on spending more to beef up in-house accounting and compliance staffs, more on non-employee directors' fees, more for directors and officers liability insurance and more for fees of counsel, auditors and financial printers.

Perhaps the most significant impact of the Sarbanes-Oxley Act, and the rulemaking that followed, are the changes it has brought in board dynamics and the relationship between the board and its management team. In the post-Sarbanes-Oxley world, many boards of directors have tended to become "watchdogs" of management, as opposed to being partners with management, and CEOs and boards alike should be realistic in assessing how being a public company will affect the social and cultural aspects of the oversight and management of the company.

Reduced flexibility in corporate affairs

While a company is private and relatively closely held, many aspects of corporate governance are conducted informally. "Annual" stockholders meetings may or may not actually be held on an annual basis. Board and stockholder actions frequently are taken by written consent on short notice. Stockholder communications may consist of nothing more than an occasional letter from the president and periodic financial statements, which may or may not be audited. Individual executive compensation arrangements need not be disclosed to the company's stockholders or other employees. Arrangements between the company and its customers or strategic business partners can be kept secret. Company management may discuss the company's prospects with selected stockholders and others without restriction. Perhaps most importantly, company management can make long-term strategic decisions without worrying about short-term effects on stock price.

Once a company goes public, it becomes subject to extensive new regulations and important strategic decisions are made under intense public scrutiny. Periodic reports containing specified financial information, along with certifications made by the company's CEO and CFO regarding the accuracy and completeness of such information, must be publicly filed by legally imposed deadlines. Independent directors must approve director nominations and executive officer compensation. Stockholders' meetings must be held annually, and solicitations of stockholder proxies may be made only by means of proxy statements that contain specified information and that are filed with the SEC. Stockholder approval may be required to adopt or materially amend employee stock option or purchase plans and in connection with transactions (other than public offerings) involving the sale, issuance or potential issuance of 20% of more of the company's common stock. Compensation arrangements for top management must be approved by independent directors and be publicly disclosed in detail. Certain management employment agreements must be publicly filed as exhibits to SEC filings. Transactions in the company's stock by company insiders must be publicly disclosed and may trigger insider trading liability claims. Important contracts with customers and others may be required to be publicly filed with the SEC for all the world, including the company's competitors, to see (with very limited confidential treatment for sensitive financial or trade secret terms). Casual comments by company officials may lead to claims of selective disclosure and insider trading. Strategic decisions which have a negative effect on short-term financial results may be disfavored by investors and depress the company's stock price.

Practical Tip: Consider Timing and Disclosure Impact of Potential Acquisitions

A privately held company generally has no obligation to publicly disclose plans that it may have to acquire another business. However, if a company is engaged in material acquisition discussions at the same time that it is engaged in the public offering registration process, the SEC may require the company to provide detailed disclosure about the proposed transaction in the prospectus, and may even require the inclusion of extensive pro forma financial information to be included in the prospectus. As a result, the company may be forced to choose between premature disclosure of sensitive acquisition negotiations and delay of its public offering. Company counsel should be consulted as early as possible if the company is considering any acquisition activities near the time of its IPO.

Depending on the size of the acquisition, financial statements of the target may be required to be included in the prospectus for the acquirer's IPO. Preparation of these financial statements may require significant time, expense and effort, and could impact the timing of the IPO process. Also, the acquisition agreement may need to be publicly filed as an exhibit to the IPO registration statement. If this is the case, care should be taken to ensure that sensitive confidential information is not included in the agreement. Care should also be taken to evaluate with the underwriters how the accounting for the acquisition will impact the acquirer's operating results in the first few quarters following the IPO, and how that is likely to be perceived by Wall Street and reflected in the company's stock price.

Exposure to class action securities litigation

Public companies also face increased exposure to lawsuits for securities fraud. Typically, these suits arise when a company has made a major announcement that surprises the market (for example, financial results that fall significantly short of expectations or the loss of a major contract)

and the stock price drops. Certain law firms specialize in bringing these suits on behalf of the entire class of investors who traded in the company's stock during the period leading up to the announcement of bad news. Any recent public offering of stock by the company or sale of the company's stock by insiders will be used as evidence that the company and its insiders knew of the bad news in advance and benefited from such information at the expense of unsuspecting public investors. Class action securities litigation can take years to resolve, can be tremendously distracting for a company' management team and can result in multimillion dollar judgments or settlements. Chapter 4 discusses D&O liability insurance in greater detail.

Loss of Control

One consequence of an IPO is that the founders (or other members of senior management) of the company will lose a significant amount of the control over the company that they exercise prior to the offering. The public disclosure obligations, the scrutiny of the public capital markets, the threat of potential securities litigation and the restrictive influence of active institutional investors all serve to significantly temper the power and flexibility that a company's senior mangement has prior to going public. The senior management team must be prepared for this change in its freedom to operate, and still be able to execute on the business plan.

Vulnerability to a hostile takeover

On the one hand, raising capital through an IPO may provide a company with the financial resources that it needs to remain independent. On the other hand, going public may increase the company's vulnerability to a hostile takeover, particularly if insiders no longer hold a significant percentage of the company. There are a number of defensive mechanisms that a company can put in place to give the company's board of directors more control in a takeover situation, some of which are discussed in more detail in Chapter 3. This issue should be addressed with the company's counsel and investment bankers at the beginning of the offering process, because many defensive measures are more easily implemented while a company is still private.

Effect on employee compensation

The promise of liquidity and the desire for a high valuation can drive employee performance in the years and months leading up to the IPO. However, once the event has occurred, potential new hires may feel that the opportunity for the "big score" has passed, and they may therefore be more difficult, or more expensive, to recruit. Further, a large and sudden increase in the net worth of existing employees may result in attrition following the IPO, especially among employees who are fully vested in their stock options. The board of directors of a company contemplating an IPO should consider whether key employees have the proper incentives to continue contributing to the company's success following the offering. The company should review its option plans with counsel and consider the adoption of additional benefit plans that are appropriate for public companies, such as employee stock purchase plans.

Expense

The public offering process is expensive, and the costs of going public and being public have dramatically increased in recent years, in large part as a result of recent corporate governance reforms.

Expenses of an Initial Public Offering

The cost of going public has increased significantly since the height of the Internet boom in 1999, a year in which 541 IPOs were completed (versus the 87 IPOs that were completed in 2003)*:

	2003		**1999**	
	Average	***Median***	***Average***	***Median***
Legal	$1,087,677	$725,000	$521,857	$400,000
Accounting	775,118	450,000	412,120	275,000
Printing	364,857	250,000	301,455	200,000
Transfer Agent	16,086	10,000	15,698	10,000
Total Expenses	$3,434,606	$1,745,000	$1,694,954	$1,172,500

* In 1999, over 62% of the IPOs involved issuers from computer-focused industries (Internet, Computer Software/Services, Telecommunications, Computer Systems/Products and Semiconductor/Electronics Components). In contrast, only a little over 19% of IPOs completed in 2003 involved issuers from those industries (none of which involved an Internet company).

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Expenses of an Initial Public Offering (continued)	
The following additional expenses are based on the size of the offering (as of May 31, 2004):	
Underwriters' discount and commission	Typically 7.0% of the aggregate offering proceeds.
*SEC filing fee**	$126.70 per $1 million of aggregate offering amount.
NASD fee	$500, plus .01% of the proposed maximum aggregate offering amount. The maximum fee is $30,500.
The following are exchange listing fees for domestic issuers:	
Nasdaq National Market	$5,000 non-refundable application fee, plus an increasing fee that is based on the number of shares listed (up to a maximum fee of $150,000). The maximum total fee is $155,000.
NYSE	$36,800, plus a decreasing marginal fee per million shares listed ($14,750 to $1,900 per million shares). The minimum total fee is $150,000 and the maximum total fee is $250,000.
Amex	$5,000 non-refundable application fee, plus an increasing fee based on the number of shares listed (up to a maximum fee of $60,000). The maximum total fee is $65,000.

* The filing fee is subject to periodic adjustment. The SEC issues a "Fee Rate Advisory" each time such fees change and posts the advisory on the its web site located at http://www.sec.gov. For example, on April 30, 2004, the SEC issued Fee Rate Advisory #1 for Fiscal Year 2005, pursuant to which the SEC announced that, effective on the later of October 1, 2004, or 5 days after the SEC receives its fiscal year 2005 regular appropriation, the filing fee will be reduced to $117.70 per $1 million of aggregate offering amount.

For example, a domestic company applying to be listed on the Nasdaq National Market selling $50 million of common stock to the public, with 20 million shares outstanding after the offering, would pay $3.5 million in underwriting fees, incur an SEC filing fee of $6,335, an NASD fee of $5,500 and listing fees of $105,000.

The direct costs of an offering generally are netted against the gross proceeds for accounting purposes and therefore do not have a negative impact on the company's operating results. However, the ongoing expenses of being a public company will have a direct effect on the company's bottom line.

In addition to the costs of the public offering itself, there are a host of additional expenses that come with being a public company. These include the costs of preparing periodic reports to be filed with the SEC, the costs of soliciting proxies prior to each annual stockholders' meeting, the additional cost for directors and officers liability insurance, the costs of putting into place and maintaining the corporate governance structures that are required of public companies and the costs of dealing with the disclosure and other securities laws issues that public companies face on a regular basis. These costs can be quite significant.

Is the Company Ready?

After a company takes into account the direct expenses of an offering, the ongoing expenses that it will incur once it becomes a public company, and some of the more intangible burdens of being a public company, it may decide that an IPO is not the most desirable way to raise capital. However, if it appears that the benefits will likely outweigh the burdens, the company's board of directors and management team should consider the following:

Does the company have the "right stuff"?

Answering this question requires a combination of soul-searching on the part of the company and candid advice on the part of the investment bankers. The "right stuff" may vary from company to company or industry to industry, but generally includes such things as a disciplined and experienced management team, strong internal financial controls, reasonable visibility as to future financial results, a large target market, a sustainable and scalable business model and a defensible competitive position.

Does the company meet the criteria of underwriters and the market?

The criteria for going public vary from industry to industry over time, and the characteristics of IPOs have changed substantially over the past few years. During the Internet boom of the late 1990s, many investors were willing to buy "concept" stories, growth and market share gains at any expense, complex or unproven business models, sector plays and early stage Internet companies. However, the equity markets and investors seem to have returned to a more traditional (and, as many observers would say, more balanced) approach in valuing companies and determining whether they make promising investment opportunities. Investors are now focusing on companies that are profitable (or have a short, visible path to profitability), driven by experienced and credible senior managers, have proven business models and differentiated products or technologies that present strong barriers to entry for real or potential competitors and have large, rapidly growing market opportunities.

For example, a technology company contemplating an IPO with a top-tier investment banking firm in this new IPO era should (ideally) be profitable (preferably with several pre-IPO quarters of profitability), but at a minimum should show a clear path to profitability based on successive quarters of improving top- and bottom-line performance. The typical IPO candidate will also have quarterly revenues of at least $15 to $20 million, a path of sequential quarterly earnings growth, a projected post-IPO valuation in excess of $200 million, and a proposed offering size of at least $40 million. However, the criteria used by the various underwriters will differ, with the larger underwriting banks generally requiring a stronger financial profile. The criteria may also differ based on the industry sector in which the company competes (for example, the financial profiles of biotech companies going public will differ from those of software companies). Of course, exceptions to these rules of thumb abound. Thus, a company with an unusually innovative product or an exceptionally accomplished management team may be able to attract underwriters and investors even if it falls short on certain other criteria. Also, for many technology companies, projected revenue and income growth have been far more important factors than current profitability. It is also important to keep in mind that many fund managers are restricted by certain mandated breakpoints in terms of the size of company in which the managers can invest. In sum, the market's appetite for particular types of companies

Four Quarters Trailing Revenue and Net Income (Loss) Leading up to the IPO
(Selected Technology IPOs Prices During 2002-2003

		Q-4	Q-3	Q-2	Q-1	TOTAL
		(in thousands)				
altiris	Revenue	8,471	8,903	10,633	11,562	39,569
	Net Income (Loss)	(1,527)	(4,199)	(1,914)	(1,824)	(9,464)
FormFactor	Revenue	22,157	18,669	22,094	26,076	88,996
	Net Income (Loss)	1,589	699	1,287	2,505	6,080
interVideo	Revenue	11,802	11,176	11,349	13,373	47,700
	Net Income (Loss)	829	4,570	1,250	1,608	8,257
iPass	Revenue	24,007	27,406	30,498	33,103	115,014
	Net Income (Loss)	2,174	27,096	2,310	2,952	34,532
Payment Inc.	Revenue	16,479	21,540	29,249	48,545	115,813
	Net Income (Loss)	(718)	(589)	1,213	(399)	(493)
NETFLIX	Revenue	18,359	18,878	21,618	30,527	89,382
	Net Income (Loss)	(8,001)	(5,554)	(4,465)	(4,508)	(22,528)
NETGEAR	Revenue	55,538	64,362	71,903	67,706	259,509
	Net Income (Loss)	1,832	2,346	3,424	1,612	9,214
SIGMATEL	Revenue	9,827	11,948	12,876	19,672	54,323
	Net Income (Loss)	(844)	117	(615)	765	(577)

varies over time, and a company contemplating an IPO should discuss current market criteria with prospective underwriters.

Is the company's business and financial model realistic?

Predictability of results is essential for maintaining credibility with analysts and investors, as well as for reducing stock price volatility and the likelihood of a lawsuit. Before embarking on an IPO, company management must be justifiably confident in the company's ability to execute on its plan. The public capital markets are unforgiving with companies that fail to meet Wall Street financial performance expectations, especially shortly after an IPO before the company has established a history of credible public company results.

Would the company's offering benefit from the achievement of additional milestones?

If a company's financial situation permits, the company may benefit from delaying its IPO until it achieves a certain milestone, such as the introduction of a new product line or a significant increase in revenue. The

timing of an offering is a complex matter, and deteriorating market conditions could offset the benefits of delay. The company should discuss the trade-offs with its investment bankers.

Can company management participate in the offering process without jeopardizing the company's business operations?

A company will be severely penalized by the market if it loses momentum because management was too distracted to properly run the business during the offering process. Falling short of projections during the first few quarters following the IPO can virtually guarantee securities litigation.

Is the company prepared to operate under strict publicity guidelines during the offering process?

If the proposed timing of the IPO conflicts with significant opportunities to promote the company, such as speaking at analyst conferences or giving interviews to important publications, the company should consult with its counsel and investment bankers. Managed carefully, certain types of marketing and publicity are permissible during the registration process. However, if it is determined that the proposed activities would jeopardize the timing of the offering, then the company must decide whether the offering or the publicity is the higher priority.

Is the company prepared to make the level of disclosure required in connection with a registration of its stock?

If sensitive negotiations, contractual restrictions, competitive factors or other issues would prevent the company from making the level of disclosure required by the securities laws about material aspects of the company's business, financial condition or risks, the company should re-evaluate the proposed timing for its initial public offering. The company should discuss sensitive disclosure issues with its counsel in the early stages of planning for an IPO.

Is the company prepared to meet the ongoing obligations of being a public company?

Chapter 10 addresses the reporting obligations of a public company. It is common for companies to increase staffing in the finance and administration departments in contemplation of becoming subject to these requirements.

Are the company's insiders willing to relinquish control and answer to the public?

Depending on the amount of stock sold in the offering, insiders may lose voting control immediately or may lose it over time as the company issues additional stock through employee stock plans, follow-on offerings and acquisitions. Even if insiders retain a majority of the outstanding voting stock following the IPO, the company's directors and officers will have fiduciary duties to the company's minority, public stockholders. These fiduciary duties will limit the insiders' ability to declare dividends to meet their personal financial needs, to grant themselves perquisites that may be considered by public investors to be excessive, to cause the company to enter into business dealings with themselves or businesses controlled by them or to engage in other self-dealing activities.

Can the company meet Nasdaq or stock exchange listing requirements?

The company should discuss with its investment bankers the appropriate place to list the company's stock. The listing requirements of the NYSE and the Nasdaq National Market are set forth in ***Appendix A***.

Is an IPO the best route to achieving the company's objectives?

In weighing the benefits and burdens of going public, the company should also evaluate other alternatives to achieving its capital raising, liquidity or other objectives, as there are a number of other paths a company can follow. If raising a limited amount of cash is a company's primary objective, a private financing, bank loan, lease financing arrangement or joint venture may be a faster, cheaper and less burdensome solution.

Now or Later?

The valuation that a company receives in connection with its IPO is a function of market conditions as well as a function of the company's current condition and future prospects. Many companies attempt to time their offerings to coincide with periods when the market is especially receptive to new issues. These periods are often cyclical. For example, a particular industry may be perceived as "hot" and companies in that industry will race to complete their offerings while the market window is open. In subsequent quarters, some of those companies will falter. Investors may then become more cautious about new issues and the market window will begin to close, even for relatively strong companies that easily could have sold stock at the beginning of the cycle.

Catching the market at its peak has the obvious advantage of a higher valuation. However, the temptation to go public before the company is ready can result in frustration for management and disappointment for stockholders if the company's performance is not sufficient to keep the stock price up after the market cools off.

Market windows can also be seasonal. According to conventional wisdom, it is difficult to bring new deals to the market during the second half of August when many professionals are enjoying the last days of summer with their families before the school-year begins and many European countries are essentially closed for business. The Thanksgiving and Christmas holiday seasons have been historically difficult times to bring new offerings.

Market conditions can change between the time that a company decides to undertake its IPO and the effectiveness of the IPO. In deciding when to go public, a company must take into account its own readiness and financial needs, and seek the advice of experienced investment bankers.

Chapter 2

Assembling Your IPO Team

Once a company has decided to go public, the next step is to assemble an experienced team to guide the company through the rigorous process that lies ahead. The company's success will depend to a large extent on a coordinated team effort among the members of the working group, which is comprised of the company's management team and board of directors, the company's counsel, the managing underwriters and their counsel, the company's independent auditors, and in cases where needed, special experts. The primary goal of the working group is to complete a successful offering that complies with applicable laws and regulations. One of the principal tasks of the working group is drafting the registration statement, including the prospectus, that will be used to (1) satisfy legal disclosure requirements, (2) market the company's stock to investors and (3) protect the company and the members of the working group from liability with respect to their participation in the IPO.

The Company's Management Team

The most important working group members are the company's management team, led by the CEO and CFO. The management team acts as a liaison between the working group and the company's board of directors and plays a critical role in all aspects of the offering process. The market responds favorably to complete and experienced management teams, especially those that have worked together for some time, and may penalize a company for an inexperienced or incomplete team.

Additionally, the company's management team, and in particular the CEO and CFO, will be the critical points of contact between the company and the public capital markets. They will be communicating directly with the public capital markets in the road show during the IPO process, in the company's quarterly earnings conference calls after the IPO, and in other public settings. How effective these management team members are at conveying information effectively to the market, and how they respond to questions from analysts and investors under pressure, could impact how the company's business is perceived by the market, and could impact the company's stock price. How the information is communicated can often be as important as the content of the information itself. A premium is

placed on executives that can instill trust and confidence in the capital markets. These principles are especially true in the world of relatively volatile technology company stocks. A company that is exploring a public offering would be well served to ensure that the executive team includes individuals that have experience communicating with the public capital markets, and working within the complicated and changing framework of securities and corporate governance regulation.

The company should discuss any management gaps or anticipated turn-over with its investment bankers and counsel early in the offering process.

Role of the company's management team

Making structural and timing recommendations to the board. The management team must make a number of structural and timing recommendations to the board of directors that are relevant to the IPO, including recommendations regarding the size of the offering, the inclusion of selling stockholders, the drafting schedule, and the timing and extent of the road show. While experienced investment bankers and counsel can provide valuable advice on many issues, most key decisions in the offering process are ultimately made by the management team under the guidance of the board of directors.

Preparing the registration statement and responding to SEC comments. The CEO, CFO and, depending on the nature of the business, key engineering, sales and marketing, manufacturing and other employees will be the most important resources to the working group as it prepares the registration statement and prospectus for the offering. The drafting process is a group effort, and company management and key employees will actively participate in the drafting, reviewing and editing of key portions of the registration statement. The management team will be the critical source of information about the company's business and operations that will enable the working group to accurately describe the company in the prospectus. While one or two members of the management team may become the primary liaisons to the working group, the availability of the entire executive staff is crucial to ensuring the accuracy of the registration statement. When SEC comments on the registration statement are received, company management will be integral to the preparation of responses.

The drafting process is a labor-intensive process. Different members of the management team may be required to spend significant periods of time participating in drafting and reviewing the registration statement. In particular, the CEO, CFO, head of marketing and head of sales will play critical roles. The CFO is usually the primary manager of the public offering process for the company, with a controller-level person carrying the laboring oar with respect to collecting and disseminating information as part of the due diligence and drafting processes. The CFO will also play a key role in helping other team members understand the company's financial position and results of operations, and describe these in the financial disclosures portions of the registration statement. The CEO and the marketing and sales executives will be invaluable in helping the working group to quickly understand and describe the company's business. A company should be prepared for this demand on the time and attention of its key executives, and plan accordingly. Inadequate time and attention from these critical players can degrade the efficiency of the offering preparation process, and can contribute to inadequate disclosure in the offering documents.

Practical Tip: Carefully Plan for Availability of Management Team Members to Avoid Slowing Down the Process

One of the key challenges a company embarking upon the IPO process will face is reconciling the competing realities that the management team is critical to the IPO process and also critical to the successful operation of the company's business on a daily basis. The IPO process will demand significant time from management team members, but, of course, they cannot neglect their duties in managing the business. If management team members are not sufficiently available to the working group, it can affect the timing of the IPO process.

Practical Tip: Carefully Plan for Availability of Management Team Members to Avoid Slowing Down the Process (continued)

In order to ensure that management team members can adequately participate in the process, the working group should carefully plan the working group's drafting schedule for the entire process and ensure that this schedule is consistent with the availability of the management team members. For example, if a company's business has a seasonal characteristic so that one part of the year is disproportionately busy or critical to the business, the company should carefully consider how that reality will be reconciled with the demands of the IPO process if the IPO process would overlap with the busy period.

Making road show presentations. After the registration statement is drafted and a red herring, or preliminary prospectus, is printed by the financial printer, the management team and managing underwriters will conduct a road show to market the offering to investors. The road show is the primary opportunity for the company to tell its story, showcase its business and ultimately sell the offering to investors. While the managing underwriters will handle the logistics of the road show and assist company management in preparing for their presentations, it is company management, not the underwriters, that investors are interested in meeting. During the road show, the CEO and CFO of the company are presenting to investors, and the credibility of the CEO and CFO and the effectiveness of their presentations will be critically important to the success of the offering. Underwriters sometimes suggest that companies work with outside consultants to polish the road show presentations.

The Company's Board of Directors

The company's board of directors must be involved throughout the IPO process, from the initial decision to undertake a public offering to the final decision to proceed with the offering. The non-employee directors typically are not involved in the working group due diligence sessions and drafting sessions, but they must be provided with interim drafts of the registration statement and kept informed as to the status of the process as the deal progresses. In addition to approving the offering itself, the

board will be responsible for reviewing and authorizing any necessary corporate housekeeping matters, reviewing and authorizing the filing of the registration statement and forming a pricing committee comprised of directors who will have the authority to negotiate with the managing underwriters to establish the terms and conditions of the offering (including pricing terms). SEC rules require a majority of the board to sign the registration statement; as such, board members will be liable for material misstatements and omissions unless they can establish a due diligence defense, as discussed in Chapter 7. Directors should be active and diligent in reviewing the registration statement for accuracy and in asking questions of management and the company's counsel with respect to the registration statement and the offering process to ensure that they benefit from the due diligence defense discussed in greater detail in Chapter 7.

Newly adopted SEC, NYSE and Nasdaq rules and regulations impose requirements relating to the composition of the boards of directors, and certain committees of the board of directors, of public companies. These requirements mandate that public company boards of directors be composed of a majority of independent directors and that audit committee members meet certain financial literacy requirements, and confer authority over certain board functions to the independent directors.

The NYSE and Nasdaq rules, as well as SEC rules, will require public company boards of directors to comply with the following requirements:

- *Majority independent directors.* Both the Nasdaq and NYSE rules require that boards of directors be composed of at least a majority of independent directors.
- *Executive sessions of independent directors.* Both the Nasdaq and NYSE rules require that independent directors hold regularly scheduled meetings at which only those directors are present. The NYSE rules require that non-management directors meet regularly, and also recommends that, if there are non-management directors who are not independent (within the meaning of the rules), the independent directors should additionally meet at least once a year.
- *Independent audit committee.* The Nasdaq and NYSE rules and securities laws require that listed companies must have an audit committee composed of at least three directors, all of whom are independent and meet basic financial literacy requirements.

- *Audit committee required to include one financially sophisticated member:* The Nasdaq and NYSE rules and securities laws require that least one member of the audit committee must meet more stringent financial sophistication requirements, including prior experience in finance, accounting or otherwise in preparing or overseeing the preparation of financial statements.
- *Board nominations by independent directors:* The Nasdaq rules require that board nominations must be determined by, or recommended to the board of directors by, either a majority of the independent directors or a nominating committee composed solely of independent directors. The NYSE rules require that board nominations must be determined by a nominating committee composed solely of independent directors.
- *Independent compensation committee:* The Nasdaq rules require that executive compensation must be determined by, or recommended to the board of directors by, either a majority of the independent directors or a compensation committee composed solely of independent directors. The NYSE rules require that listed companies establish a compensation committee composed solely of independent directors charged with making recommendations to the board of directors regarding compensation.

The rules for determining independence are very detailed and fact-specific. The company should work closely with its counsel in determining whether its directors meet the independence requirements, especially in questionable cases.

Depending on the composition of a company's board of directors prior to embarking on the public offering process, these requirements may require the company to significantly alter the structure of its board of directors. It takes a substantial amount of time and effort to identify and install qualified independent directors. In the past, companies were often able to enlist new directors on the eve of the IPO. However, many director candidates tend to be more cautious because of heightened concern over the potential personal liability that arises in connection with the offering. An IPO-bound company can expect new directors to conduct a thorough review of the company's indemnification measures (for example, D&O insurance and indemnification agreements) to ensure adequate protection is in place and to make all inquiries necessary in connection with the IPO process to avail themselves of the due diligence defense. The combined

effects of recent corporate governance reforms making the requirements for some board positions more stringent and increasing the amount of work required by directors promise to make for a tight market in qualified candidates for public company directorships. As a result, it is important to begin this process early.

Public companies will also need to have charters for their board committees. It is important for a company contemplating an IPO to work closely with counsel to ensure that the committee charters will comply with the applicable exchange or Nasdaq rules and securities laws.

In recognition of these timing issues, the NYSE, Nasdaq and SEC provide newly public companies with special phase-in periods for compliance with certain independent director requirements. Companies may initially be allowed to have only one independent director at the time of listing, a majority of independent members within 90 days following listing, and fully independent committees within 1 year. Notwithstanding the grace periods for newly public companies, companies may wish to consider, as a corporate governance best practice, complying with all (or as many as are reasonably practicable) of the requirements as of the date of the company's IPO (or, if possible, as of the initial filing of the registration statement). Institutional investors may expect to see newly traded companies follow best practices with regard to corporate governance matters. As a result, it is conceivable that a company that is not compliant at the time of the IPO may be penalized in the marketing of its offering for its failure to follow best practices in corporate governance. Companies that anticipate taking advantage of the phase-in provisions for newly public companies should confer with their counsel and their underwriting team regarding the potential impact that not accelerating compliance with these requirements before the IPO could have on the offering. A company taking advantage of the phase in provisions will also be required to disclose that fact in the IPO prospectus.

As it prepares for its IPO, a company should review its board composition with its counsel and investment bankers, with particular thought given to the SEC and applicable exchange or Nasdaq rules as well as marketing bringing on additional outside and independent directors with relevant industry or public company experience, as discussed in Chapter 3.

The Managing Underwriters

Most IPOs are made with the assistance of investment banking firms that act as firm commitment underwriters. In a firm commitment underwriting, the company sells the IPO shares to the underwriters at a discount from the price at which the shares will be sold to the public. The underwriters then sell that stock, either directly or through a selling group, to investors who have subscribed to the offering.

Structure of the underwriting group

The company typically chooses two or three investment banks to act as managing underwriters, although the number may be smaller or larger in any particular case, depending on factors such as the size of the offering and the level of interest among underwriters. In most IPOs there will be more than one manager. If more than one managing underwriter is selected by the company, one of the managers will be designated as the "lead" manager (also sometimes called the "book runner") with the other managing underwriters referred to as "co-managers." In rare cases, for particularly hot IPOs, there may be two lead managers. The lead manager plays the dominant role with respect to the structure, allocation, timing and pricing of the offering, the preparation of the registration statement and the organization of the road show. In addition to establishing the roles in managing the IPO process, the designation as a lead manager or co-manager impacts the allocation of the underwriting fees and discounts. The lead manager is listed on the bottom, left side of the cover of the prospectus, and the other managing underwriters are listed below and to the right of the lead manager. The lead manager and co-managers are the members of the underwriting syndicate that will actually be involved in the IPO preparation process, attending drafting sessions and the road show meetings.

It is up to the company to determine which bank will be the lead manager and which bank or banks will be the co-managers. Investment banking firms' relationships with one another can be competitive or cooperative, and usually are a bit of both. There is a definite hierarchy of firm prominence in the investment banking world, and it would not be unheard of for a bank that is not selected as the lead manager to refuse to act as a co-manager to the bank that is chosen, if the selected bank is the less prominent of the two. The decision regarding the lead manager and

the ordering of the co-managers should be made prior to the organizational meeting to ensure that the underwriters spend their time working together toward the success of the offering.

The managing underwriters may organize a larger group of investment banks to help distribute the stock and bear the risk of the offering. The entire group of investment banks is referred to as the "underwriting syndicate." The underwriting syndicate may, in turn, sell part of the offering through a selling group consisting of even more investment banks and broker/dealers. It is not necessary for the company to participate in the selection of the syndicate or selling group members, although the managing underwriters will often take into account any preferences expressed by the company. The syndicate and selling group members other than the managing underwriters do not participate in the due diligence, drafting or road show processes.

The Role of the Managing Underwriters

The managing underwriters coordinate many aspects of the IPO process, conduct due diligence on behalf of all of the underwriters, advise the company on IPO structural issues, assist in drafting the registration statement, arrange the road show, market the offering to potential investors and provide after-market support and analyst coverage for the company.

Selection criteria

The selection of underwriters for an IPO is a critical step in the process. When choosing managing underwriters, a company should consider the factors listed below. If two or more managing underwriters are to be used, the company may wish to base its decision, in part, on whether the banks have complementary strengths. For example, if a company desires to sell both to institutional and retail investors, it may wish to select one bank that is particularly strong in the institutional arena and one that is equally strong in the retail channel.

Analyst coverage. Analyst coverage is essential to maintaining investor interest in a company's stock following its IPO. Without it, the market for the company's stock may be relatively illiquid, volatility of the stock may be heightened and follow-on offerings may be difficult to place. This type of analyst is known as a "sell-side" analyst, and is typically an employee of the underwriting firm (though there are independent ana-

lysts that are not part of firms that underwrite equity offerings). The role of the sell-side analyst is to research a particular industry and the companies in that industry, and to report on the results of that research and make predictions about the anticipated performance of the industry, the companies and their securities. The sell-side analyst's reporting is outward facing, intended for the potential purchasers of securities who are brokerage customers (or potential brokerage customers) of the securities firm for which the analyst works. Sell-side analysts are to be contrasted with buy-side analysts, who typically do similar investigatory work, but whose reporting is internally facing, intended for the financial institution employing them in buying decisions on behalf of the institution itself. The buy-side analysts figure into the IPO process as well by attending road show presentations to glean information about the company to determine whether the analyst's institutional employer should purchase the IPO securities.

Although individual sell-side analysts have a reputation for frequently moving from one investment bank to another (or from investment banking into venture capital or business), the fact that an investment bank currently provides significant analyst coverage of a particular industry is generally a sign that the investment bank is committed to that industry and will be likely to hire additional analyst talent if the current analyst jumps ship. A good analyst will help position the company properly and may help reduce volatility in a company's stock by setting realistic expectations for the company's performance. The company should read recent research reports issued by analysts at each of the prospective underwriting firms and investigate the analysts' experience and published industry ratings. The company should then determine whether the reports reflect an understanding of the company's industry and its future, and the company's position in that industry, that is consistent with the company's understanding.

The role of analysts in the IPO process, as well as after the IPO, has undergone intense scrutiny in recent years as a result of the analysts' high profile in the late 1990s, their increasing power to influence stock prices and the widespread perception that analysts were tainted by a raft of conflicting interests. These conflicts included perceived entanglement of research analysts with the investment banking/underwriting side of the analysts' firms' business and perceived entanglement between the analysts and the companies on which they report. The result was a serious undermining of investor confidence in analysts' recommendations, and a

backlash of regulatory action. These actions included the promulgation of Regulation FD, which restricts non-public communications between public companies and investment professionals (Regulation FD is discussed in greater detail in Chapter 10), the enactment of the Sarbanes-Oxley Act, which required SROs to adopt rules relating to analyst conflicts, the promulgation by the NYSE and Nasdaq of rules relating to analyst conflicts of interest, and a series of regulatory enforcement actions against securities firms and analysts for past transgressions relating to analyst research. Many of the enforcement actions were settled in a global settlement that resulted in several leading investment banks agreeing to structural and operational restrictions designed to eliminate the analyst conflicts of interest. The result of the regulations is that research analysts will be much less involved in the investment banking aspects of the IPO process, and there may be some duplication of efforts as the analysts and bankers have to essentially operate entirely separately during the process. These analyst conflicts, the regulatory responses and the impact on the analysts role in the IPO process are discussed in more detail later in this chapter and in Chapter 9.

Level of interest in the company. The company should try to gauge how important its offering will be to the underwriter. During particularly frenzied market periods, an investment bank simply may not have the resources to staff all of its deals adequately. Even during normal market periods, a small deal simply may not meet the criteria of bulge- or major-bracket investment banks, in which case the company may wish to consider regional or boutique firms. When interviewing a prospective underwriter, a company should try to get a sense of what priority that investment bank will place on the company's deal by, for example, making inquiries of the bank's interest in the company and its industry, which individuals from the bank will be actively engaged in the IPO process, and whether competing transactions will enable the bank to devote sufficient attention to optimize the success of the road show.

Track record with similar IPOs. Does the prospective underwriter have experience marketing the stock of companies of a similar size, stage of development and industry as the company. Underwriters that have successfully placed the stock of similar companies may be more likely to have relationships with investors that would be interested in purchasing the company's stock. Relationships with customers, suppliers and competitors of the company may indicate a deeper understanding of the

company's industry and a real commitment to providing analyst coverage in that area. However, this must be weighed against the possibility of conflicting loyalties, problems in handling the company's confidential information and an inability to provide evenhanded advice in certain acquisition situations.

Reputation. Some investment banks are more respected than others, either in general or for their expertise in particular market segments. For investors whose first introduction to the company is through the IPO, the reputation of the managing underwriters may have a significant influence on the perceived quality of the investment and, in turn, may even influence valuation.

Distribution capabilities and focus. Among the most critical aspects of choosing an underwriting team is ensuring that the company has underwriters who are going to be able to complete the distribution, and are going to be able to get the company's shares into the hands of the right investors. Companies should ascertain the bank's distribution capabilities and objectives, its key institutional accounts, whether the bank will be able to build a quality syndicate to achieve optimum distribution, liquidity and visibility for the company's offering.

Some investment banks sell primarily to institutions, which tend to be more sophisticated and capable of understanding a complex business model. However, institutions tend to take a more activist approach to corporate governance and are less likely than individual investors to accede without a compelling rationale to management recommendations on items such as increases in stock option pools, mergers and acquisitions and anti-takeover measures. Retail investors tend to provide greater liquidity for a company's stock because they contribute to the public float and the actions of a single investor can rarely influence the prevailing market price. Theories abound for whether it is better to be more heavily weighted toward institutional or retail investors. The company's management team should ensure that its prospective lead managers explain their approach and support it with empirical evidence from recently completed deals. Most companies prefer a mix of institutional and retail stockholders. If a company has a particular international distribution objective, it should discuss that also with prospective underwriters.

Underwriters differ based on many other characteristics as well. Different underwriters may have different strengths in terms of types of technologies. They may also differ as to the regional strengths of their

institutional investor relationships. For example, some firms may have stronger connections with East Coast institutional investors. So, if a company chooses a West Coast based lead managing underwriter for some reason, and yet wants to make sure that East Coast institutional investors take positions in the company, the company would be well served to ensure that one of the co-managers (or, at a minimum, one of the other syndicate members) is an underwriter with strong connections to East Coast institutional accounts. Strategizing the makeup of the underwriting team with a view to leveraging their various strengths in terms of reach to investors is a matter on which the company should work very closely with the lead managing underwriter and the company's other advisors.

Aftermarket support. While getting the deal sold is critical to a successful IPO, post-offering market support can be just as important. In order for the trading price of the stock to accurately reflect the underlying business fundamentals and not be distorted by liquidity concerns, there must be a fluid and efficient market in the company's stock. This requires a few strongly capitalized firms that act as market makers, and stand ready to buy and sell the company's stock at the market prices, so that trading can continue efficiently at all times. Aftermarket support also includes the ability to help the company get other analysts interested in covering the company, and attracting large institutional investors to the company's stock after the IPO. In determining a prospective investment bank's aftermarket support capabilities, a company should request that the bank provide its track record in terms of aftermarket performance of other IPOs it has managed.

Experience in secondary offerings, debt offerings, mergers and acquisitions, anti-takeover measures and other investment banking functions. A company will realize greater benefits from its investment bankers if it maintains long-term relationships that allow the bankers to develop an intimate understanding of the company's business, objectives and management team. Ideally, a company's investment bankers will keep the company abreast of market developments, make creative financing suggestions, bring desirable acquisition opportunities to the company's attention and assist the company in implementing appropriate anti-takeover measures. A company should look ahead and consider whether the banks that it chooses to manage its IPO will be able to meet the company's expanding needs.

References. The company should ask each prospective managing underwriter that it is seriously considering to provide a list of the several most recent IPOs for which it was selected as a managing underwriter. If possible, this request should be refined to the most recent deals in the company's industry or a related field in which the analyst or corporate finance team that will be working on the company's IPO participated. Company management should then contact the CEO or CFO of those companies to find out whether, with the benefit of hindsight, they were satisfied with their choice.

The company may also wish to ask each prospective managing underwriter for a list of more mature companies with which it has maintained a long-term investment banking relationship. Company management should then contact the CEO or CFO of each of those companies and ask many of the same questions that it asks of the more recently public companies. Company management should also inquire as to whether the reference company did or did not use that investment bank for all follow-on offerings or acquisitions which it has undertaken since its IPO, and why. Has the investment bank stayed in close contact with the company, or does it only show up when a commission is involved? Are the individual bankers familiar with the company's developments, or are they spread too thin or have too much turnover in the team?

The company should also consider asking each prospective underwriter to provide a list of institutional investors with which it has placed IPO securities. When checking these references, the company should not only inquire as to the credibility of the prospective underwriter that provided the reference, but the reputation of the other prospective underwriters as well. These calls should be limited to their stated purpose of checking the prospective underwriters' references. For both practical and securities law reasons, it is not appropriate to discuss other details of the offering or the company on these calls.

Finally, the company should take into account the opinions of its board members, counsel and others who may have first-hand experience with the various investment banking firms under consideration.

Chemistry. When company management selects an investment banking firm, it must be comfortable with the people from that firm who will be responsible for providing service to the company. A successful IPO requires teamwork, the ability to read each other's signals and, quite frankly, the ability to spend day after day together in drafting sessions and

road show activities. A successful post-IPO investment banking relationship will be far more fruitful if the bankers are enthusiastic about the relationship, understand the company's long-term goals and have management's trust. In considering chemistry, management should try to distinguish between bankers that tell the company what it wants to hear from those that are willing to provide candid advice. The company should make sure it gets to know the broader investment banking team, not just the deal team that pitched the business. The company's senior executives should make a point of meeting the capital markets leads and the institutional sales leads.

Offering price and underwriting discount. Generally speaking, price is one of the least important criteria in selecting a managing underwriter. The final offering price will ultimately be determined by factors such as the company's performance, market conditions prevailing at the time of pricing and the level of interest generated during the road show. While investment banks will discuss a ballpark valuation with the company at the beginning of the offering process, no bank can realistically promise a particular price in advance. Company management should be wary of any bank whose valuation of the company is significantly out of line with the consensus of the other prospective underwriters. Because most investment banks (and their customers) use similar valuation techniques and will use a similar group of comparable companies for determining the applicable earnings or revenue multiple, a valuation that is substantially different from others may mean that the prospective underwriter does not grasp the company's business model, does not understand the company's industry, or is playing games in hopes of winning the company's business.

The underwriting discount for a firm commitment IPO listed on the Nasdaq National Market or a major exchange is typically 7%, and generally does not vary across major investment banks.

Practical Tip: Selection of the Underwriters May Mean You Are "In Registration" — Be Ready for All That Entails…

Not only is selection of underwriters a key decision for a company's IPO process, it is also a pivotal moment in the process. There are a number of restrictions on a company's ability to freely speak publicly when the company is "in registration." While there are no bright lines, it is commonly understood that selection of underwriters for a public offering with the intent of commencing the offering process marks the beginning of this restricted period, as discussed in greater detail in Chapter 5. The company must work closely with counsel to ensure that it understands these restrictions and is prepared to comply with them once underwriters have been selected.

The changing role of research analysts in the IPO process

The role of research analysts in the capital markets and the investment banking industry has received a great deal of media and regulatory attention in recent years, particularly in the aftermath of the severe declines in the public equity markets following the late 1990s. The SEC investigated the role of Wall Street analysts in the securities industry in 1999 as it became apparent that the analysts were playing an increasingly prominent and pivotal role in the industry, and in the capital raising process in particular. The SEC reviewed industry practices and conducted examinations of the largest full service investment banking firms on Wall Street. The results of the SEC investigation outlined a number of conflicting pressures to which analysts had become exposed, including:

- analysts had become increasingly involved in the activities of the investment banking groups;
- analyst compensation had become increasingly tied to the success of the investment banking groups;
- investment banks and analysts often held equity positions in the companies they covered;
- the disclosure of conflicts involving analysts was deemed inadequate; and

- there was suspicious timing of favorable ratings relative to the timing of the release of the post-IPO lock-up.

The regulatory inquiry into the perceived structural problems present in the interaction of research analysts with the investment banking business resulted in a number of responses. These regulatory actions are described in more detail in Chapter 9.

The Company's Legal Counsel

The company's lawyers will play an instrumental role throughout the IPO process. In particular, they will quarterback the drafting process, provide critical advice to the company throughout the process and serve as the primary liaison between the company and the SEC. In selecting counsel for its IPO, the company should choose a firm that is experienced in securities law matters generally, and the IPO process in particular, and that has sufficient resources to perform all of the tasks required in the time frame set by the company and the managing underwriters.

Role of company counsel

The company's lawyers will have numerous responsibilities throughout the IPO process, including:

- Assisting the company with its pre-IPO corporate housekeeping and IPO preparations;
- Helping the company to anticipate potential or likely issues in the SEC review process, and to formulate strategies and solutions for those issues;
- Helping the company to coordinate the due diligence process;
- Taking the lead in drafting the registration statement;
- Advising the company with respect to the registration statement's compliance as to form with the requirements of the securities laws;
- Filing the registration statement with the SEC;
- Coordinating, drafting and filing responses to SEC comments on the registration statement;

- Negotiating with the SEC regarding contentious issues;
- Preparing the confidential treatment request and negotiating it with the SEC, when applicable;
- Preparing and submitting the Nasdaq or exchange listing application;
- Negotiating the underwriting agreement on behalf of the company;
- Advising the company with respect to directed shares program issues;
- Coordinating the selling stockholder process, when applicable;
- Advising the company on publicity restrictions during the registration process;
- Helping the company formulate its insider trading policy, analyst and investor relations policies and other public company policies;
- Advising the company with respect to employee benefits matters for public companies;
- Educating the company about the many legal restrictions and reporting and other requirements faced by public companies;
- Assisting the company in implementing corporate governance structures applicable to public companies;
- Advising the company regarding anti-takeover measures;
- Advising the company on an ongoing basis after its IPO on securities-related matters;
- Advising the board of directors regarding their duties in the IPO process, including with respect to their due diligence defense; and
- Representing the company in the event of securities litigation.

Selection criteria

A company that already has experienced counsel meeting the criteria discussed below will have a head start on the offering process. Many companies approaching an IPO, however, discover that they have outgrown their current counsel's ability to meet their evolving legal needs or decide

to engage counsel with more extensive IPO and public company experience. If a company is considering retaining new securities counsel in anticipation of an IPO, it should do so sooner rather than later so that the new lawyers will have time to familiarize themselves with the company and to perform the many pre-IPO tasks described in Chapter 3.

Experience, experience and experience. An IPO is a highly technical, time-sensitive, high-stakes event, and the company's counsel is directly responsible for the execution of the entire registration process. Counsel's experience with the IPO process and the practices of the SEC will be invaluable in ensuring an efficient, timely and successful offering. Only law firms with extensive corporate and securities law experience should be considered. A law firm that regularly represents companies going through the IPO process will be much more effective in leading the working group and performing the many tasks described above. A firm with an active IPO practice also will be better equipped to anticipate problem areas and respond to difficult SEC comments. Many of the issues that arise in the IPO process are as much lore as law, and the knowledge and expertise to efficiently deal with the issues can generally only be adequately obtained though extensive first hand experience with the process.

Timing the effectiveness of the registration statement to coincide with the culmination of the road show is important to the success of any offering, and the company will want to have counsel capable of offering timely, creative solutions to outstanding issues as the desired effective date draws near. A law firm that has experience representing underwriters, as well as companies, will have more credibility in negotiating the underwriting agreement and resolving due diligence and disclosure issues with the underwriters. Finally, a law firm with a large, public-company client base should be able to steer the company around many of the pitfalls common to newly public companies following the IPO, and help position the company to be well prepared to meet its public company legal obligations.

An experienced securities law firm will also likely have partners involved in various policymaking groups and task forces that work with the regulatory bodies to evaluate current laws, identify timely issues and propose improvements to the system. That institutional perspective on the process can be helpful in anticipating and addressing particular issues that arise in the IPO process.

IPO LEGAL REPRESENTATION
(IPO Transactions 1998 through 2003)

Law Firm	TOTAL IPO REPRESENTATIONS			
	Number of IPOs	Percent of Total IPOs	Aggregrate Offering Amount	Percent of Total Aggregate Offering Amount
Wilson Sonsini Goodrich & Rosati	239	14.6%	$21,481,959,386	6.6%
Brobeck, Phleger & Harrison	148	9.1%	10,422,274,009	3.2%
Shearman & Sterling	124	7.6%	46,968,162,961	14.5%
Skadden, Arps, Slate, Meagher & Flom	110	6.7%	52,399,011,290	16.2%
Cooley Godward	99	6.1%	6,513,777,652	2.0%
Davis Polk & Wardwell	98	6.0%	70,040,722,014	21.6%
Latham & Watkins	94	5.7%	18,047,373,669	5.6%
Sullivan & Cromwell	82	5.0%	52,504,809,491	16.2%
Cravath, Swaine & Moore	82	5.0%	30,484,100,140	9.4%
Hale and Dorr	81	4.9%	6,845,979,181	2.1%

Source: © 2004 Corporate Finance Institute.

Full-service capabilities. A company's legal needs will change significantly following its initial public offering. Forming a long-term relationship with a full-service law firm will lead to higher quality and more efficient service. The corporate and securities lawyers from the IPO team will be able to spot issues early, introduce the company to lawyers within the firm who have relevant expertise, and quickly bring those lawyers up to speed on the company's background and current situation. Therefore, when selecting IPO counsel, the company should consider whether a firm can serve its needs in areas such as general corporate and securities counseling, securities litigation, employee benefits and compensation, antitrust counseling and litigation, tax and intellectual property law.

Interest in the company. Because company counsel plays such a critical role on the IPO team, company counsel must be motivated to help the company jump-start the IPO process and drive it to completion. In addition to legal abilities and business judgment, selection criteria should include enthusiasm and responsiveness. Company counsel should be willing to roll up his or her sleeves and do whatever it takes to help the company make the transition from a privately held company to a public company. Company counsel also will need to be a quick study on the company's industry, operations, risks and financial condition, and be able to explain these concepts to investors and the SEC in a prospectus.

References. Company management should ask prospective counsel to provide contact information for CEOs and CFOs of clients which have recently gone public, as well as clients which have been public for at least a few years.

In checking references with newly public companies, management should ask whether counsel adequately prepared the company for the challenges of the IPO process. Was counsel organized or erratic? Did counsel help the company get a running start on the numerous pre-IPO items listed in Chapter 3? Did counsel drive the process through to the end, or fizzle out and require pushing from the other team members? Did counsel demonstrate good judgment on sensitive disclosure issues, negotiations with the underwriters and dealings with the SEC? Did counsel take the time to thoroughly understand the company's business and financial situation? How much did counsel contribute during the drafting process, particularly in the "MD&A" and "Risk Factors" sections of the registration statement? What has counsel done to help the company transition to life as a public company? Has it helped the company map out its first year of reporting and annual meeting activities? Has it coached the company on dealing with securities analysts and minimizing the risks of a stockholder lawsuit?

In checking references with more seasoned public companies, management should ask how long the company has worked together with the prospective counsel. Does the company value counsel's business judgment and include counsel in major strategic decisions? Has counsel provided responsive and efficient service? Has the law firm been able to satisfy the company's growing needs? How has counsel responded in times of crisis?

Chemistry. Company management must not only be confident in the capabilities of the *firm* it has selected, but must also trust the experience and judgment of the *individual lawyers* who will be responsible for guiding the company through the IPO process and beyond. Are the CEO and CFO interested in counsel's opinion on issues of strategic importance to the company? Would their rapport with counsel allow them to successfully wrestle with difficult judgment calls together? Are they comfortable sharing the company's dirtiest laundry with counsel and asking for recommendations? Do they feel that counsel is interested in having this sort of working relationship with them?

Fees. A company's focus should be on value for the dollar rather than on absolute fees. In assessing value, there are several factors that a company should take into account. A firm that is experienced in the IPO process may be more efficient in the long run, even if its hourly rates are higher than those of other firms. (Company management should be sure to ask each firm it is considering what its rates are. Companies are often surprised to find that the rates of experienced securities counsel are not significantly higher than those of less experienced firms.) Interest on the proceeds of an average offering can exceed $10,000 *per day* and market windows are often unpredictable. Counsel that can effectively drive the registration process and run the gauntlet of SEC comments may save the company tens of thousands to millions of dollars just by keeping the process on schedule. Additionally, experienced counsel that can advise the company wisely on disclosure issues and policies regarding insider trading and dealing with analysts may help save the company millions of dollars in litigation exposure.

The Underwriters' Legal Counsel

Role of underwriters' counsel

The underwriters' counsel is responsible for:

- Assisting the underwriters in satisfying their due diligence obligations, including document review, factual back up of statements made in the prospectus and negotiation of the comfort letter from the auditors;
- Participating in the drafting process;
- Satisfying applicable state securities laws and regulations;
- Obtaining NASD clearance of the underwriting arrangements;

- Drafting the underwriting agreement and negotiating it with the company's counsel;
- Coordinating the mechanics of the underwriting syndicate with the lead manager's capital markets department; and
- Coordinating the closing with company counsel.

Selection criteria

The underwriters' counsel should have extensive public offering experience. Many of the same criteria discussed above for company counsel are equally applicable to the role of underwriters' counsel. Underwriters' counsel generally is chosen by the lead managing underwriter.

The Company's Auditors

Role of the company's auditors

The company's auditors ensure that the financial information included in the registration statement satisfies SEC financial information disclosure requirements, which are different and in some cases more extensive than GAAP.

In addition, the auditors are the primary liaison between the IPO working group and the SEC's accounting staff, and generally take the lead in drafting responses to the SEC's comments relating to accounting matters.

The auditors will also be responsible for delivering a comfort letter to the underwriters and the company's board of directors confirming that the financial statements contained in the registration statement comply with accounting requirements, and tying the tables, statistics and other financial information included in the registration statement to the financial statements and other financial records of the company.

Following the IPO, the auditors will assist the company in its ongoing financial reporting obligations.

Selection criteria

Almost by definition, a company's auditors must become intimately familiar with the company's financial situation and accounting practices. Therefore, if a company is considering changing auditors in anticipation of its IPO, it should make the decision as early as possible.

Reputation and general IPO experience. The company's auditors should be well regarded and have extensive IPO experience. Most public companies use one of the Big Four accounting firms. In addition, issuers should evaluate the relevant experience of the key audit partners and the partners expected to replace them under the SEC's audit partner rotation requirements. If the issuer has or expects to have operations in foreign countries, the auditor should have offices or experience in those countries.

Specific industry experience. The company's auditors should have extensive and ongoing experience with other clients in the company's industry. The SEC almost always raises issues about the company's accounting practices during the SEC's review of the registration statement. As a result, it is essential that the company's auditors be current on accounting developments specifically applicable to the company's industry and be able to effectively justify the company's position with the SEC.

Track record. The company's audit committee should consider the audit firm's recent record with respect to restatements and disciplinary proceedings before the SEC.

Suitability for post-IPO matters. Following the IPO, the company will rely on its auditors to audit its annual financial statements, as well as to provide advice regarding complex issues such as tax planning or the accounting impact of mergers and acquisitions or new business initiatives.

References. As with the company's other service providers, the company (under the direction of its audit committee) should carefully check references, inquiring as to experience, judgment, responsiveness and efficiency.

Consequences of terminating audit relationship. Once an auditor has been hired, it is difficult to terminate the relationship. Any resignation or dismissal of the company's auditors must be disclosed on SEC Form 8-K when it occurs, as well as in the company's periodic SEC reports for two fiscal years following the change, along with the reasons for the resigna-

tion or dismissal. While changes in accounting firms that occur prior to the IPO are easily explained, changes once the company is public may be viewed by the market as a sign of trouble at the company. Therefore, the company should give careful thought to its choice of auditors well in advance of its IPO.

The Company's Financial Printer

The company's counsel generally will maintain early drafts of the registration statement on its word processing system. A few weeks prior to the initial filing of the registration statement, the company's counsel will transfer the draft to the financial printer's document management system. The financial printer will then host the remaining drafting sessions, circulate new proofs of the document to the working group members and provide word processing and other administrative support. Finally, once the draft is finalized, the financial printer will transmit the registration statement via EDGAR to the SEC, print prospectuses and promptly distribute them to the underwriting syndicate.

Role of the Company's financial printer

The company's financial printer is responsible for document management throughout the registration process, including:

- Typesetting/conversion of word-processing documents into the registration statement, including the prospectus, in the appropriate underwriter's style;
- Hosting working group sessions at the financial printer's facilities, utilizing conference rooms, telephone, facsimile and Internet capabilities, administrative support and food services;
- Document management, including author alterations and proof distribution of the registration statement throughout the IPO process;
- EDGARization of the registration statement, including all exhibits, for filing with the SEC;
- Electronic transmission via EDGAR to the SEC of each filing, including correspondence with the SEC staff;

- Printing of the prospectus and distribution of it to the selected underwriters' syndicate and working group; and
- Electronic conversion of the prospectus to HTML/PDF formatted files for distribution by the underwriters and electronic posting of the document to the company's web site.

Following the company's IPO, the financial printer often will assist the company with its ongoing printing and filing responsibilities as a public company, including:

- SEC filing requirements, such as the company's filings on Forms 10-K, 10-Q and 8-K, Section 16 filings and the filing and printing of the company's annual report and proxy statement;
- Other filing needs, including filings made in connection with future follow-on public equity or debt offerings and merger and acquisition transactions; and
- Certain ancillary services, including translation services, localization/globalization services, digital and print services.

Selection criteria

Company management is responsible for selecting the financial printer, and should do so relatively early in the IPO process. Criteria that should be used in selecting a financial printer include the following:

Level of service. Time will be of the essence as the initial registration statement nears completion and the underwriters and management team gear up for the road show. Rapid and accurate service from the financial printer can reduce the time between receiving SEC comments and filing an amendment to the registration statement. Around-the-clock, professional work by the financial printer will be essential to keeping the offering on schedule.

Location and facilities. The location of the financial printer's office, as well as the availability of conference rooms, private telephone rooms, modem and Internet connections and other amenities are factors worth considering for the convenience of the working group.

Cost. Cost is a factor, and the multiple variables that affect the IPO process can add to the time and expense of the transaction. In evaluating costs of the financial printing services, a company should consider these

costs in relation to the value of the printing services received. The quality of service will affect the time commitment and cost of other service providers during the transaction. The company may also want to consider the importance of developing a strong, long-term relationship with its printer in light of the future needs that the company will have following its IPO.

To ensure that the financial printer can give an accurate and competitive proposal, the company should give the printer as much information as possible, including the number and quality of prospectuses to be produced, a rough estimate of the number of pages, and the type and number of photographs, artwork and other graphic elements to be included. The company should also inquire about the financial printer's pricing of variable aspects of the transaction, such as amendments to the registration statement, author's changes, conference rooms and client accommodations (for example, meals, secretarial services, postage and delivery, and rush, overtime or weekend service).

References. The financial printer should be able to give the company a list of other companies for which the printer has recently performed financial printing services in connection with IPOs. Additionally, the financial printer generally will be able to provide the company with names of some of its long-time public company clients. These kinds of references will reflect the quality of the financial printer's long-term services to public companies. The company may also wish to solicit the opinion of company counsel and the underwriters, who likely will have dealt on numerous transactions with all the major financial printers.

Special Experts

Most working groups do not include special experts. Where the nature of the company's business requires an understanding of highly technical information, however, it may be appropriate to involve a special expert in the registration process. For example, if patented technology is central to the company's business, special patent counsel may be needed to explain the status of a patent application, the strength of the company's patent portfolio or claims of patent infringement. If a company operates in a heavily regulated field, such as medical devices or telecommunications, special regulatory counsel may be helpful to the working group.

The extent of a special expert's involvement in the public offering process can vary widely depending on the working group's requirements. A special expert's involvement may consist of a brief telephonic due diligence interview with the underwriters, an informal review and edit of relevant sections of the registration statement, the rendering of a legal opinion on matters of particular concern, or actual "expertizing" of a portion of the registration statement. In most general terms, Section 11 of the Securities Act describes an expert as one whose profession gives authority to his or her statements. Section 11 of the Securities Act describes an expertised portion of the registration statement as one that is prepared or certified by an expert who, with his or her consent, is named in the registration statement as having prepared or certified a part of the registration statement, or report or valuation that is used in connection with the registration statement. The level of special expert participation should be decided by the company and the underwriters, with the advice of their respective counsel, early in the IPO process. The expected extent and purpose of an expert's role should be made very clear to the expert, who may not have much familiarity with the IPO process.

Others

Numerous other parties will be tangentially involved in the IPO process as well. For example, the company will need to select a banknote company to print stock certificates and a transfer agent and registrar to administer stock issuances and transfers. Company counsel generally can assist the company in offering recommendations on the basis of prior experience and reputation and assisting the company in making these arrangements. The company may also wish to retain a design firm to assist with graphics and artwork to be used in the prospectus, and a professional to help the CEO and CFO refine their public speaking and presentation skills for the road show. The underwriters generally can put the company in touch with people experienced in providing these services in the public offering context.

Chapter 3

Gearing Up

A company will need to undertake a number of corporate housekeeping and administrative tasks to prepare itself for the IPO process and the transition to becoming a public company. The extent and expense of the work required will vary from company to company and will depend on a number of factors, including the length of the company's operating history and the quality and accuracy of the company's corporate records. In addition to the corporate clean-up items that should be performed, the company should address with its counsel and underwriters any desired structural changes such as a reincorporation, a stock split, various defensive mechanisms and new equity compensation plans.

Among the issues that a company should consider in anticipation of its IPO are the following:

Structure of entity

Most entities that go public in the U.S. are domestic C corporations. If the business proposing to go public is a limited liability company (LLC), a partnership, an S corporation, a foreign corporation or other form of entity, legal and tax counsel should be consulted as to the desirability, timing and consequences of converting into a domestic C corporation.

State of incorporation

A fundamental organizational issue that a company should address at the early stages of the IPO process is the state in which it is incorporated and whether the company should reincorporate in another state. Benefits that are often sought in connection with a reincorporation include extensive legal precedent (and therefore predictability) in matters of corporate governance and a judiciary experienced with corporate affairs and a history of upholding stockholder rights plans, or poison pills, and other defensive measures. The primary disadvantages are the effort and costs, which include legal fees and additional annual franchise taxes.

Many legal practitioners recommend that companies reincorporate in the State of Delaware prior to an IPO. More than 500,000 business entities have their legal home in Delaware, including more than 50% of all U.S.

public companies and 58% of the Fortune 500 companies. There are a number of reasons why companies choose Delaware, including the following:

- The Delaware General Corporation Law is one of the most advanced and flexible corporations statutes in the nation;
- Delaware's highly respected Court of Chancery dates back to 1792 and is widely recognized for its expertise in corporation law matters;
- The Delaware legislature, which gives high priority to corporation law matters and utilizes the sophistication of experienced practitioners of the Delaware Bar Association (plus, each year, the Delaware Governor and General Assembly work with their Courts and the Delaware State Bar Association to ensure that Delaware's legal system is the most modern, flexible and responsive in the nation); and
- The highly developed body of case law created by the Court of Chancery and the Delaware Supreme Court, with which lawyers and judges in every state are familiar and which provides a wealth of precedent for corporate executives and directors to utilize in making decisions.

A reincorporation is generally accomplished by creating a new subsidiary in the state in which the company wishes to reincorporate, and then merging the company into the newly formed subsidiary. Additional effort and expense will be associated with assigning contracts, patents, trademarks and copyrights from the original entity to the reincorporated entity, and obtaining new qualifications for the reincorporated entity to do business in various states. There is some debate among legal experts as to whether the benefits of reincorporating outweigh the effort and expense, and the company should discuss the matter with its counsel before making a decision.

Capital structure

Some changes to the company's capital structure may be necessary to complete the IPO. Often, a company needs to authorize additional shares of common stock to have enough shares to complete the IPO and for future needs. In addition, with the advice of its investment bankers, the company may choose to effect a forward or reverse stock split in order to

achieve a proposed offering price in a particular target range. As a general rule, the offering price of an IPO will be in the range of $10 to $20 per shares. Pricing a stock too high may make the purchase of round lots of shares too expensive, limiting the number of potential investors, and pricing the stock too low may make the stock more susceptible to extreme fluctuations in price and price manipulation, and may increase the risk of falling below the listing requirements of Nasdaq or the applicable exchange after the offering.

Because stockholder approval is required for most changes to a company's capital structure, any reasonably foreseeable changes should be made while the company is private and the procedure for obtaining stockholder approval is still relatively simple. For example, the company may wish to authorize even more common stock than is necessary to complete the IPO in order to provide flexibility for future public (or private) offerings, certain acquisitions or the addition of shares to stock option pools. The company may also wish to authorize undesignated preferred stock that can later be used for future financings or in connection with the implementation of a stockholder rights plan, as discussed in greater detail in Chapter 2.

The board of directors and committees of the board

A company should consider whether changes in the composition of its board of directors should be made prior to or in connection with the IPO. Does the current board have sufficient depth and experience? Would adding one or more independent directors with relevant industry experience provide additional insight and make the company more attractive to investors? Also, does the company's board composition comply with applicable Nasdaq or exchange listing requirements and SEC rules? For example, the NYSE and Nasdaq require that a majority of the board of directors of a listed company be composed of directors who satisfy their respective independence standards. Does the company need to add one or more independent directors? Also, are there any directors who may resign in anticipation of the IPO?

In addition, a company should consider whether to organize additional board committees. The board of directors of a public company must have a standing audit committee that is directly responsible for the appointment, compensation, retention and oversight of the company's auditors. Audit committee members must meet stringent standards of

independence, and public companies are required to disclose whether they have at least one "financial expert" serving on their audit committees. For example, pursuant to SEC Rule 10A-3, an audit committee member may not, other than in his or her capacity as a member of the board of directors or a committee of the board, accept any payments for services as an officer, employee or consultant of the company. Also, SEC Rule 10A-3 requires national securities exchanges and associations to prohibit the initial listing of any security of a company that is not in compliance with the rule. The SEC has provided certain limited exemptions from its independence standards, including exemptions for the newly public company such that all but one member of the audit committee may be exempt from the standards for 90 days from the effective date of the company's registration statement and a minority of the members of the audit committee may be exempt from the standards for 1 year from the effective date of the company's registration statement.

In addition, the NYSE and Nasdaq have requirements with respect to board and board committee composition. The NYSE and Nasdaq require that a listed company have an audit committee of at least three directors and composed entirely of independent directors (pursuant to their respective standards of independence), among other requirements, including certain financial literacy requirements. The NYSE also requires that a listed company have a compensation committee and a nominating/corporate governance committee composed entirely of independent directors. Nasdaq does not mandate that its listed companies have compensation or nominations committees. However, Nasdaq does require that the compensation of a listed company's CEO and other executive officers must be determined, or recommended to the board of directors, either by a majority of the independent directors or a compensation committee composed solely of independent directors. Also, Nasdaq requires that director nominees be selected, or recommended for the board's selection, either by a majority of the independent directors or a committee composed solely of independent directors. The NYSE and Nasdaq have provided exemptions to new public companies from their respective governance rules for a limited transition period.

If a company cannot meet the independence or other corporate governance standards of the SEC and applicable Nasdaq or exchange listing requirements prior to its IPO, the company should begin implementing an appropriate process to become compliant within the permitted transition periods. The process of identifying qualified, independent directors takes

time and diligence. Many companies engage recruiting firms to assist in the process. Regardless, this is an area of corporate housekeeping that requires serious attention early in the IPO process.

Indemnification of directors and officers

The company should review, with the assistance of counsel, the adequacy of the indemnification provisions contained in its charter documents. The company should also make sure that its form of officer and director indemnification agreement reflects the current state of the law, has been approved by the stockholders (to the extent necessary to ensure its enforceability), and has actually been entered into with each officer and director. In addition, the company should purchase appropriate director and officer liability insurance, as discussed in greater detail in Chapter 4.

Capitalization records

The company should make sure that its capitalization records accurately reflect all stock issuances, transfers and cancellations; all option and warrant issuances, exercises and terminations; all convertible debt issuances, transfers, conversions and cancellations; all anti-dilution adjustments; and details of any other securities transactions. In order to determine holding periods under Rule 144, the date of payment should also be recorded. Ideally, the date of board authorization, the blue sky exemption relied upon, and any special rights or restrictions (such as rights of first refusal, registration rights, voting agreements or lock-up restrictions) will also be noted in the capitalization records.

Practical Tip: Avoiding Lost Stock Certificate Charges

While a company is private, company counsel often acts as the company's transfer agent and lost stock certificates are relatively easily replaced. Prior to the effectiveness of the IPO, the transfer agent function passes to the professional transfer agent selected by the company. Professional transfer agents typically require a fee in connection with the issuance of a replacement certificate. The fee represents a premium for a bond to indemnify the company and the transfer agent in the event that the "lost" certificate resurfaces and is traded in error. The bond premium fee is often calculated as a percentage of the value of the certificate being replaced, and therefore can be quite expensive. As part of its pre-IPO preparation, a company may wish to remind its employee-stockholders and investors to locate their certificates or promptly request replacements.

Company counsel will need to trace the company's capitalization history to ensure that the prospectus accurately discloses the company's current capital structure, the dilution to new investors, and the shares that will be eligible for sale by existing investors following the IPO. Underwriters' counsel will review these records carefully during the due diligence process. If the company's outstanding securities were not issued in compliance with applicable federal or state securities laws, a time-consuming rescission offer may be required. The company's new transfer agent will also require accurate records.

True Story: Due Diligence Uncovers Potential Violations

During the IPO due diligence investigation of one technology company, attorneys discovered that certain stock issuances and stock option grants by the company to its employees and consultants were not made in compliance with federal and state securities laws. This discovery was made just prior to the filing of the company's registration statement. The company and the IPO working group were forced to consider two alternatives – either delay the IPO for several months while the company made an offer to stockholders and optionholders to rescind the earlier stock transactions or proceed with the IPO and hope to be able to convince the SEC to allow the company to conduct the rescission offer after the IPO.

Fortunately for this company, the SEC permitted the company to move forward with its IPO. However, the company was required to register the rescission offer after the IPO as a public offering on a Form S-1 registration statement. The company's IPO was successful, but the company spent well in excess of $100,000 in legal, accounting and other fees to remedy the problem.

Lock-up situation

The number of shares sold in an IPO is typically only a fraction of the company's total outstanding stock. If all of the company's existing investors tried to sell their stock in the open market at the same time or shortly after the IPO while the underwriters were trying to establish a market for the company's stock, the market price would be severely depressed. Most underwriters would refuse to accept the risk of bringing the offering to the market under such circumstances. Underwriters therefore require that a company's existing stockholders enter into contractual agreements to refrain from selling their stock during a specified time following the IPO, typically 180 days.

Often, lock-up restrictions will be included in existing contracts with stockholders, such as stock purchase agreements, registration rights agreements or option plans. Generally, underwriters are not willing to rely on these provisions and require each existing stockholder to enter into a lock-up agreement with the underwriter on its standard form. The

company should analyze which of its stockholders are already bound by lock-up agreements with the company and have this information available for the underwriters early in the registration process. Underwriters typically require that all or a large percentage of the company's outstanding shares are locked-up before the preliminary prospectus is printed. Accordingly, it is important for the company to get an early start on obtaining lock-up agreements from its stockholders.

In May 2003, the NYSE/NASD IPO Advisory Committee issued a report in which it made several recommendations for the SEC and the self-regulatory organizations (such as the NYSE and the NASD) to enhance public confidence in the integrity of the IPO process. In particular, the IPO Advisory Committee concluded that investors reasonably expect that the company's directors, officers and large pre-IPO stockholders who agree to lock-up their shares will be bound by those agreements for the stated period. Accordingly, the IPO Advisory Committee recommended that underwriters be required to notify the company prior to granting a lock-up exemption and to announce the exemption through a national news service. The Committee also recommended that companies be required to file a report on Form 8-K with the SEC concerning any exemptions granted by underwriters to such persons. As of the date of this edition of the guidebook, the NYSE and NASD had proposed amendments to their rules to implement these recommendations, but the rules had not yet been adopted.

Analysis of registration rights

The company may have granted some of its stockholders the right to include their shares in a public offering of the company's stock. The company, together with its counsel, should analyze these rights, including the number of shares subject to them, whether the rights apply in the case of the company's IPO, whether the underwriters can reduce or eliminate the number of such shares to be sold if marketing considerations so require, the order of priority among registration rights holders in the event of a cutback, the steps required to obtain an amendment or waiver of the registration rights and applicable notice periods. The company should have this information available for the underwriters early in the registration process.

"Overhang" analysis

Closely related to an analysis of the company's capitalization records, lock-up situation and registration rights is the "overhang" analysis. This analysis, which will be summarized in the section of the prospectus entitled "Shares Eligible for Future Sale," reflects the interplay of required holding periods under the securities laws, lock-up restrictions and registration rights. The analysis shows the maximum number of shares held by existing securityholders that may be sold at various intervals after the effective date of the IPO.

Analysis of other rights

During the company's financing history, it may have granted various rights to certain investors, including the right to receive advance notice of certain events, such as an IPO, or rights of first refusal to purchase stock in new rounds of financing. The documents containing these rights should be reviewed carefully to ensure that, to the extent that such rights apply to an IPO, they are satisfied or properly waived, and to analyze whether it is appropriate to seek to terminate these rights upon effectiveness of the IPO.

Minute books

The company should make sure that its minute books contain final minutes of all board, board committee and stockholder meetings, as well as actions of the board or stockholders taken by written consent. Not only is this good corporate practice, but both company counsel and underwriters' counsel will insist upon reviewing a complete set of all minutes and consents as part of the due diligence process.

Due diligence materials

The company can begin assembling the many documents that the underwriters and their counsel will want to review in the course of their due diligence. This includes capitalization records, minute books, material contracts and many other documents. Once underwriters have been selected, the company can obtain due diligence checklists from them and their counsel. The company can obtain a sample due diligence checklist from its counsel or use the one in ***Appendix B*** to begin collecting materials in anticipation of the underwriters' request. This topic is discussed in greater detail in Chapter 7.

Stock plans

The company will need to review its existing stock plans with its counsel. Once the company is public, certain provisions of the federal securities laws will become applicable to the company's stock plans, while certain provisions of state securities laws may no longer apply. As a result, the company's existing plans may be inadequate or inappropriate for a public company. Many companies also use the IPO preparation process as an opportunity to add shares to the pool of options available for future grant. The company should authorize a sufficient number of shares for its anticipated needs for the foreseeable future. Finally, new types of plans which were not practical prior to the company's stock becoming publicly traded, such as employee stock purchase plans (ESPPs), will become available following the IPO. Because most of these plans require board and stockholder approval and must be described in the prospectus, it is advisable to finalize them as early in the IPO process as possible.

Audit and review of material accounting issues

The prospectus must contain audited statements of operations, cash flows and changes in stockholders' equity for the three most recently completed fiscal years and audited balance sheets as of the end of the two most recently completed fiscal years. While there is no requirement that the period since the end of the prior fiscal year be audited, some underwriters will request an audit of such interim period, particularly where the company's financial situation has changed rapidly and the offering will go effective late in the current fiscal year. The company should keep its auditors apprised of its IPO plans to give them sufficient time to complete their audit work. The company should also discuss with its underwriters, auditors and counsel any accounting practices that may deviate from the industry norm, which involve unusual facts or which may otherwise cause concern or confusion for the SEC or investors. Common problem areas historically include revenue recognition, deferred charges, accounting for business combinations, goodwill amortization periods, capitalization policies for intangible assets, reserves, related-party transactions and stock-based compensation. The company will also need to be prepared to comply with new SEC rules relating to the use of non-GAAP financial measures, critical accounting policies and off-balance sheet arrangements, as well as have a roadmap for compliance with rules relating to management reports on internal controls (and required auditor attestation), disclosure controls and procedures, certifications regarding the accuracy of financial statements and periodic reports filed with the

SEC following the IPO. It will be particularly important for the company to ensure that it has the right internal accounting and control team and that its systems have been designed to ensure the company can satisfy its disclosure requirements as a public company.

"Cheap stock" analysis

One issue that emerging growth companies have long encountered in the IPO process is the "cheap stock" issue. The cheap stock issue revolves around a debate between the SEC and companies concerning how equity compensation should be reflected in the company's financial statements. This issue is prevalent for emerging growth companies because they typically rely heavily on equity compensation (stock options in particular) to provide incentives to their employees and consultants.

Historically, accounting standards have allowed companies to avoid recording a compensation expense on their income statements when they grant stock options to employees if the exercise price of the stock option is equal to the fair value of the underlying stock on the date that the option is granted. If the option exercise price is less than the fair value of the underlying stock at the time of grant of the option, the company must record compensation expense on its income statement in the aggregate amount of that differential over the vesting period of the option. However, the SEC, in examining the financial statements of a company in the context of the IPO, often disagrees with the company's determination that the exercise price of options was equal to the fair value of the underlying stock at the time of grant of the options and requires the company to add compensation expense to its financial statements. This can materially affect the company's results of operations for the historical periods reflected in the financial statements included in the registration statement, as well as in future periods as stock options continue to vest. The added expense is not a cash expense, and so it does not negatively impact the company's capital resources. However, it is hotly debated whether the non-cash expense negatively impacts the market price of the company's stock.

The issue arises as a result of the fact that private companies, by definition, do not have a liquid market for their stock that can efficiently determine the value of the company's stock based on third party, arm's-length transactions. Also, there are no clear rules regarding valuation of private company equity for purposes of determining compensation expense in connection with equity compensation arrangements. As a result,

boards of directors, in determining a fair value of their stock for purposes of establishing an exercise price for stock option grants, must exercise their own judgment in an environment of significant uncertainty. In the past, many private companies have been somewhat lax in the methodologies they have employed in making these determinations. It has not been uncommon for venture capital-backed companies to employ informal discount approaches to reflect junior liquidation and other rights, lack of marketability and minority interest discounts. For example, in the emerging growth company practice, a 90% discount is often taken in valuing common stock (this approach values the common stock of a private company at 10% of the price at which the company most recently sold preferred stock to investors). The across-the-board 90% discount has largely been dismissed in recent years as a valid method for determining the fair value of common stock, in large part because the accounting profession has become more aggressive in requiring private companies to justify fair value determinations for purposes of financial reporting. Nevertheless, it is typical for venture-backed companies to price the common stock at a discount at anywhere from 50% to 90% to the price of its convertible preferred stock because of the superior rights held by the holders of preferred stock (for example, liquidation preferences, dividend preferences, protective voting provisions and registration rights). As an IPO draws near, this differential approaches zero, since a typical venture capital preferred stock converts into common stock in connection with an IPO, and often the company's valuation at the time of the IPO is such that the liquidation preferences of the preferred stock are often essentially worthless.

The SEC has long been critical of the option pricing techniques used by private companies. The SEC, in the context of its review of initial public offerings, often finds (in hindsight) that the option exercise prices were too low. Support for the company's option prices must be based on specific facts relating to the company's business and transactions in its stock. The SEC will also typically reject arguments based on a statistical analysis of other companies' pre-IPO option price increases.

It appears that the SEC's view on the role of third party valuations in determining fair value of common stock has evolved somewhat in recent years. In the past, the SEC has given little weight to valuations obtained in connection with public offering cheap stock analyses, considering them to be somewhat suspect and self-serving. However, in the August 31, 2001 version of the *"Division of Corporate Finance Current Accounting and Disclosure Issues"* outline prepared by the SEC Staff (the "SEC Accounting Issues

Outline"), the Staff indicates that it "encourages companies to obtain independent valuations from competent professionals contemporaneous with the issuance of equity instruments." The Staff also cautions issuers in the outline that there are a number of specific concerns that the SEC has had with valuations and encourages issuers to avoid these issues in future valuations. Among the listed concerns are the use of "rule of thumb" discounts from recent financing transaction prices and "rule of thumb" lack of marketability discounts and minority discounts.

The SEC provides guidance in the SEC Accounting Issues Outline regarding the type and quality of the information that it expects the equity valuation analysis to be based upon. The SEC has indicated that valuations should be based on objective, verifiable evidence that has been documented contemporaneously with the issuance. The SEC further indicated that company-specific information will strengthen the valuation determination and noted that the following analyses should be included in a valuation:

- a discussion of the company's operating performance, both in the past and as anticipated in the future;
- a quantitative reconciliation of the fair value of the options and the IPO price;
- a discussion of the valuations of the company performed by underwriters who have been approached with respect to the IPO; and
- a discussion of contemporaneous transactions in the company's securities with independent third parties, including a discussion of the nature of the transactions and the securities sold.

An interesting point to note is that historically the SEC Staff has taken a dim view of discounting option exercise prices significantly from contemporaneous preferred stock financing prices as a general matter. In part, this viewpoint was based on the SEC's strong feeling that the rights and preferences of preferred stock in private companies (most notably, the liquidation preference) did not justify significant discounts because the investment was made principally with a view to a future public offering, at which time the preferred preferences would terminate in connection with the conversion of the preferred stock into common stock. Following the substantial decline in the stock markets beginning in 2000, valuations of many public and private companies have plummeted, and the liquidation preferences of preferred stock have proven to create an enormous disparity in relative value between preferred stock and common stock on an actual basis. The value of

preferred stock liquidation preferences has been demonstrated in multiple ways and in transactions, even for companies that were close to embarking upon initial public offerings (and, indeed, may have been in registration) prior to the precipitous decline in the stock markets.

Practical Tip: Adopt Best Practices for Common Stock Valuation to Proactively Minimize the Cheap Stock Issue

Long before its IPO, the company should be proactive in minimizing the possibility or size of cheap stock charges and should work closely with its auditors and counsel to determine a proper option pricing strategy. Regardless, in making fair value determinations, the board of directors should analyze all relevant factors. A preliminary draft of a proposed practice aid on valuation of private company stock published by the American Institute of Certified Public Accountants sets forth a list of factors relevant to a valuation determination that serves as a good guide:

- The achievement or failure to achieve significant development or business milestones;
- The state of the company's industry, and the economy in general;
- The experience and competence of the management team and other key employees, and whether the key team members are in place;
- The company's share of its market;
- The presence or absence of barriers to entry in the market;
- Competitive forces, including potential competition, substitute products, buyers' bargaining power, suppliers' bargaining power and current competition;
- The existence of proprietary technology, products or services;
- The quality of the company's workforce;
- Characteristics of the company's customers and vendors-their number, health, profitability, etc;

Practical Tip: Adopt Best Practices for Common Stock Valuation to Proactively Minimize the Cheap Stock Issue (continued)

- Strategic relationships with major suppliers or customers;
- The nature of the major investors in the company;
- The company's cost structure and financial condition;
- The attractiveness of the industry segment; and
- General risks, conditions and developments in the industry in which the company operates (as well as company-specific risks, such as failures to ship product, delays in product development, etc.).

The company's board of directors should also consider analyzing the following factors:

- The company's performance, both historically and prospectively and the ability to generate sufficient revenue or to raise necessary capital;
- The company's stage of development and associated risks (for example, product development risks, manufacturing risks, lack of backlog, etc.);
- Valuations of the company performed by a third party, if any; and
- Significant "arms-length" transactions in the company's securities between the company and third parties.

It is important that the board of directors create a record of its valuation deliberations, particularly as the company approaches the point in time when a public offering is a realistic possibility within an 18 to 24 month horizon. The record will serve to support the company's position that its valuation determinations are based on concrete analyses rather than unprincipled rules of thumb, and it will also make it easier for the board and company counsel to respond in a detailed fashion to the SEC's cheap stock comment(s).

In cases where the SEC has asserted that exercise prices were below the fair market value of the stock, the SEC will require the company to record a compensation expense equal to the difference between the deemed fair market value of the underlying stock at the time of grant and the exercise price, typically amortized over the vesting periods of the applicable options. The SEC conducts its cheap stock analysis for a period of time preceding the effective date of the offering. Typically this period is from 12-18 months prior to the offering, though there are occasional instances in which the SEC will look back over a longer period of time. The SEC's positions have become increasing strict over the past few years. In addition to becoming more aggressive on the period of time leading up to the IPO over which option grants are examined, the SEC has also changed from comparing option exercise prices to the low point of the proposed offering price range to the mid-point of that range. Depending on the level of option activity at a given company, compensation charges resulting from SEC cheap stock scrutiny can materially change the company's reported financial results and negatively impact valuation in the IPO. Charges have ranged from *de minimus* to over $160 million.

The cheap stock issue is sometimes the most significant issue debated between the company and the SEC during the offering process, and can require many communications between the company and the SEC before resolution. Since this review cycle takes time, a company may want to consider ways to shorten the process. One approach is for the company to acknowledge that options were granted with an exercise price lower than the fair value of the common stock and proactively recognize a compensation charge prior to the initial filing of the registration statement. The theory underlying this approach is that the company will have taken a reasonable proactive step to address the SEC's potential concerns, and that the resulting compensation charge represents a more defensible position.

As an alternative or complementary strategy, the company can consider preemptively filing with the SEC simultaneously with the initial filing of the registration statement or shortly thereafter (in any event prior to receiving the SEC's first round of comments) a detailed analysis that describes how the company has determined the fair value of its common stock over the 12-18 months prior to the commencement of the offering, and defends those determinations with references to company-specific credible evidence. One factor that could delay the ability to file a preemptive analysis letter is that underwriters often want a company to file the initial registration statement without a price range for the offering. Without this

price range, the SEC cannot effectively analyze the cheap stock issue. Notwithstanding the lack of a price range in the initial filing, a cheap stock analysis filed by letter can assure a broad price range.

Practical Tip: Avoiding the Cheap Stock Timing Trap with the Preemptive Strike

A company may choose to accelerate the determination of whether there is a cheap stock issue, and if so, the magnitude of the issue. Companies often wish to print their preliminary prospectus based on the prospectus included in the first pre-effective amendment of the registration statement, which is the amendment including the responses to the SECs first round of comments to the registration statement. Absent an acceleration of the cheap stock dialog, as described in the text above, at the time a company desires to print preliminary prospectuses, its only indication of the SEC's comfort with the company's cheap stock position is a generic initial comment regarding the exercise price of stock options (the comment would simply ask the company to explain its cheap stock position).

The SEC would not be commenting based on an understanding of the analysis that the company had undertaken (because the SEC would not have received that analysis yet).

If a company accelerates the process, as described in the body of the text above, it could cause the SEC's first comment letter to include a specific reaction by the SEC to the company's cheap stock analysis. This means that, at the time of the company's decision whether to print preliminary prospectuses, the company will have the benefit of having some indication of how far apart the company and the SEC are on this important issue. The risk of printing without this information is that it may turn out that the SEC will require a material additional compensation charge after the printing of preliminary prospectus, which could require the company to reprint and re-circulate the preliminary prospectus, which is expensive and could delay the timing of the offering.

Regardless of whether or not the company believes that its option pricing history is defensible, the cheap stock issue is a complicated one in which the company's legal and accounting advisors should be deeply involved in the analysis and strategy.

It is worth noting that the accounting treatment of option grants is likely to change in the not-too-distant future. There have been several significant developments relating to accounting for stock options. In March 2004, FASB issued an exposure draft of a proposed Statement of Financial Accounting Standards – "Share-Based Payment," which proposes to amend FASB Statements No. 123 and 95 and addresses a wide range of equity-based compensation arrangements. Under the proposal, all forms of share-based payments to employees, including stock options, would be treated the same as other forms of compensation by recognizing the related cost in the income statement. The expense of the award would generally be measured at fair value at the grant date and, in effect, results in a compensation charge that will lower a company's net income or net income per share. Current accounting guidance requires that the expense relating to most stock options only be disclosed in the footnotes to the financial statements. The final rules are expected in late 2004, which would be effective in 2005 for publicly traded companies and 2006 for privately held companies.

In anticipation of the FASB proposal, two separate legislative proposals were introduced in the U.S. Congress that could trump FASB's efforts: the Broad-Based Stock Option Plan Transparency Act of 2003 (the "Transparency Act") and the Stock Option Accounting Reform Act of 2003 (the "Reform Act"). The Transparency Act is designed to ensure that stockholders and potential investors have accurate and meaningful financial information and yet enable companies to continue granting stock options. The Transparency Act proposes a three-year moratorium of any new standard while the SEC conducts a study of the economic impact of any such accounting change. The Reform Act, which was applauded as a reasonable compromise by the National Venture Capital Association (NVCA) and a large number of emerging growth companies in the U.S., proposes a limit on stock option expensing to options granted to a company's top five executives. However, the Big Four accounting firms sent a letter to the U.S. Congress urging members to refrain from blocking FASB's proposals.

There are several schools of thought regarding what privately held companies should do before the FASB proposal rules take effect. While many companies may retain their existing equity compensation practices, other companies are taking measures to adopt alternative equity award programs or modifying existing programs to reduce the potential impact of the proposed rules.

Deemed dividends; discount on sale of equity to strategic partners

In recent years, the SEC has extended the cheap stock concept to sales by the company to outside investors. Under this type of analysis, the SEC takes the position that sales of stock during the time preceding an IPO (usually within six months of filing the registration statement) were made at a price less than the fair value of the stock and requires the company to record a one-time "deemed dividend" charge – in essence, saying that the company paid a dividend to the investors in an amount equal to the difference between the price paid and the deemed fair market value.

The SEC looks most closely at rounds of financing led by existing investors in the company under the theory that the transaction may not have been at arm's length and that the investors may have used their position to buy stock at a discounted price. However, the SEC has required a deemed dividend charge even with respect to some transactions in which a company has no discernible incentive to sell its stock to investors at a reduced price. For example, one company recorded a charge of over $65 million in connection with its first registration statement filing. The charge related to the sale of preferred stock three months before the filing to a group led by outside financial investors. Unfortunately, for both the investors and the company, the eventual IPO price was significantly less than the price paid by these investors, but the charge remained on the books.

The SEC also closely scrutinizes sales to investors who also have a commercial relationship with the company (for example, customers and suppliers). The assumption is that the negotiated price does not represent the true fair value of the stock because the strategic partner is otherwise transferring value to the company in exchange for a reduced purchase price. If the relationship with the strategic partner yields revenue for the company, the SEC may require the company to reduce revenue in an amount equal to the deemed discount. In other cases, the charge will increase the cost of revenue or an operating expense line item. The charge is usually amortized over the life of the contract.

Defensive measures

Once a company's stock becomes publicly traded, the company can be vulnerable to unwanted takeover attempts. Some of the lessons to be learned from hostile transactions (or attempted transactions) during

recent years include: size alone is no defense; stock may be used in hostile takeover attempts; aggressive agitators can become catalysts for stockholder action and can provoke corporate change; foreign companies are a threat; and cross-border issues will not deter a buyer coveting a strategic asset at a compelling value. The goal of defensive measures is to enable the company to control the timing and process of unsolicited takeover bids and to encourage bidders to negotiate with the company's board of directors. A defensive measure is not intended to, and will not, preclude all unsolicited takeover bids.

There are numerous defensive measures that can give the company procedural advantages in ensuring that the stockholders are not subject to abusive takeover tactics and that make a hostile takeover more difficult and costly to complete. These measures include undesignated preferred stock, stockholder rights plans (also known as "poison pills"), certain charter and bylaw amendments, option acceleration provisions, golden parachutes, elimination of cumulative voting, a classified board of directors, a dual class stock structure (with one class of stock, which is not publicly traded, having super voting rights) and many others. Several of these measures are discussed below.

Classify the Board of Directors. A corporation can divide its board of directors into two or three classes of directors, with the term of office (in years) for directors equal to the number of classes, and the election of each class to occur in staggered years (for example, the term of directors in the first class to expire at the next annual meeting following the adoption of the classified board, the second class one year thereafter and the third class two years thereafter). By so dividing the board into classes, only the members of one class of the directors are up for re-election in any given year. In connection with the classified board, the company may also provide in its charter documents that directors may only be removed by stockholders for cause (in some states, this automatically results from opting for a classified board). Classifying the company's board of directors may increase continuity of board membership, make it harder for a stockholder to acquire control of the board in one election, give time for a long-term strategic plan to be implemented, and prevent some types of unfriendly creeping acquisitions or partial bids for control or other abusive takeover tactics. Critics of classified boards argue that it is more difficult to hold directors accountable for their actions when they are up for election only every two or three years.

Board Size and Vacancies. A company may amend its charter documents to vest solely in the board the power to change the size of the board of directors and to fill any vacancies (other than following removal by a vote of stockholders). These provisions, together with supermajority requirements to amend such provisions in the charter documents (discussed below), protect against expansion of the board by a simple majority stockholder vote and allow the board to control who fills all vacancies other than those created by a stockholder vote.

Eliminate cumulative voting. Where cumulative voting by stockholders is required or permitted in the election of directors, a stockholder can cast a number of votes equal to the product of the number of directors to be elected multiplied by the number of votes to which the stockholder's shares are entitled, and allocate those votes all to a single candidate or distribute the votes among as many candidates as the stockholder thinks fit (not to exceed the number of board seats up for election). This type of voting can allow a minority stockholder to gain board representation. A company should consider the benefits of eliminating cumulative voting, if possible.

Eliminate ability of stockholders to act by written consent. A company may provide in its charter documents that stockholders may not act by written consent. As a result, stockholders of the company would only be able to act at a meeting duly called and held in accordance with the company's charter documents, the applicable state corporation law and the proxy rules under the federal securities laws. These amendments help to prevent a small number of investors that hold a majority of the outstanding shares of the company from acting quickly to take corporate action that may or may not be in the best interests of the company or the minority stockholders. In addition, these amendments ensure that all stockholders are entitled to consider and vote upon a stockholder proposal.

Eliminate right of stockholders to call special meetings. A company's charter documents can eliminate the ability of the stockholders to call special meetings. This would mean that a stockholder would have to wait until an annual meeting or a special meeting called by the board of directors to bring a proposal for stockholder approval. This is likely to prevent a majority stockholder or proxy contestant from forcing stockholder consideration of a proposal before the board has had an opportunity to review the proposal.

Require specific advance notice for director nominations and stockholder proposals. A lengthy advance notice provision for director nominations and stockholder proposals for consideration at stockholder meetings allows a company and its board of directors an adequate amount of time to prepare before these nominations or proposals come before the other stockholders.

Create a class of undesignated preferred stock. A company may authorize in its certificate of incorporation a class of undesignated preferred stock (often referred to as "blank check preferred"). This class of undesignated preferred stock enables the board of directors, without any action by the stockholders, to create one or more series of preferred stock, to establish the terms of each such series and to issue (or reserve for issuance) the shares of each such series. This gives the company a high degree of flexibility to rapidly issue securities with terms different than those of common stock. This flexibility can be very important in acquisitions, in financing transactions and in other strategic transactions where a company wishes to issue securities to one or more parties.

Blank check preferred also enables the board of directors to implement a stockholder rights plan (often referred to as a "poison pill") without stockholder approval. The primary goal of a stockholder rights plan is to encourage potential bidders to come to a company's board of directors with an acquisition proposal and negotiate, rather than going directly to stockholders with a tender offer. The existence of a stockholder rights plan helps to discourage inadequate bids, and gives the board the opportunity to adequately evaluate an acquisition overture and take steps to maximize stockholder value. A rights plan can have this effect because of its potential to make it financially unattractive for someone to acquire the company without approval of the board of directors. A stockholder rights plan is usually implemented through the issuance of a pro rata dividend of rights to acquire a newly designated series of preferred stock of the company or, under certain circumstances, another company involved in a business combination with the target at a designated price.

Supermajority vote for certain amendments to the company's certificate of incorporation and bylaws. Most of the defensive measures discussed above are implemented through the company's charter documents. The certificate of incorporation and bylaws generally can be amended with a vote of stockholders holding a majority of a company's outstanding stock. To provide the company with additional protection, the company may amend its charter documents to include a supermajority (often 66-2/3% or

some other percentage in excess of a simple majority) vote requirement for any proposed future amendments to the sections of the charter documents that implement the defensive measures discussed above. The absence of super-majority voting provisions could make it easier for a hostile third party to eliminate defensive protections.

Statutory anti-takeover measures. In addition to the protections discussed above, depending on a company's state of incorporation, the company may be subject to the protection of a state anti-takeover statute. These provisions generally prohibit mergers, sales of material assets and certain other specified transactions between the company and a holder of a threshold percentage of the company's outstanding voting stock for a number of years following the date on which the stockholder became a holder of the significant percentage of the outstanding stock, subject to certain qualifications. The ban typically does not apply if (1) the proposed transaction by which the stockholder became a significant stockholder is approved by the company's board of directors prior to the date on which the stockholder became a significant stockholder, (2) the transaction involves a business combination approved by the board of directors of the company or by holders of the outstanding voting stock not owned by the significant stockholder, or (3) the company elects under certain circumstances to exclude itself from the coverage of the anti-takeover statute. These statutes vary from state to state, and companies should consult with counsel about whether the company's state of incorporation has an anti-takeover statute and how it works.

Most defensive measures can be implemented at any time, provided the company can obtain the required corporate approvals. However, adopting them while the company is private has certain advantages. Any necessary stockholder approval can be obtained more easily before the company becomes public and has institutional stockholders and before it is required to comply with the proxy solicitation rules applicable to public companies. Many institutional investors vote against the implementation of additional defensive measures because they believe such measures may deprive them of a change in control premium for their shares. In addition, a court is more likely to enforce a mechanism that is implemented following careful and orderly consideration by the board, rather than one that is hastily adopted in the face of a particular threat.

The existence of, or absence of, defensive measures could in theory have an effect on the success of an IPO. After all, the institutional investors who typically vote against the implementation of defensive measures are often the same institutional investors to which the company's underwriters are attempting to sell shares in the IPO. However, as a general rule the existence of most typical, middle-of-the-road defensive measures such as a classified board and blank check preferred at the time of an IPO will not have an adverse effect on the marketing of the IPO. An exception to this rule is the stockholder rights plan; conventional wisdom has been that the existence of a stockholder rights plan at the time of an IPO generally does have an adverse effect on the marketing of the IPO.

Each of the defensive measures mentioned above are highly specialized topics, and the formulation of an effective package of defensive measures should be discussed in detail with the company's counsel and investment bankers. Additionally, the implementation of defensive measures requires analysis of and advice regarding the fiduciary duties of the company's board of directors.

Review and amendment of charter and bylaws

The company's certificate of incorporation and bylaws may have been adopted many years prior to the IPO and may contain a number of artifacts from early rounds of financing or other provisions that are obsolete and no longer appropriate for a public company. The company and its counsel should review these charter documents and amend them as necessary as part of its pre-IPO corporate housekeeping.

Third-party consents

The company may have lines of credit with banks or other agreements with third parties that require consent to certain actions contemplated in connection with the IPO. For example, even if the IPO itself does not require any third-party consents, a reincorporation might require approval under certain bank covenants, or naming a customer in the prospectus might require the customer's approval. Also, a company is often required to file its customer, strategic partner, distributor and other agreements with the SEC because of their materiality to the company. These agreements often contain confidentiality provisions that require the consent of the other party. The company will also need to obtain consents from customers to include their logos or case studies in the company's

prospectus. If the company decides to include statements and statistical data from market research firms, it will need consents from those parties as well. In seeking such consents, the company should request that the third parties keep the company's IPO plans confidential.

Settlement of claims

If a company has outstanding disputes, it should consider how the IPO might change its negotiating position and what steps can be taken to resolve the disputes before the company's IPO plans become known. Litigants may be less likely to settle for a reasonable amount once the company has large cash reserves. Disputes regarding ownership of stock, intellectual property or other significant rights may create marketing problems for a company in the IPO, lowering its valuation or making a successful IPO impossible. Material unresolved disputes generally must be disclosed in the prospectus.

Qualifications to do business

The company should confirm that it and all of its material subsidiaries are qualified to do business and are in good standing in all jurisdictions where their respective activities require that they be so qualified. Although this is primarily an administrative task, getting everything in order can take a significant amount of time, especially if foreign country jurisdictions are involved, and may involve the payment of back-taxes or late fees in the event required qualifications were neglected. The underwriters will expect certificates of good standing from each applicable jurisdiction to be delivered at the closing of the IPO.

Income and sales tax

Another corporate housekeeping item that may require some lead time is confirming that the company is current in the payment of all of its income and sales taxes.

Draft of the registration statement

Having a good first draft of the registration statement available for the working group early in the registration process can shave many days, and sometimes weeks, off of the drafting timetable. Although the final version may bear little resemblance to the initial draft, the information contained in a good first draft will give the group something to react to

and will make subsequent due diligence meetings and drafting sessions more productive. Sections that are particularly useful to have available early in the process are the financial statements and "Business," "Risk Factors" and "MD&A."

Confidential treatment

The company may be required to file with the SEC certain of its contracts as exhibits to its registration statement. SEC rules require a company to file all contracts "not made in the ordinary course of business which are material to the company and are to be performed in whole or in part at or after the filing of the registration statement…or was entered into not more than two years before such filing." If the contract is such as ordinarily accompanies the kind of business conducted by the company, it will be deemed to have been made in the ordinary course and need not be filed with the SEC *unless* it falls within one of the following categories, in which case it must be filed except where immaterial in amount or significance to the company:

- any contract to which directors, officers, the underwriters, stockholders named in the registration statement and certain others are parties, subject to certain exceptions;
- any contract upon which the company's business is substantially dependent (for example, continuing contracts to sell the major part of the company's products or services or to purchase the major part of the company's goods, services or raw materials or any license agreement to use a patent, trade secret or other intellectual property right upon which the company's business depends to a material extent);
- any contract calling for the acquisition or sale of any property, plant or equipment for a consideration exceeding 15% of the fixed assets of the company (on a consolidated basis); or
- any material lease under which a part of the property described in the registration statement is held by the company.

Regardless, any management contract or any compensatory plan, contract or arrangement in which any director, the CEO or any of the other four most highly compensated executive officers of the company participates

is deemed material and must be filed. Other such management contracts or compensatory plans must be filed unless immaterial in amount or significance to the company.

Once the company files a contract with the SEC, the contract is publicly available on the SEC's EDGAR web site. However, the company may request confidential treatment for certain portions of exhibits, particularly financial and technical details, so long as the disclosure of the information would be harmful to the company and is not necessary for the protection of investors. The process of obtaining confidential treatment can be time consuming and should be started as early as possible to ensure that the initial request can accompany the initial filing of the registration statement (or shortly thereafter). This process is discussed in greater detail in Chapter 8.

Mezzanine and other financing considerations affected by an IPO

Some companies raise additional equity capital as they are nearing the IPO, either to bolster the balance sheet or to bring in strategic investors. During the late 1990s, some companies had to raise capital before filing their registration statements to avoid a qualification in the audit of their financial statements as to the company's ability to finance its future operations, and obviously it is important that the company make a determination regarding its capital (or strategic financing) needs early on in the process and ensure that it conducts any such fund-raising activities carefully so as to avoid violation of SEC rules.

The SEC's integration doctrine. In general, a company may only offer and sell securities either (1) pursuant to an effective registration statement filed with the SEC or (2) pursuant to a valid exemption from the registration requirements (typically, a private placement exemption). In determining whether a private placement of securities has a valid exemption from registration, the SEC will review not only the private placement at issue but also any offering of securities that occurs within six months before and after the private placement. In the event of multiple offerings occurring within six months of each other, the SEC may view the offerings to be integrated. In other words, the SEC may consider the offerings as one, single offering for purposes of determining securities law compliance. The integration of multiple offerings can have the effect of destroying the availability of a valid exemption for the current transaction but also of retroactively invalidating the exemption upon which the

earlier offering relied. This issue took on increased importance for companies caught in the IPO market slowdown that began in late 2000. Some of these companies, after beginning the IPO process, find themselves needing to raise money from private sources.

The integration question arises most often in three public offering contexts: (1) where the company wishes to make a private offering contemporaneously (or nearly contemporaneously) with the IPO; (2) where the company wishes to make a private offering after it has abandoned its IPO; and (3) where the company wishes to proceed with its IPO after it has abandoned a private offering.

Private offerings completed before registration statement is filed. Companies that complete a private financing prior to filing their registration statements can benefit from the safe harbor protection from integration offered by Rule 152 of the Securities Act.

Contemporaneous private and public offerings – Black Box. Absent a six-month interval, the question of whether two offerings should be integrated is generally a fact-based analysis using five factors outlined by the SEC in 1962. These five factors are whether: (1) the offerings are part of a single plan of financing; (2) the offerings involve the issuance of the same class of security; (3) the offerings are made at or about the same time; (4) the same type of consideration is being received; and (5) the offerings are made for the same general purpose. Rule 152 of the Securities Act provides a safe harbor from the subjective application of these five factors relating to the potential integration of certain completed private placements with a company's subsequent IPO, even though the offerings may be nearly contemporaneous in time.

Most private offerings to investors while a company is in registration to go public would fail a straightforward application of the five-factor test. However, the SEC provided significant relief to companies with the issuance of the *Black Box* and *Squadron, Ellenoff* line of no action letters. Among other important guidance given, the SEC in *Black Box* expanded the safe harbor for private offerings completed prior to the initiation of an IPO by stating that a private offering will be deemed completed (even if not closed) if the only closing conditions that remain are ones beyond the control of the investors.

The *Black Box* no-action letter, as supplemented by *Squadron, Ellenoff,* also provides a means of effecting a contemporaneous private placement transaction (which can be initiated and closed during any part of the

registration process) to "qualified institutional buyers" (QIBs) and no more than three "large institutional accredited investors." Therefore, companies have relied on the *Black Box* approach to issue securities to up to three strategic partners who represent that they are QIBs or institutional accredited investors either during the registration process or concurrently with the closing of the IPO.

Private offering following an abandoned IPO. Once the IPO market began to deteriorate in late 2000, and valuations of numerous companies fell, many companies that were in the process of going public were forced to postpone those plans indefinitely and withdraw their registration statements. Many of those companies still needed to raise money but faced significant integration concerns. Companies were required to wait for up to six months before initiating a private offering following an abandoned public offering. In response, the SEC adopted Rule 155, which allows a company to pursue certain types of private offerings following an abandoned public offering without fear of integration with the abandoned public offering so long as certain specific conditions set forth in the rule are met. The intent behind these conditions is to ensure that investors in the private offering fully understand that the abandoned public offering was separate and distinct from the private offering and that the protections of Section 11 of the Securities Act that would have been available to them in the abandoned public offering will not be available to them in the private offering.

Abandoned private offering followed by an IPO. Rule 155 also provides integration relief for companies wishing to begin the public offering process after abandoning a private offering. A private offering will not be integrated with a public offering in this situation so long as certain specific conditions set forth in the rule are met. The intent behind these conditions is to ensure that investors in the public offering fully understand that any offers to sell securities in the abandoned private offering are withdrawn and are distinct from the offer to sell stock in the public offering. Rule 155 permits most companies to commence their IPOs immediately following the abandoned private offering subject to satisfying the conditions of the rule.

Chapter 4*

D&O Liability Insurance

When a company considers an initial public offering, a question that will be in the forefront of the minds of current and potential board members will be: "What is the nature of the company's director and officer (D&O) liability insurance?" During the period leading up to an IPO, board members will be particularly concerned with D&O insurance because the chances that a company will be sued by its stockholders increases substantially once the company's shares are publicly traded and because there is a chance that the directors will be personally named in such a lawsuit. One way to recruit and retain board members, especially independent directors, is by offering them the best possible D&O insurance available.

The Need for D&O Liability Insurance

D&O liability insurance is a form of insurance that will respond when a company and/or its directors and officers are named in a lawsuit for certain alleged actions or omissions. Federal securities class action litigation is the main type of suit that is brought against a company and its directors and officers. Officers and directors of companies undertaking an IPO have particular reason to be concerned about this type of lawsuit: a securities class action lawsuit is more likely to be filed within three years of an IPO than at any other time. This type of suit is most likely to occur when there is a precipitous decline in a company's stock price. The average stock price drop of companies against which all federal shareholder class action lawsuits have been filed since the passing of the Securities Litigation Reform Act in 1995 has been 58.8%.

These lawsuits are of great concern for companies because the trend in average cash settlements has been upward. The average cash settlement in 1996 was $6.4 million, compared to $22.9 million in 2003. One way to avoid paying a settlement in these types of cases is by having the case

* The authors wish to thank Priya Cherian Huskins for preparing the initial draft of this chapter. She was an associate at Wilson Sonsini Goodrich & Rosati from 1997 to 2003, and is currently a Vice President at Woodruff-Sawyer & Co., an insurance brokerage that specializes in D&O liability insurance. The authors also wish to thank Woodruff-Sawyer & Co. for making their database available for use in preparing this chapter.

dismissed. Lawsuits brought in the months following an IPO tend to be brought under Section 11 of the Securities Act and they have a lower dismissal rate because the pleading standards under Section 11 are easier for plaintiffs to satisfy as compared to other civil liability provisions of the federal securities laws. (Section 11 is discussed in greater detail in Chapter 7.) Another reason these lawsuits are of great concern to companies is that they often take years to settle, resulting in legal defense fees in the millions of dollars.

An increasingly common type of suit being brought against officers and directors is the derivative suit. Derivative suits are brought in state court by a stockholder on behalf of a corporation. In these suits, the stockholder alleges that the officers and directors who are the subject of the suit have breached a fiduciary duty owed to the company and its stockholders, and must disgorge their wrongful gains back to the company. Like federal securities class action lawsuits, these suits can be extremely expensive for a company to defend.

Most companies have indemnification agreements with their directors and officers that obligate the company to indemnify them in the case of securities litigation. Nevertheless, directors and officers usually require the company purchase D&O insurance as a form of balance sheet protection as well as to protect themselves if, during the midst of a long-running lawsuit, the company itself becomes financially unable to indemnify its directors and officers.

Outline of a D&O Insurance Policy

Most D&O liability insurance policies are claims made policies, as opposed to occurrence policies. When a policy is a claims made policy, the policy that responds is the one that was in effect at the time the claim was made; in contrast, with an occurrence policy, the policy that responds is the one that was in effect at the time the occurrence took place. Despite being claims made policies, D&O insurance policies often have a past acts clause, which means that when a D&O insurance policy has a past acts date, the policy will not respond to a claim that is made during the policy period if the claim relates to an occurrence that took place before the past acts date. It is important to keep this in mind as a company assesses its potential exposure and the timing of any claims that may arise.

Practical Tip: Past Acts Date

A common mistake that can be made in obtaining D&O insurance coverage for a company undertaking an IPO is to have a past acts date that is the effective date of the IPO registration statement. While such a past acts date ought to result in a lower premium, the result of such a past acts date would be to exclude from coverage anything relating to the preparation of the IPO prospectus. This is because the prospectus was prepared before the date of the IPO effective date.

To understand the coverage provided, one must keep in mind that each D&O insurance policy is divided into three parts. Side A Coverage is that part of a D&O policy that protects directors and officers directly by responding to those claims for which a company cannot indemnify its officers and directors. This circumstance can arise as a matter of law (for example, in the case of derivative lawsuits or because a company is in bankruptcy).

Side B Coverage is that part of a D&O policy that protects directors and officers indirectly by reimbursing the company for those claims for which the company is obligated to indemnify its directors and officers. This is typically the case with federal securities class action litigation.

Side C Coverage (also known as "Entity Coverage") in a D&O policy responds to securities claims made against the company. This coverage fills what might otherwise be a gap created by Side B Coverage. Side C Coverage was created because in a typical federal securities class action lawsuit, the company is a named defendant along with the directors and officers. If an insurance policy does not have Side C Coverage, the insurance carrier and the company have to negotiate what portion of defense costs and the settlement is to be allocated to the company and what portion is to be allocated to the directors and officers. This will be a contentious negotiation because any portion of the suit that is allocated to a company without Side C Coverage is a portion the insurance company does not have to pay. Purchasing Side C Coverage eliminates this area of dispute.

The inclusion of Side C Coverage carries with it a risk, however, that if a company were ever to enter bankruptcy, the bankruptcy trustee may seize the insurance policy proceeds for the bankruptcy estate and leave the directors and officers without coverage. Although there is no controlling case law on this point, legal experts agree that there is a higher probability that that a bankruptcy judge will allow a bankruptcy trustee to seize all the proceeds of an insurance policy if the policy includes Side C Coverage. This is because the now-bankrupt company paid for the insurance policy and is an insured party under the policy. Therefore, the insurance policy may be viewed by the bankruptcy court as an asset of the now-bankrupt company and not an asset of the directors and officers. Although not yet settled in case law, it is widely held that deletion of Side C Coverage from the D&O policy will decrease, if not entirely remove, the possibility of the policy being seized in a bankruptcy and therefore preserve coverage for the directors and officers in a bankruptcy.

Typically, bankruptcy is not a concern of a company that is about to embark on an IPO. Thus, most companies planning to undertake an IPO would purchase an insurance policy with Side A Coverage, Side B Coverage and Side C Coverage.

To further understand the policy, one must examine the policy exclusions carefully. These are items that the insurance policy will not cover, notwithstanding that the item might otherwise seem to be covered by an insuring agreement. One exclusion that will appear on all D&O insurance policies is an exclusion for fraudulent or dishonest conduct. This exclusion exists as a matter of public policy, so no insurance carrier can insure for these items. The critical concern here, however, is the point at which conduct becomes excluded. For example, if the conduct can only be excluded after a final adjudication, then clearly all defense costs will be advanced by an insurance company until the final adjudication is made. Other typical exclusions are those for which other types of insurance can be purchased. Examples of these are ERISA claims and pollution claims.

Another area for critical analysis in a D&O insurance policy is the definitions. Often the definitions that are provided by an insurance company in its policy form can be beneficially amended by endorsement. For example, since an insurance policy covers claims, it is helpful to the company if the claim is defined as broadly as possible. An experienced D&O insurance broker will be able to provide guidance on the types of definition modifications that are available from each insurance carrier.

Selecting the Right Broker

When selecting a D&O insurance broker, a company's management team must keep in mind that the market for D&O insurance is complex. Each company's policy is a highly customized, heavily negotiated contract, and the pricing for D&O insurance is similarly specialized. As a result, to get the best advice possible, a company will often choose a D&O broker with specific expertise in the D&O markets, thereby using a different insurance broker for its D&O insurance than for its other lines of insurance.

A good D&O insurance broker should be able to give the company specific recommendations for limits of liability that are based on historical data and provide guidance on the important terms and conditions in a D&O insurance contract. A company's D&O insurance broker should also be able to provide a company with information and advice on alternative vehicles to D&O insurance that can help control cost. At the same time, a company's D&O insurance broker should offer loss control and risk management consulting that can drive down a company's overall D&O insurance premium. Finally, a D&O insurance broker should supply the company with information about each potential insurance company's claims history, financial stability and rescission history. A good place to start for recommendations for D&O insurance brokers is the company's legal counsel.

Practical Tip: Avoid Sending Multiple D&O Insurance Brokers Into the Insurance Market

In an effort to obtain the best price for a company's D&O insurance, some companies will consider a strategy of asking multiple D&O insurance brokers to place the D&O insurance. However, insurance companies will only give quotations for a specific company to a single broker. D&O insurance is heavily market driven, insofar as the broker approaches multiple insurance companies and tries to build their interest in insuring the company. The greater the number of interested insurance companies (that is, the more competition for the company's insurance risk), the lower the premium and the better the terms and conditions of the insurance contract will be for the company. If a company asks more than one broker to go into the market, each broker will necessarily be limited in his or her ability to drive down costs as effectively as a single broker with quotations from all of the insurers. Accordingly, to obtain the best price for D&O insurance, a company should avoid asking multiple brokers to place its D&O insurance.

The Insurance Process

A company should select its D&O insurance broker at least a couple of months prior to the initial filing of the registration statement for the IPO. During the time leading up to the IPO, the broker will work with the company and its counsel to develop an appropriate D&O insurance program for the company. This work includes providing the company with guidance on items of corporate governance about which D&O insurance company underwriters are particularly sensitive, such as corporate communications policies and insider trading policies, and the adoption of controls and procedures in compliance with the Sarbanes-Oxley Act of 2002. Also during this time, the D&O insurance broker in conjunction with the company's management team should give a company's board of directors a presentation on the company's plans for its D&O insurance. The majority of the work taking place during this time, however, is done behind the scenes by the D&O broker who is using this time to build a company's insurance program, usually with multiple insurance compa-

nies. For example, a company that seeks to obtain $20 million in liability limits might put together its insurance program with as many as four different insurance companies.

Other items that should be considered during this time are concepts such as coinsurance and setting high self-insured retentions. Coinsurance refers to a company's sharing a portion of all losses with the insurance company. Self-insured retentions are dollar thresholds under which an insurance policy would not pay. Having coinsurance and a high self-insured retention are two ways to bring down the cost of D&O insurance.

It is also during this time that management and its board of directors would want to consider alternatives to traditional D&O liability insurance, such as Side A only insurance and independent director liability insurance. Side A only insurance can be a way to save money for a company that does not seek balance sheet protection in the case of an indemnifiable lawsuit such as federal securities class action litigation. Independent director liability insurance polices are insurance policies that are designed specifically to cover independent directors and no one else.

Part of the process of building the final form of the insurance program often involves members of a company's senior management team speaking directly with insurance underwriters. These telephone calls or in-person meetings, which are all conducted under strict non-disclosure agreements, allow insurance underwriters to get a better feel for management as well as to obtain detailed information that may not be available in the IPO prospectus. These telephone calls and meetings also give management the opportunity to explain to insurance underwriters why the company is a good risk for the insurance company.

The entire insurance program should be completed – except for the actual binding of policies – before the CEO and the CFO leave for the roadshow. This work includes the completion of all insurance applications, which are long forms that will be time consuming to complete.

The D&O liability insurance application for a company about to go public will contain a number of representations and warranties that are the basis of the insurance company's decision to issue the insurance contract at the agreed-to premium. Misrepresentations or omissions in the application can lead to the rescission of an insurance contract, which would leave all directors and officers without insurance coverage. Therefore, the application process must be taken seriously. Companies will

often poll members of the senior management team, the entire legal and finance departments, and all the members of the board of directors in advance of completing the application to make sure that the application is as complete and thorough as possible. In addition, between the date on which the application is signed and the date of the IPO, the company has a duty to update its insurance companies on any changes to the application, such as any new litigation against the company.

The final order to bind a company's D&O insurance will be placed immediately prior to pricing. This timing ensures that there is D&O insurance coverage from the moment a company's directors and officers have public company liability exposure, but also that the company is not paying for D&O liability insurance before it is needed.

Chapter 5

Managing Publicity during the Offering Process

The federal securities laws are designed to ensure that a public offering is made only by means of a prospectus that contains disclosure required by SEC rules and that is subject to review by the SEC. When a company engages in other publicity near the time of its public offering, there is a concern that the company may be using other means to draw attention to itself and encourage the sale of its stock. The boundaries of what is permissible vary according to the stage of the offering.

The Pre-Filing Period; Gun Jumping Concerns

Overview

Prior to the time that a company has filed a registration statement with the SEC in connection with a public offering of its stock, any offer to sell or solicitation of an offer to buy the company's stock is forbidden (with narrow exceptions for offers such as grants of employee stock options). The Securities Act definition of "offer" is broad, is not intended to be exclusive, and includes "every attempt to offer to dispose of, or solicitation of an offer to buy, a security or interest in a security, for value." In addition, the SEC has further broadened the definition by including activities that condition the market for the securities to be sold in the offering. Therefore, publicity that may increase public interest in an offering of the company's stock is forbidden during the pre-filing period.

Exactly when the pre-filing period begins is not always clear. At the latest, a company should consider itself as being in registration and subject to the SEC's pre-offering publicity rules when the company has selected the managing underwriters and has reached an understanding with them to proceed with the IPO; this may be well in advance of the organizational meeting. As soon as a company begins to seriously contemplate its initial public offering, it should meet with its counsel to establish appropriate publicity guidelines, since press releases, presentations, advertising and interviews can all lead to potential problems discussed in greater detail below.

Exceptions to the definition of "offer" and the Rule 135 press release

There are two generally applicable exceptions to the definition of offer. The first applies to preliminary negotiations with underwriters. The second exception is found in SEC Rule 135, which permits the company to announce its proposed IPO so long as it contains only the information permitted by the rule. However, there is no legal requirement for a company to make a pre-filing announcement of its intention to make a public offering. In fact, such an announcement is rarely made unless it becomes necessary to end inquiries and conjecture. If a pre-filing announcement of a proposed offering is made, Rule 135 requires that the announcement state that the offering will be made only by means of a prospectus; it must not contain anything more than the specific items of information enumerated in the rule; and it must not identify the underwriters or describe the company's business. Any such announcement should be prepared with the assistance of counsel to ensure compliance with the rule.

Guidelines for managing publicity during the pre-filing period

Where does a company draw the line between publicity about a proposed offering and legitimate marketing and public relations activities necessary to carry on the company's business? Most companies cannot afford to eliminate communication with the outside world during the registration process, and this is not what the securities laws require. On the other hand, a company cannot condition the market for its securities by dressing up hype as legitimate business news.

Practical Tip: Striking a Balance

The SEC has provided guidelines for striking a balance between impermissible hype and legitimate business communications. Under these guidelines, a company may continue to issue press releases with respect to factual business and financial developments, continue to advertise products and services and continue stockholder communications, provided that:

- such disclosures are consistent with prior practice;
- such disclosures are in customary form;
- such disclosures do not contain projections, forecasts or valuations; and
- the content, timing and distribution of such disclosures do not otherwise suggest that a selling effort with respect to the company's stock is underway.

The first three points noted above are relatively easy to follow. The fourth point involves subjective determinations and an examination of motive. Companies sometimes attempt to time their offerings to coincide with major corporate events, such as the launch of a new product by the company or one of its largest customers. There is nothing wrong with a company delaying its offering until it has achieved a new milestone and can take advantage of a corresponding increase in its valuation. However, timing an offering to take advantage of publicity surrounding a highly visible event may prove to be a risky strategy if the SEC determines that the publicity was actually an attempt to generate interest in the company's IPO. The SEC has stated that the prohibitions on offers of a company's stock during the pre-filing period are "equally applicable whether or not the issuer or the surrounding circumstances have, or by astute public relations activities may be made to appear to have, news value."

Practical Tip: Avoiding Publicity Foul-Ups During the IPO

Executives do not always find the securities laws' restrictions on publicity to be intuitively obvious. A company will likely run afoul of the rules unless affirmative steps are taken to control publicity during the offering process and guidelines are communicated to all employees. To avoid inadvertent foul-ups:

- As soon as the company has decided to proceed with a public offering, the company should have its counsel visit the company and make a presentation explaining the restrictions on publicity;
- Executive officers should attend this tutorial, as should all other personnel or outside consultants responsible for public relations or marketing activities;
- The company should designate one person, usually the CFO or general counsel, to pre-approve all press releases, speaking engagements, interviews and major public relations and marketing activities occurring at any time during the offering process;
- Generally, all interviews with newspapers and business or financial magazines, and all speeches to groups covering the company's business or financial condition or outlook, should be prohibited after the decision to proceed with the IPO is made and prior to the effective date of the company's registration statement;
- The company should purge its web site of any information (including information on third-party web sites to which the company hyperlinks) that is inconsistent with its publicity policy and the company should also designate a person, usually the CFO or general counsel, to pre-approve all new content prior to its posting on the web site (all web site communications should be reviewed regularly, dated, evaluated for continued accuracy and relevance, and removed as they become stale or irrelevant); and

Practical Tip: Avoiding Publicity Foul-Ups During the IPO (continued)

- When the company announces to its employees that a public offering is being undertaken, it should also announce that all non-routine inquiries, including any inquiries from reporters, analysts or brokers, must be referred immediately to the designated publicity clearance person.

The SEC has long been concerned about companies conditioning the market prior to a public offering by generating publicity about the company or its financial prospects. Impermissible public announcements or disclosures during the registration process (referred to as "gun jumping") are considered illegal offers in violation of the securities laws. As a practical matter, statements made in the early stages of the offering process may have little impact by the time the company is ready for its registration statement to be declared effective. Nevertheless, a company should be careful about its publicity activities during all stages of the offering process. Interviews given early in the pre-filing period may appear in print shortly before the desired effective date. Regardless, gun jumping concerns at the SEC have intensified since the late 1990s.

Internet web sites

The company is responsible for the accuracy of its statements that reasonably can be expected to reach investors or the securities markets regardless of the medium through which the statements are made, including the Internet. For example, information posted on a company's web site will be deemed published in the same way as information contained in a press release, and the information will be considered continually republished so long as it stays posted on the web site. In other words, the federal securities laws apply in the same manner to the content of the company's web site as to any other statements made by or attributable to the company while in registration, including information on a third-party web site to which the company has established a hyperlink. The SEC staff has indicated informally that a company may archive old information, such as press releases, on its web site so long as the company indicates clearly that the information speaks only as of a certain date and that the

company will not update such information. Whether third-party information will be attributable to the company depends upon whether the company has involved itself in the preparation of the information or explicitly or implicitly endorsed or approved the information. Ideally, the companies in registration would not link to any site where it has no control over the content, but most companies would find this advice impractical.

To ensure compliance with the federal securities laws, the company must be vigilant in regards to the content on its web site, including hyperlinks to third-party web sites and information. The company and its counsel should carefully review the company's web site and any information on third-party web sites to which the company hyperlinks to ensure not only that there are no gun jumping concerns, but also that the information is consistent with the disclosure contained in the registration statement. For hyperlinks that are retained on the web site, the company should add a clear and noticeable disclaimer indicating that the user is leaving the company's site. The company may also want to consider displaying hyperlink addresses as inactive text (rather than as "hot" links) or adding a "pop-up" window notifying the user that he is leaving the company's web site.

Consequences of a gun jumping violation

The consequences of a gun jumping violation can be severe. In many cases, the SEC has forced the company to repeat the statements made in the registration statement, which subjects the company to strict liability for its accuracy. In other cases, the SEC has disciplined companies by imposing a cooling off period. In other words, the SEC may delay the date of effectiveness of the company's registration statement until the impact of the premature publicity has faded. This type of discipline can destabilize the entire marketing effort of a company and its underwriters and can result in a company missing an IPO window. In still other cases, the company has been forced to include a risk factor in its prospectus stating that the company may have violated securities laws and describing the risk of recission (that is, a purchaser of shares in the IPO may have the right to rescind his or her purchase or be entitled to damages if he or she no longer owns the securities). Pre-filing publicity can also result in heightened SEC scrutiny of the entire transaction. If an underwriter is involved in a violation, the SEC may require that the underwriter be excluded from the deal. In egregious cases, the SEC may bring formal enforcement action, and may seek an injunction as well as other sanctions.

True Story: Teddy Bears and the SEC

A toy company that was conducting a public offering was contacted by the SEC concerning hundreds of newspaper and magazine articles that had appeared in the months leading up to the offering. The company explained to the SEC that most of the articles were about the company's top-selling product, a talking teddy bear, that had been the hit of the Christmas season. The company argued that the publicity had nothing to do with conditioning the market for its stock. The company was able to establish that as soon as the decision to proceed with the offering had been made, the company had instructed its public relations firm to halt all publicity activities and the company's officers had declined all requests for interviews. In the end, the SEC permitted the offering to proceed without imposing a cooling off period.

Is the moral of this story that a company won't get into trouble if it can establish legitimate business reasons for extensive publicity while it is in registration?

Maybe. More likely, the lesson to be learned is that even if a company follows the rules, high-profile publicity will attract SEC attention and may jeopardize the timing of the company's offering while the SEC evaluates the situation.

Directed shares program

The company may consider requesting that the underwriters set aside a certain number of IPO shares to be sold to individuals specifically designated by the company. Depending on the number of the IPO shares to be reserved for this purpose, a formal program may need to be implemented, with corresponding disclosure in the company's registration statement. These programs are referred to as "directed shares" or "friends and family" programs, and they are a fairly common feature of IPOs. Most underwriters offer some type of directed shares programs. A majority of the IPOs completed since 1996 involved some form of directed shares program, and in most of those deals, 5% or less of the IPO shares were reserved for the program.

Generally, directed shares are freely tradeable once the company's stock begins trading on the market, and they are not subject to the underwriters' lock-up agreement. As a result, directed shares can prove quite valuable in IPOs in which the price rises quickly after trading in the stock commences.

However, there are a number of burdens that accompany the use of these programs. For example, after announcing IPO plans, many companies find that they have more "friends" than they ever realized, and the demands for directed shares can become overwhelming. The company's CEO and CFO (and sometimes other officers) must then deal with the distraction of numerous telephone calls from participants or would-be participants. Participants do not get a discount to the price that is offered to the public; they pay the same offering price as other IPO investors. As a result, if the company's stock price drops after trading in the stock commences, participants quickly forget the benefits of participation and the CEO and CFO soon find themselves dealing with disgruntled friends and family; in fact, in some situations, participants have attempted to refuse settlement of the purchase price, which can create severe tension among the underwriters, the company, and the participants. Also, if directors and officers of the company decide to participate in the program, they must be careful that they do not violate the Section 16 short-swing trading liability provisions discussed in Chapter 10.

Administering a directed shares program necessarily involves communicating with the participants prior to the effectiveness of the company's registration statement. Such communications are likely to be considered offers subject to the securities laws. The SEC closely scrutinizes these types of programs. Also, as discussed in Chapter 9, the NYSE/NASD IPO Advisory Committee has recommended, and the NASD has proposed, rules that would require any lock-up agreement applying to shares owned by officers and directors to include any shares purchased by those individuals in the company's directed shares program.

If the company is contemplating a directed shares program in connection with its IPO, it should carefully weigh the potential advantages and disadvantages before moving forward. If the company decides to conduct such a program, it should work closely with its counsel and the underwriters to ensure compliance with applicable securities law requirements in the administration of the program.

True Story: Directed Shares Programs Can Be Dangerous

Caution should be used in administering directed shares programs, as potential violations of the securities laws have led to undesirable consequences for some companies and underwriters. In certain offerings in which the SEC believed that the company or its underwriters may have violated securities laws, the SEC required the company to include a risk factor in its prospectus informing investors of a potential violation of securities laws and describing the resulting potential liability for recission. The following risk factor from one such company's IPO prospectus illustrates this unpleasant result:

> *Some shares in this offering may have been offered or sold in violation of the Securities Act of 1933*
>
> Prior to the effectiveness of the registration statement covering the shares of common stock being sold in this offering... an underwriter of this offering provided written materials to approximately 80 employees of [the company] that we had designated as potential purchasers of up to 300,000 shares of common stock in this offering through a directed share program. These materials may constitute a prospectus that does not meet the requirements of the Securities Act of 1933. No employee who received these written materials should rely upon them in any manner in making a decision whether to purchase shares of common stock in this offering.
>
> If the distribution of these materials by [the underwriter] did constitute a violation of the Securities Act of 1933, the recipients of these materials who purchased common stock in this offering would have the right, for a period of one year from the date of their purchase of common stock, to obtain recovery of the consideration paid in connection with their purchase of common stock or, if they had already sold the stock, sue us for damages resulting from their purchase of common stock. These damages could total up to approximately $4.5 million plus interest, based on the initial public offering price of $15.00 per share, if these investors seek recovery or damages after an entire loss of their investment. If this occurs, our business, results of operations and financial condition would be harmed.

True Story: Directed Shares Programs Can Be Dangerous (continued)

Other companies have had to make similar disclosures in their IPO prospectuses. For example, a risk factor in one prospectus disclosed risks of potential securities laws violations related to the fact that certain information regarding its directed shares program had been posted on an internal bulletin board and that certain executive officers had sent e-mails to potential participants in the program.

The Waiting Period

Overview

The "waiting period" is the period between the filing of the registration statement with the SEC and the time that the SEC declares the registration statement effective. The purpose of the waiting period is to give investors time to become acquainted with the information in the prospectus and arrive at an informed investment decision, as well as to allow the SEC time to review and comment on the registration statement.

During the waiting period, offers (but not sales) of the company's securities are permitted. However, the methods for making offers during the waiting period are highly regulated. With a few exceptions, publicity relating to the company's offering is limited to oral offers and written offers made by means of the preliminary prospectus. The term "prospectus" is broadly defined and includes any written offer (including offers made via television, radio or the Internet) or a confirmation of a sale. Anything in writing (for example, press releases and articles quoting the company or its officers) that conditions the market for the company's securities will be construed by the SEC as an offer. Accordingly, the pre-filing guidelines for determining whether an announcement is legitimate business news or impermissible hype are also applicable during the waiting period.

Because oral offers are permitted during the waiting period, the company and the underwriters can commence the selling effort and conduct the road show during this period. However, the distinction

between an oral offer and a written offer is not always intuitive, and issuers must recognize a number of limitations on their activities during the waiting period, including:

- Offers by means of radio or television broadcasts or by audio or video recordings are not permissible during the waiting period (however, the SEC has permitted companies to conduct some of their road show activities via the Internet subject to specific conditions);
- Misleading statements, whether written or oral, are never permissible; and
- Written materials other than the preliminary prospectus, such as copies of slide presentations which accompany an oral presentation, may not be distributed during the waiting period.

The company must be careful to avoid making statements or projections during the road show or in interviews that could be deemed to be factually inaccurate or misleading or to speak of material items or developments that are outside the scope of the prospectus. The best method for avoiding these pitfalls is to limit the content of statements during the road show or in interviews to only the information contained in the prospectus.

Emails are considered writings, and any email communication during the offering process could be considered a written offer. During the waiting period, telephone calls should not be supplemented by email. The company should hold telephonic conference calls or in-person meetings to keep employees or other constituencies informed of the progress of an offering rather than using email.

Rule 134 press release

A public announcement is allowed during the waiting period so long as the press release contains only the limited amount of information permitted by SEC Rule 134 and states from whom a prospectus can be obtained. Although there is no requirement that such a post-filing announcement be made, most companies issue such a press release shortly after the registration statement is filed with the SEC. The contents of such a press release are limited by SEC rules, and any such press release should be reviewed in advance of its publication by counsel.

Consequences of violations

The consequences for violations during the waiting period are the same as those for violations during the pre-filing period and include delay in effectiveness, expulsion of offending underwriters from the syndicate and injunctions. Because the desired effective date is closer at hand, the effect of an SEC-imposed cooling off period at this stage can be more detrimental to the proposed timing of the offering. For the offending parties, it can also be very embarrassing.

True Story: The SEC Goes Online Grocery Shopping

In October 1999, the SEC required Webvan Group, Inc. to take a three-week cooling off period and to include certain statements made to the public to be included in Webvan's registration statement because of concerns about publicity surrounding the company, certain statements that were reportedly made to prospective investors during the company's road show that had not been included in its prospectus and comments reportedly made by Webvan's CEO during an interview with *Forbes* magazine. As one commentator put it, the SEC put Webvan's IPO in the frozen-foods section.

Ironically, the Webvan controversy generated only more media attention regarding the company and its offering, which several observers claimed only helped to push the offering price of the stock to $15 (much higher than the $11 to $13 range initially projected) and the aggregate offering proceeds from $300 million to $375 million. Regardless, the SEC could have imposed more severe penalties.

It is difficult for a company to remain quiet during such an exciting time, especially when employees, journalists and investors are seldom satisfied to learn the details of the company's offering from its registration statement filed with the SEC. Nonetheless, the important lesson in the Webvan IPO case is that a company in registration should err on the side of caution rather than try to test the boundaries of the rules. The company should approach the IPO process with the assumption that the SEC will find any statement that is published, either on its own or with the aid of the internet or interested parties, including competitors.

The Post-Effective Period

The post-effective period begins when the SEC declares the company's registration statement effective and it continues until the distribution of the company's securities is completed (a 25-day period in the case of an IPO conducted on Nasdaq or on an exchange).

Once the registration statement has been declared effective, offers and sales of securities are permitted. A final prospectus must precede or accompany any delivery of the security. During this period, a communication (for example, sales material or literature) is not deemed a prospectus so long as it is preceded or accompanied by the final prospectus. These types of communications are commonly referred to as "free writing."

Following the pricing of the IPO, the company will typically issue a press release announcing the pricing of the deal. The content of the press release is governed by SEC Rule 134 discussed above. As a result, most pricing press releases look similar – they include the number of shares offered, the price, the names of the managing underwriters, a very short description of the company's business and instructions as to how to contact the managing underwriters to obtain a final prospectus.

While the rules for publicity during the post-effective period are substantially less restrictive than the rules applicable to the waiting period and the pre-filing period, caution is still advisable. Statements made during the post-effective period are subject to general antifraud rules and may serve as the basis for liability.

After the twenty-fifth day following the pricing of the IPO, research analysts who are employed by underwriters in the IPO can publish research reports regarding the company. An extensive discussion of the role of research analysts in the IPO process is included in Chapter 2.

Chapter 6

Hosting the Organizational Meeting and Management Presentations

Purpose

The registration process formally commences with the organizational meeting, which is usually held at the offices of the company, or sometimes at the offices of company counsel. The purposes of the organizational meeting are to allow the working group members an opportunity to meet each other and to consider the IPO issues at a high level. This portion of the organizational meeting typically lasts for a few hours. Management due diligence presentations are often combined with the organizational meeting, although they may be held separately. If management presentations are included, the organizational meeting will be a full-day event.

Agenda for the Organizational Meeting

Review the working group list

The managing underwriters will distribute a draft working group list that contains office and home address, telephone and other contact information about each member of the working group. The list should be reviewed and any changes should be noted and returned to the managing underwriters.

Review the proposed time schedule

The working group will outline a proposed schedule at the organizational meeting. The schedule will cover drafting sessions, the SEC review process and the road show. Time should be allowed for any necessary corporate housekeeping, stockholders meetings or financial audits. ***Appendix C*** is a sample IPO timetable.

Actual or contemplated acquisitions by the company during the offering process could significantly affect the timing of the offering due to the related disclosure requirements. Any proposed acquisitions should be discussed with company counsel prior to the organizational meeting.

Structure of the offering

Topics to be discussed at the organizational meeting are listed below. While all of these issues are typically discussed at the organizational meeting, most of them are not finally resolved until later in the offering process.

Size of the offering. The size of the offering will be determined by the company and the underwriters, taking into account the amount of proceeds the company is interested in raising, the level of dilution the company is willing to accept, the amount of shares (or float) needed to ensure a liquid trading market after the offering and the appetite of the market.

Price of the offering. Although the price will not be determined until after the road show is complete, the company should advise the underwriters of any price-related parameters, such as price thresholds for the automatic conversion of preferred stock into common stock.

Participation of selling stockholders. Often, the IPO will not only include shares issued and sold by the company but also shares sold by existing stockholders of the company. Who is allowed to participate as a selling stockholder and how much they are allowed to sell in the offering will be influenced by several factors. Contractual registration rights must be considered, although these are often amended or waived. If the company intends to sell a large amount of stock for its own account, there may be little room for selling stockholders. If there is a large stockholder which could flood the market with stock after the lock-up is released (or worse yet, which is not subject to a lock-up), the company and the underwriters may wish to include that stockholder's shares in the IPO in order to reduce this unpredictable overhang. The underwriters will advise the company as to the marketing implications of a particular stockholder's participation in the offering. For example, potential investors may be alarmed if the company's CEO sells most of his or her stock in the IPO, but may be understanding of an early investor's desire to achieve liquidity.

Over-allotment option. The over-allotment option, also known as the "green shoe," virtually always consists of an additional 15% of the stock being offered and can be exercised by the underwriters within 30 days of the initial closing to cover over-allotments of the company's stock. The company and the underwriters should discuss whether the over-allotment shares will come from the company, selling stockholders or a combination of the two.

Desirability of a directed shares program. The company may request that the underwriters set aside a certain number of IPO shares to be sold in a directed shares program. To ensure compliance with applicable securities law requirements, the company should closely coordinate any directed shares program with the underwriters and company counsel. This topic is discussed in greater detail in Chapter 5.

Overhang analysis and lock-up situation. The trading price of a company's stock following its IPO is a function of supply and demand. The post-IPO performance of the stock can be adversely affected if large quantities of stock flood onto the market. At the organizational meeting, the underwriters will want to discuss the number of the company's outstanding shares that can be sold in the public market following the IPO in reliance on Rule 701, Rule 144 or otherwise, and the dates that these shares will become eligible for sale.

In order to reduce downward pressure on the stock, the underwriters will likely insist that most, if not all, of the stock outstanding prior to the IPO be subjected to contractual lock-up restrictions prohibiting the sale of the stock for a specified period following the IPO. The company should alert the underwriters if it expects to have difficulty obtaining a lock-up with respect to any significant block of shares.

Distribution objectives. The company and the underwriters will briefly review the proposed allocation between retail and institutional investors, as well as any international distribution objectives.

Listing on Nasdaq or an exchange. Company counsel should be prepared to discuss the applicable listing requirements and any concerns about the company's ability to satisfy them. The working group may also briefly discuss proposed ticker symbols.

Use of proceeds

The company's intended use of the IPO proceeds must be disclosed in the prospectus, as must the fact that management will have broad discretion over the use of the proceeds if no definitive use is contemplated at the time of the IPO. If the proceeds are to be used for the repayment of existing debt or specific acquisitions of other businesses, extensive disclosure, including pro forma financial statements, may be required in the prospectus. The underwriters will need to understand the intended use of proceeds in order to understand its effect on the company's future business and financial projections.

Legal issues

Company counsel will review the important legal issues and concerns relating to the offering. Although the working group members will not expect an extensive report, they will expect a brief summary of the status of most of the items addressed in Chapter 3. Company counsel should identify and the working group should discuss any issues that will have a significant impact on disclosure or timing.

Accounting issues

The timing of the offering may be significantly dependent upon the ability to quickly close the company's books, prepare financial statements and complete an audit. Therefore, the working group members should use this opportunity to clarify any accounting-related timing issues. When will the audit for the most recently completed fiscal year be completed? Will financial statements for the company's most recent quarter be required for the initial filing? When will they be available? Will financial statements for the following quarter need to be included in an amendment to the registration statement? When will these financial statements be prepared? Will financial statements for the stub period since the last annual audit need to be audited?

Practical Tip: Identify Need For Special Accounting Work As Early As Possible

If the company has a significant "stub" period for financial statements (6 or 9 months) the underwriters may want the stub period financials to be audited. Often this will occur if the issuer company does not have a long history of operations, and the stub period represents a significant part of the positive financial results trend in which investors will be investing. Because the trend is not preceded by a significant history of audited financial results that is consistent with the trend, the underwriters may want the audit as a matter of due diligence. This audit could require a significant amount of time to complete and could prove to be a rate-limiting step in the IPO process. It is important to highlight this issue as soon as possible in the process so the audit can be started, and the entire working group can properly factor its timing into the overall timing for the IPO. Even if the underwriters do not require the company to audit stub periods, the company and the underwriters may wish to include financial statements for those stub periods in the prospectus (whether or not SEC rules require inclusion). In addition, the underwriters may advise the company to include in the prospectus summary quarterly financial information for some number of quarters (typically at least 4 but not more than 10) prior to the time of the IPO, even though the SEC does not require such quarterly information. It is typical in these circumstances for the underwriters, as part of their due diligence, to require the company's auditors to perform a limited review of the quarterly financial statements. While the procedures performed by the auditors when reviewing interim financial information is more limited than the procedures performed in an audit, it is important to highlight this issue early in the process so that the review can be started and any issues associated with the review can be identified.

The CFO and the company's auditors should identify for the working group any significant accounting issues, such as controversial revenue recognition or other accounting methods used by the company, unusual reserves, the need for restatement of financials, or anticipated cheap stock problems.

Finally, the auditors and the managing underwriters' counsel may briefly discuss the auditors' comfort letter and any potential points of contention that may arise.

Due diligence

If the working group members have not already done so, they can begin exchanging due diligence requests and materials with the company. The company should alert the working group if there have been any major recent developments.

Publicity policy

At the organizational meeting, the underwriters will want to confirm that the company has its pre-offering publicity policy in place. If the company is aware of any upcoming product announcements, press releases, third party research reports or other publications involving the company, it should alert the IPO team at the organizational meeting.

Additional issues

The working group may also briefly discuss the status of the company's decisions regarding the financial printer, the registrar and transfer agent, the bank note company and the custodian for the selling stockholders, if any.

Management Presentations

Management presentations are essential for the group that will be conducting due diligence, drafting the registration statement and marketing the company's stock. In preparing presentations, the company should bear in mind that the audience members may vary widely in their understanding of the company and its industry. The investment bankers may already be quite familiar with the company and may ask fairly sophisticated questions. For other members of the team, such as the underwriters' counsel, the organizational meeting may be the first introduction to the company.

Each executive officer of the company typically speaks for one-half to a full hour, although more or less time may be appropriate depending on the scope of the officer's responsibilities. Follow-up meetings may be requested by the IPO team at a later date.

The CEO. The CEO typically begins by discussing the history of the company and giving a general overview of the company's industry, overall operations, culture and organizational structure, including board composition. The CEO will also discuss the company's short-term and long-term goals and plans for achieving those goals. Any foreseeable roadblocks to the company's success should also be discussed at this time.

Other Executive Officers. The working group typically expects to hear from the head of each principal function/division, such as sales and marketing, engineering, manufacturing and customer service, as applicable. Each executive officer should describe his or her professional background, the activities and personnel for which he or she is responsible, and significant factors influencing his or her area of responsibility. The vice president of sales may discuss the company's sales and distribution strategies and programs, sales channel, customers and strategic relationships, sales force and compensation policies, product sales trends, market share and competitive pressures on sales and pricing, pricing and selling terms, and forecasting methodology. The head of engineering or chief technology officer may discuss product development activities and strategy, technology and skills, and intellectual property position. The head of manufacturing may discuss the company's current manufacturing operations, capacity for growth, sole source components and relationships with suppliers.

The CFO. The CFO is responsible for presenting historical financial information as well as projections. Because the working group members often have a limited ability to absorb new information by the end of a full day of management presentations, the CFO often limits his or her initial presentation to a brief overview of the company's financial status, projections, accounting controls and financing requirements. A more in-depth review of the company's financial situation and projections is then given in a separately scheduled financial due diligence session. Prior to the organizational meeting, the CFO should discuss with the underwriters their preference for the timing and format of a detailed financial presentation.

Practical Tip: Effective Management Presentations

The task of coordinating the management presentations typically falls to the CEO or CFO. To ensure an effective meeting, the coordinator should consider taking the following steps:

- Schedule the date of the presentations far enough in advance to ensure that each presenter will be available;
- Ensure that each presenter understands the purpose of, and audience for, the presentation;
- Ensure that each presenter is prepared;
- Find out how many people will be attending and make sure the conference room is large enough for the entire group;
- Have a writing surface available for all attendees;
- Make sure all audio-visual equipment is set up properly;
- At the meeting, distribute hard copies of any slides BEFORE the presentation so that the attendees can focus on what the presenter is saying rather than trying to transcribe all the information from the slides;
- Mark all slides and hand-outs "CONFIDENTIAL";
- Allow time for questions;
- Schedule regular breaks and re-convene on schedule;
- Try to stay on schedule and arrange for follow-up meetings as necessary; and
- Have food and beverages available at the beginning of the meeting and at appropriate intervals.

Chapter 7

Potential Liability and the Role of Due Diligence

By the end of the initial public offering process, most executives would rather hear underwriters' counsel drag their fingernails over a chalkboard than ask another due diligence question. Still, due diligence is an essential part of the offering process. Due diligence is a small price to pay for the liability protection that it provides, and in most due diligence matters the interests of all of the working group members will be aligned.

Potential Liability for Violations of Federal Securities Laws

It has become an unfortunate fact that a sharp drop in a public company's stock price is often closely followed by a securities class action lawsuit. This results from a variety of factors including the structure of the securities laws and the financial incentives for the plaintiffs and their counsel (especially shortly following a public offering when there are underwriters and other potential defendants who have substantial financial resources).

The federal securities laws impose special disclosure obligations (and concomitant liabilities) on a company and others involved in the IPO process when the company avails itself of the securities markets. There are three principal securities law provisions that create potential civil liability in connection with a company's IPO: Section 11 and Section 12 of the Securities Act, Section 10(b) of the Exchange Act and SEC Rule 10b-5.

Section 11 of the Securities Act

Section 11 of the Securities Act creates an obligation of candor in the context of a public offering – specifically relating to the contents of the registration statement. It provides securities purchasers with an express right of action for damages if any part of the company's registration statement (when it is declared effective by the SEC) contains "an untrue statement of a material fact or omit[s] to state a material fact required to be stated therein or necessary to make the statements therein not misleading." Section 11 does not require a plaintiff to establish a culpable state of mind in the defendant as a requirement of recovery, nor does it require a showing of reliance by the plaintiff on misstatements in the registration statement.

The parties who can be sued pursuant to Section 11 are limited. Section 11 gives the plaintiff the right to sue:

- every person who signed the company's registration statement (SEC rules require the registration statement to be signed by the company's principal executive officer, principal financial officer, principal accounting officer and a majority of the directors of the company);
- every person who was a director of the company at the time of the filing of the registration statement;
- every expert (for example, accountants, engineers, appraisers) whose profession gives authority to a statement made by him, who is named as having prepared or certified any part of the registration statement, or as having prepared or certified any report or valuation used in connection with the registration statement, with respect to the statement in such registration statement, report, or valuation, which purports to have been prepared or certified by him; and
- every underwriter in the offering.

Section 11 also provides a plaintiff with three alternative methods for computing damages. A successful plaintiff may recover the difference between the amount paid for the securities (not to exceed the IPO offering price) and (1) the value at the time of the lawsuit, (2) the price at which the plaintiff sold the securities prior to the lawsuit, or (3) the price at which the securities were sold by the plaintiff after the lawsuit was brought but before judgment so long as the damages computed under this third alternative would be less than those based on the difference between the price paid for the security (not to exceed the IPO offering price).

The company is strictly liable for material misstatements or omissions contained in its registration statement. However, Section 11 provides each potentially liable party other than the company a due diligence defense as an escape from liability. The due diligence defense is discussed in greater detail later in this chapter, but it is worth noting that an officer or employee director who signs a registration statement containing a material misstatement will find it difficult to prove that he or she had reasonable grounds to believe the statement was true. The closer the involvement of a defendant in the IPO process (or in the company's busi-

ness and operations generally) and the higher his or her position within the company, the more a court will expect of the defendant and the more difficult it will be for him or her to establish the due diligence defense.

Section 12 of the Securities Act

Section 12(a)(2) of the Securities Act supplements liability pursuant to Section 11 by providing securities purchasers with an express remedy for material misstatements or omissions in connection with the offer or sale of the company's securities by means of a prospectus or oral communication. Unlike Section 11, Section 12(a)(2) is not limited in scope to the statements made in the company's registration statement but extends to oral statements (for example, statements made during the company's road show and other meetings with potential investors). Also, liability pursuant to Section 12(a)(2) extends beyond the persons enumerated in Section 11 (for example, it is possible that directors or stockholders who actively participate in the IPO process may be deemed "sellers" for purposes of Section 12(a)(2)). However, Section 12 liability is narrower than Section 11 liability in regards to privity - the plaintiff must have purchased the securities directly from the defendant. Similar to Section 11, a plaintiff is not required to establish a culpable state of mind in the defendant as a requirement of recovery, nor does it require a showing of reliance by the plaintiff on misstatements.

A successful Section 12(a)(2) plaintiff is entitled to rescission – to recover the purchase price paid for the company's securities plus interest, less any income received on the securities, upon tender of the securities to the company – or to damages if the plaintiff no longer owns the securities. However, if a defendant proves that any or all of the amount otherwise recoverable by the plaintiff pursuant to Section 12(a)(2) arose from something other than the misstatement or omission, then such amount is not recoverable.

Section 12(a)(2) expressly provides that a defendant is not liable if he or she did not know, and in the exercise of reasonable care could not have known, of the misstatements or omissions. Accordingly, a proper due diligence investigation in connection with the preparation of the company's registration statement can be effective in minimizing potential liability.

Section 15 of the Securities Act – liability of controlling persons

In addition, Section 15 of Securities Act provides that any person who controls a person liable pursuant to Section 11 and Section 12 will be liable jointly and severally with and to the same extent as the controlled person. It is important to note that the term "controls" is broadly defined for purposes of Section 15 and the concept of control in this context can include directors, officers and principal stockholders depending on the specific facts and circumstances. There is one exception to Section 15 liability - the controlling person will not be held liable if such person can prove that he or she had no knowledge of or reasonable ground to believe in the existence of the facts by reason of which the liability of the controlled person is alleged to exist.

Section 10(b) of the Exchange Act and SEC Rule 10b-5

Section 10(b) of the Exchange Act makes it unlawful "to use or employ…in connection with the purchase or sale of any security…any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the [SEC] may prescribe as necessary or appropriate in the public interest or for the protection of investors." Based on the authority granted to it by Section 10(b), the SEC adopted Rule 10b-5 to prohibit fraudulent devices and schemes, material misstatements and omissions of material facts, and acts and practices that operate as a fraud or deceit upon any person in connection with the purchase or sale of a security. Unlike Section 11 and Section 12 of the Securities Act, neither Section 10(b) nor Rule 10b-5 provides an express private right of action to securities purchasers injured by a violation. However, an implied private right of action has developed over time in the federal courts based on basic common law principles used in fraud cases.

Unlike Section 11 and Section 12 claims, a plaintiff in a private damages action brought under Section 10(b) and Rule 10b-5 must demonstrate that the defendant had a culpable mental state with respect to the misstatement or omission (for example, that the defendant made a misrepresentation with the intent to deceive). The courts have interpreted Section 10(b) and Rule 10b-5 to extend liability to defendants who were reckless with respect to the statements (for example, where the defendant had reasonable grounds to believe material facts existed that were misstated or omitted, but nonetheless failed to obtain and disclose such facts). Stated differently, a completely innocent misstatement may not

result in Rule 10b-5 liability, but if the company's registration statement is drafted with a reckless disregard for its accuracy there will likely be liability exposure. Presumably if the working group takes reasonable steps to ensure the accuracy of the registration statement, liability under Section 10(b) and Rule 10b-5 can be avoided. Accordingly, one reason why due diligence is important in the IPO process is that a thorough due diligence effort will go a long way to undermining any claim that there was recklessness if it turns out that the registration statement contains a material misstatement or omission. The diligence effort will also reduce the risk that the registration statement will contain a misstatement or omission in the first instance.

In a Section 10(b) case, the plaintiff ultimately must show actual damages caused by the misstatement or omission. In most of these cases, an appropriate measure is the out-of-pocket loss caused by such statement or omission. However, the courts have not always agreed on what constitutes an appropriate measure of damages in these cases.

The IPO process exposes the company and certain other participants in the process to potential liability. However, there are a number of things that the working group can do to mitigate the risk of liability. This is why due diligence takes on enormous importance for the participants in the IPO preparation process.

What is Due Diligence?

Due diligence is the process of ensuring that the information in the registration statement is accurate, that the registration statement does not omit any required information, and that the registration statement does not omit any information necessary to prevent the statements in the registration statement, taken as a whole, from being misleading. Due diligence is an iterative, fact-findind investigation.

What is the "Due Diligence Defense"?

Section 11 of the Securities Act provides a special defense against liability for certain participants in the IPO process. This defense is called the "due diligence defense." If this defense is established by a defendant, it will effectively shield the defendant from Section 11 liability.

In order to establish a due diligence defense and avoid liability for a misleading registration statement, a working group member must prove that:

- the working group member made a reasonable investigation regarding the contents of the registration statement; and
- the working group member had reasonable grounds to believe, and did believe, at the time the registration statement became effective, that the statements in the registration statement were true, that there was no omission to state a material fact required to be stated in the registration statement, and that there was no omission to state a material fact necessary to prevent the statements in the registration statement from being misleading.

The due diligence defense is available to working group members but not to the company itself.

As noted above, the due diligence activities that create the defense pursuant to Section 11 are also useful in mitigating potential liability pursuant to Section 12 and Rule 10b-5.

Why is Due Diligence Important to the Company, the Board of Directors and Management?

As noted above, the company does not have the benefit of a due diligence defense to claims regarding the contents of the registration statement. As a result, a company's only real defense against a lawsuit brought in connection with a public offering of its stock is to avoid the misstatement or omission that causes a lawsuit. Specifically, the company must ensure that the registration statement was materially accurate and that the registration statement did not omit any material information required to be contained in the registration statement or necessary to prevent the registration statement from being misleading to a potential investor. A material inaccuracy or ommission, regardless of how innocent, will give rise to potential liability. Accordingly, the most important reason for due diligence is that it significantly decreases the likelihood that the registration statement will be deficient.

The second reason that due diligence is important to the company is that the company's officers and directors do have a due diligence defense. Under the federal securities laws, directors of the company and officers of the company who sign the registration statement may be personally liable

to a purchaser of the company's stock if the registration statement is materially defective. However, the federal securities laws provide that if a director or officer can establish that he or she conducted a reasonable due diligence investigation, such person can escape personal liability even if the registration statement is materially misleading.

Why is Due Diligence Important to the Underwriters?

Underwriters also have a due diligence defense. Of course, underwriters would rather avoid the need to rely on the due diligence defense by simply making sure that the registration statement is accurate. Regardless of whether a court determines that the managing underwriters made a reasonable investigation in connection with the offering, a managing underwriter's reputation in the financial community may be tarnished if it appears that the underwriter failed to uncover a critical issue in connection with the company's business. In other words, the underwriters have a business motive, as well as a legal motive, to conduct thorough due diligence. In today's environment, underwriters and their counsel will do all that they can to perform a careful and conscientious diligence investigation.

In addition to the underwriters' general diligence investigation relating to the registration statement, underwriters and their counsel will interview the company's auditors and the company's audit committee regarding their respective roles in auditing and reviewing the financial statements and disclosure in the registration statement. The underwriters will likely insist on holding these meeting without management being present. The underwriters will focus on the company's critical accounting policies, accounting controls and systems (and whether such controls and systems will be adequate to enable the company to meet its disclosure requirements as a public company following the IPO) and the trends in the company's business.

The underwriters will conduct due diligence regarding the company's officers and directors. Underwriter's counsel will review resumes and responses to detailed directors' and officers' questionnaires. The form of questionnaire is generally prepared by the company's counsel, and the responses enable the company to make certain required disclosures in the registration statement and to the NASD and to provide an efficient way for the underwriters to formalize a part of their due diligence investigation.

True Story: It's OUR Prospectus

In a drafting session for a telecommunications equipment company's public offering, the CFO and one of the representatives of the managing underwriter were arguing over some proposed language for the "Risk Factors" section of the prospectus. The conversation went something like this:

CFO: I do not want to discuss this risk in the prospectus. It's ridiculous. It's just going to scare people off. I hired you to sell my stock, not to tell people why they shouldn't buy it.

Underwriter: It's not ridiculous. Our due diligence investigation revealed that this risk has been a real problem for the company in the past and there's a real probability that these problems could crop up again. If it does scare people off, then by definition it's material and we're all going to get sued if something blows up and we didn't disclose it.

CFO: This is MY prospectus and I'm not letting YOU people tell me how to write it.

Underwriter: The prospectus has our fingerprints on it too.

The underwriter was right. Underwriters, as well as the company, have liability if the prospectus is false (unless, of course, the underwriters can establish their due diligence defense).

In this case, the CFO begrudgingly allowed the risk factor language into the document and the offering passed without incident. Unfortunately, the company's fundamental disregard for public disclosure didn't change, and a few years later the company's auditors abruptly resigned, the SEC commenced an investigation of the company, and a criminal investigation was commenced against members of the management team.

What's the Standard?

Under the federal securities laws, the standard for reasonable investigation and reasonable ground for belief is defined as "that required of a prudent man in the management of his own property." This is a negli-

gence standard – as long as the members of the working group are not negligent in their efforts to confirm the material accuracy and completeness of the registration statement, the due diligence defense should be available to working group members other than the company. So, the investigation need not be perfect, just reasonable under the circumstances.

Examples of Bad Due Diligence

Understanding what constitutes a reasonable investigation and a reasonable ground for belief lies partly in understanding what does not constitute adequate due diligence.

Escott v. BarChris Construction Corporation, decided in 1968, is the landmark case on this topic. To make a long story short, BarChris failed to disclose certain unusual accounting policies, related-party transactions, accounts receivable collection problems and an assortment of other financial irregularities in its public offering prospectus.

Shortly following the public offering, BarChris's precarious financial position collapsed and BarChris was forced to file for bankruptcy. A stockholder lawsuit was filed against the company, the underwriters, the principal officers, the non-employee directors and the auditors (that is, most of the working group). The case involved over 60 plaintiffs and 10 law firms, and took nearly 5-1/2 years to reach a final decision.

BarChris was found liable because the prospectus was materially misleading; as discussed above, as the issuer of the securities in the offering, the due diligence defense was not available to it. Most of the other working group members asserted that they had satisfied the due diligence standard. The court, however, ruled in favor of the plaintiffs. The BarChris case is illustrative of the types of behavior that will not satisfy the due diligence obligation of IPO working group participants. The court made the following points regarding the due diligence standard:

- An officer will not be held to a lower standard just because it is the officer's first time to be involved in a public offering;
- An officer may not rely exclusively on its attorneys and auditors to determine what the prospectus should contain, especially if the officer is aware of factual misstatements and omissions in the prospectus;
- An officer will not be excused of his or her due diligence obligations due to a lack of formal education, or a lack of understanding

of the issues. An officer should make an effort to investigate matters which he or she does not understand;

- An officer may not rely on its auditors to expertize sections of the prospectus when the officer knows or has reason to believe that those sections are partially untrue;
- An officer may not rely on other members of the management team to ensure that the disclosure in the prospectus is accurate;
- A director cannot satisfy his or her due diligence obligations by briefly glancing at a preliminary draft of the prospectus in a board meeting. A director may not rely exclusively on management's general assurances that everything is "all right" to ensure that the prospectus is accurate and not misleading;
- A director may not satify his or her due diligence obligations by relying on general inquiries about the company that are not specifically related to the contents of the prospectus;
- A director will not be excused of his or her due diligence obligations just because he or she joined the company's board shortly before the offering;
- A director should not be satisfied with a prospectus that is a "scissors and paste-pot job" from a prospectus used by the same company in connection with an earlier offering where the company's business has changed significantly between the two offerings;
- A director should insist that minutes of executive committee meetings that he or she did not attend be written up and made available for the director's review prior to the filing of the registration statement;
- It may be appropriate for a director to have a discussion with the company's auditors if the director is aware that the company has from time to time in the past entered into unusual financial arrangements with the company's officers;
- When a prospectus takes many months to prepare, a director should investigate whether statements in an early draft are still accurate or need to be updated before the filing of the final version;

- The underwriters may not be able to establish their due diligence defense if they fail to thoroughly follow up on potential problems and missing records identified by their counsel;
- The underwriters may not be able to establish their due diligence defense if neither they nor their counsel review copies of the company's material contracts, especially where such documents are necessary to substantiate important figures such as backlog;
- The underwriters may not rely solely on assurances from the company's officers that the prospectus is accurate;
- If the underwriters delegate due diligence tasks to their counsel and their counsel performs those tasks inadequately, the underwriters will suffer the consequences of their counsel's failure;
- A failure to follow-up on facts that would cause a reasonable person to engage in further inquiry or merely accepting a general indication that there is no problem without a reasonable attempt to verify the answer, may be evidence of a lack of due diligence;
- A director who is actively involved in the preparation of the registration statement may be required to do more to satisfy the due diligence defense than a director who is not so involved; and
- The failure to make a check of easily verifiable matters is evidence of a lack of due diligence.

Of course, these are only examples from one particular case. The due diligence review necessary in connection with any particular offering will be very fact-specific and will vary depending on the unique facts and circumstances surrounding the particular company that is going public.

Another important lesson that *BarChris* teaches is that it is important to create a record of diligence. Those members of the working group who are entitled to rely on a due diligence defense must bear the burden of proving that they in fact satisfied that duty of care. This is a sensitive area though, that must be reconciled with the document retention policies of the company and the underwriters. Officers and directors should work closely with their counsel in determining how to create a reasonable and effective record of diligence.

Examples of Good Due Diligence

For years, *BarChris* was the leading authority on due diligence (or the lack thereof), leaving working groups to wonder just what sort of investigation would meet the standard necessary to establish a due diligence defense. In two important cases, *In re Software Toolworks, Inc. Securities Litigation* (decided in 1992) and *In re International Rectifier Securities Litigation* (decided in 1997), the court went to great lengths to describe good due diligence. In both cases, the underwriters asserted that they were entitled to rely on the due diligence defense. In both cases, the court agreed. The following actions were helpful to the underwriters in establishing their due diligence defense:

- Interviewing company officials, exploring all aspects of the company's business;
- Reviewing trade journals and other industry-related publications to ascertain industry trends, market trends and competitive information;
- Contacting major customers to verify management's representations;
- Contacting major distributors to verify management's representations;
- Contacting major developers and licensees to verify management's representations;
- Contacting major customers of the company's OEM partners;
- Contacting an industry organization regarding the health of the company's market;
- Inspecting the factory in which the company's product was being manufactured;
- Subjecting the company's annual budget to line-by-line scrutiny;
- Reviewing the company's financial statements with the company's auditors;
- Reviewing the company's internal financial model with the company's management;
- Obtaining a comfort letter from the company's auditors;

- Obtaining written representations from the company that the prospectus was accurate;
- Obtaining written representations from the selling stockholders that the prospectus was accurate;
- Confirming with customers the company's return policy;
- Surveying retailers to confirm that no price cutting on the company's products was occurring;
- Contacting officials at an industry organization in order to follow up on negative information about the health of the company's market appearing in an article in a financial magazine;
- Following up on information discovered during the due diligence process that appeared to contradict the disclosure in the prospectus;
- Repeatedly asking the company about the current quarter's expected financial results;
- Discussing the current quarter's preliminary financial results with the company's auditors;
- Relying on financial statements expertised by the company's auditors;
- Confirming the company's OEM revenue recognition policy with other accounting firms;
- Reviewing confirmations and reconfirmations from each OEM;
- Questioning company personnel about the development and scheduled availability of products;
- Employing an analyst who is knowledgeable about the issuer company's industry;
- Interviewing consultants and other service providers to the company;
- Interviewing outside counsel on specialized matters such as patents and environmental issues;
- Having underwriters' counsel review the company's contracts, board minutes and similar documents;

- Having entire working group review the prospectus line by line; and
- Maintaining involvement by the company's management throughout the drafting process.

Other examples of good due diligence techniques can be derived from the securities regulators' occassional forays into proposing formal due diligence requirements upon underwriters. While these rule proposals have not been adopted, they serve as a good suggestion of diligence processes to consider. In 1973, the SEC requested that the NASD consider establishing appropriate standards of underwriter due diligence, as a result of SEC findings that there was significant differnce among underwriters relating to due diligence practices (including disagreement as to which parts of the prospectus must be verified, the extent to which verification should be carried and the methods of such verification). As a result, the NASD proposed requiring the following minimum diligence standards for underwriters of public offerings:

- Review by underwriters' counsel of the issuer's corporate charter, bylaws, and corporate minutes;
- Examination of the audited and unaudited financial statements of the issuer, including footnotes, for the preceding 10-year period or for the entire period of the issuer's existence if less than 10 years;
- Review of all changes in auditors by the issuer within the preceding 10-year period, if applicable, and the reasons therefor;
- Review, with the issuer's auditors, of the financial statements that will appear in the prospectus;
- Review of the issuer's budgets, budgeting procedures and order/backlog figures;
- Review of internal projects of the issuer, including the intended use of the proceedings of the offering;
- Review of all pertinent marketing, scientific or engineering studies or reports concerning the issuer or its products during the previous 10-year period or for the term of the issuer's existence, if less than 10 years;
- Consideration as to the necessity of third party review of appropriate portions of the inquiry if the issuer is a promotional organi-

zation or engaged in marketing high technology or previously unmarketed products;

- Investigation of the issuer's current and past relationships with banks, creditors, suppliers, competitors and trade associations;
- Communication with key company officials and appropriate marketing and operating personnel regarding the nature of the issuer's business and the role of each of the above individuals in the business operation;
- Inspection of the issuer's property, plant and equipment;
- Examination of business protection devices and related data such as trademarks, patents, copyrights and production obsolescence, among others;
- Review of available information with respect to the issuer's position within its industry;
- Review of pertinent management techniques, organization of management and the background of the management personnel of the issuer; and
- Preparation and maintenance of memoranda pertaining to all meetings or conversations regarding the issuer held during the member's performance by it of its obligation of adequate inquiry.

In addition to the lessons of recent cases and the NASD proposal, there are many other due diligence investigation steps that underwriters and their counsel will typically follow. These include (in part) the following:

- Review communications between the company and its stockholder;
- Confirm the capitalization of the company (tying it to the board authorizations, as well as to the paper records of the stock ledger and agreements relating to the issuance of stock);
- Confirm that securities issuances complied with applicable securities laws;
- Confirm contractual rights relating to securities (including voting agreements, participation rights and registration rights);

- Perform analysis of outstanding shares which were issued pursuant to exemptions from the registration requirements of applicable securities laws, including the ability of the holders to re-sell those shares;
- Review of material contracts and standard forms of contracts;
- Review of registered intellectual property of the company and other intellectual property protection strategies;
- Analyze outstanding litigation matters;
- Understand the company's principal sales channels and the structure of agreements relating to those channels;
- Review benefit plans for employees, including all equity compensation plans, agreements and arrangements;
- Circulate comprehensive directors' and officers' questionnaire;
- Review recent publicity regarding the company;
- Investigate the company's relationships with its material suppliers (identify limited source suppliers; identify actual or potential problems regarding suppliers);
- Examine management letters issued by the company's accounts;
- Review any recent appraisals or valuation reports;
- Review disclosure documents of comparable companies;
- Review industry sector reports for the company's industry; and
- Obtain report of recorded liens.

The foregoing is not a comprehensive list. Rather, it is representative of the types of inquiries that underwriters and their counsel will typically pursue in the IPO process.

Different Diligence Standards for Different Participants

It is important to note that all of the foregoing procedures are not required. The investigation does not have to be perfect. However, the process must be reasonable. Notwithstanding the cases discussed above, members of the working group are not prohibited from relying on statements made by the company's management. On the contrary, reliance on

management representations is acceptable, as long as it is reasonable. The reasonableness will depend on the facts and circumstances, including the materiality of the information, the difficulty of verifying the information and the absence or presence of information that calls into question the accuracy of the management representations.

Is the same level of due diligence required of every member of the working group? No. The due diligence required of the different working group members will vary according to their situations. As noted by the court in *Feit v. Leasco Data Processing Equipment Corporation* in 1971: "[w]hat constitutes a 'reasonable investigation' and a 'reasonable ground to believe' will vary with the degree of involvement of the individual, his expertise, and his access to pertinent information and data…[and] [w]hat is reasonable for one director may not be reasonable for another by virtue of their differing positions." The *Leasco* court indicated that underwriters might be held to a higher duty than some other members of the working group. The court noted that, since underwriters are expected to assume an opposing posture with respect to that of the issuer's management in an offering, the courts "must be particularly scrupulous in examining the conduct of underwriters." The court further noted that the adverse posture of the underwriters requires that they must be alert to exagerations and rosy outlooks put forth by management and must play the role of devil's advocate in the transaction. On the other hand, in *Weinberger v. Jackson*, a non-employee director was able to defeat a lawsuit by demonstrating that, after reviewing six drafts of the registration statement and discussing certain aspects of the registration statement with management, he saw nothing suspicious or inconsistent with the knowledge he had acquired as a director. In *BarChris*, the court made it very clear that the chief financial officer of a company cannot rely on the report of the company's auditors to the same degree as other members of the working group who are not as intimately familiar with the financial records, processes and performance of the company. In *Software Toolworks*, the court noted that underwriters cannot be held to have the same intimate knowledge of a company's affairs that inside directors have, and so the underwriters' duty must be considered in light of this more limited access.

It is an important part of the role of both company and underwriters' counsel in the IPO process to educate the working group on the potential liabilities from the transaction for their respective clients, and the steps that they may take to satisfy their due diligence duty obligations.

Practical Tip: Helping the Outside Directors Build a Due Diligence Defense

Outside directors (non-employee directors) typically do not have the same opportunities as the other working group members to participate in the due diligence and drafting processes. To assist the outside directors in building a due diligence defense, the company should include the outside directors on the distribution list for drafts of the registration statement, copies of SEC comments, responses to SEC comments and amendments to the registration statement. Shortly before the initial filing of the registration statement is made with the SEC, the board should hold a meeting at which it reviews the registration statement in detail with the company's officers, counsel and auditors.

The Use of Experts

Section 11 of the Securities Act describes an "expert" as every accountant, engineer, or appraiser or any person whose profession gives authority to a statement made by him, who has with his consent been named as having prepared or certified any part of the registration statement, or as having prepared or certified any part of the registration statement or report or valuation used in connection with the registration statement. An expertised portion of the registration statement is one that is prepared or certified by such an expert who, with his consent, is named in the registration statement as having prepared or certified a part of the registration statement, or report or valuation that is used in connection with the registration statement. The most common example of an expertized section of a registration statement is the report of the company's auditors and the accompanying audited financial statements. Other examples of expertization include opinions of special counsel, reports of engineers and reports of appraisers.

Courts take a narrow view in determining whether a portion of a registration statement has been expertized. For example, the involvement of auditors in the preparation of a registration statement will not result in the unaudited figures being expertized. Similarly, the participation of company counsel in preparing the registration statement will not result in expertization, even if company counsel is the primary drafter.

Each potential defendant, other than the issuer, has a due diligence defense to the potential liability imposed by Section 11 of the Securities Act. The burden of proof associated with each due diligence defense varies with the class of the potential defendant (for example, expert or non-expert) and whether the portion of the registration statement giving rise to the potential liability has been expertised.

- *Non-expert defendant sued for non-expertised portion of registration statement.* To invoke the due diligence defense, a non-expert facing potential liability for statements contained in a non-expertised portion of a registration statement must demonstrate that he or she had, after reasonable investigation, reasonable grounds to believe and did believe, at the time the portion of the registration statement giving rise to the potential liability was declared effective by the SEC, that statements in the portion of the registration statement were true and that there was no omission to state a material fact required to be stated therein or necessary to make the statements therein not misleading.
- *Expert defendant sued for expertised portion of registration statement.* To invoke the due diligence defense, an expert facing potential liability for statements made upon his or her authority as an expert or as a copy or extract from his or her report or valuation as an expert contained in a portion of a registration statement must demonstrate that either (1) he or she had, after reasonable investigation, reasonable ground to believe and did believe, at the time the portion of the registration statement giving rise to the potential liability was declared effective by the SEC, that the statements in such portion of the registration statement were true and that there was no omission to state a material fact required to be stated therein or necessary to make the statements therein not misleading or (2) such portion of the registration statement did not fairly represent such expert's statement as an expert or was not a fair copy of or extract from his or her report or valuation as an expert.
- *Non-expert defendant sued for expertised portion of registration statement.* To invoke the due diligence defense, a non-expert facing potential liability for statements contained in an expertised portion of a registration statement must demonstrate that he or she had no reasonable ground to believe and did not believe, at the time the portion of the registration statement giving rise to the potential liability was declared effective by the SEC, that the state-

ments therein were untrue or that there was an omission to state a material fact required to be stated therein or necessary to make the statements therein not misleading, or that such part of the registration statement did not fairly represent the statement of the expert or was not a fair copy of or extract from the report or valuation of the expert.

Practical Tip: A Few Ways to Minimize the Disruption Caused by Due Diligence

Due diligence is inherently a laborious and disruptive process for the company. To keep due diligence running smoothly and in parallel with other aspects of the offering process, keep the following tips in mind:

1. *Anticipate.* Reduce the number of interruptions later in the process by obtaining due diligence checklists from the underwriters and their counsel prior to the organizational meeting. Assemble the requested materials as early as possible (and make a second copy, so that large copying projects are minimized during the busier parts of the process). If the checklist is not yet available, assemble materials based on the list at ***Appendix B*** and then supplement them as necessary. In addition, as factual information is added to the registration statement (for example, industry size data or industry growth rates) obtain copies of supporting sources.

   Failure to provide the underwriters with backup for statistics or other factual information may result in important marketing or other factual information being pulled from the registration statement on the eve of filing. It is a good practice to create a binder of backup materials that is indexed to the prospectus, so you have an organized and easily referenceable source for all of the factual statements in the prospectus.

Practical Tip: A Few Ways to Minimize the Disruption Caused by Due Diligence (continued)

2. *Control the flow of documents.* Do not allow the due diligence process to get out of control. Designate a single person at the company as the primary contact for due diligence materials. Often the controller or another member of the CFO's staff is well suited for this job. A relatively new employee who is unfamiliar with the company's records and history is not a good choice. The company's counsel should similarly designate one person to take primary responsibility for due diligence document matters. Requests for documents such as company contracts, stock option records or minute books should then be made through the designated company and legal contact persons. Obviously, company officers still will need to make themselves available to discuss key aspects of the business. It is also very helpful if the company coordinates diligence production through its counsel. This way, the company's counsel can be sure that it is seeing everything that is provided to the underwriters' counsel.
3. *Be cooperative.* While due diligence requests rarely come at a convenient time, everyone benefits from the improved disclosure and liability protection resulting from thorough due diligence. Due diligence responsibilities often fall on the relatively junior members of the team, who are simply doing their jobs when they ask for backup information. Cooperating with these team members will avoid last-minute crises.
4. *Stay organized.* Many companies find it helpful to create a master set of indexed binders containing all requested due diligence materials. Responding to multiple due diligence requests then becomes a simple photocopying exercise. Also, if these materials are indexed based on the diligence request list, it is easy to determine what has, and has not, been provided and it is easy to refer back to previously produced materials when the inevitable follow-up questions are

Practical Tip: A Few Ways to Minimize the Disruption Caused by Due Diligence (continued)

asked throughout the process. It is helpful not only to organize the materials in accordance with the diligence list, but also to annotate the list with a brief description of each individual piece of diligence material provided so that it may become a useful guide to the assembled materials.

5. *Resolve issues early.* If a due diligence request is unclear or seems unreasonably burdensome or disruptive, the company and its counsel should discuss the issue with the underwriters and their counsel. Often the scope of a request can be clarified or narrowed. Invariably, issues will arise during the due diligence process. The company and its counsel should address these issues as quickly as possible.

Chapter 8

Preparing the Registration Statement and Going Effective

Timeline

From the date of the organizational meeting until the closing, the IPO process takes roughly from three to five months. An illustrative timeline is contained in ***Appendix C.***

The Drafting Process

Drafting a registration statement is a group effort. Active participation without pride of authorship generally leads to the best result.

Company management and counsel should work together to prepare a draft of the registration statement for distribution to the working group several days prior to the first drafting session. The initial draft is primarily intended to get the drafting process started by giving the working group something to react to. Inevitably, the registration statement will go through many revisions before being filed with the SEC.

Preparing the initial draft of the registration statement will be a more productive exercise if done with input from the underwriters as to the general marketing positioning of the company. All members of the working group should review prospectuses (or other SEC filings) for comparable companies, including the company's competitors, that can be used as examples or counterpoints. Business plans, private placement memoranda and marketing brochures previously prepared by the company may provide material for the registration statement, although care should be given to making a balanced presentation.

The most effort and detail initially should go into the "Risk Factors," "Business" and "MD&A" sections. The financial statement pages also should be made available to the working group as soon as possible. The balance of the prospectus, which contains management biographies, compensation data, descriptions of option plans and certain other information generally can be added to a later draft.

Company counsel typically runs the master draft of the registration statement and is responsible for processing changes from the working group. During the early drafting sessions, comments from the working group are likely to be broad, structural comments, such as "draft a new section to explain," "rearrange this section to emphasize" or "condense these sections." Turn-around time will be slow for the first few drafts, but can be improved if other members of the working group help draft or revise certain sections. For example, the CFO and the company's auditors might make certain requested revisions to "MD&A," while the underwriters might bring their marketing expertise to bear on certain parts of the "Business" section, particularly the "Industry Background" and "Strategy" sections. The ultimate drafting burden, however, tends to fall squarely on company counsel (because it typically has experience drafting registration statements) and the management team (because it has the company-specific knowledge).

Practical Tip: Drafting Schedule

An overly ambitious schedule for turning drafts of the registration statement can be counterproductive. Enough days should be allotted between each drafting session to allow company counsel to collect all comments, draft revisions and circulate the new draft. Time also should be allowed for the working group to read the new draft carefully prior to the next drafting session.

As the registration statement takes shape, the working group's comments should become more focused, and company counsel can make specific changes with the working group during the drafting sessions. At this point, the size of the working group often shrinks to a core of representatives of each working group member. Not only is this cost-effective for the company, but it also makes the drafting process more efficient. The last few drafting sessions typically are held at the financial printer, where pages marked with changes can be submitted for revision as the group continues to work.

Contents of the Registration Statement

Form S-1 is the registration statement form most commonly used by companies selling securities to the public for the first time. Forms SB-1 and SB-2 are available to "small business issuers" (which is defined as a U.S. or Canadian issuer having annual revenues and a public float of less than $25 million) but are used far less frequently. Form F-1 is available for certain non-U.S. issuers, as discussed in more detail in Chapter 11.

The principal SEC regulations affecting the Form S-1 registration statement are Regulation S-K and Regulation S-X. Regulation S-K dictates the content of the registration statement exclusive of the financial statements. Regulation S-X states the requirements applicable to the form and content of financial statements included in the registration statement. There are additional SEC regulations guiding the mechanics of the filing (such as fees and signatures) and the SEC's electronic filing system (EDGAR).

The Form S-1 registration statement consists of two parts. Part I contains most of the information about the company's business and financial condition. The prospectus, which is the portion of the registration statement delivered to investors, is Part I of the registration statement without the Form S-1 cover page. Part II of the registration statement contains supplemental information not required to be included in the prospectus, such as information regarding offering expenses, indemnification of officers and directors of the company, recent sales of unregistered securities, undertakings and exhibits and financial statement schedules. Part II is not required to be delivered to investors, although it is publicly available.

The prospectus portion of the registration statement is typically comprised of the following sections.

Front and back cover pages

The front and back cover pages of the prospectus contain certain information required by Regulation S-K, such as the company's name and the number and type of securities being offered. The company may elect to include additional information and color graphics or photos on the back cover page or inside cover pages to increase the marketing appeal of the document. The company should work closely with the financial printer if graphics or photos are to be used, as a certain amount of lead

time will be required to prepare them for inclusion on the cover. The content of graphics and photos is subject to SEC review and can serve as the basis of liability. Therefore, graphics and photos included in the cover pages should not make claims or imply information that would be inappropriate to include in the body of the prospectus.

Practical Tip: Get Artwork Started Early

Many prospectuses include artwork on the inside cover page. The company should discuss this artwork very early in the drafting process to develop a consensus from the working group regarding the artwork. Depending upon the company's internal graphics capabilities, designing the artwork, and the iterative process of review/redesign, can be a time consuming process. The SEC will want to see the artwork (or at least a nearly final draft of it) with the initial registration statement filing, or soon thereafter. If the artwork is delayed, it could slow down the registration statement review process.

Summary

The Summary section, which comprises the first few pages of the prospectus, is the first substantive information about the company that investors will see. For many investors, it is the only section that they will read before making an investment decision. The Summary contains a brief description of the company and its business, typically consisting of a few paragraphs. It also sets forth the type and amount of securities being offered, the number of shares that will be outstanding following the offering, the use of proceeds and the proposed listing symbol. Condensed financial statement information is also included, generally consisting of a table showing information for the prior three or five years (or such shorter period as the company has been in existence), as well as information for the current year stub period and the corresponding prior-year period. A summary version of the most recent balance sheet, as well as a corresponding balance sheet adjusted to reflect the receipt and application of the offering proceeds, is also included. Companies also include their mailing address and telephone number, as well as their Internet home page address. Other interesting or useful information may also be

included. The Summary section is often one of the last sections to be drafted due to the fact that it is a condensed version of the other portions of the prospectus.

Risk Factors

Material risks faced by the company or that may cause investments in the company's stock to be risky should be disclosed in the "Risk Factors" section. To maximize protection from liability, risk factors should be specific and disclose enough information to place the risk in context and enable an investor to assess the magnitude of the risk. Each individual risk must be disclosed under a descriptive heading that clearly and concisely describes the risk and several different (even though related) risks should not be grouped under a single risk factor heading, but rather should be separated into different risk factors.

Risk Factors customarily are listed in the approximate order of importance and likelihood of occurrence. Although SEC regulations do not specify any particular required order, they do require that risk factors be organized logically. The exact order should be decided among the working group members. However, the SEC has provided some guidance with respect to the manner in which the risk factors should be categorized to make that section more readable. The SEC has noted that risk factors generally fall into three broad categories, and the risks should be specifically identified to the applicable category. These three categories are risks faced by companies in the industry, risks that are specific to the company and risks related to investing in the company's securities.

The SEC also indicates that companies should not use boilerplate risk factors copied from the prospectuses of similar companies or companies in the same industry. Rather, a company should provide disclosure that enables readers to understand the specific risks applicable to the company.

Practical Tip: Risk Factors – A Cheap Form of Insurance

During the process of drafting the company's registration statement, management will no doubt hear from company counsel or underwriters' counsel that good risk factor disclosure may be the company's "cheapest form of insurance." There are certainly plenty of examples in securities litigation where risk factor disclosure led to the dismissal of multi-million dollar securities class action lawsuits. A company should strive to prepare thorough and thoughtful disclosure of each material risk faced by the company.

Use of Proceeds

The registration statement must disclose the proposed use of the net proceeds of the offering or, if the company has no specific plan for the use of the proceeds, a discussion of the principal reasons for the offering. Examples of uses of offering proceeds include capital expenditures, working capital, debt repayment and acquisitions. If debt repayment is a use of proceeds, the company must make specific disclosures regarding the debt to be repaid. If the company identifies acquisitions as a use of proceeds, the SEC will require the company either to represent that it has no current plans, arrangements or intentions concerning specific acquisitions or to include certain detailed information about any proposed acquisition, including pro forma financial information if the acquisition is probable within the meaning of the accounting rules and would meet certain materiality thresholds. Therefore, the company should discuss any thoughts about acquisitions with its counsel as early in the IPO process as possible.

Dividend Policy

This section addresses the company's current and anticipated dividend policy, including the frequency and amount of dividends. If there are any legal, contractual or other restrictions on the ability of the company to pay dividends, such as negative covenants in the company's bank line of credit, the nature of those restrictions should be disclosed.

Capitalization

The company's capitalization information, including short- and long-term liabilities and stockholder equity, is included in tabular format both on an actual basis and on a pro forma basis reflecting the offering.

Dilution

When new investors will be diluted immediately following the offering due to a difference between the IPO price and the net tangible book value per share, the prospectus must disclose (i) the net tangible book value per share before and after the offering, (ii) the increase in net tangible book value resulting from the offering and (iii) the amount of dilution from the public offering price which will be absorbed by the new investors.

Selected Financial Data

In order to highlight trends in the financial condition and results of operations of the company, SEC Regulation S-K requires that selected historical financial data for at least the last five fiscal years (or since incorporation, if the company has not been in existence for five full fiscal years) be included in the registration statement. If financial statements for the interim period since the end of the last fiscal year are included in the registration statement, then the "Selected Financial Data" section should also set forth selected financial data for such period and the corresponding prior-year period.

Management's Discussion and Analysis of Financial Condition and Results of Operations (MD&A)

Overview and Results of Operations

The MD&A section of the prospectus analyzes the company's operating results, capital resources and other relevant financial information. MD&A focuses particularly on year-to-year comparisons of the company's prior three fiscal years and a comparison of any subsequent interim period against the corresponding prior-year period. In a number of interpretative releases, most recently in "Commission Guidance Regarding Management's Discussion and Analysis of Financial Condition and Results of Operations" (Release Nos. 33-8350 and 34-48960, dated

December 29, 2003), the SEC has stated that the purpose of MD&A is to provide readers with the information necessary for them to understand the company's financial condition and results of operations and should satisfy the following principal objectives:

- provide a narrative explanation of the company's financial statements that enables investors to see the company through the eyes of management;
- enhance the overall financial disclosure and provide context within which financial information should be analyzed; and
- provide information about the quality of, and potential variability of, a company's earnings and cash flow, so that investors can ascertain the likelihood that past performance is indicative of future performance.

Accordingly, a well-drafted MD&A does more than state the obvious about whether a line item has gone up or down. Good MD&A will help investors gain insight into the reasons behind the trends and will identify material events or uncertainties that could affect the company's future operating results or financial condition. Careful thought should be given to signaling anticipated changes from historical trends experienced by the company.

The SEC has suggested that companies provide an introductory section or overview to the MD&A that facilitates the reader's understanding of the company's financial condition and operating performance. The SEC has cautioned that this overview should include the most important matters on which a company's executives focus in evaluating such matters. The SEC has suggested that a good introduction or overview should:

- include economic or industry-wide factors relevant to the company;
- inform the reader about how the company earns revenues and income and generates cash;
- to the extent necessary or useful to convey this information, discuss the company's lines of business, location or locations of operations, and principal products and services (but an MD&A introduction should not merely duplicate disclosure in the Business section of the prospectus); and

- provide insight into material opportunities, challenges and risks such as those presented by known material trends and uncertainties, on which the company's executives are most focused, both short- and long-term, as well as the actions they are taking to address these opportunities, challenges and risks.

Liquidity and Capital Resources

In its MD&A, the company also must assess its liquidity and capital resources. Specifically, MD&A must include an assessment of the company's cash requirements, sources and uses of cash and debt instruments, guarantees and related covenants.

Critical Accounting Policies

MD&A must discuss the significant implications of the uncertainties associated with the methods, assumptions and estimates underlying the company's critical accounting measurements. MD&A must disclose the company's accounting measurements if:

- the nature of the estimates or assumptions is material due to the levels of subjectivity and judgment necessary to account for highly uncertain matters or the susceptibility of such matters to change; and
- the impact of the estimates and assumptions on financial condition or operating performance is material.

This disclosure should supplement, not duplicate, the description of accounting policies that must be disclosed in the notes to the company's financial statements.

Off-Balance Sheet Transactions

The SEC also requires that MD&A provide the following disclosure with respect to certain off balance sheet transactions that have, or are reasonably likely to have, a material current or future effect on the company's financial condition, changes in financial condition, revenues or expenses, results of operations, liquidity, capital expenditures or capital resources:

- an identification and critical analysis of the arrangement; and
- an assessment of the likelihood of the occurrence of any known trend, demand, commitment, event or uncertainty that could affect the arrangement.

Related-Party Transactions

The SEC has stated that transactions involving related parties will not be presumed to be transactions carried out on a market basis due to the potential lack of arm's-length dealings. Accordingly, the SEC has advised companies that MD&A should discuss material transactions with related parties to the extent necessary for an investor to understand the company's current and prospective financial position and operating results, financial statements and the business purpose and economic substance of such related-party transactions. These disclosures are likely to include:

- the business purpose of the arrangement;
- identification of the related parties;
- a description of how the transaction prices were determined;
- a description of the terms or other transaction arrangements that differ from those which would likely be negotiated with clearly independent parties;
- a description of the methodology for the evaluation, if disclosures represent that the transactions have been evaluated for fairness; and
- a description of any ongoing contractual or other commitments as a result of the arrangement.

Practical Tip: High-Level Attention to MD&A

Delegating the primary drafting of the MD&A section to less experienced team members is a mistake. The MD&A, more than any other section of the prospectus, is the company's forum for setting investor expectations and helping financial analysts understand the company's financial model. Although it often lacks the marketing impact of the Summary or Business sections of the prospectus, the MD&A section is important to sophisticated investors. If thoughtfully prepared, the MD&A section can go a long way toward protecting the company in the event of securities litigation.

Business

SEC Regulation S-K requires a comprehensive narrative discussion of the company's business during the previous five-year period (or such shorter period as the company has been in existence). Specifically, this section of the prospectus should include a discussion of the company's industry segment, the company's products and services, capital equipment purchases, seasonality of the company's business, intellectual property, foreign operations and export sales, properties, sources and availability of raw materials, inventory practices, customer concentration, backlog, competition, research and development expenditures, regulatory environment, legal proceedings involving the company and number of employees. The Business section has evolved over time into a very stylized format incorporating this information. Variations of the following categories are used, roughly in this order: Industry Background, Company Solution, Strategy, Products, Sales and Marketing, Customers, Manufacturing, Competition, Research and Development, Intellectual Property, Employees, Properties and Legal Proceedings. Of course, the exact layout and content of the information to be included is determined according to the company's specific business and the preferences of the working group, particularly the underwriters.

Practical Tip: Anticipating the Comment Regarding the Customer List

For obvious marketing reasons, companies and their underwriters often like to include a list of the company's representative customers in the Business section. Care should be taken to ensure that the customers named are truly representative and are not selected simply for their name recognition. The SEC frequently requires companies to justify their selections or revise their lists. The company should be prepared to defend its choices on the basis of revenues generated, units purchased or some other relevant criterion.

Management

The prospectus must state the names, ages, business experience and certain other information for each of the company's directors and executive officers. For the chief executive officer and the four other most highly compensated executive officers of the company, extensive compensation data must be presented in the format specified by Regulation S-K. The management section also describes committees of the board of directors, employment contracts, the company's stock plans and indemnification of directors and officers.

Certain Transactions

The company must disclose certain transactions in which any director, executive officer or 5% stockholder (or any of their family members) had a direct or indirect interest. Examples include purchases of stock by these individuals, transactions between the company and another entity in which these individuals have a substantial interest or loans between the company and these individuals.

Principal and Selling Stockholders

The prospectus must disclose the total number of the company's securities owned by (1) any person known to the company to be the beneficial owner of more than 5% of the company's stock, (2) the company's chief executive officer and each of the other four most highly compensated executive officers, (3) all directors (and director nominees), and (4) directors and executive officers of the company as a group, without naming them. The prospectus also must state what percentage of the total number of outstanding securities each such individual owns. If there are selling stockholders, information regarding the number of shares owned and the number of shares being sold by each selling stockholder also must be disclosed. The information presented must reflect not only stock currently held by such persons, but also stock which such persons have the right to acquire within 60 days.

Description of Capital Stock

This section provides a description of the important rights and characteristics of the securities being sold in the offering. Where the security being offered is common stock, this section of the prospectus can be fairly simple. Provisions of the company's certificate of incorporation or bylaws that would have the effect of discouraging a takeover attempt also must be described.

Underwriting Arrangements

SEC Regulation S-K requires a list of the underwriters involved in the offering and the respective amounts of stock each underwriter is allotted. This section also includes a description of the principal terms of the underwriting arrangements, any material relationship between the company and any underwriter involved in the offering, any conditions to the obligations of the underwriters to sell the securities, an analysis of restrictions on resale of the company's unregistered securities and the factors considered in determining the offering price of the securities. Each investment banking firm typically has its own preferred format for this section.

Financial Statements

Generally, the prospectus is required to present (1) audited balance sheets as of the end of the company's two most recent fiscal years, (2) audited statements of operations, statements of cash flows and statements of changes in stockholders' equity and footnotes for each of the company's three most recent fiscal years and (3) depending on the length of time between the end of the prior fiscal year and the date of filing or effectiveness, an unaudited balance sheet as of the end of the interim period and statements of operations, statements of cash flows and statements of changes in stockholders' equity for the interim period and for the corresponding prior-year period.

A Word about Words: Plain English Disclosure

Prospectus - disclosure document or protective document?

One of the central means by which the securities laws protect investors is through rules requiring that a prospectus provide adequate information regarding the issuer and the offering to prospective investors. Key to the protective effect of these disclosure requirements is the clarity and accessability of the disclosure – the most detailed description of a business is of little value to investors if it is conveyed in inpenetrable language or if its presentation discourages investors from reading it in the first place. SEC rules have long required that prospectuses be clear, concise and understandable.

The prospectus, which was conceived as a means of providing information to investors (in part as a selling document and in part to protect investors), gradually came to be viewed by issuers as largely a defensive document. Increasingly, the driving force behind the language in the prospectus was the tenet that an issuer cannot be liable for something it has truthfully told the investors in the prospectus. This notion led to the natural corrollary that more is better (that is, that more information, more detail and more repetition equates to more protection from potential liability). Once these defensive doctrines gained control of the drafting process, it became increasingly a legal document – the focus was the protective needs of the issuer more than the informational needs of the investors. The result was that, over the years, quantity supplanted quality, the prospectus became increasingly highly stylized and a great deal of non-specific boilerplate disclosure crept in, resulting in an incredibly dense and repetitive document.

The Plain English Disclosure requirements

In 1997, the SEC adopted the Plain English Disclosure rules in response to these trends in disclosure. The Plain English requirements apply to the cover page and the Summary and Risk Factors sections of the prospectus, and are designed to make these sections more accessible to the average reader. Specifically, these sections must use the following six basic principles:

- Short sentences;
- Definite, concrete, everyday language;

- Active voice;
- Tabular presentation or bullet list presentation of complex information wherever possible;
- No legal or business jargon or highly technical terms; and
- No multiple negatives.

In addition, the rules require the company to design and format the cover page and the Summary and Risk Factors sections to make them easy to read and to highlight important information for investors. The rules permit companies to use pictures, charts, graphics, and other design features to make the prospectus easier to understand.

Appendix F contains sample comments that were released publicly by the SEC in its June 1999 Staff Legal Bulletin regarding Plain English disclosure (originally issued in September 1998 and updated in June 1999).

A copy of the SEC's *Plain English Handbook: How to Create Clear SEC Documents* is available on the SEC's web site at www.sec.gov.

Filing the Registration Statement with the SEC

Once in its final form, the registration statement will be electronically filed with the SEC. The financial printers routinely provide the service of converting the registration statement into the electronic format required by the SEC, known as "EDGARizing," and transmitting the document to the SEC.

Prior to filing, the company must obtain an EDGAR ID number, deposit an amount sufficient to cover the SEC filing fee in a special SEC bank account established for this purpose, obtain signature pages to the registration statement from the company, its principal executive officer, its principal financial officer, its controller or principal accounting officer and at least a majority of the board of directors, and obtain an executed auditors' report and consent. Although these originally executed signature pages, reports and consents are not filed with the SEC, they must be obtained prior to the EDGAR filing, must be kept on file by the company for at least five years and must be provided to the SEC upon request.

Filing Exhibits with the SEC and Requesting Confidential Treatment

Regulation S-K requires that certain documents, including the underwriting agreement, the certificate of incorporation, bylaws and other documents affecting the rights of security holders and certain material contracts be filed with the registration statement as exhibits. (*See* Chapter 3 – "Confidential Treatment" for a discussion of the SEC's rules regarding the filing of material contracts.) All exhibits must be filed electronically with the SEC via its EDGAR system, absent a hardship exemption. Preparing the exhibits for filing can require significant lead time, particularly when an electronic version does not exist and must be created. (Yes, this means that those lengthy leases, lines of credit and other contracts may need to be scanned or re-typed by hand if electronic versions do not exist.)

As discussed earlier in Chapter 3, exhibits filed with the SEC are not included in the prospectus, but they are publicly available when filed. Disclosure of the company's material contracts may be harmful to the company, especially where the contracts contain sensitive technical or financial information that would be useful to the company's competitors or hinder the company's future negotiations with its customers or suppliers. As a result of these hardships, the SEC will consider requests for confidential treatment of limited portions of material contracts.

To request confidential treatment of sensitive information, the company must prepare two versions of its exhibits. One version, which is filed via EDGAR and becomes publicly available, should have the sensitive portions redacted (that is, eliminated and replaced with a placeholder such as *****). The other version, which is submitted to the SEC in paper format only, should have the sensitive portions bracketed. This paper version of the exhibits should be submitted to the SEC with an accompanying letter identifying each item of information for which confidential treatment is sought and explaining in specific detail for each item the company's position as to why such confidential treatment should be granted.

Generally, the SEC will grant confidential treatment only if the request meets the following requirements:

- *Type of information entitled to protection.* The information to be granted confidential treatment must be entitled to protection under an exemption from the disclosure requirements of the Freedom of Information Act. Most confidential treatment requests rely on the exemption covering trade secrets and commercial or financial information.
- *Information not publicly disclosed.* Confidential treatment will not be granted if the information has been publicly disclosed already, either in the prospectus or elsewhere. The SEC will deny confidential treatment of publicly disclosed material, even if the disclosure was inadvertent, such as an erroneous EDGAR filing of unredacted exhibits.
- *Information not necessary for protection of investors.* The SEC must be persuaded that disclosure of the information is not necessary for the protection of investors. The SEC will not grant confidential treatment if withholding the sensitive information would obscure a material risk faced by the company.
- *Narrow request.* The request should be as narrow as possible. A common mistake is to request confidential treatment for an entire sentence or paragraph where only a few words or numbers are truly sensitive. The SEC will require that a request be amended if it is too broad.
- *Duration of request.* The company must state the specific term for which confidential treatment for a specific item is requested, along with an analysis that supports the period requested. The term should be as short as is necessary to protect the company.
- *Consent to release.* The confidential treatment request must contain the company's consent to the release of the information to other governmental agencies, offices or bodies and Congress.

The SEC examiner will review the company's confidential treatment request and respond with a comment letter. The company may respond by giving the examiner additional information to support the company's request, or may file an amendment to the registration statement in which exhibits are re-filed to include those portions of information for which the SEC is unwilling to grant confidential treatment. This process continues until the only redacted items are those for which the SEC has agreed to grant the company's request for confidential treatment.

Practical Tip: Begin the Confidential Treatment Process Early

The confidential treatment review process has its own timeline which is separate but parallel to the registration statement review process. In order to prevent the confidential treatment process from delaying the effectiveness of the company's registration statement, the company should submit its initial confidential treatment request as soon as possible after the initial filing of the registration statement.

Confidential treatment requests present a number of logistical challenges. For example, the agreement required to be filed may include confidential information of the company's major customer or strategic partner. Companies often must obtain consent from customer or partner legal departments, which can take weeks in large organizations. Moreover, concessions required by the SEC may require disclosure of confidential information of the company's customer or partner and resolution can require disclosure of information that can be damaging to the relationship. In summary, companies should plan early and strategize with counsel to ensure that the confidential treatment request process does not delay the offering or harm the company's business.

Exchange Act Registration

While the IPO registration process focuses on preparing and filing a Form S-1 registration statement under the Securities Act, the company also must register its common stock pursuant to the Exchange Act if it plans to be listed on Nasdaq or an exchange. Even if the company did not plan to initially list on Nasdaq or an exchange, the IPO would eventually cause the company to trigger certain numeric thresholds requiring Exchange Act registration under the federal securities laws. Exchange Act registration is accomplished by filing a short registration statement on Form 8-A, which contains basic information about the characteristics of the company's stock (dividend rights, voting rights, etc.) and which identifies anti-takeover provisions in the company's charter documents. The

working group generally does not focus on Form 8-A, which is not distributed to investors. Rather, company counsel usually prepares the document, which is reviewed briefly by underwriters' counsel prior to filing.

Care should be taken to avoid the Form 8-A becoming effective, which occurs automatically 60 days after filing, pre-maturely if the IPO process is delayed. To do so could cause the company to inadvertently become subject to the public company reporting requirements of the federal securities laws.

SEC Review

The SEC's purpose in reviewing registration statements is to ensure adequate disclosure, not to determine the merits of the offering. In other words, the SEC's comments and the company's responses to them will focus on whether investors are being provided with sufficient disclosure to make an informed investment decision, not whether investing in the company at the proposed offering price is a good or bad idea.

Once the company's registration statement is filed with the SEC, it will be assigned to the division within the Division of Corporation Finance that has experience with the company's industry. This assignment is based on the company's SIC code, so care should be given to stating it correctly on the cover page of the registration statement. An SEC staff attorney or analyst, referred to as the "examiner," will be assigned to review all aspects of the registration statement other than the accounting aspects, and a staff accountant will be assigned to review the financial statements and accounting-related issues. The examiner and the staff accountant review their respective portions of the registration statement separately, although they coordinate to discuss areas of concern and prepare comments. The examiner will deliver to the company, typically within 30 days of the initial filing, a letter containing the SEC staff's comments on the registration statement.

When the comment letter is received, it should promptly be circulated to the working group. A conference call or meeting should be scheduled for the working group to discuss the comments, the proposed responses and the timing of the response letter. The working group then will prepare an amendment to the registration statement and a response letter to the SEC. The response letter will address each comment made by the SEC,

noting where the company revised the registration statement in response to the comment or the company's reasons for not revising the registration statement in response to the comment. The comment letter may ask that the company supplementally provide information to the SEC staff. The company's response letter will contain such supplemental information or an explanation of why the information is not available or should not be required. Depending on the extent of the revisions to be made in response to the SEC's comments, the working group may or may not convene at the financial printers for a drafting session prior to filing the amendment.

Once the amendment to the registration statement and the letter in response to SEC comments are filed with the SEC, the examiner and staff accountant will review them and provide another comment letter to the company. This process may go through several cycles until the SEC staff is satisfied with the disclosure in the registration statement. The SEC will not declare a registration statement effective until all outstanding comments have been resolved to the satisfaction of the SEC.

For disclosure issues that are particularly complex or sensitive, it may be helpful for company counsel to call the examiner to discuss the matter and the proposed response. The company's auditors may become involved in discussions with the SEC staff if the issues are accounting-related. If the company reaches an impasse with an examiner or staff accountant on an important issue, the company may request to have the examiner's or accountant's supervisors within the division get involved. Most issues can be resolved by telephone, and it is often helpful to put the company's thoughts on the matter into a short letter that can be faxed to the SEC staff in advance of the call. Going over the examiner's head is not something to be done lightly or in an adversarial manner, as the company must continue to work with the examiner through the remainder of the transaction. Politely requesting the examiner's assistance in involving more senior members of the SEC staff is generally the best strategy. Protocol generally requires the company to obtain working group consensus before escalating an issue to higher levels within the SEC.

One ancillary challenge of navigating the SEC comment process is that much of the information in the company's response letters (including any confidential information contained in any supplemental materials) will be available to the public if so requested under the Freedom of Infor-

mation Act (FOIA) unless the proper procedures are followed. In recent years, the number of FOIA requests for this information has increased substantially.

If the company is concerned about any information provided electronically it must seek confidential treatment of such information when it files its response letter with the SEC. A common mistake to avoid is to simply state in the response letter that the company requests confidential treatment of the contents of the letter under the FOIA. The SEC will not accept this kind of blanket response. Rather, the company will be required to redact each specific occurrence of confidential information from the electronic filing and then deliver a paper copy of the full response letter that includes the unredacted information accompanied by a separate, formal letter requesting confidential treatment containing an analysis of the justification for such treatment. Reaching a resolution with the SEC in this regard will require time, which can slow the offering process.

If the company submits supplemental information, the company generally may submit the information in paper so long as it requests that the information be returned following the SEC's review at the time of the submission. However, if the company submits supplemental information in paper and does not request its return (and request confidential treatment), the information must then be filed with the SEC electronically in full.

The SEC review process will span many weeks. Before going effective, the working group should consider whether the registration statement must be amended to reflect changes that have occurred in the company's business between the initial filing of the registration statement and the desired date of effectiveness. This step should be taken even if SEC comments do not specifically call for it.

Exchange Listing or Nasdaq Quotation (or Both)

Early in the offering process, the company should consider where it would like its stock to be listed. Listing the company's securities on Nasdaq or a securities exchange, such as the NYSE, is the primary method for achieving stockholder liquidity and generally will be required by the underwriters.

In January 2004, Nasdaq announced its new dual-listing initiative with the NYSE. Initially, six companies that had previously been listed only on the NYSE began to be listed on both the NYSE and Nasdaq. Companies desiring to be dual listed must meet the listing requirements of both the NYSE and Nasdaq.

Company counsel will assist the company in preparing its listing application and reserving the company's proposed trading symbol. The company should review the requirements of the desired securities market with its counsel and determine the likelihood of its application being approved. Although the specific requirements differ, each market requires that companies meet certain quantitative and corporate governance standards, certain of which are discussed in Chapter 1 and Chapter 3. In special cases, a company may petition a securities market for an exemption from certain listing requirements that the company falls short of satisfying.

Appendix A of this guidebook sets forth the listing requirements for the NYSE and the Nasdaq National Market.

The NYSE vs. NASDAQ:
The Big Board or the Electronic Market

During the height of the Internet boom market (1999-2000), Nasdaq was the clear IPO leader by capturing 85% of the number of IPOs. The following year, Nasdaq's market share fell to 54% and in 2002, the NYSE nearly tied with Nasdaq by listing 42 new issuers compared to Nasdaq's 43. In 2003, Nasdaq gained back some of the market share it lost and closed out the year with 58% of the newly listed companies. Typically, however, the NYSE captures the larger IPOs in terms of deal size, and the NYSE controls nearly 80% of the U.S. market in listed stocks.

The NYSE vs. NASDAQ: The Big Board or the Electronic Market (continued)

NYSE

The New York Stock Exchange, also known as the "Big Board," the largest and oldest stock exchange in the U.S., traces its origins back to 1792, when a group of brokers met under a tree at the tip of Manhattan and signed an agreement to trade securities. Unlike some of the newer exchanges, the NYSE still uses a large trading floor to conduct its transactions. However, the NYSE is considering ways to increasingly use an electronic system to trade. For example, the NYSE has proposed a series of reforms that would update the structure of the exchange for the first time in nearly three decades by combining traditional human-based trading floors with automatic-trading facilities to create a hybrid automated and live-auction trading market.

Nasdaq

Unlike the NYSE, the Nasdaq (once an acronym for the "National Association of Securities Dealers Automated Quotation" system) does not have a physical trading floor that brings together buyers and sellers. Instead, all trading on the Nasdaq is done over a network of computers and telephones. The Nasdaq began when brokers started informally trading via telephone; the network was later formalized and linked by computer in the early 1970s. In the subsequent decades it has become a serious rival to the NYSE. For example, certain prominent companies, such as, Cisco and Microsoft have opted to list on Nasdaq instead of the Big Board. In addition, certain other prominent companies, such as Cadence Design Systems, Charles Schwab and Hewlett-Packard Co., have decided to dual list their stock on Nasdaq as well as the NYSE.

Going Effective

At least two full trading days before the company and the underwriters intend to price and begin selling the stock, the company and the managing underwriters should submit letters to the SEC requesting that the SEC accelerate the effective date of the registration statement to a specified date and time. The registration statement then will be calendared for review by the Assistant Director of the division reviewing the registration statement. The company also should request that its Exchange Act registration statement on Form 8-A be declared effective simultaneously. Before the SEC will declare the company's registration statement effective, the NASD must notify the SEC that it has no objections to the underwriting arrangements (this process is described in more detail in Chapter 9). The company also should notify Nasdaq or the exchange where its stock will be listed of the anticipated date and time that trading will commence.

Post-Effective Matters and the Closing

Final prospectus

The SEC will declare a registration statement effective even though certain information that cannot be determined until immediately prior to the offering is omitted. Specifically, the SEC will not require the version of the registration statement that is declared effective to contain certain information about the offering price, the identity of the participants in the underwriting syndicate or the amount of underwriting discounts and commissions. However, no later than two business days after the earlier of the pricing or initial sale of the shares, the company must file with the SEC a final prospectus, also known as the "424(b) prospectus," filling in the missing information. This final prospectus is then professionally printed and distributed to purchasers of the company's shares.

The closing

The closing is the settlement of the sale of the IPO shares. At its most basic level, the closing is an exchange of the IPO shares for cash. The company authorizes the delivery (typically electronic) of the stock in the names and denominations specified by the underwriters. The underwriters, in turn, deliver a check or wire transfer for the proceeds, net of underwriting discounts and commissions, to the company and selling stockholders.

Various documents are exchanged as called for by the underwriting agreement, including cross receipts, management certificates, legal opinions and an auditor's comfort letter. The closing is largely an administrative task. While representatives of the company and the underwriters may be present, the company's and underwriters' respective counsel essentially run the closing.

The federal securities laws require that the closing occur no later than the third business day following the pricing of the deal, unless the pricing occurs after the close of the market, in which case the closing may occur as late as the fourth business day following the pricing.

Practical Tip: Don't Disappear until after the Closing

IPO closings are usually anti-climactic events. Some executives choose to attend them and turn them into a small celebration. Other executives skip them altogether (especially on the West Coast, where closings are typically held early in the morning). Often at the end of the demanding IPO process, the CEO and CFO are anxious to go on vacations and get reacquainted with their families. Before disappearing, these management team members should check in with company counsel and make sure that all closing documents requiring their signatures are in order. Because so many of the closing documents require original signatures, it is preferable for the CEO and CFO to stay in town until the closing has been completed, just in case there are any last-minute changes in the closing documents that would necessitate additional original signatures.

The underwriters' over-allotment option

The underwriters of a public offering typically receive an option to purchase up to an additional 15% of the number of shares being sold to cover over-allotments, if any. These over-allotment shares are purchased on the same terms and conditions as the other IPO shares. In the process of marketing the IPO shares during the road show, the managing underwriters will build a list of prospective investors and allocations of IPO shares at given prices. At the closing, market and other factors may lead to excess demand for the IPO shares and the underwriters may elect to

exercise all or part of the over-allotment option to satisfy some of this demand. The underwriters generally have up to 30 days following the effective date to exercise the over-allotment option. If this option is exercised at the effective date or shortly thereafter, the closing for the over-allotment shares can be combined with the closing of the initial IPO shares. If not, a second closing must be scheduled to settle the sale of the over-allotment shares.

Chapter 9

Underwriting Arrangements and Marketing

Most IPOs are made by means of a firm commitment underwriting, meaning that the underwriters are obligated to purchase all of the registered shares from the company at the offering price, less underwriting discounts and commissions. The underwriters then re-sell the shares to the public at the offering price stated on the cover of the prospectus. As a practical matter, the underwriters reduce their risk by entering into the underwriting agreement only after the road show has been completed, the SEC has declared the registration statement effective, the underwriters have solicited indications of interest from potential investors in the offering and the shares are ready to be traded. The underwriters further reduce their risk by syndicating the deal among a number of investment banking firms, sometimes as many as 20 or 30 or more.

The Underwriting Fee

In a firm commitment underwriting, the underwriters charge a fee, known as the underwriting discount, as compensation for marketing and selling the deal. This fee is calculated as a percentage of the gross proceeds of the offering. For most IPOs , the fee is 7%. There are, however, some exceptions. For example, in Seagate Technology's IPO, which priced in December 2002, the underwriting discount was 4.25%. The underwriting fee is divided among the managing underwriters and the members of the underwriting syndicate and the selling group, with the managing underwriters getting a larger share of the fee for managing the offering.

NASD Review of Underwriting Arrangements

The SEC will not declare a registration statement effective until the NASD has approved the underwriting arrangements. The NASD is a private, self-regulatory organization of the securities industry and operates subject to SEC oversight. Virtually every underwriter and broker/dealer in the United States that sells securities to the public is a member of the NASD. SEC rules relating to the acceleration of effectiveness of the registration statement require that the issuer company inform the SEC whether

the NASD has reviewed the underwriting arrangements, and whether the NASD has determined that it has no objections to the arrangements. NASD rules provide that an offering will not commence until the NASD has reviewed the terms of the transaction and has no objections to the proposed underwriting and other terms and arrangements. The required standard is set forth in the NASD "Corporate Financing Rule."

To facilitate the NASD's review, the NASD requires that copies of the following documents relating to the offering be provided to the NASD for review:

- the registration statement;
- the preliminary and final prospectus;
- the underwriting agreement;
- the agreement among underwriters;
- the selected dealers agreement;
- any other document which describes the underwriting or other arrangements in connection with or related to the distribution, and the terms and conditions relating thereto; and
- any other information or documents which may be material to or part of such arrangements, terms and conditions and which may have a bearing on the NASD's review.

As these documents are revised or amended, updated drafts must also be provided to the NASD (including a marked copy showing the changes). Documents that are filed with the SEC on its EDGAR electronic filing systems are deemed to be filed with the NASD.

The NASD also requires that certain information regarding the basic underwriting arrangements and any relationships between the company, officers, directors and stockholders, on the one hand, and NASD members, including the underwriters, on the other hand, be disclosed to the NASD. The proper application of several provisions of the NASD rules requires an understanding of the nature of these relationships. Specifically, the NASD requires information regarding the following:

- an estimate of the maximum public offering price;
- an estimate of the maximum underwriting discount or commission to be paid to the underwriters;

- an estimate of the maximum reimbursement of underwriters' expenses, and underwriters' counsel's fees (except for reimbursement of "blue sky" fees);
- an estimate of the maximum financial consulting and/or advisory fees to the underwriter and related persons;
- a statement of any other type and amount of compensation which may accrue to the underwriter and related persons;
- a statement of the association or affiliation with any NASD member of any officer, director or security holder of the issuer;
- a description of factors to be considered in determining whether items of value received by underwriters prior to the offering were in connection with or related to the offering; and
- a description of any agreement entered into with any underwriter within 12 months preceding the filing of the offering that provides for an underwriter or any of its related persons to receive items of value, warrants, options or other securities of the issuer.

The NASD will accept disclosure of these matters based on the member's or its counsel's reasonable inquiry into the background of the stockholders of the issuer and any transactions between the issuer and the underwriters and related persons, but will not accept disclosure that is merely based on the knowledge of the issuer. As a result, the underwriters and their counsel must make a reasonable inquiry sufficient to provide statements that the NASD can rely on when reviewing the offering. The procedure typically employed involves circulation of a detailed questionnaire to the company's securityholders, officers and directors. Company counsel and underwriters' counsel should coordinate to ensure that appropriate questionnaires are circulated to these parties to obtain the required information. Underwriters' counsel is responsible for providing the required information to the NASD and responding to any questions that the NASD examiner may have. Underwriters' counsel should keep company counsel informed of the progress of the NASD review so that the entire working group is aware of any timing issues that the NASD review process may create.

Practical Tip: Send Out NASD Questionnaires Early

Work early in the process with underwriters' counsel to prepare and distribute questionnaires to the company's directors, officers and stockholders soliciting information required for the NASD's review. It is sometimes a time-consuming process to collect the information, so getting started early will ensure that the NASD review process does not slow the offering. Also, there are additional documents that will be sent to stockholders, and sending the paperwork in a single package can streamline the process and increase chances of getting people to respond in a timely manner.

In reviewing the underwriting arrangements, the NASD considers whether the fees being charged by the underwriters are reasonable. NASD rules provide that no member or person associated with a member may receive an amount of underwriting compensation in connection with a public offering which is unfair or unreasonable and no member or person associated with a member shall underwrite or participate in a public offering of securities if the underwriting compensation in connection with the public offering is unfair or unreasonable. The NASD does not publish what it considers "reasonable," as this will vary according to the circumstances of the transaction and general trends in the market (though the rules indicate that the amount of compensation that is reasonable, expressed as a percentage of the proceeds of the offering, will be higher if more risk is borne by the underwriters, and will be lower if the size of the offering is larger).

In determining the amount of underwriting compensation, the NASD not only looks at the underwriting discount and commission charged in connection with the IPO, but also looks at all items of value received or to be received by the underwriters and related persons which are deemed to be in connection with or related to the offering. Other items of value might include warrants or other compensation that the underwriters may have received in earlier transactions with the company. These other items of value may be aggregated with the IPO underwriting discounts and commissions for the purpose of determining whether the total underwriters' compensation is reasonable. In making the reasonableness determination, the NASD will review all items of value received by the underwriters and

related persons during the 12-month period preceding the filing of the registration statement. Items received prior to such 12-month period are presumed not to be underwriting compensation. Items received during the 6-month period preceding the filing of the registration statement will be presumed to be underwriting compensation received in connection with the offering, unless the underwriters can demonstrate to the NASD that these other items of value were received in connection with a bona fide investment or for bona fide services unconnected to the IPO. The NASD rules provide a number of factors that are considered in determining whether items of value are received connection with or related to an underwriting.

If the company has had prior transactions with members of the selling group, such as an investment from a venture capital fund affiliated with one of the underwriters, it will be important for underwriters' counsel to begin correspondence with the NASD on these issues early in order to determine whether there will be any difficulty in obtaining NASD clearance of the underwriting arrangements.

The NASD also reviews the underwriting arrangements for other terms that may be unreasonable, including unreasonable provisions relating to reimbursement of expenses and rights of first refusal to underwrite future offerings. The standard forms of underwriting agreements used by most major investment banks do not contain provisions that would be deemed unreasonable under the NASD's rules.

The NASD also reviews the underwriting arrangements for conflicts of interest. Where the lead underwriter has a large investment stake in the company or certain other conflicts of interest exist, NASD rules may require that a "qualified independent underwriter" set the offering price. As a practical matter, this means that one of the co-managers that has participated in the due diligence process will price the deal.

The Underwriting Agreement

The underwriting agreement is the principal written document outlining the rights and obligations of the company, the underwriters and any selling stockholders. Each investment banking firm has its own form of underwriting agreement, and the form of the lead manager is the form that will be used for a given offering. Underwriters' counsel should obtain these forms from the lead manager as soon as the IPO process begins, and

is responsible for tailoring this form for the particular offering and negotiating it with the company's counsel. The ability to deviate from the form will vary from underwriter to underwriter. Some underwriters are very protective of their form and want their in-house counsel to review any changes to the form for a particular deal. Others are more accommodating to changes from the form in this regard. In negotiating the terms of the underwriting agreement, the lead manager will typically be very conscious of the fact that changes may be used against it as precedent when negotiating an underwriting agreement in future offerings.

Obligation to sell and buy the IPO shares

The underwriting agreement is, in its essence, a stock purchase agreement. The primary purpose of the underwriting agreement is to establish the obligations of the underwriters to buy, and the company and any selling stockholders to sell, the IPO shares at a fixed price (stated in the underwriting agreement as the price per share to the company and any selling stockholders net of the underwriting discount). The underwriting agreement also typically includes provisions relating to an over-allotment option allowing the underwriters to purchase up to an additional 15% of the underwritten shares from the company or selling stockholders for a period of up to 30 days following the date of the offering in order to cover over-allotments of the stock.

Representations and warranties

The underwriting agreement contains numerous representations and warranties made by the company to the underwriters as to the accuracy and completeness of the registration statement, and that the registration statement complies with applicable securities laws, and as to certain other aspects of the company's business. If stockholders of the company are selling shares in the IPO, then the underwriters will require the selling stockholders to make certain representations and warranties relating to their ownership and ability to transfer title to their shares, among others. Underwriters will occasionally request that a selling stockholder make representations and warranties similar to those made by the company as to the accuracy and completeness of the prospectus and as to other aspects of the company's business, or confirm that to the selling stockholder's knowledge the company's representations are true. The outcome of this request typically will depend on whether the stockholder is in a position

to evaluate the accuracy of the prospectus and whether the stockholder has an economic incentive to bear the risk of making such representations and warranties.

Indemnification

This part of the underwriting agreement provides the manner in which risk will be allocated among distribution participants (the company, the underwriters and selling stockholders) in the event that the registration statement or prospectus contains or is alleged to contain a material mistatement or omission. The company will agree to indemnify the underwriters from liability arrising from mistatements and omissions in the registration statement and prospectus, except to the extent that the liability arises from information provided by the underwriters specifically for inclusion in the offering documents. The underwriters will agree to indemnify the company from liability arising from misstatements or omissions, but only to the extent that the liability arises from information provided by the underwriters for inclusion in the offering documents. This information provided by the underwriters is typically very limited.

The negotiation of this section is closely related to the representations and warranties and involves many of the same considerations. Common points of negotiation include, among others:

- whether the company and the selling stockholders are jointly and severally liable for each other's representations and warranties, or only for their own;
- whether indemnification obligations are of the company, the selling stockholders or the underwriters capped at the amount of proceeds (or, in the case of underwriters, discounts) received; and
- whether the company will be liable for misstatements or commissions in a preliminary prospectus that have been corrected in a final prospectus when the final prospectus is not delivered as required.

Covenants

The underwriting agreement will have a section containing agreements by the company relating to the offering, which agreements are to be performed following the offering. The covenants vary from deal to deal, and from underwriter to underwriter, but there are some common covenants that are typically required. Typical covenants include that the company agrees to inform the underwriters of proposed amendments or supplements to the registration statement and prospectus, to inform the underwriters of the company's communications with the SEC and to promptly make all required amendments or supplements to the prospectus. Additionally, the company will be required to agree to provide copies of the final prospectus, comply with SEC reporting requirements, cause the IPO shares to be listed on the applicable exchange or market, and pay certain costs and expenses in connection with the IPO.

One covenant that is typically negotiated is the agreement by the company to refrain from issuing securities for a period of time following the effectiveness of the registration statement (typically 180 days). Often there are exceptions to this restriction (for example, issuances upon exercise of outstanding options and warrants, and issuance under the company's equity compensation plans). The exceptions are typically one of the more heavily negotiated provisions in the underwriting agreement. The negotiation usually centers around issuances that the company contemplates making or reasonably expects it may need to make during the 180-day period following the IPO, and that may not be ordinary course transactions – such as issuances in connection with acquisitions and commercial transactions. Sometimes underwriters will allow an exception for certain acquisitions and other strategic transactions.

Closing conditions

The underwriting agreement will list certain requirements that must be satisfied as conditions to the closing of the purchase and sale of the IPO shares and the closing of the sale of any over-allotment shares that the underwriters elect to purchase. These conditions typically include requirements that the representations and warranties of the company and selling stockholders are true and correct, that the company has performed its covenants that are to be performed prior to closing, that no material

adverse event has occurred which impacts the company or the offering, that the opinions of counsel have been delivered, and that an auditors comfort letter has been delivered.

Provisions allowing termination of the offering by the underwriters

The underwriting agreement will also set forth certain situations in which the underwriters may abort the offering after the underwriting agreement has been signed, but prior to closing. These provisions typically include matters such as:

- the suspension of trading generally on national securities exchanges;
- the suspension of trading in the company's securities;
- the disruption of the securities trading settlement process;
- the declaration of a moratorium on banking activities, and
- the outbreak or escalation of hostilities or the occurrence of other conditions or events which make it in the underwriters' discretion impractical or inadvisable to proceed with the offering.

While these seem like remote scenarios, they do in fact become relevant at times. These provisions take on enormous importance to the company because there is potentially a large price to pay if they are invoked. In addition to the loss of the benefits of the offering, companies that have filed registration statements and fail to complete the offering (especially under unusual circumstances) will have the burden of explaining why the failed offering is not a negative commentary on the company. However, underwriters regularly refuse to negotiate any provision of this section.

Provisions regarding a default by one or more of the underwriters

In the event that an underwriter defaults in its obligation to purchase shares, the agreement contains provisions that outline how the offering will proceed, if at all. The underwriting agreement will provide that if the defaulting underwriter is responsible for a relatively small portion of the offering, the other underwriters will be obligated to take responsibility for the defaulting underwriter's share. If the default is for more than the threshhold amount, there is a period of time during which the underwriters and

the company can make arrangements for the purchase of the defaulting underwriter's allocation of the offering shares, which arrangements are mutually satisfactory to the underwriters and the company. If such arrangements cannot be made in that period of time, the underwriting agreement will terminate. The stated period of time is typically 36 hours.

Practical Tip: Conditions to Closing Involving Third Parties

The underwriters' obligation to purchase the IPO stock is conditioned upon a number of documents being delivered at the closing. Many of these documents must be delivered by third parties. Examples include the comfort letter to be delivered by the company's auditors, legal opinions to be delivered by the company's counsel, legal opinions to be delivered by foreign counsel addressing matters related to the company's foreign subsidiaries, legal opinions to be delivered by counsel to the selling stockholders and legal opinions to be delivered by patent, regulatory or other expert counsel. To avoid last minute surprises and failures to satisfy closing conditions, particularly with respect to opinions of foreign counsel where time zone and language issues may present delays, these third parties should be included in the negotiation of the portions of the underwriting agreement describing the documents they are expected to deliver at the closing.

The Comfort Letter

The comfort letter (also known as a "cold comfort" letter) is a critical part of the underwriters' due diligence process, and it is one of the key closing items for an IPO. The comfort letter is a letter from the company's accountants addressed to the underwriters (and often the company's board of directors, who also have a due diligence defense, as discussed in Chapter 7) that describes the accountants' review of the financial information contained in the prospectus, and the results of that review. It helps to demonstrate that the underwriters have made a reasonable investigation of the financial information included in the prospectus. A comfort letter is typically issued as of the date of pricing of the offering, and an update of the letter (the "bring down" comfort letter) is issued as of the closing of the IPO.

The form and content of comfort letters is governed by accounting professional standards as set forth in the Statement on Auditing Standards No. 72 – "Letters for Underwriters Underwriters and Certain Other Requesting Parties," as amended by Statement on Auditing Standards No. 76 and Statement on Auditing Standards No. 86, which are published by the American Institute of Certified Public Accountants. The two primary principles that establish the scope of a comfort letter are:

- Independent accountants may properly comment in their professional capacity only on matters to which their professional expertise is substantially relevant. This effectively limits the accountants' assurances in the comfort letter to information included in the prospectus that is derived from the accounting records of the company and that is subject to the internal control policies and procedures of the company's accounting system. Examples of matters on which accountants cannot provide comfort include square footage of facilities, number of employees, beneficial ownership of securities and (subject to limited exceptions) backlog.
- The limited procedures that precede the issuance of a comfort letter (much more limited than an audit) provide only the basis for negative assurance with respect to the items reviewed. Negative assurance refers to a statement that nothing has, as a result of the procedures, come to the attention of the accountant that causes the accountant to believe that the reviewed items do not meet a specified standard.

The comfort letter process should include the following:

- Early in the process, the underwriters' counsel should discuss with the accountant expectations regarding the procedures to be conducted by the accountants in connection with the comfort letter;
- The accountants should, soon thereafter, prepare a draft of the comfort letter, so that the underwriters and the auditors can agree upon basic form;
- As soon as the prospectus develops to a point where it is substantially complete, the underwriters' counsel should provide to the accountants a copy in which the numbers for which comfort is sought are circled; and

- The accountants should review the preliminary comfort letter markup, and discuss with underwriters' counsel any requested comfort that the accountants find problematic.

The comfort letter will typically cover the following matters:

- A list of the financial statements included in the prospectus that the accountant has audited;
- A statement regarding the independence of the accountants;
- A statement that the audited financial statements included in the registration statement comply as to form with the accounting requirements of the Securities Act and related rules;
- A statement of the procedures carried out by the accountants with respect to unaudited financial statements for interim periods, when such financial statements are included in the prospectus, or condensed financial information from such financial statements is included in the prospectus;
- A statement that the unaudited interim financial statements comply as to form in all material respects with accounting requirements of the Securities Act and related rules;
- A negative assurances statement regarding the interim financial statements;
- A negative assurances statement regarding the absence of adverse changes in certain financial data (for example, capital stock, long-term debt, stockholders' equity, net sales and net loss) between the date of the latest balance sheet included in the prospectus and the date of the comfort letter;
- A list of procedures used to provide comfort with respect to specific financial data set forth in the prospectus which vary in the degree of comfort they provide; and
- A statement that the accountants offer no assurances that the comfort letter procedures will be sufficient to satisfy the purposes for which the accountants requested the comfort letter.

Practical Tip: Start Comfort Letter Process as Early as Possible; Establish Expectations

The comfort letter is an easy matter to defer, particularly given the other priorities of an IPO process. However, the comfort letter negotiation can take a significant amount of time. This is exacerbated by the need for multiple levels of review within the accounting firm, particularly for difficult issues. If the resolution of comfort letter issues causes a delay in the IPO process, the company and the underwriters will typically become frustrated with the company's auditors and underwriters' counsel. In order to reduce the risk of delay, working group members should work together as follows:

- Craft prospectus disclosure with a view toward comfort. Many times, disclosure of a particular financial datum can be made in a variety of ways. If one method of disclosure (for example, expressing the datum as of a recent balance sheet date instead of as of the date of the prospectus) lends itself to an easier degree of comfort without negatively affecting the quality of the disclosure, the working group should consider that method of disclosure. Experienced counsel will guide disclosure in this regard during the drafting process.
- Discuss important financial disclosure items with the company's auditors early in the process. If the disclosure is important, but the accountants cannot address it in the comfort letter, the underwriters and their counsel will be required to perform due diligence on the disclosure in another manner, which can result in delays.
- Request a draft of the comfort letter from the company's auditors early in the process and ensure that the auditors review the preliminary comfort letter markup as early in the process as possible, to identify any unexpected issues.

Other Underwriting Documents

The Agreement among Underwriters and the Selected Dealers Agreement are the principal written documents that govern the relationships among the underwriters and between the managing underwriters and the dealers included in the selling group. Each major investment bank has its own forms of these agreements. Investment banks typically sign on to each other's forms as master documents which apply to all future deals in which the banks participate. The primary purpose of the agreements is to grant the managing underwriter the authority to act on behalf of, and as the agent for, each of the other underwriters and dealers. The company is not a party to either of these agreements and, absent unusual circumstances, it is not necessary for the company or the company's counsel to review these documents.

Selling Stockholder Documents

If selling stockholders are participating in the offering, a number of additional documents will be required. The purpose of these documents is to give the underwriters and the company comfort (prior to the time that they begin the road show) that the selling stockholders will actually participate in the IPO. Because neither the underwriters nor the company are contractually bound to participate in the IPO until the underwriting agreement is signed at the time of pricing, the underwriters and the company work on the basis of trust for the several months of the IPO process prior to pricing. When several selling stockholders are participating in the offering, that level of trust does not develop. Accordingly, the underwriters and the company must have some contractual assurances that, if the company includes the selling stockholders in the prospectus and the company and the underwriters market an IPO of a certain size assuming selling stockholder participation, no selling stockholder will change its mind and decide not to participate.

The documents required of the selling stockholders include a Power of Attorney, which appoints two or three individuals (often the company's CEO, CFO and general counsel) as attorneys-in-fact with the power to negotiate and sign the Underwriting Agreement on behalf of the selling stockholders, and a Custody Agreement placing the selling stockholders' shares with a custodian to hold until the consummation or termination of the offering. These documents are often subject to some negotiation. For example, some selling stockholders may refuse to grant a

Power of Attorney that enables shares to be sold at any price, and may request a "floor" price below which the attorneys-in-fact cannot sell the shares. It is important that these issues be resolved well in advance of the commencement of the road show.

In many cases, the company's counsel will also act as counsel for the selling stockholders. In other cases, particularly where a selling stockholder is a large institution, a selling stockholder may choose to retain its own separate counsel to negotiate the selling stockholder documents and underwriting agreement on its behalf.

Recent Reforms to IPO Allocation and Distributions Process

As a result of perceived excesses during the late 1990s, securities regulators have closely examined the IPO share distribution and allocation process, and either have adopted or are in the process of examining a series of new regulations to curb the perceived abuses.

In August 2002, the Chairman of the SEC requested that the NYSE and Nasdaq convene a committee to review the allocation process of IPOs. In response, the NYSE and the NASD formed the NYSE/NASD IPO Advisory Committee, composed of a committee of corporate, financial and academic leaders. The Advisory Committee issued its final report with 20 recommendations for self-regulatory organizations (such as the NYSE and Nasdaq) and the SEC to enhance public confidence in the integrity of the IPO process, which reflect the following themes:

- promoting transparency in pricing and avoiding aftermarket distortions;
- eliminating abusive allocation practices; and
- improving the flow of, and access to, information regarding IPOs.

In September 2003, the NASD submitted to the SEC proposed new Rule 2712 to expressly prohibit certain practices in the allocation and distribution of IPO securities. This proposal incorporated certain suggestions made by the IPO Advisory Committee. The proposed rule provides the following:

- *Quid Pro Quo Agreements.* The rules would prohibit the allocation of IPO shares in exchange for excessive compensation relative to the service provided by the underwriter. This provision would

expressly prohibit not only IPO allocations in return for inflated commissions, but also an allocation in return compensation for any service offered by the investment bank. The rule also prohibits threatening to withhold allocations of IPO shares if this compensation is not paid.

- *Spinning.* The rules would prohibit an NASD member from allocating IPO shares to an executive officer or director of a company (or member of the officer or director's immediate family) (1) if the member has received compensation from the company for investment banking services to the company in the last 12 months or expects to receive or intends to receive from the company compensation for investment banking services in the next 3 months or (2) on the condition that the officer or director send the company's investment banking business to the NASD member.
- *Inequitable Penalty Bids.* The rules would prohibit NASD members from penalizing other NASD members whose retail customers have flipped IPO shares when similar penalties have not been imposed by the managing underwriter with respect to distribution participants. The NASD is concerned that these inequitable penalty bids may result in undue pressure being placed on retail investors to hold their investments longer than they actually want to while such pressure is not placed on institutional investors.

In November 2003, the NASD proposed for comment to its members a second set of rules relating to the IPO allocation process. These new proposed rules include the following:

- *Disclosure of indications of interest.* This provision would require the lead underwriter to disclose to the issuer indications of interest prior to pricing the deal, and to disclose the final allocations after pricing. The idea is that greater participation by issuers in pricing and allocation decisions will allow for more informed pricing decisions by issuers and will provide management with more information to evaluate an underwriter's performance.
- *Delay in market orders.* Prohibit NASD members from accepting a market order to purchase IPO shares for one trading day after an IPO. This provision addresses the concern that investors placing market orders on the first day of trading may inadvertently purchase shares at prices that do not reflect their investment intent as

a result of the volatility and lack of information on that first day. By preventing market orders for the first trading day following an IPO, the the market will have time to develop trading information, making uncapped orders less risky.

- *Restrict allocation of uncompleted allocations.* This provision would impose procedures to ensure that reneged allocations are not used to benefit favored clients of the underwriter. Without this new rule, in a situation where the IPO shares are trading at an immediate aftermarket premium, shares that are allocated but not purchased could be allocated to favored customers with a built-in immediate gain. The rules requires that these shares are allocate first to the existing syndicate short position (the allocations made by the underwriters in excess of the primary offering amount), and any remaining returned shares must be sold on the open market with the profit returned to the issuer.
- *Apply lock-ups agreements to directed shares.* This provision would require that any lock-up that applies to shares owned by the issuer's officers and directors will also apply to shares they receive in directed shares programs.
- *Impose new notification requirements when underwriters waive lock-ups.* This rule would require underwriters to notify an issuer prior to allowing a waiver of the restrictions of a lock-up agreement and would require the underwriter to publicly announce the waiver though a nationwide news service.

The NASD noted that its proposed rules regulating the IPO process were mainly focused on the allocation of IPO equity securities. The NASD also noted that many IPOs in the 1990s experienced a sharp run-up in price shortly after the offering, and then suffered a precipitous decline thereafter. The NASD suggested this might indicate the need for regulation of the pricing process, and it requested comments on various additional regulatory steps that might be taken to promote transparency in IPO pricing. These possible approaches include requiring underwriters to:

- Retain an independent broker/dealer to opine that the initial IPO price range at which the offering is marketed and final offering price are reasonable and to require that the opinion be disclosed in the prospectus; or

- Use an auction system, such as a Dutch auction system (described elsewhere in this book) or similar system to collect indications of interest to help establish the final IPO price; or
- Include a "valuation disclosure" section in the prospectus, including information about how the managing underwriter and issuer arrived at the initial price range and final IPO price (for example, the issuer's one-year projected earnings or P/E ratios and share price information of comparable companies).

As of the date of this edition of the guidebook, the NASD had not adopted any of these approaches.

The Changed Role of Research Analysts in the IPO Process – Analyst Conflicts

One of the important roles that financial institutions play in the IPO process involves research coverage of a company's stock. In order for the stock to have a healthy, liquid trading market, it is important that respected research analysts track the company's industry and the company's performance and make recommendations to the investing public regarding whether they should buy the stock, sell the stock or hold it in their portfolios. The same institutions that provide investment banking services to the company also have a research group that provides research coverage.

The conflict problem

The role of research analysts in the capital markets and the investment banking industry has received a great deal of media and regulatory attention in recent years, particularly in the aftermath of the severe declines in the public equity markets following the late 1990s. Historically, analysts played a somewhat low-profile role in the industry. However, in the late 1990s, some analysts were gaining notoriety for their following among institutional and retail investors and the recommendations they were making, and were receiving substantial, well-publicized compensation packages. At the same time that a relatively small number of analysts was raising the profile of the industry, the role of the analyst in the securities industry was changing, and was resulting in potential conflicts of interest that eventually undermined investor confidence in the capital markets.

The SEC began investigating the role of Wall Street analysts in the securities industry in 1999 as it became apparent that the analysts were playing an increasingly prominent and pivotal role in the industry, and in the capital raising process in particular. The SEC reviewed industry practices and conducted examinations of the largest full service investment banking firms on Wall Street. The results of the SEC investigation outlined a number of conflicting pressures to which analysts had become exposed, including the following:

- A*nalysts were involved in the investment banking group's activities.* Analysts routinely participated in pitches for prospective banking engagements, participated in road shows, initiated analyst coverage on prospective banking clients, developed relationships with prospective banking clients and provided informal consulting to privately held companies.
- *Analyst compensation was tied to the investment banking groups.* Many firms paid their analysts based on the operating performance of the investment banking group. Some firms' investment banking groups were involved in the performance reviews of analysts and in determining analyst compensation. Favorable research reports could result in increased trading (and, hence, increased brokerage commissions) and in future investment banking engagements (and, hence, increased banking fees), which would boost the operating performance of the company, and also the compensation of the analysts. Some firms also directly linked bonus compensation to analysts assisting in generating new banking business.
- *Investment banks and analysts often held equity positions in the companies they covered.* It was not uncommon for investment banks, and even their analysts, to hold stock in the companies for which the investment bank and the analyst provided research coverage. In some cases analysts had purchased shares of private companies in advance of the analyst's firm managing the company's IPO.
- *Inadequate disclosure of conflicts.* The disclosure of stock ownership conflicts was inconsistent across firms. The disclosure of investment banking relationships between covered companies and the analysts' firm was deemed inadequate.
- *Suspicious timing of favorable ratings relative to lock-up release.* There were numerous examples of analysts issuing favorable reports on

companies coincident in time with the release of the post-IPO lock-up. These so-called "booster shot" reports had the effect of boosting the stock price at precisely the time that the company management and others subject to lock-up agreements were first able to sell their shares.

The SEC was so concerned about these issues that, in June 2001, it issued a lengthy investor alert urging investors to be suspicious of securities analyst reports. In addition, SEC, the NASD, the NYSE and certain state regulators brought actions against leading investment banks. The allegations made in these actions (which were settled with neither admission nor denial of the charges by the accused) included: issuing fraudulent research reports; issuing research reports that were not based on principles of fair dealing and good faith and did not provide a sound basis for evaluating facts, contained exaggerated or unwarranted claims about the covered companies, or contained opinions for which there were no reasonable bases; receiving payments for research without disclosing such payments; and failing to maintain appropriate supervision over their research and investment banking operations in violation of NASD and NYSE rules.

The regulatory response

A number of regulatory actions have been taken to correct these perceived structural problems with the investment banking and research coverage businesses, and to instill confidence and trust in the public capital-raising process.

Global Analyst Research Settlements. Several large investment banks, and certain of their analysts, were subject to actions by attorneys general and state securities regulators for their practices involving research analysts. These actions were settled in April 2003. The settlement resulted in a number of major investment banking firms being enjoined from future violations of the rules they were accused of violating. These firms also agreed to make payments totaling $1.4 billion, including $875 million in penalties. The firms that were party to the settlement (which do not include all investment banks with research departments) also agreed to implement the various structural changes to their research organizations.

New NYSE and Nasdaq Analyst Rules. In May 2002 and July 2003, the SEC approved new rules for Nasdaq and the NYSE relating to analyst conflicts of interest which are specifically designed to ameliorate the risk of

analyst conflicts that undermine the public confidence in analyst recommendations. The rules cover some of the same basic topics that the Global Research Analyst Settlement covered, but also go further. The new rules apply to all investment banking firms (whether or not such firms were parties to the global settlement) and cover the following areas:

- *De-coupling the research and investment banking ends of the business.* The rules prohibit analysts from being under the supervision or control of the investment banking group, and require legal and compliance groups to act as intermediaries with respect to communications between research and banking groups regarding the contents of research reports. The rules also prohibit securities firms from directly or indirectly retaliating or punishing an analyst who issues an unfavorable research report or comments unfavorably in a public appearance.
- *Limitations on company review of reports.* The rules limit the extent to which analysts can have subject companies review their reports prior to issuance, and require legal and compliance groups to be copied on portions of reports submitted to subject companies for review.
- *Disclosure of investment banking compensation from companies covered by the bank's research.* The rules require disclosure in research reports if the analyst's investment bank managed or co-managed a public offering of securities of the subject company in the past 12 months, received investment banking compensation from the subject company during the past 12 months. Disclosure is also required for non-investment banking compensation received by affiliates of such banks, subject to certain exceptions.
- *Breaking links between analyst compensation and the investment banking business.* Securities firms are prohibited from paying any compensation to securities analysts that is based upon investment banking transactions, and analysts are required to disclose if their compensation is based in any part upon the operating results of the investment banking group. Analyst compensation must be reviewed and approved by a compensation committee that has no participation from the investment banking group. The committee must base its review in part upon the analyst's report performance

and may not consider the analyst's contributions to the investment banking business of the firm.

- *Prominence of disclosures.* The disclosures regarding analyst conflicts must either be set forth on the cover of the research report, or the cover page must include an explicit cross reference to the pages in the report where the disclosure may be found.
- *Prohibition on research report issuance shortly following an IPO.* The rules prohibit securities firms from publishing research reports on, or making public appearances regarding, a company for which the firm acted as a managing underwriter in an IPO for a period of 40 calendar days following the IPO. The blackout period is 25 calendar days for securities firms that participated in the offering as an underwriter or dealer but not as a managing underwriter.
- *Prohibition on research report issuance near time of lock-up expiration.* Analysts are prohibited from publishing research reports or making public appearances for a period of 15 calendar days prior to or after the expiration, waiver or termination of a lock-up agreement restricting the sale of shares following a public offering.
- *Disclosure of stock ownership by an analyst's firm.* An analyst must disclose in a research report or public appearance if the analyst's firm has an ownership position of 1% or more of a company that is a subject of the research report or the public appearance.
- L*imitations on trading by analysts in securities they cover.* Research analysts and members of their households are prohibited from (1) obtaining pre-IPO shares in companies that they cover, (2) trading in the securities of companies they cover for a period beginning 30 days prior to, and ending 5 days following, the issuance of a research report or a modification in the rating or price target for the company and (3) trading contrary to the analyst's recommendation with respect to a security. Legal or compliance personnel are required to approve securities transactions by supervisors of research analysts.

R*egulation AC (Analyst Certification).* In April 2003, the SEC adopted Regulation AC, which requires that underwriters that publish, circulate or provide research reports must clearly and prominently include in the reports:

- A statement by the analyst that the views expressed in the report accurately reflect the analyst's personal views about the companies and securities discussed in the report; and
- A statement as to whether any part of the analyst's compensation was, is or will be directly or indirectly related to the recommendations or reviews contained in the report. If the answer is "yes," the report must also disclose detail regarding the source, amount and purpose of that compensation, and an explicit statement that the compensation may influence the recommendations in the report.

The rule also requires investment banking firms to keep records of public appearances by their research analysts. Within 30 days of the end of any calendar quarter in which an investment bank's research analyst makes a public appearance, the investment bank must create a record that includes statements by the research analyst substantially similar to the statements required in research reports.

Online Offerings

It has become quite common for a company's public offering to include an online, retail component. Internet-focused underwriters, however, typically play a limited role in the overall deal, with a major portion of the offering still being sold in a traditional institutional manner. The SEC has issued only limited guidance in this area, but a number of practices, supported by various levels of SEC guidance, have surfaced. E-brokers use differing methods for conducting the online portion of their offerings. Accordingly, the company should decide whether to include an online component to its offering early in the IPO process, fully understand the underwriter's procedures and ensure that such procedures have received SEC approval.

Dutch Auction Offerings

Some underwriters utilize a method of distribution in IPOs that differs somewhat from the method traditionally employed in firm commitment underwritten offerings – the "Dutch action." In a Dutch auction offering, the public offering price and allocation of shares are determined following an auction process conducted by the underwriters and other securities dealers participating in the offering. All investors, both individuals and institutions alike, have priority to buy shares based on the number that they indicate they are willing to pay (that is, the higher bids receive higher priority). The actual public offering price is then deter-

mined based on the "clearing price," which is the highest price at which all shares in the offering can be sold. Accordingly, investors whose bids are accepted will pay the price that is either the same or lower than their bidding price.

True Story:
WRHambrecht's OpenIPO wins bid in Overstock.com IPO

In 2002, Overstock.com, Inc. (Nasdaq: OSTK), an online "close-out" retailer that offers discount, brand-name merchandise for sale over the Internet, completed its IPO using the OpenIPO® auction process created by William Hambrecht, Chairman and CEO of WR Hambrecht + Co. Hambrecht's auction process, a system designed by Nobel Prize-winning economist William Vickrey, uses a mathematical model to treat all qualifying bids in an even-handed and impartial way (similar to the model used to auction U.S. Treasury bills, notes and bonds).

In an OpenIPO auction, the entire process is private and the highest bidders win. Winning bidders all pay the same price per share – the public offering price. The auction is typically open for bids for 3-5 weeks prior to the effective date of the offering. Once the bidding concludes, all bids are assembled and, working from highest to lowest, the first bid price that will sell all the offering's shares is determined. This bid sets the "clearing price" or the maximum price at which all of the shares the company seeks to offer will be fully subscribed.

The company may choose to sell shares at the clearing price, or it may offer the shares at a lower offering price, taking a number of economic and business factors into account.

True Story:
WRHambrecht's OpenIPO wins bid in Overstock.com IPO (continued)

If the number of shares bid above the clearing price exceeds the number of shares in the offering, WR Hambrecht + Co. allocates the shares among the bidders on a pro-rata basis, with allocations rounded to multiples of 100 or 1,000 shares, depending on the size of the bid.

In its IPO, Overstock.com sold 3,101,000 shares of its common stock at a price of $13.00 per share.

The Road Show

Logistics

Once the preliminary prospectus has been printed and distributed, the management team and managing underwriters conduct the road show. Introduced in the 1970s, road shows today play an integral part of the IPO process. The primary purpose of the road show is to sell the offering shares to institutional investors.

A typical road show will last two to three weeks and will visit 10 or more cities in the United States. If the company and managing underwriters have decided to include an international tranche or allocation in the offering, the road show will include presentations outside the United States as well, usually in Europe.

The CEO and CFO should expect to make one or two large group presentations in each city, as well as several one-on-one presentations each day. Occasionally, the managing underwriters will have a second road show team with other members of the company's management, doubling the number of possible one-on-one presentations. It is not uncommon for the management team to meet as many as 200 potential investors over the course of a single road show.

The biggest logistical challenge is generally determining the schedule for the road show. As a practical matter, the road show is scheduled only after the company and the underwriters are satisfied that the company has

responded sufficiently to the SEC's comments such that no SEC comments that would require a material revision to the registration statement are outstanding. Depending on the subject matter of the SEC comments, this may require one or two rounds of comments and responses before the company and the underwriters are comfortable scheduling the road show. For example, an unresolved comment relating to revenue recognition may warrant delaying scheduling the road show. The risk of beginning the road show before all material SEC comments are resolved is that if new material information is added to the registration statement after the preliminary prospectus is printed for use in the road show, the SEC could require the company to "recirculate" the prospectus, which is expensive and could delay the pricing of the offering.

Preparation

Preparation for the road show generally begins after the initial filing of the registration statement and during the period of time that the company is waiting for SEC comments.

Practical Tip: Listen to the Underwriters

Once the company's road show begins, there will be almost no time to make adjustments to the road show presentation. The underwriters have every incentive to ensure a successful road show, and therefore company management should follow the practical suggestions of the underwriters when it comes to preparing for this event. Underwriters often suggest the company retain a professional coach to help management improve its road show presentation skills. Underwriters may also recommend that the company engage a design firm to help create the visual portion of the presentation

In the days prior to the road show, presentations will be made to the managing underwriters' sales forces. In addition to being an excellent opportunity for the management team members to refine their presentations, these sessions also serve the purpose of educating the sales forces about the company to enable them to call on their retail accounts to solicit interest in the offering.

Presentations

Road show presentations are designed to provide large amounts of high-level information in a very short period of time. As a general rule, the entire presentation should take 30 to 45 minutes and is often shorter. Group presentations are virtually the same format and length as one-on-one presentations, although one-on-ones are generally more conducive to detailed Q&A. As a practical matter, the company should recognize that not all attendees will have studied the prospectus prior to hearing the company's presentation, and should prepare the presentation accordingly.

A representative of the lead underwriter typically introduces the management team and makes a few comments regarding the company and the industry.

The CEO then speaks. Investors do not expect more than an overview of the company, given that they can review the detailed financial and business information contained in the prospectus to the extent that they are interested. The CEO's presentation should describe the company's history, business, products and services, sales and marketing, customers, competitive situation and other pertinent information about the company.

The CFO typically follows the CEO's presentation with a review of financial and accounting matters. This involves a review of the company's financial statements and general financial status.

The company's road show presentation should not disclose information about the company that is not contained in the prospectus. Discussions of projections or other forward-looking information can be particularly dangerous because such discussions cannot be protected by the safe harbor described in Chapter 10. Moreover, information presented in a road show discussion can serve as the basis for a claim under the anti-fraud provisions of the federal securities laws, and, if material, may raise questions about the adequacy of a prospectus that omits the information.

Although the federal securities laws allow oral and audio/visual communications such as the road show presentation during the pre-effective period, no written materials may be handed out to investors, analysts or other spectators except for the preliminary prospectus. Copies of the slide show presentations and other written or recorded materials used in the road show presentations may not be distributed.

Electronic Road Shows

A number of commentators have argued that companies and their underwriters should be permitted to leverage technology to improve the road show process by broadening investor access and reducing the time and money spent to attend in-person meetings. For example, by utilizing the Internet, a company may be able to make its road show available to a much larger audience of investors. Investors who either live in cities that are not visited in-person by the road show team or cannot attend in-person meetings due to scheduling conflicts can attend the online road show at their convenience.

The SEC has provided some limited guidance regarding electronic road shows. The SEC permits issuers to utilize video or electronic road shows in connection with their offerings so long as they follow certain procedures to ensure that the electronic road show is, for all practical purposes, the same as the live, in-person meetings. For example, the transmission must be made available only to viewers who are of a type customarily invited to road show presentations and viewers must receive or have access to the prospectus before the transmission can be viewed. Also, information disclosed during the electronic road show presentation must be consistent with the disclosure in the prospectus and viewers must not be permitted to copy, download, or distribute any road show material. As discussed earlier with respect to online offerings, the company should decide early in the IPO process as to whether an electronic road show component will benefit its offering, fully understand the underwriter's procedures and confirm with the underwriters that such procedures have received SEC approval.

Pricing the IPO

Incentives

The incentives of the company and the managing underwriters are mostly, but not entirely, aligned when it comes to pricing the IPO. A higher price raises more money for the company with less dilution and also generates higher fees for the underwriters. An unsustainably high price, however, can harm the company and the underwriters. Disappointing aftermarket performance may cause investors and analysts to lose interest, make a follow-on offering more difficult, and even expose the company to securities litigation. Similarly, poor aftermarket performance

can expose the underwriters to potential liability and tarnish the underwriters' credibility with their institutional accounts. The company and managing underwriters therefore have an incentive to establish as high a price as possible while still ensuring some after-market demand that will support the trading price in the days following the IPO. However, the company and the managing underwriters do not always see eye-to-eye on the exact valuation that will accomplish these dual objectives, especially since the underwriters face conflicting pressures to place stock with favored brokerage customers at a favorable price.

Valuation analysis

The underwriters use a number of different financial models to determine company valuations. By the time the deal is priced, the company will be familiar with the valation approach used by the managing underwriter, which will have presented its approach to the company first during the underwriter selection process and then again prior to recommending a price range to include in the preliminary prospectus for marketing the offering during the road show. If there are comparable companies in the same industry which are already publicly traded, the underwriters generally will use a similar multiple of earnings, revenue or cash flow in valuing the company. Another method of valuation, which is particularly useful in valuing companies with no publicly traded counterparts, is a discounted cash flow, or net present value, method whereby projected cash flow or earnings for some future period are discounted to a current valuation.

Companies should expect some discount to be taken after a valuation of the company is determined. First, this discount reflects the desire to ensure after-market demand as discussed above. Second, it also reflects the relatively higher risk of investing in a young, unproven company compared with more established companies with more resources in the same industry segment.

Finally, the managing underwriters will have a good feel for the demand for the company's stock as they near the end of the road show and see the levels of potential orders. During the road show, the underwriters will be tabulating the indications of interest as they come in and should be able to provide the company with visibility as the "book" is built as the road show progresses. In fact, as discussed in greater detail earlier in this chapter and Chapter 2, certain rules proposed by the NASD

mandates greater transparency into the IPO pricing process. A particularly strong or weak demand for the company's stock will influence the final valuation, regardless of the preliminary results of the various calculations described above. This bears out in particular because many institutional investors have analysts that develop their own valuation models which may be different, positively or negatively, than the underwriters model.

Final pricing negotiation

The final pricing negotiation between the company and the underwriters will occur as the registration statement is ready to be declared effective and the underwriters are ready to sign the underwriting agreement and commence sales of the stock. Because events at this stage move rapidly, it usually is not practical for the company's entire board of directors to convene for the purpose of considering and approving the final price. Therefore, boards of directors typically delegate this authority to a "pricing committee" consisting of two or three members, usually including the CEO and one or more outside directors. As discussed earlier in this chapter, the company and the underwriters typically require all selling stockholders to name an attorney-in-fact with the power to negotiate and determine the price on behalf of the selling stockholders.

During the pricing call with the company's pricing committee, the underwriters will present data to support their pricing recommendation. This data may include performance of the equity markets in general, the performance of comparable companies in recent weeks and the corresponding valuation multiples, the book of institutional investor demand and the extent to which the offering is oversubscribed, expected aftermarket interest in the company's stock, price information and aftermarket performance of other recent IPO companies. Based on the data, the underwriters will make a recommendation that will form the basis either of an agreement, further negotiation or a decision to postpone (or cancel) the offering.

Chapter 10

Now that You're Public...

Once a company is public, life is noticeably different. Some of the most significant areas of change are discussed below.

Managing Relations with Wall Street

One of the things that management of a new public company finds most stressful, and for which it often feels inadequately prepared, is dealing with Wall Street research analysts and disclosure issues in general. Managing analyst contacts has been characterized as "fencing on a tightrope." On the one hand, having well-respected analysts publishing reports regarding the company raises the company's visibility with investors and contributes to liquidity in the stock. On the other hand, if managed poorly, contacts with analysts may lead to lawsuits or SEC enforcement actions based on claims of selective disclosure of material, nonpublic information or insider trading.

Public companies use analyst conference calls (or webcasts on the Internet, or both), in conjunction with press releases issued prior to such calls, as one method of providing new or updated information to the market. Most of these conference calls are held following the end of the company's fiscal quarter to discuss financial results. These calls are preceded by an earnings press release, which is also furnished on Form 8-K with the SEC prior to the call. Companies also use these calls (or webcasts) to discuss unexpected material or irregular news (for example, corporate reorganizations or acquisitions, including mergers, or other significant developments). Research analysts attend these calls to evaluate the information disclosed by the company and then publish reports to inform investors of their analysis. Each research analyst hopes to build an accurate model of the company's future performance.

General Disclosure Obligations

General rule

The securities laws have historically given companies latitude to determine when and how they communicate material information to the public. The courts and the SEC have stated as a general rule that, in the absence of insider trading or previous inaccurate disclosures, a company has no affirmative duty to disclose material information, apart from an obligation to make required disclosures in their periodic and current reports filed pursuant to the Exchange Act (for example, Form 10-K, Form 10-Q, Form 8-K), as well as annual reports and proxy statements.

However, such a general rule has little practical value in light of the day-to-day circumstances that are widely acknowledged to impose an affirmative obligation of disclosure on a public company. In fact, a more open communications policy is encouraged by constant inquiries from the investment community for current information, internal pressures from employee stockholders and insiders with respect to purchases and sales of the company's stock, as well as the company's motivations in apprising the investment community of current developments. In addition, as discussed in greater detail below, the NYSE and Nasdaq require listed companies to promptly disclose material information. As a result, most public companies adopt affirmative policies to disclose material information, subject to certain exceptions (for example, when it is necessary to keep the information confidential or when the Company has a legitimate business reason for not disclosing it). As discussed in greater detail below, Regulation FD prohibits public companies from selectively disclosing material information to certain persons, such as securities analysts and stockholders, prior to public disclosure of the information.

Timing issues

Once a company concludes that certain information is material, the company must then determine when such information must be disclosed to the public. Materiality determinations are often difficult, and companies should consider various timing issues and concerns, such as whether the company is in a position to adequately and accurately disclose the information. Disclosure is appropriate only when the information to be released by the company is accurate, clear and specific. For example, information that is released prematurely may be susceptible to misinterpretation. As a general matter, the courts concede that the timing of disclosure of material information, outside a company's periodic and

current reporting obligations, is a matter of the company's business judgment. However, most companies as a matter of practice follow the rule, that unless there is a legitimate business reason for delaying disclosure, a company should promptly disclose material information. Generally, a company has a legitimate business reason for nondisclosure when to disclose information would likely adversely impact the ability to reach agreement on a pending transaction (for example, a merger or product partnership). However, when price, terms and structure have been agreed upon, courts have ruled the information generally becomes material.

Exceptions requiring disclosure

Notwithstanding the general rule discussed above, there are certain specific circumstances in which a public company will have an affirmative disclosure obligation. A company has an immediate duty of disclosure if insiders possessing material, nonpublic information are trading in the company's stock (except for trading pursuant to Rule 10b5-1 plans discussed later in this chapter), or if the company itself is involved in such trading. In some circumstances, a company will have a duty to correct existing information in the marketplace that is inaccurate when published. Such a duty may well arise where such previously existing information was published by the Company, is attributable to the Company through express or tacit endorsement in one form or another, or where such information was generated by a person or institution with whom the Company has a special relationship. However, a company generally does not have an obligation to rectify or correct rumors in the marketplace that are not attributable, directly or indirectly, to the company. A company may also have a duty to update existing information that it put in the marketplace that is still material information but subsequently becomes incorrect due to later facts.

Additionally, even if a company is not required to disclose material information under the federal securities laws, the company is subject to the Nasdaq rules or applicable exchange rules. Nasdaq requires listed companies to promptly disclose to the public material corporate information and that such information be provided to the Nasdaq MarketWatch Department by telephone and facsimile at least 10 minutes prior to public announcement. Also, the NYSE requires listed companies to promptly disclose to the public material corporate information via press release. (In fact, the NYSE has stated that it continues to believe that a press release

constitutes the single best way to ensure that new material information released during the trading day becomes available to all traders and the investing public as promptly as possible.)

Disclosures of forward-looking information – using the safe harbor

Historically, a large portion of securities fraud suits were based on projections and other forward-looking statements that companies failed to meet. In 1995, as part of its attempt to reduce the incident of abusive securities litigation, Congress passed the Federal Private Securities Litigation Reform Act, which, under some limited circumstances, provides for a safe harbor for certain forward-looking statements. However, this safe harbor can provide immunity for forward-looking statements only if it is used properly.

The safe harbor works differently depending on whether the communication is written or oral. For written statements, such as in press releases and SEC filings, the safe harbor applies where the forward-looking statement is identified as such and is "accompanied by meaningful cautionary statements identifying important factors that could cause actual results to differ materially from those projected in the forward-looking statement." To invoke the safe harbor for oral communications, such as conference calls, the company simply needs to announce at the beginning of the call that it may give forward-looking information (and, ideally, identify the nature of such information), that actual results could differ materially and that the factors that may cause the difference are explained in the Risk Factors section of the Company's SEC filings, identifying the filings (for example, "our Form 10-K for the fiscal year ended December 31, 2003, filed with the SEC on March 15, 2004"). If the referenced document contains a meaningful description of the risks facing the company, the oral forward-looking statements cannot be the basis of a private securities suit, even if they turn out to be off the mark.

In addition to properly invoking the safe harbor, it is important to understand that the statement must be truly forward-looking (that is, truly a projection of the future) to be protected by the safe harbor. For example, if a company knows present or historical facts that belie the projection, the statement would not qualify as forward-looking and would not be protected by the safe harbor.

A new public company should ensure that all analyst calls, press releases and any other public statements include the disclosure necessary for the company to invoke the protections of the safe harbor. (However, note that the safe harbor does not apply to IPOs and a few other transactions and does not protect a company in an enforcement action brought by the SEC.)

Regulation FD (Fair Disclosure)

Background

Effective October 23, 2000, the SEC adopted Regulation FD (Fair Disclosure), which introduced new rules intended to improve the transparency and fairness of the dissemination of information and address the SEC's growing concerns regarding the selective disclosure of material information by companies to securities analysts and selected institutional investors. Regulation FD prohibits selective disclosure of material information.

As reflected in well-publicized reports, many companies had been selectively disclosing important nonpublic information, such as advance warnings of earnings results, to securities analysts or selected institutional investors or both, before making full disclosure of the same information to the general public. These disclosures took the form of limited-access analyst conference calls or one-on-one conversations, during which material information regarding corporate earnings and other key financial and operating metrics were disclosed, directly or indirectly, by giving qualitative feedback on analysts' assumptions and financial models. As a result, those who had the information before public announcement were in a position to make a profit or avoid a loss at the expense of those investors who were kept in the dark. The SEC believed that the practice of selective disclosure was leading to a loss of investor confidence in the integrity of the capital markets. The SEC stated that selective disclosure bore a close resemblance in this regard to tipping and insider trading, which are topics discussed in greater detail later in this chapter. Moreover, many commentators believed that these inefficiencies in the public dissemination of information had contributed to the speculative euphoria that characterized the late 1990s.

Regulation FD was also designed to address another important concern of the SEC – the potential for corporate management to treat material information as a commodity to be used to gain or maintain favor with particular analysts or investors. The SEC believed that in the absence of a prohibition of selective disclosure, analysts may feel pressured to report favorably about a company or otherwise slant their analysis to have continued access to selectively disclosed information. The SEC expressed concern with reports that analysts who published negative views of a company were sometimes excluded by that company from calls and meetings to which other analysts were invited.

Finally, the SEC acknowledged that recent technological developments had made it much easier for companies to disseminate information broadly. Historically, companies may have had to rely on analysts to serve as information intermediaries. In addition to press releases, companies now can use a variety of methods and mediums to communicate directly with the market.

Regulation FD in a nutshell

Regulation FD requires that, whenever a public company intends to disclose material information to securities market professionals and stockholders that are likely to use the information in buying and selling securities, it must do so through a public disclosure. In addition, if the company discovers that it has mistakenly made a material selective disclosure to any such person, it must make prompt public disclosure of the information (within 24 hours of learning of such disclosure).

Some of the key elements of Regulation FD are as follows:

- *Material information.* The regulation does not define what is material or nonpublic information. Instead, it relies on the definitions from case law which hold that information is material if there is a substantial likelihood that a reasonable investor would consider it important in making an investment decision, or the information would be viewed as having significantly altered the total mix of information available in the market.

  However, the SEC has provided a non-exclusive list of certain types of information that is likely to be material:

  - earnings data, either historical or projected;
  - acquisitions, joint ventures and dispositions of assets;

- new products or discoveries or developments regarding key customers or suppliers;
- changes in control or management;
- changes in auditors or auditor notification that a company may not rely on an audit report;
- events regarding the issuer's securities (defaults, redemptions, repurchase plans, splits, changes in dividends, changes in rights, and public and private sales of additional securities); and
- bankruptcy-type events.

The SEC has made it clear, however, that by providing such a list it did not mean to imply that each of these items is *per se* material – the information and events on the list still require analysis and judgment.

The SEC Staff Accounting Bulletin No. 99, which addresses financial statement materiality looking at quantitative and qualitative factors, can be useful in making materiality determinations as well. However, the company cannot assume that items are immaterial simply because they fall below a certain percentage threshold.

Finally, Nasdaq's definition of "material news" may also be helpful in making materiality determinations. Nasdaq defines "material news" as information that would reasonably be expected to affect the value of the company's securities or influence investors' decisions. Nasdaq's list of events that triggers its advance notice requirement is similar to the SEC's list discussed above.

- *Non-public information.* Information is nonpublic if it has not been disseminated in a manner making it available to investors generally.
- *Required public disclosure.* Regulation FD requires that whenever an issuer discloses material information"it shall make public disclosure of that information." A variety of methods can satisfy this requirement. These include making a public filing with the SEC on Form 8-K, the issuance of a press release on a wire or news service and holding press conferences or conference calls at which members of the public may either attend or listen via telephone or

the Internet, so long as the company discloses that it intends to have such a conference call.

- *Disclosures to members of the financial community.* Although Regulation FD is very broad at first glance, it does not apply to all of a company's communications with the outside world. The regulation applies only to communications with market professionals and security holders under circumstances in which it is reasonably foreseeable that someone will trade on the basis of the information. Regulation FD does not apply to communications with advisors who owe a duty of trust or confidence to the company (for example, lawyers, accountants, investment bankers) or to communications with the press, rating agencies, and business communications with customers. In addition, the SEC carved out communications made to persons who expressly agrees to maintain the disclosed information in confidence (for example, pursuant to a non-disclosure agreement entered into prior to the disclosure that prohibits trading on the information).
- *Disclosures by persons acting on behalf of the public company.* Regulation FD does not govern the conduct of all employees. Rather, it applies only to communications made by senior management, investor relations professionals, and others who regularly communicate with the market and investors. Statements made in connection with most registered securities offerings will be exempt from Regulation FD.
- *Timing of disclosure.* Intentional disclosures covered by the regulation (which includes disclosure with respect to which the issuer is reckless) must be made public simultaneously with the covered disclosure to a member of the financial community. If an issuer discovers that it has mistakenly made a material selective disclosure to a covered person, it must make a prompt public disclosure, within 24 hours, of the covered disclosure.

Regulation FD does not create a private right of action for violations. Thus, a stockholder cannot file a suit for a company's violation of Regulation FD. However, the SEC may bring an enforcement action against the company and the individual who made a disclosure where a violation was intentional or reckless.

Practical Tips: Managing Contacts with Analysts and Investors

Prior to the effective date of its IPO, a company should work together with its counsel to adopt an analyst policy and an investor relations policy. Managing relations with analysts and investors is not always intuitive, and guidance from someone who regularly defends companies in stockholder lawsuits can be invaluable. Among other things, the company should heed the following:·

- Make sure that the policies are realistic. Having a policy that is not practical, and therefore not followed, may put the company at a disadvantage in defending a stockholder lawsuit.
- Designate company spokespersons who are authorized to talk to the financial community. Require employees to refer all analyst, investor and financial press inquiries to one of the designated spokespersons. Get a tutorial from the company's counsel and make sure that each of the company's designated spokespersons attends.
- Prepare scripts and anticipate Q&As for analyst calls; preclear scripts and material press releases with counsel, and ensure that the appropriate safe harbor language is included in every communication.
- Do not distribute analysts' reports or otherwise endorse them.

Practical Tips: Managing Contacts with Analysts and Investors (continued)

- Do not be pressured into disclosing information; it is often appropriate to say, "We are not commenting on that." Consider imposing an analyst blackout period during which no calls from analysts will be accepted (for example, during the last two weeks of each quarter), to avoid inadvertent violations of Regulation FD.
- Review analyst and investor relations policies periodically as the company's situation changes.

True Story: The Schering-Plough Enforcement Action and Settlement

In September 2003, the SEC announced its first settlement of a Regulation FD enforcement case. The settlement with Schering-Plough Corporation and its former Chairman and CEO illustrates the SEC's views on enforcement of Regulation FD and highlights the important of strict adherence to the rules.

The SEC's complaint against Schering-Plough alleged that the company's Chairman and CEO and its Senior Vice President of Investor Relations met privately with analysts and portfolio managers. During these meetings, the company allegedly disclosed, through a combination of spoken language, tone, emphasis and demeanor, material and adverse nonpublic information regarding the company's earnings prospects, including the fact that analysts' estimates for third quarter 2002 earnings were too high and that earnings would significantly decline in 2003.

True Story: The Schering-Plough Enforcement Action and Settlement (continued)

Immediately after the meetings, analysts at two of these firms downgraded their ratings on the company, and portfolio managers at three of the firms heavily sold the company's stock. The price of the company's stock declined over the next several days by more than 17% on approximately four times normal volume.

The SEC charged the company with violations of Section 13(a) of the Exchange Act and Regulation FD. Schering-Plough paid a $1 million fine, and the Chairman and CEO paid a $50,000 fine.

Periodic Reporting and the Disclosure Obligations of a Public Company and its Stockholders

Quarterly reports on Form 10-Q and annual reports on Form 10-K

The IPO registration statement is only the first SEC disclosure filing that a public company will make. Companies must file quarterly reports on Form 10-Q within 45 days of the end of each of the first three quarters of their fiscal years and annual reports on Form 10-K within 90 days of the end of the last quarter of their fiscal years. The SEC recently amended its rules and forms to accelerate the filing of Forms 10-Q and 10-K for "accelerated filers," and these changes will be phased in through 2005. (For more information on these new rules please refer to ***Appendix E.***) Failure to make timely filings may result in the company's ineligibility to use Registration Statement on Form S-3 for follow-on public offerings and Rule 144 being unavailable for certain resales of restricted shares of the company's stock. As a general matter, public companies simply do not miss filing deadlines, and any delinquency in a required filing can be interpreted by analysts and investors as a sign that the company does not have its house in order.

Proxy solicitation materials and annual reports

Once the company has registered its securities under the Exchange Act, it will be required to comply with the SEC proxy rules. The company will be required to file with the SEC proxy statements that comply with Schedule 14A relating to annual and special meetings of stockholders. Definitive proxy solicitation materials relating to an annual meeting at which the only agenda items are the election of directors, amendments to stock plans, certain stockholder-sponsored proposals, and ratification of the independent auditors selected by the Audit Committee of the Board of Directors are required to be filed with the SEC concurrent with mailing to stockholders.

However, proxy solicitation materials containing agenda items other than these items may not be distributed to stockholders until the materials have first been filed with the SEC for its review. Such preliminary proxy solicitation materials must be submitted to the SEC at least 10 days prior to the date definitive copies are first sent to stockholders. Because the SEC may review these preliminary proxy materials in detail, it is often advisable to submit the preliminary materials earlier than 10 days before the scheduled mailing date, so that any changes requested by the SEC can be accommodated without disrupting the mailing schedule.

Most public companies solicit proxies for their stockholder meetings. If the company elects not to solicit proxies from stockholders, the stockholders must nevertheless be furnished with an information statement containing information substantially equivalent to that required in a proxy statement.

In addition, the SEC proxy rules require that, where the solicitation is made on behalf of management of the company and relates to an annual meeting of stockholders at which directors are to be elected, the proxy statement must be accompanied or preceded by an annual report to stockholders. This annual report must contain, among other things, audited financial statements, MD&A, a brief description of the business done during the most recent fiscal year, and information regarding each of the company's directors and executive officers. The annual report gives the company a chance to tell its story not only to its stockholders but also to the financial community and investing public at large. As a result, the annual report is often a lengthy document prepared with great concern for literary content and visual form. If this will be the company's practice, it

should recognize that the preparation of the report will involve a great deal of lead time, especially with respect to graphics and color printing, and the company should therefore begin early enough so that it will be completed in time for mailing not later than the date the notice of annual meeting and proxy statement are mailed to stockholders. The annual report and proxy materials, as is the case with all public disclosures by the company, should be carefully prepared, as they could give rise to liability for material misstatements or omissions.

Current reports on Form 8-K

Certain significant events that occur between periodic filings, such as certain changes of control, material acquisitions or dispositions, bankruptcies, changes in accountants, and resignations of directors must be reported on Form 8-K. A public company may also use Form 8-K to report on other events which are not specifically required to be disclosed, but which the company wishes to include promptly in its formal SEC disclosure documents.

The SEC has adopted amendments to Form 8-K, effective August 23, 2004. The amendments add 10 disclosure items to Form 8-K, including transferring 2 items to the current report from the periodic reports. The amendments will also provide investors with more timely disclosure of material information by replacing the current 5 business and 15 calendar day Form 8-K deadlines with a new 4 business day deadline.

These amendments are responsive to the current disclosure goals of Section 409 of the Sarbanes-Oxley Act by requiring public companies to disclose, on a "rapid and current basis," material information regarding changes in a company's financial condition or operations as the SEC, by rule, determines to be necessary or useful for the protection of investors and in the public interest.

The eight new disclosure items include:

- entry into a material agreement outside of the ordinary course of business;
- termination of a material agreement outside of the ordinary course of business;
- creation of a material direct financial obligation or a material obligation under an off-balance sheet arrangement;

- triggering events that accelerate or increase a material direct financial obligation or a material obligation under an off-balance sheet arrangement;
- material costs associated with exit or disposal activities;
- material impairments;
- notice of delisting or failure to satisfy a continued listing rule or standard; transfer of listing; and
- non-reliance on previously issued financial statements or a related audit report or completed interim review (restatements).

The two disclosure items transferred, in part, from the periodic reports are:

- unregistered sales of equity securities; and
- material modifications to rights of security holders.

Expanded disclosure items include:

- departure of directors or principal officers, election of directors, or appointment of principal officers; and
- amendments to charter or bylaws and change in fiscal year.

The disclosure documents referred to above are not simply forms to be filled in. They are substantive disclosure documents which are relied upon by analysts and investors, and which, if carefully prepared, may protect the company from liability. For these reasons, they should not be left until the last minute or delegated to administrative personnel. Rather, they should be prepared by, or under the close supervision of, the CFO or other senior personnel who have perspective on the company's business, results of operations, risks and prospects. Like the company's IPO prospectus, Forms 10-Q, 10-K and 8-K, and Schedule 14A are based on Regulation S-K. A well-drafted IPO prospectus will serve as a good starting point for a public company's first periodic reports.

Practical Tip: Make a 12-Month Compliance Calendar

Shortly after the effective date of a company's IPO, the CFO and the company's counsel should create a list of SEC reporting deadlines, annual meeting events and similar compliance items covering a full annual cycle. Toward the end of the year covered by the calendar, a new calendar for the following year can be created, and so on. ***Appendix D*** contains a sample compliance calendar.

Resales of Restricted Stock

Overview

Just because a company has gone public does not mean that all of its shares, however or whenever acquired, may be publicly traded. The company's registration statement on Form S-1 registers only those shares to be offered and sold to the public in the IPO. Similarly, the company's registration statement on Form S-8 applies only to those employee benefit plan shares specifically registered. Shares that were acquired while the company was private remain unregistered and may be publicly resold only if they are included in an effective registration statement or if an exemption from registration is available. These unregistered shares are referred to as "restricted stock."

One of the goals of an IPO is to provide liquidity for the company's employees and private investors. Newly public companies are often surprised by the level of activity that this new liquidity generates, especially when the lock-up period expires. In order to adequately respond to inquiries of employees and investors, the company should have some familiarity with the basic rules governing resales of restricted stock as it embarks on the new path of being a publicly traded company.

Stockholders of the company who propose to sell restricted stock into the public market following the IPO must comply with the applicable provisions of Rule 144 or Rule 701 under the Securities Act. These rules apply to both restricted securities and control securities. Control securities are any securities held by an "affiliate" of the company. An executive officer,

director, or large stockholder, who, directly or indirectly, controls the management or policies of the company is deemed an affiliate for purposes of the rule.

Rule 144

Briefly, under Rule 144 of the Securities Act, unregistered stock may be publicly resold if:

- the shares have been beneficially held for at least one year;
- the company has been subject to the reporting requirements of the Exchange Act for at least 90 days and has filed all required reports;
- the amount of stock sold by the seller, together with certain sales made by the seller within the preceding three months, does not exceed the greater of one percent of the outstanding shares of the company or the average weekly reported volume of trading in the company's stock during the preceding four calendar weeks;
- the shares are sold in a brokers' transaction or directly with a market maker; and
- a notice on Form 144 is filed with the SEC and the principal exchange on which the company's shares are traded.

However, pursuant to Rule 144(k), sales of unregistered securities by a non-affiliate of the company who has held the shares for at least two years may be made without compliance with the public information requirement, the volume limitation, the manner of sale requirement or the Form 144 filing requirement noted above.

Rule 701

Rule 701 provides even more relief for employees, consultants, directors and certain others who hold unregistered shares of a company's stock that they obtained pursuant to a written compensatory benefit plan (such as a stock option plan) or a written contract relating to compensation (such as an employment agreement) prior to the IPO. This stock will be considered "701 stock" so long as the company complied with the limitations on offers and sales under Rule 701. Ninety days after a company becomes subject to the reporting requirements of the Exchange Act (that is 90 days

following the effective date of the company's IPO), non-affiliates may sell 701 stock without compliance with the current public information, holding period, volume limitation or Form 144 filing requirements of Rule 144, and affiliates may sell 701 stock without compliance with the holding period requirement of Rule 144.

Application of Rule 144 and Rule 701

The application of Rule 144 and Rule 701 to particular fact patterns can be complex. Issues often arise regarding the determination of affiliate status, the permissibility of tacking the holding period of one holder to that of a subsequent holder, and the aggregation of sales of related or affiliated parties for purposes of computing compliance with volume limitations. The company need not attempt to master these rules in this level of detail, as the company's counsel generally will provide advice regarding these issues.

Stock certificates issued prior to the IPO generally bear a restrictive legend referring to the Securities Act, indicating that the shares represented by the certificate are unregistered and may not be transferred unless subsequently registered or unless an exemption from registration is available. The company's transfer agent will not transfer a stock certificate bearing a restrictive legend unless the transfer agent receives instructions from the company or its counsel that the legend may be removed and the shares may be transferred in compliance with the provisions of the Securities Act. For this reason, when a broker receives "legended stock" that a holder wishes to sell, the broker typically will send a legend removal request directly to the company's counsel. Much of the analysis necessary for determining the Rule 144 or Rule 701 status of unregistered securities will have already been conducted in preparation of the "overhang analysis" included in the IPO prospectus. However, company counsel may require additional detail from the company when preparing a legend removal instruction letter. Sellers usually are impatient to have their trades cleared, and the company can facilitate the delivery of the legend removal instruction letter by promptly responding to its counsel's requests for information.

Section 16 and Insider Trading

Section 16 reporting and short-swing liability

Each of the directors, officers and beneficial owners of more than 10% of any class of the company's equity securities registered under Section 12 of the Exchange Act are subject to Section 16 of the Exchange Act. The three sections of Section 16 that concern Section 16 insiders are: Section 16(a) requiring disclosure and reporting; Section 16(b) – imposing liability for short swing trading; and Section 16(c) – prohibiting short sales.

Determining Beneficial Ownership under Section 16

The issue of beneficial ownership arises in two contexts under Section 16: (1) determining who is a 10% stockholder; and (2) determining beneficial ownership for purposes of reporting and short-swing profit. Beneficial ownership in the first context (that is, 10% stockholder determinations) is determined by reference to Rule 13d-3. Rule 13d-3 provides that a person is the beneficial owner of a security if the person has or shares the power to vote, or direct the voting of, or the power to dispose, or direct the disposition of, that security. In addition, a person is the beneficial owner of securities where such power can be obtained within 60 days through the exercise or conversion of derivative securities.

For all Section 16 purposes other than determining who is a 10% stockholder, beneficial ownership means a direct or indirect pecuniary interest in the subject securities through any contract, arrangement, understanding, relationship or otherwise. "Pecuniary interest" means the opportunity, directly or indirectly, to profit or share in any profit derived from a transaction in the subject securities.

Section 16(a) – Reporting Obligations

Section 16(a) imposes the reporting obligations on Section 16 insiders. It provides that Section 16 insiders (1) must file an initial report on Form 3 with the SEC of their beneficial ownership of equity securities of the company (including derivative securities, such as options, warrants and stock appreciation rights) and (2) must report subsequent changes in their beneficial ownership of those securities on Forms 4 and 5.

In 2002, the SEC implemented new and amended rules that require most changes in beneficial ownership to be reported by Section 16 insiders to the SEC within two business days after the change occurs. Examples of

the many transactions by a Section 16 insider involving the company's securities that will require filing within two business days include: stock and option grants, regrants, repricings and cancellations, stock option exercises, open market purchases, discretionary transfers to or from a company stock fund in a 401 (K) plan, and transactions under non-qualified deferred compensation plans. Certain other transactions may be filed on Form 5 within 45 days after the end of the company's fiscal year.

In the event that a Section 16 insider fails to timely file any required report under Section 16(a), the company must report such failure in its subsequent proxy statement, information statements and annual Report on Form 10-K under a section entitled "Section 16(a) Beneficial Ownership Reporting Compliance." The company must identify by name its Section 16 insiders who, during the prior fiscal year, reported transactions late or failed to file required reports, and must disclose the number of delinquent filings and the number of transaction that were reported late for each such insider.

Although the company is not obligated to prepare or file reports under Section 16(a) for its Section 16 insiders, many companies assist their reporting persons or submit reports on their behalf to facilitate accurate and timely filing. The two-business day filing requirement will most likely present an administrative challenge to the newly public company and advance planning will be necessary to ensure compliance. In addition, Section 16(a) requires public companies to post Section 16 reports filed by its Section 16 insiders on its public web site by the end of the business day after the filing.

Section 16(b) – Short-Swing Liability

Section 16(b) is a liability provision, and it provides that Section 16 insiders are liable to the company for any profits made purchases of the company's stock within six months of a sale of the company's stock. To violate Section 16(b), there must be a purchase and sale (or a sale and purchase) within a period of less than six months. The prohibition on short-swing trades applies regardless of whether the purchase or the sale occurs first. The purpose of Section 16(b) is to prevent the unfair use of information about the company that may have been obtained by Section 16 insiders by virtue of their position.

Section 16(b) is applied strictly, and liability is not dependent on a proven or actual use of the material, non-public information and may be imposed regardless of good faith. In other words, the Section 16 insider's actual intentions and actual awareness or possession of inside information at the time of the trade are irrelevant. If a Section 16 insider makes a short-swing trade, he or she is required to disgorge the profits from the trade to the company. If the company fails to bring a suit against the Section 16 insider for recovery of the profits within 60 days after demand by a stockholder to do so (or fails to prosecute the suit diligently), a suit may be brought on behalf of the company by the stockholder. Certain attorneys specialize in discovering short-swing trading violations, and the company can expect to receive letters from such attorneys from time to time seeking information regarding Section 16 insiders' trading activities. These attorneys actively review computerized databases of all Forms 3, 4 and 5 filed by Section 16 Insiders in the hope of matching transactions that will result in Section 16(b) liability.

Section 16(c) – Prohibition of Short Sales

Section 16(c) prohibits Section 16 insiders from engaging in both traditional short sales of the company's securities and certain other transactions that are economically or functionally equivalent to a short sale.

Practical Tips: Ensuring Section 16 Compliance

Given the administrative demands of the Section 16 filing requirements, companies should consider the implementing the following procedures to help ensure compliance:

- annually review the status of the company's Section 16 insiders and determine whether the designations are still appropriate;
- require all Section 16 insiders to pre-clear all transactions in the company's securities and all Rule 10b5-1 trading plans with an internal compliance officer (for example, the CFO or general counsel);

Practical Tips: Ensuring Section 16 Compliance (continued)

- consider requiring each Section 16 insiders' brokers to (1) confirm with the Company all proposed trades (other than trades made pursuant to a pre-cleared and compliant Rule 10b5-1 plan) and Rule 10b5-1 plans have been pre-cleared by the compliance officer and (2) promptly report the details of all trades (including trades made pursuant to Rule 10b5-1 plans);
- establish a specific e-mail address for Section 16 notification purposes so that if the compliance person is on vacation or unavailable, someone can still easily check for broker notifications;
- circulate proposed option grant lists to the compliance officer before the board meeting at which approval for such grants is being sought;
- meet in person with each Section 16 insider to explain the rules and procedures, including pre-clearance procedures;
- confirm that the company has a power of attorney from each Section 16 insider that authorizes specified members of the company's management team to sign and file Section 16 reports on behalf of the Section 16 insiders;
- ensure that the company's insider trading policy includes the mandatory pre-clearance and notification procedures;
- send periodic reminders to Section 16 insiders of reporting requirements and deadlines; and
- obtain EDGAR filing codes for each Section 16 insider.

Insider trading; insider trading compliance programs; pension fund blackouts

Insider Trading

The securities laws broadly prohibit fraudulent activities of any kind in connection with the offer, purchase or sale of securities. A person may be subject to criminal and civil fines and penalties, as well as imprisonment, for engaging in transactions in the company's securities at a time when such person was aware of material, non-public information about the security or the company as well as for disclosing the information ("tipping") to others who then trade on such information. This is known as "insider trading." The person who is aware of material, non-public information about the company or its securities is often referred to as an "insider," even though the person may not be an executive officer or director of the company.

Insider Trading Compliance Program

There may often be occasions when material, non-public information regarding a public company should not, for legitimate business reasons, be publicly disclosed at a particular time (for example, prior to the announcement of the execution of a merger or acquisition agreement). The implementation of an insider trading compliance program is important to protect the company and its insiders from liability under Rule 10b-5 and the other insider trading laws.

A good insider trading compliance program will include a strong, but thoughtful, policy regarding the unauthorized disclosure of non-public information acquired in the workplace in general and the misuse of material, non-public information in securities trading.

The policy should also establish a windows of time during which certain insiders cannot engage in transactions in the company's securities. For example, many public companies have trading windows that open one or two trading days after an earnings release and close three or four weeks prior to the end of their fiscal quarters. While the length of time of the closure varies from company to company in light of its revenue and earnings cycles and other factors, the trading window can prevent insiders from trading for periods ranging from 10 days to 6 weeks. Regardless, the policy always prohibits a person who is aware of material, non-public information from trading. As an added measure of precaution, many companies have mandatory pre-clearance procedures for their insiders,

executive officers and directors, which apply even during open trading windows, and designate one or more corporate officers as "compliances officers" to oversee such procedures. The good compliance program should also include a training component, which begins with new hires and involves regular periodic training for directors, officers and other employees.

Prohibition against Trading during Pension Fund Blackout Periods

The Sarbanes-Oxley Act of 2002 contains a prohibition against trading by directors and executive officers of a company during a pension fund blackout period. The SEC has also adopted a new regulation – Regulation Blackout Trading Restriction, or BTR – to clarify the scope and operation of that provision of the Sarbanes-Oxley Act. The purpose of these new rules is to equalize the treatment of corporate executives and rank-and-file employees with respect to their ability to trade in company stock during pension fund blackout periods.

Regulation BTR provides that during a pension fund blackout period, directors and executive officers of a public company are prohibited from purchasing, selling or otherwise acquiring or transferring a security acquired in connection with service as a director or officer. For purposes of these rules, a "blackout period" means any period of more than three consecutive business days during which pension plan participants (or beneficiaries) are temporarily suspended from trading in company securities held in their individual accounts but only if the suspension applies to at least 50% of the pension plan participants. The penalty for violations is disgorgement of any profits. There are a number of transactions that are exempt from these rules. For example, purchases and sales made under a Rule 10b5-1 trading plan are exempt. The rules also require the company to provide advance notice of a pension fund blackout period to directors and executive officers and to file such notice on Form 8-K.

Rule 10b5-1 trading plans

Legal and company policy constraints (for example, SEC insider trading rules, company-imposed trading windows and other "black-out" periods), frequently prevent executive officers and directors from selling company stock. Individually, and in combination, these constraints and other factors can effectively prevent insiders from selling stock for extended periods of time. Even when trading windows are open and

other constraints lifted, insiders who decide to engage in market transactions risk being second-guessed by regulators, prosecutors and private securities class action plaintiffs.

In October 2000, the SEC adopted Rule 10b5-1 to provide a safe harbor for certain trading arrangements that are designed to cover situations in which a person can demonstrate that the material, non-public information was not a factor in the trading decision. However, a trading plan only merits the protection of the safe harbor if it is in writing, was adopted in good faith by the person before he or she became aware of any material, nonpublic information and the plan:

- specified the amount of, the price at, and the date of the purchases or sales;
- included a formula or algorithm, or computer program, for determining the amount of, the price at, and the date of the purchases or sales to be made; or
- did not permit the person to exercise any subsequent influence over how, when, or whether to effect purchases or sales (so long as the actual person who did exercise such influence (for example, the broker, was not aware of the material, non-public information.

Any person can adopt a trading plan, including the company or a stockholder otherwise unaffiliated with the company. In fact, a Rule 10b5-1 trading plan can be used by an entity (for example, a stockholder of the company that is a venture capital firm) as an affirmative defense to insider trading if it can demonstrate (1) that the individual making the investment decision on behalf of the entity was not aware of any material, non-public information and (2) the entity had implemented reasonable policies and procedures to ensure that individuals making investment decisions on its behalf would not violate insider trading laws.

Trading plans, if properly constructed, may provide insiders with liquidity and diversification opportunities, while reducing the risk of insider trading allegations by serving as an affirmative defense. Even if the insider is aware of material, nonpublic information at the time of a trade, he will not be liable for insider trading if he can demonstrate that plan complied with Rule 10b5-1.

While Rule 10b5-1 trading plans can provide several potential benefits, they do present a few risks. For example, these plans have not yet been tested in any regulatory or court action. Also, implementing a trading plan requires the insider to plan future trades in advance, resulting in reduced flexibility. The insider essentially relinquishes the ability to easily modify those future trades, even if his financial situation or the value of the stock changes significantly. And while trading plans can be modified, and terminated, there are risks to entering a plan and then deviating from it. Accordingly, insiders should consider adopting a trading plan only if they intend to follow it to the letter and should assume that they will not sell any additional shares outside of the plan.

Persons subject to Section 16 who adopt trading plans must still file Forms 4 and avoid short-swing trading, and Rule 144 still applies to sales made pursuant to trading plans by affiliates. However, the SEC has clarified that an insider may modify the Form 144 to state that the representation regarding the seller's lack of knowledge of material information is made as of the date the plan was adopted, rather than the date the person signs the Form.

A company should consider various issues regarding trading plans as well. The company must ensure that its insider trading policy permits trades made pursuant to compliant plans. The company must also determine to what extent it desires to retain authority to approve an insider's proposed trading plan before allowing the insider to benefit from an exemption from the insider trading policy. The company and insiders must also decide how much information they are going to publicly disclose regarding the adoption of trading plans. Disclosing that insiders' trades are being made pursuant to pre-established Rule 10b5-1 plans may help avoid unintended signaling effects that the market may infer from such sales, and may deter some potential plaintiffs from filing securities lawsuits based in part on insiders' trades.

Additional Reporting Requirements for Certain Stockholders

Section 13 of the Exchange Act; Schedules 13D-G

Sections 13(d) and 13(g) of the Exchange Act, and the related SEC regulations, require any person who acquires beneficial ownership of more than 5% of the outstanding shares of any class of the company's securities that is registered under Section 12 of the Exchange Act (a "5% Stockholder") to report such ownership to the SEC by filing a Schedule 13D or Schedule 13G with the SEC via its EDGAR system. A 5% stockholder must also provide a copy of the filing to the company and the national securities exchange on which the company's securities are traded.

Determining beneficial ownership for purposes of Sections 13(d) and (g)

Rule 13d-3 provides that a person is the beneficial owner of a security if the person has or shares the power to vote, or direct the voting of, or the power to dispose, or direct the disposition of, that security. In addition, such person is the beneficial owner of securities where such power can be obtained within 60 days through (1) the exercise of any option, warrant or right, (2) the conversion of a security, (3) the revocation of a trust, discretionary account or similar arrangement, or (4) the automatic termination of a trust, discretionary account or similar arrangement. Finally, a person is the beneficial owner of securities if the rights described in (1), (2) or (3) above are acquired for the purpose of changing the control of the company, irrespective of whether that right can be exercised within 60 days.

Beneficial ownership may be acquired either individually or as a group. If two or more persons agree to act together in acquiring or voting securities, a group is considered to have acquired the securities of each member thereof as of the date of that agreement.

Initial reporting on Schedule 13G

Within 45 days following the calendar year in which the company completes its IPO, each 5% Stockholder who became a 5% Stockholder before consummation of the company's IPO must report such ownership to the SEC on a Schedule 13G. These pre-offering stockholders are identified as "exempt" stockholders because their shares were acquired before the company's public offering was consummated.

Continuing reporting following the IPO

As soon as the company becomes a public company, any exempt stockholders who acquire more than 2% of the company's stock within any 12-month period, or any other person who becomes a 5% Stockholder, may be required to file a Schedule 13D, which is a significantly more extensive form than the Schedule 13G. However, the Schedule 13D filing need not be made if the 5% Stockholder is a "passive investor," meaning such 5% Stockholder beneficially owns less than 20% of the company's common stock and did not acquire the company's securities for the purpose, or with the effect, of influencing or changing control of the company. A 5% Stockholder who qualifies as a passive investor may continue filing reports on Schedule 13G in lieu of the more burdensome report on Schedule 13D. Directors and officers, because of their positions of influence in relation to the company, have been deemed by the SEC staff not to qualify as passive investors under any circumstance and are required to file reports on Schedule 13D, as applicable.

Generally, reports on Schedule 13G must be amended annually to indicate any change in beneficial ownership. In addition, whenever a passive investor who was filing reports on Schedule 13G acquires more than 10% of the company's securities, the investor is required to file an amendment to its report on Schedule 13G promptly after the date of the additional acquisition of the company's securities. From that time on, such investor must file an amendment to its report on Schedule 13G promptly anytime after its beneficial ownership in the company's outstanding securities changes (whether by increase or decrease in holdings) by more than 5%. A non-passive investor must amend its report on Schedule 13D promptly to indicate any material changes to the information on such schedule and must also promptly amend its report to indicate any change of 1% or more in such investor's beneficial ownership in the company's outstanding securities.

Chapter 11

Special Considerations for Non-U.S. Companies

Over the last 10 years, the number of foreign companies accessing the U.S. public markets has increased significantly. Since 1997, over 600 foreign companies have registered securities with the SEC for the first time. A public offering in the United States can provide a non-U.S. company with access to the world's largest capital markets at favorable valuations. It can also subject the company to numerous expenses, regulatory compliance burdens and liability. This chapter highlights issues of special concern to non-U.S. companies contemplating a public offering in the United States and points out certain areas where non-U.S. issuers are treated differently from U.S. issuers. Except as noted below, most of the issues identified in the preceding chapters of this book also apply to non-U.S. issuers.

"Foreign Private Issuers"

Under the U.S. securities laws, a "foreign private issuer" is subject to somewhat narrower disclosure obligations than U.S. issuers and is exempt from the application of certain U.S. securities regulations. The U.S. securities laws define a "foreign private issuer" as a corporation or other organization (other than a foreign government) that is incorporated or organized under the laws of any foreign country unless:

- more than 50% of the outstanding voting securities of the issuer are directly or indirectly held of record by residents of the United States; and
- any of the following:
  - the majority of the executive officers or directors are United States citizens or residents;
  - more than 50% of the assets of the issuer are located in the United States; or
  - the business of the issuer is administered principally in the United States.

In determining the percentage of outstanding voting securities held by U.S. residents, the inquiry may be limited to accounts held by brokers, dealers, banks and other nominees located in the United States, the issuer's jurisdiction of incorporation, and the jurisdiction that is the primary trading market for the issuer's voting securities, if different than the jurisdiction of incorporation.

Mechanics of the Public Offering

Type of security to be offered

A non-U.S. issuer may offer its shares directly to United States investors or instead may make its public offering in the United States through the use of American Depositary Receipts (ADRs).

An ADR is a negotiable instrument issued by a third-party financial institution, referred to as a Depositary, and evidences ownership of a certain number of underlying shares of the non-U.S. issuer, which underlying shares are held by the Depositary's correspondent bank, referred to as a Custodian Bank, located in the home country of the non-U.S. issuer. Investors trade in the ADRs and not the underlying security. ADRs add complexity and additional documentation to the IPO process, but can be useful in circumventing difficult and expensive transfer procedures, certain voting restrictions, and tax and foreign exchange control problems in the issuer's home jurisdiction.

There are specific advantages in using ADRs as opposed to making a direct offer of shares of a non-U.S. issuer in the United States. Laws in certain foreign jurisdictions prohibit or limit direct foreign ownership or impose a transfer or stamp tax for transfers of shares. Use of ADRs avoids the concerns associated with direct foreign ownership or transfer taxes, as the shares underlying the ADRs are held by the Custodian Bank located in the issuer's home country, and when ADRs are transferred, the underlying shares held by the Custodian Bank are not transferred.

Advantages may also accrue to U.S. investors as a result of holding ADRs as opposed to directly holding shares of a non-U.S. issuer. ADRs can be transferred and exchanged by presentment to the Depositary rather than having to deal with a transfer agent located outside the United States. Further, dividends can be paid to U.S. investors in U.S.

dollars. The Depositary takes on the responsibility of handling currency conversions and facilitating stockholder communications and voting rights in exchange for fees, which are paid by the ADR holders.

The question of whether shares of a non-U.S. issuer should be offered directly or through ADRs should be discussed with counsel at the beginning of the offering process.

Form of registration statement to be used

Foreign private issuers are eligible to register shares in connection with an initial public offering on a registration statement on Form F-1, which is similar in many respects to a registration statement on Form S-1. However, the Form F-1 registration statement must contain additional disclosure relating to the following:

- the nature and extent of the principal non-U.S. trading market for the company's securities;
- limitations on the rights of investors outside of the home jurisdiction to hold and vote the stock;
- governmental restrictions applicable to the export or import of capital, and the payment of dividends and interest to investors outside of the home jurisdiction, as well as procedures for nonresident holders to claim dividends;
- taxes to which United States investors may be subject under the laws of the home jurisdiction or treaties between the home jurisdiction and the United States;
- historical exchange rates between U.S. dollars and the home country currency;
- the ability of United States stockholders and the SEC to make claims under U.S. securities laws against the company and its officers and directors located outside of the United States; and
- laws or regulations of the home jurisdiction applicable to rights of stockholders, stockholder meetings, restrictions on changes of control, and other material rights, where such laws or regulations are significantly different from those in the United States.

The Form F-1 registration statement may omit some of the more detailed executive compensation and stock ownership information required in a Form S-1 registration statement. However, in order to appear less "foreign" to U.S. investors, many foreign issuers elect to include some amount of the information that they may otherwise omit under the SEC rules.

A non-U.S. company wishing to make a public offering in the United States using ADRs, in which it intends to raise capital, is required to work with a Depositary to register the ADRs on a registration statement on Form F-6, and to register the underlying shares on a Form F-1 registration statement. Different variations of ADR programs exist. A non-U.S. company wishing to use the ADR program should consult its U.S. counsel for information on the procedures and implications of doing so.

Review process

One important difference between registration on a Form F-1 registration statement by a foreign private issuer and registration on a Form S-1 registration statement by a United States issuer is the review process. While the Form S-1 review process does not commence until the Form S-1 registration statement is publicly filed with the SEC via EDGAR, the initial submission of a Form F-1 registration statement to the SEC can be done on a confidential, paper basis. This allows the foreign issuer to receive the first round of SEC comments before making any public disclosure of its offering plans. As a result, if the SEC comments reveal any "show stoppers," the company may simply terminate the offering process without having exposed any sensitive business or financial information, or even the fact that it was contemplating a public offering.

Translation of certain documents into English

Documents required to be filed as exhibits to the registration statement, such as charter documents and material contracts, must be filed in English, or a summary of such documents in English must be filed. Translation may require a significant amount of lead time. Therefore, it is important to identify the documents that will need to be filed and begin translation early in the registration process.

Financial Disclosure Requirements

A foreign private issuer must include in its registration statement on Form F-1 financial statements and selected financial data covering the same periods as would be required of a U.S. issuer filing a registration statement on Form S-1. The company's financial statements may be prepared either in accordance with U.S. generally accepted accounting principles (U.S. GAAP) or another comprehensive body of generally accepted accounting principles. If the financial statements are not prepared in accordance with U.S. GAAP, the registration statement must disclose the basis of preparation, discuss the material differences in accounting principles between U.S. GAAP and the principles used, and provide a table which reconciles the primary financial statements to U.S. GAAP by quantifying material variances applicable to the income statement and balance sheet.

A foreign issuer is not required to select the U.S. dollar as its reporting currency. If the reporting currency is not the U.S. dollar, the issuer may include a translation for the most recent fiscal year and any subsequent interim period presented using the exchange rate as of the most recent balance sheet included in the filing. If materially different, the exchange rate as of the latest practicable date should be used.

Financial reporting under one set of accounting standards and in one currency is difficult enough. Reporting under two sets of accounting standards and providing a translation into a second currency can be overwhelming. Underwriters often recommend that a company report in U.S. dollars and U.S. GAAP, if at all possible, to allow for easier comparison of the company's performance with that of U.S. issuers. A foreign issuer planning a public offering in the United States should consult with its counsel in its home jurisdiction and explore whether financial statements prepared in accordance with U.S. GAAP and reported in U.S. dollars can be used to satisfy local reporting requirements.

Ongoing Reporting Requirements

Foreign private issuers are not required to file annual reports on Form 10-K, quarterly reports on Form 10-Q or current reports on Form 8-K. Rather, foreign private issuers with securities registered under the Exchange Act must file an annual report on Form 20-F with the SEC within 6 months after the end of each fiscal year. Quarterly reports are not

legally required, although the company's underwriters may insist that the company file quarterly reports on Form 6-K to provide investors with the same level of information as would be provided by a U.S. issuer. A foreign private issuer generally must file a report on Form 6-K whenever the company gives public information under the laws of its home jurisdiction. In addition, Form 6-K requires that a foreign private issuer must promptly provide to the SEC any information that is filed with any foreign stock exchange on which its securities are listed and made public by such exchange or information that is distributed to its securityholders. While a foreign private issuer is not specifically required by SEC regulations to file a current report on Form 8-K to report acquisitions, dispositions or other material events, companies listed on the Nasdaq National Market must disclose to the United States public any material information that would reasonably be expected to affect the value of its securities or influence investors' decisions. In addition, a company with shares listed on the Nasdaq National Market must provide a formal annual report to its stockholders.

Corporate Governance

Certain corporate governance requirements are imposed by U.S. securities laws, the rules and regulations of Nasdaq and other U.S. stock exchanges, and the expectations of U.S. investors. Many of these requirements may seem strange to a non-U.S. issuer, but compliance with them may be essential to a successful offering in the United States. For example, U.S. investors expect a company's management team to operate under the ultimate authority of the company's board of directors, which should exercise independent judgment on important matters. U.S. stockholders expect the board of directors to have the authority to issue additional shares of the company's authorized stock in connection with financings, certain acquisitions or other events without stockholder approval or compliance with stockholder preemptive rights. In addition, the NYSE and Nasdaq have published a number of proposals relating to director independence, including various proposals requiring independent directors, and independence requirements related to auditing, nominating and compensation functions of the board of directors, many of which are discussed in earlier chapters of this guidebook.

The Sarbanes-Oxley Act of 2002 introduced sweeping reform covering corporate governance of and disclosures by reporting issuers in the United States. Although there are some differences between the treatment of U.S. issuers and non-U.S. issuers under the Sarbanes-Oxley Act and the SEC rules adopted under that Act, which changes are largely with respect to the frequency of providing the required disclosure, the reforms generally apply equally to both. A summary of selected SEC rules adopted under the Act is provided in ***Appendix E***. In preparing for an IPO in the United States, a foreign issuer should consult with its U.S. counsel regarding the application and impact of the Act and any corporate governance restructuring or housekeeping that may be necessary or advisable.

Exemptions from Certain Provisions of the Exchange Act

Foreign private issuers are exempt from the proxy solicitation requirements of Section 14 of the Exchange Act and the short-swing trading prohibition and reporting requirements of Section 16 of the Exchange Act.

While a company may qualify as a foreign private issuer at the time of its IPO, it may later cease to qualify as a foreign private issuer due to changes in the composition of its stockholder base, management team, board of directors or in the nature of its operations. Therefore, it is important for management to keep a close eye on the foreign private issuer tests in order to determine if the company will no longer be eligible to operate under the more lenient rules applicable to foreign private issuers.

Appendix A

NYSE Minimum Numerical Standards for Domestic Companies

(as of May 31, 2004)

Size / Volume Criteria (a company must meet one of the following size/volume criteria):	
1. Round-lot Holders[1]	2,000
OR:	
2. Total Shareholders[1]	2,200
together with average monthly trading volume for the most recent 6 months (in shares)	100,000
OR:	
3. Total Shareholders[1]	500
• *together with* average monthly trading volume for the most recent 6 months (in shares); and	1,000,000
• number of publicly held share outstanding[2]	1,100,000
Market Value of Public Shares (a company must have an aggregate market value of):	
1. IPOs Spin-offs, Carve-outs and Affiliated Companies[3]	$60,000,000
OR:	
2. Public Companies[4]	$100,000,000
Financial Criteria (a company must meet one of the following financial standards):	
1. Earnings Test	
Aggregate pretax earnings:[5]	
(a) Over the last 3 years (must be positive amounts in all 3 years); and	$10,000,000
(b) Each of the 2 preceding years	$2,000,000
OR:	
2. Valuation/Revenue Test (a company must meet either of the following requirements):	
Valuation / Revenue with Cash Flow Test:	
(a) Global market capitalization;	$500,000,000
(b) Revenues during the most recent 12-month period; and	$100,000,000
(c) Aggregate cash flows for the last 3 fiscal years (must be positive amounts in all 3 years)[6] ***or***:	$25,000,000
Pure Valuation / Revenue Test:	
(a) Global market capitalization;[7] and	$750,000,000
(b) Revenues during the most recent fiscal year	$75,000,000
OR:	
3. Affiliated Company Test	
(a) Global market capitalization;	$500,000,000
(b) At least 12 months of operating history (although it is not required to have been a separate entity);	
(c) Parent or affiliated company is a listed company in good standing; and	
(d) Parent or affiliated company retains control of the entity or is under common control with the entity.	

Notes:

1. The number of beneficial holders of stock held in "street name" will be considered in addition to the holders of record. The NYSE will check such holdings that are in the name of NYSE-member organizations.
2. If the unit of trading is less than 100 shares, the requirement relating to the number of publicly held shares will be reduced proportionately. Shares held by directors, officers, or their immediate families and other concentrated holdings of 10 percent or more are excluded in calculating the number of publicly held shares.
3. In connection with IPOs and carve-outs, the NYSE will accept an undertaking from the company's underwriter to ensure that the offering will meet or exceed the NYSE's standards. Similarly, for spin-offs, the NYSE will rely on a representation from the parent company's financial advisor in order to estimate the market value based on the as-disclosed distribution ratio.
4. If a company either has a significant concentration of stock or changing market forces have adversely impacted the public market value of a company that otherwise would qualify for an NYSE listing, such that its public market value is no more than 10% below the minimum, the NYSE will consider stockholders' equity of $60 million or $100 million, as applicable, as an alternate measure of size.
5. Pre-tax income is adjusted for various items as defined in Section 102.01C of the NYSE Listed Company Manual.
6. Represents net cash provided by operating activities excluding the changes in working capital or in operating assets and liabilities, as adjusted for various items as defined in Section 102.01C of the NYSE Listed Company Manual.
7. Average global market capitalization for already existing public companies is represented by the most recent six months of trading history. For IPOs, the company's underwriter or, in the case of spin-offs and carve-outs, the parent company's financial advisor, must provide a written representation that demonstrates the company's ability to meet the global market capitalization requirement based upon the completion of the offering.

Additional Considerations:

In addition to meeting the NYSE's minimum numerical standards listed above, there are other factors that the NYSE will consider, and the NYSE has broad discretion regarding the listing of a company. Thus, the NYSE may deny listing or apply additional or more stringent criteria based on any event, condition, or circumstance that makes the listing of the company inadvisable or unwarranted in the opinion of the NYSE. Also note that the NYSE can make such a determination even if the company meets the standards set forth above.

Nasdaq National Market Listing Requirements

(as of May 31, 2004)

A company must meet *all* of the requirements under at least one of the three listing standards for initial listing on The Nasdaq National Market.

Requirements	Standard 1	Standard 2	Standard 3
Shareholders' equity	$15 million	$30 million	N/A
Market value of listed securities[1] or Total assets and Total revenue	N/A	N/A	$75 million[1,2] or $75 million and $75 million
Income from continuing operations before income taxes (in latest fiscal year or 2 of last 3 fiscal years)	$1 million	N/A	N/A
Publicly held shares[3]	1.1 million	1.1 million	1.1 million
Market Value of Public Float	$8 million	$18 million	$20 million
Minimum Bid Price	$5	$5	$5[2]
Market Makers[5]	3	3	4
Shareholders (round lot holders)	400	400	400
Operating History	N/A	2 years	N/A
Corporate Governance Requirements[6,7,8]	• Distribution of Annual and Interim Reports • Independent directors • Audit Committees • Shareholders Meetings • Quorum • Solicitation of Proxies • Shareholder Approval • Stockholder Voting Rights • Auditor Peer Review • Notification of Material Noncompliance		

1. Listed securities are securities listed on NASDAQ or listed on a national securities exchange.
2. Companies already listed or quoted on another marketplace qualifying only under this requirement of Standard 3 must meet the market value of listed securities and the bid price requirements for 90 consecutive trading days prior to applying for listing.
3. Publicly held shares is defined as total shares outstanding less any shares held by officers, directors, or beneficial owners of more than 10% or more.
4. Round lot holders are shareholders of 100 shares or more.
5. An Electronic Communications Network (ECN) is not a market maker under these rules.
6. These requirements are set forth in NASD Marketplace Rules 4350 and 4351.
7. Nasdaq has the ability to provide exemptions from corporate governance requirements for foreign issuers when provisions of the rules are contrary to law, rule or regulation of any public authority exercising jurisdiction over such issuer or contrary to generally accepted business practices in the issuer's country of domicile, except to the extent any such exemptions would be contrary to the federal securities laws; however, a foreign issuer that receives an exemption must specifically disclose it in the issuer's IPO registration statement and annual reports following its IPO.
8. Foreign Issuers and IPO issuers have been afforded a transition period as to certain of the new rules.

Appendix B

Sample Due Diligence Checklist

Please provide copies of the indicated documents or the information requested and indicate items that the Company considers inapplicable. In each instance, requests for documents or information regarding the Company extend to similar documents and information regarding subsidiaries of the Company, if any.

1. Basic Corporate Records

a. Articles/Certificate of Incorporation, including amendments since inception.

b. Bylaws, including amendments since inception.

c. Minutes or other records of all meetings or actions of the board of directors, any committees thereof, and of stockholders, including written notices (if given) or waivers thereof since inception.

d. Communications with stockholders since inception, including annual reports, proxy statements and correspondence.

e. Press releases since inception.

f. Summary of the corporate history of the Company and any predecessors, including any mergers, acquisitions, changes in control and divestitures.

g. List of countries and U.S. states where the Company is qualified to do business.

h. List of cities and countries where the Company operates its business or maintains inventory, owns or leases property or has employees, agents or independent contractors, with approximate size and number of employees and a description of operations or services performed at each location.

i. List of cities and countries in which the Company currently contemplates undertaking business operations, either directly or through other parties.

j. List of any subsidiaries, including the address of each such subsidiary's headquarters.

2. Stockholder Information

a. List of names, addresses and holdings of current record and beneficial owners of Company stock, indicating the dates such stock was issued and fully paid for.

b. List of names, addresses and holdings of current record and beneficial owners of Company options and warrants, including date of grant, exercise price, number of shares subject to the option or warrant and vesting terms.

c. List of any oral or written promises to receive stock, options, warrants or any other form of interest in the Company.

d. Share, option or warrant books, ledgers and other records of share, option or warrant issuances of the Company since inception.

3. Securities Issuances

a. Documents generated in connection with equity financings of the Company, including stock purchase agreements and related documentation, such as offering circulars, private placement memoranda and prospectuses relating to the offer or sale of equity securities.

b. Documents generated in connection with any convertible debt financings of the Company.

c. Samples of common stock certificates, warrants, options, debentures and any other outstanding securities.

d. Stock option and purchase plans and equity incentive plans of any sort, including forms of option and purchase agreements which have been or may be used thereunder, and any options or warrants not under an equity plan.

e. Agreements and other documentation (including related permits) relating to repurchases, redemptions, exchanges, conversions or similar transactions involving the Company's securities and schedule of any dividends paid or declared since inception.

f. Voting trust, stockholder, or other similar agreements covering any of the Company's securities.

g. Agreements relating to registration rights.

h. Agreements relating to preemptive rights or co-sale rights.

i. Agreements or other documents setting forth any arrangement with or pertaining to the Company to which directors, officers or owners of more than 5% of the voting securities of the Company have been a party since inception including indemnification agreements or agreements relating to the voting or transfer of securities.

j. Forms D or any other forms filed to qualify for an exemption under the Securities Act of 1933.

k. Governmental permits, notices of exemption and consents for issuance or transfer of the Company's securities and evidence of qualification or exemption under applicable blue sky laws.

4. Corporate Finance

a. List of banks or other lenders with which the Company has a financial relationship and brief description of nature of relationship, e.g., lines of credit, etc.

b. Summary of short-term debt, long-term debt, intercompany debt and capital lease obligations of the Company.

c. Summary of currently outstanding interest rate or foreign currency swaps, caps, options, forwards or other derivative instruments or arrangements to which the Company is a party.

d. Agreements evidencing borrowings by the Company, whether secured or unsecured, documented or undocumented, including loan and credit agreements, mortgages, deeds of trust, letters of credit, indentures, promissory notes and other evidences of indebtedness, and any amendments, renewals, notices, or waivers.

e. Documents and agreements evidencing other material financing arrangements, including capital leases, synthetic leases, sale and leaseback arrangements, installment purchases, or similar agreement.

f. Documents and agreements relating to any guarantees by the Company or releases of guarantees.

g. Bank letters or agreements confirming lines of credit, including any amendments, renewal letters, notices, waivers, etc.

5. Financial Information

a. Contact information for outside parties responsible for providing the Company with accounting or tax advice.

b. Written investment policies of the Company.

c. Financial statements of the Company since inception.

d. Current internal financial projections, forecasts, budgets and cash flow anlyses of the Company.

e. Management letters or special reports by auditors and any responses thereto.

f. Description of and reasons for any change in accounting methods or principles.

g. Detailed aging schedule for accounts receivable and accounts payable at end of each fiscal quarter of last five years.

h. Detailed description of critical accounting policies, and explanation of revenue and cost recognition methods.

i. Information on planned acquisitions and dispositions.

j. Information on bad debt reserves and unusual charges to operations for the past three fiscal years.

k. Detailed description of any off-balance sheet arrangements, liabilities or obligations of any nature (*i.e.*, fixed or contingent, matured or unmatured) that are not shown or otherwise provided for in the Company's current financial statements. Please include: the nature and purpose of any such off-balance sheet arrangements; the importance to the Company of such arrangements; the amounts of revenue, expenses and cash flows arising from such arrangements; and any known event, demand, commitment, trend or uncertainty that is reasonably likely to result in the termination (or reduction in availability to the Company) if any such arrangement and the course of action the Company has taken or proposes to take in response to such circumstances.

l. Description of any non-GAAP financial measures, accompanied by the most directly comparable GAAP financial measure and a reconciliation to GAAP, along with the reasons for use of non-GAAP measures.

m. Any reports on internal controls.

n. Proposed disclosure controls and procedures and list of persons serving (or proposed to serve) on the Disclosure Committee, along with a copy of the committee charter.

o. Detailed explanation of any change in or disagreement with auditors on accounting and financial matters in the last five fiscal years.

6. Taxes

a. Federal, state, local and foreign tax returns since inception, including sales tax returns and consolidated returns of the Company.

b. Information with respect to any foreign, Internal Revenue Service or state audit of the Company's or any of its subsidiaries' or their respective predecessor's returns and the results of each audit.

c. Description of any undertakings given by the Company to tax authorities or any special tax rulings or agreements arranged with tax authorities.

d. Description of any preferred tax status or tax benefit which may be adversely affected by the proposed initial public offering and any related transactions.

e. Information to analyze tax positions taken in connection with acquisitions, dispositions, restructurings, reorganizations, or the like since inception and any tax strategies in connection with any transactions currently proposed including any ongoing tax indemnities.

f. Any notices, elections, or other correspondence with foreign, federal, state and local tax authorities regarding the reorganization of the Company and its predecessors to the extent material.

7. Intellectual Property

a. List of U.S. and other country patents and patent applications held by the Company.

b. List of U.S. and other country trademarks, trade names, service marks or registered copyrights, including applications for each of the foregoing filed by the Company, indicating in each case the date of expiration of the rights and material coverage.

c. List of proprietary processes controlled by the Company and other trade secrets.

d. List and copies of material license agreements.

e. Lists of proprietary third party tools, code protocols and other third party intellectual property employed in the Company's products and services.

f. Name of law firm(s) handling patent, trademark, copyright or other proprietary rights matters for the Company including contact person and telephone number.

g. Any correspondence from third parties regarding potential infringement of intellectual property rights of others.

h. List of any claims by third parties with respect to the intellectual property rights of the Company.

i. Material research and development agreements relating to product research, development and testing to which the Company is a party.

8. Operations

a. Business plans.

b. List of third party developers showing total and type of project for each developer during the last and current fiscal years, with contact names and phone numbers, and forms of agreements entered into with third party developers.

c. List of major licensees indicating which product is subject to the license and showing royalty obligations, advance payment on royalty, credits of any royalties against advance payment and frequency of accounting obligation for each licensee during the most recent fiscal year, with contact names and phone numbers.

d. List of top ten accounts payable with contact names and phone numbers.

e. List of top ten accounts receivable with contact names and phone numbers.

f. Backlog at end of most recent fiscal year and most recent fiscal quarter.

g. Form of agreements relating to the sale or lease of the Company's equipment.

h. Service contracts without royalty agreements.

i. List of service price changes over past five years.

j. Backlog of orders to customers at end of three most recent fiscal years and four most recent fiscal quarters.

k. Any agreements containing non-competition obligations or exclusivity provisions.

l. Any intercompany agreements between the Company and its subsidiaries.

m. Description of any toxic chemicals used in production and manner of storage and disposition. Description of any EPA, Toxic Substances Control Act or other investigation or claim.

n. Any other material agreements or drafts of proposed material agreements of the Company.

9. Sales and Marketing

a. List of the Company's products and services.

b. List of the Company's ten largest customers or groups for the last three years, indicating amounts and nature of services provided and providing contact names and phone numbers for each customer.

c. List of the Company's suppliers (other than suppliers of goods and services generally required by all businesses, e.g., office supplies, utilities, etc., unless in excess of $50,000 from an individual supplier during any 12 month period) including for each supplier, (i) total and type of purchases by the Company from that supplier during current and prior fiscal years and (ii) details of products and services purchased from such supplier that are available only from that supplier or which are potentially difficult to obtain in sufficient quantities or in a timely manner from other suppliers.

d. List of the Company's competitors.

e. Pertinent market research or marketing studies (including any studies or reports relied on or commissioned or prepared by the Company).

f. Any recent analyses of the Company prepared by investment bankers, engineers, management consultants, auditors or others.

g. Recent presentations to industry, trade or investment groups.

h. Marketing and sales literature and forms, including price lists, catalogs, purchase orders, technical manuals, user manuals, etc.

i. Service and support contracts, marketing agreements and material agency and advertising contracts, if any.

j. Distribution agreements, if any.

k. Forms of warranties and guarantees provided to customers.

10. Employees

a. Organizational charts by department and by legal entity.

b. Number of employees by department and by functional area.

c. Forms of employment agreements, if any, including independent contractor service agreements.

d. Employee Confidentiality and Invention Assignment Agreements and any consultant or contractor agreements.

e. Employment agreements or non-competition agreements or invention assignment agreements of officers and other key employees with former employers.

f. Employee benefit, pension, profit sharing, compensation and other plans.

g. Description of commissions paid to managers, agents or other employees since inception of the Company.

h. Any collective bargaining agreements or other material labor contracts.

i. Description of any significant labor problems or union activities the Company has experienced.

j. Copies of any NLRB or U.S. Department of Labor filings.

11. Officers and Directors; Corporate Governance

a. Completed Officers' and Directors' Questionnaires (including the NASD Questionnaire).

b. Resume for each officer and director/director nominee.

c. Employment, "change of control" agreements, and severance agreements with any key employee or member of management, indemnification agreements and "golden parachute" agreements, if any.

d. Schedule of compensation paid during the last five fiscal years to officers, directors and key employees showing separately salary, bonuses and non-cash compensation (*e.g.*, use of cars, property, etc.).

e. Bonus plans, retirement plans, pension plans, deferred compensation plans, profit sharing and management incentive agreements.

f. Agreements for loans to officers or directors (including relocation loans) and any other agreements (including consulting and employment contracts) with officers or directors, whether or not now outstanding, including (i) loans to purchase stock and (ii) consulting contracts.

g. Description of any transactions between the Company and any officer, director, or owner of 5% or more of any class of the Company's securities or any associate of any such person or entity or between or involving any two or more of such persons or entities.

h. List of directors who have been determined by the board of directors to be "independent" under applicable SEC and NYSE/Nasdaq rules.

i. List of directors who serve on the Audit Committee and name of the director who is the "financial expert" on the Audit Committee, along with a copy of the committee charter.

j. Audit Committee pre-approval procedures for audit and non-audit serves and regarding auditor fees.

k. Corporate policies relating to the engagement of the Company's auditors, including policies relating to the scope of services to be performed by the Company's auditors.

l. List of directors who serve on Compensation Committee, along with a copy of the committee charter.

m. List of directors who serve on Nominating and Governance Committee, along with a copy of the committee charter.

n. Lists of directors who serve on any other committees of the board of directors, along with a copy of the charters from such committees.

o. Corporate codes of ethics, corporate governance guidelines or other codes of conduct of the Company, including "whistle-blower" policies and procedures.

p. Insider trading compliance program and policies.

q. Description of any defensive measures or anti-takeover provisions.

12. Tangible Property

a. List of real and material personal property owned by the Company.

b. Documents of title, mortgages, deeds of trust, leases and security agreements pertaining to the properties listed in 12(a) above.

c. Outstanding leases for real and personal property to which the Company is either a lessor or lessee, including ground leases and subleases, estoppel certificates and related subordination or non-disturbance agreements.

d. List of any security interests in personal property, including any UCC filings.

e. Description of any toxic chemicals used in production and manner of storage and disposition. Description of any EPA or other investigation or claim.

f. Environmental Site Assessments or reports concerning any real property owned or leased by the Company.

g. Environmental, Health and Safety compliance verification reports (*e.g.*, compliance audits) and quality assurance documents.

h. Correspondence, memoranda, notes or notices of violation from foreign, federal, state or local Environmental, Health and Safety authorities.

13. Litigation and Audits

a. Letters from counsel sent to auditors for year-end and current interim audits.

b. Complaints, orders or other significant documents in pending or threatened matters involving claims of $25,000 or more or seeking injunctive or other equitable relief.

c. Active litigation files, including letters asserting claims, complaints, answers, etc. (non-privileged material only).

d. Any litigation settlement documents.

e. Any decrees, orders or judgments of courts or governmental agencies.

f. Correspondence, memoranda or notes concerning inquiries from governmental (i) tax authorities, (ii) occupational safety, health and hazard officials, (iii) environmental officials, or (iv) authorities regarding equal opportunities violations, antitrust violations, or violations of any other law, rule or regulation.

g. Description of any warranty claims that have been made against the Company, any subsidiary, or any partnership or joint venture and the resolution of such claim.

h. Information regarding any material litigation to which the Company is a party or in which it may become involved.

14. Insurance

a. List and copies of material insurance policies of the Company covering property, liabilities and operations and any significant claims currently pending thereunder.

b. List of any other insurance policies in force, such as "key person" policies, director indemnification policies or product liability policies.

15. Partnership, Joint Venture Agreements and Other Corporate Transactions

a. List of partnership or joint venture agreements, if any.

b. Partnership roll-up documents, if any.

c. Any material purchase agreements and other significant documents relating to any acquisitions or dispositions by the Company since inception or currently proposed.

d. Any material purchase agreements and other significant documents relating to any reorganization and any going private transactions, mergers, consolidations, spin-offs or reincorporation since inception or currently proposed.

e. List of special purpose entities in which the Company, any of its current or former executive officers or directors have a significant interest (on an individual or an aggregate basis) or that have purchased assets or assumed liabilities from the Company or that have significant obligations to the Company (each a "SPE"). Include a brief description of each SPE's primary purpose or activities. Any agreements or documents setting forth any arrangements (or if not memorialized, a description of any such arrangement) between or among the Company and any SPE.

16. Governmental Regulations and Filings

a. Summary of material inquiries by a governmental agency, if any.

b. Status of foreign and domestic government contracts subject to renegotiation, if any.

c. Material foreign and domestic governmental permits, licenses, certificates, etc. which the Company has obtained or had revoked.

d. Material filings made and significant correspondence by the Company with any state, federal or foreign governmental or regulatory agencies since the Company's inception.

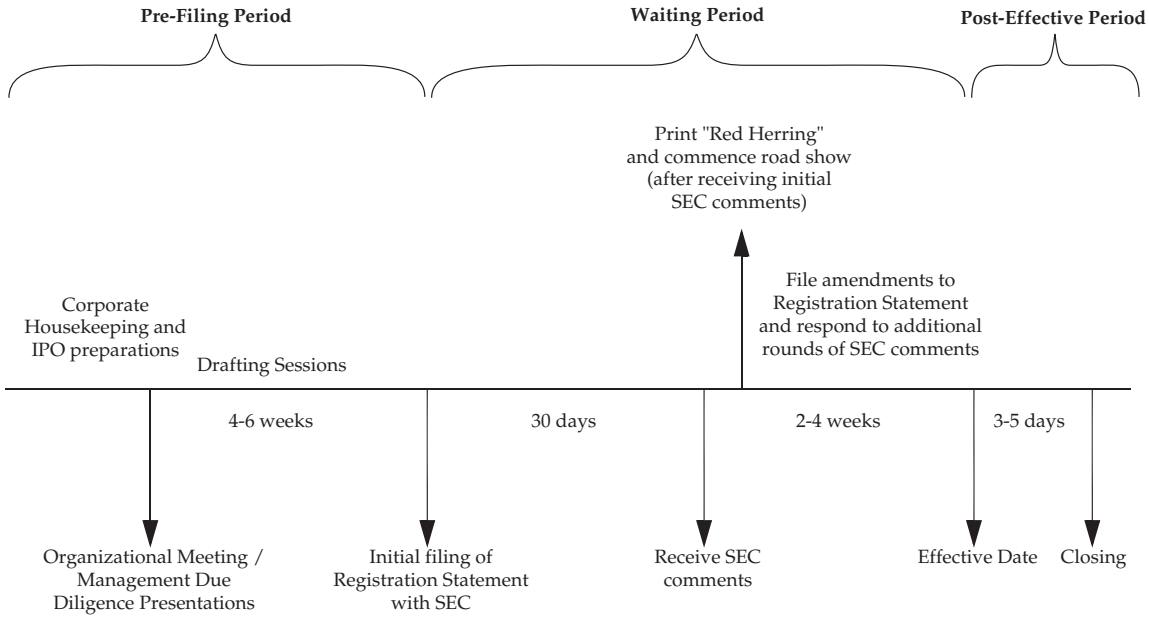
17. Miscellaneous

a. Materials that support statements to be made in the prospectus, including any documents to be cited, summarized or quoted in the prospectus.

b. Any other materials or documents that are significant or should be reviewed and considered regarding the Company, its business and financial condition, or any subsidiary.

Appendix C

Sample IPO Timeline



Appendix D

Sample Compliance Calendar

The sample compliance calendar on the following pages is designed for a newly public company's first full cycle of SEC reporting and its first annual meeting of stockholders following the IPO. For convenience, the schedule assumes that the company is a Delaware corporation with a fiscal year that ends on December 31, and that the SEC declared its registration statement effective on June 15, 2004.

The calendar is structured for the newly public company and not an "accelerated filer." (Please note that the newly public company is not an accelerated filer primarily because it will not have been subject to the reporting requirements of the Exchange Act for at least 12 months.)

The calendar is not comprehensive, rather it is designed to provide the newly public company with a snapshot of its reporting obligations during the first full cycle as a public company. The company should work together with its counsel and auditors to develop a schedule that is personalized for the company and its specific needs and tailored to ensure compliance with its charter documents, applicable corporate law, applicable SEC rules and regulations, as well as the rules and regulations of the exchange on which the company's shares are listed.

Sample Compliance Calender

Schedule of Actions for 2004-05
Annual Meeting of Stockholders and SEC Filings

June 2004

S	M	T	W	T	F	S
		1	2	3	4	5
6	7	8	9	10	11	12
13	14	15	16	17	18	19
20	21	22	23	24	25	26
27	28	29	30			

July 2004

S	M	T	W	T	F	S
				1	2	3
4	5	6	7	8	9	10
11	12	13	14	15	16	17
18	19	20	21	22	23	24
25	26	27	28	29	30	31

August 2004

S	M	T	W	T	F	S
1	2	3	4	5	6	7
8	9	10	11	12	13	14
15	16	17	18	19	20	21
22	23	24	25	26	27	28
29	30	31				

September 2004

S	M	T	W	T	F	S
			1	2	3	4
5	6	7	8	9	10	11
12	13	14	15	16	17	18
19	20	21	22	23	24	25
26	27	28	29	30		

October 2004

S	M	T	W	T	F	S
					1	2
3	4	5	6	7	8	9
10	11	12	13	14	15	16
17	18	19	20	21	22	23
24	25	26	27	28	29	30
31						

November 2004

S	M	T	W	T	F	S
	1	2	3	4	5	6
7	8	9	10	11	12	13
14	15	16	17	18	19	20
21	22	23	24	25	26	27
28	29	30				

December 2004

S	M	T	W	T	F	S
			1	2	3	4
5	6	7	8	9	10	11
12	13	14	15	16	17	18
19	20	21	22	23	24	25
26	27	28	29	30	31	

January 2005

S	M	T	W	T	F	S
						1
2	3	4	5	6	7	8
9	10	11	12	13	14	15
16	17	18	19	20	21	22
23	24	25	26	27	28	29
30	31					

February 2005

S	M	T	W	T	F	S
		1	2	3	4	5
6	7	8	9	10	11	12
13	14	15	16	17	18	19
20	21	22	23	24	25	26
27	28					

March 2005

S	M	T	W	T	F	S
		1	2	3	4	5
6	7	8	9	10	11	12
13	14	15	16	17	18	19
20	21	22	23	24	25	26
27	28	29	30	31		

April 2005

S	M	T	W	T	F	S
					1	2
3	4	5	6	7	8	9
10	11	12	13	14	15	16
17	18	19	20	21	22	23
24	25	26	27	28	29	30

May 2005

S	M	T	W	T	F	S
1	2	3	4	5	6	7
8	9	10	11	12	13	14
15	16	17	18	19	20	21
22	23	24	25	26	27	28
29	30	31				

June 2005

S	M	T	W	T	F	S
			1	2	3	4
5	6	7	8	9	10	11
12	13	14	15	16	17	18
19	20	21	22	23	24	25
26	27	28	29	30		

July 2005

S	M	T	W	T	F	S
					1	2
3	4	5	6	7	8	9
10	11	12	13	14	15	16
17	18	19	20	21	22	23
24	25	26	27	28	29	30
31						

August 2005

S	M	T	W	T	F	S
	1	2	3	4	5	6
7	8	9	10	11	12	13
14	15	16	17	18	19	20
21	22	23	24	25	26	27
28	29	30	31			

September 2005

S	M	T	W	T	F	S
				1	2	3
4	5	6	7	8	9	10
11	12	13	14	15	16	17
18	19	20	21	22	23	24
25	26	27	28	29	30	

October 2005

S	M	T	W	T	F	S
						1
2	3	4	5	6	7	8
9	10	11	12	13	14	15
16	17	18	19	20	21	22
23	24	25	26	27	28	29
30	31					

November 2005

S	M	T	W	T	F	S
		1	2	3	4	5
6	7	8	9	10	11	12
13	14	15	16	17	18	19
20	21	22	23	24	25	26
27	28	29	30			

December 2005

S	M	T	W	T	F	S
				1	2	3
4	5	6	7	8	9	10
11	12	13	14	15	16	17
18	19	20	21	22	23	24
25	26	27	28	29	30	31

DATE	ITEM
June 15, 2004	Effective date of the company's registration statement – the company becomes subject to the reporting requirements of the Exchange Act
June 15, 2004	Form 3s due for all Section 16 Insiders (executive officers, directors, and 10% stockholders)[1]
June 30, 2004	Fiscal year 2004 second quarter end
August 16, 2004	Deadline for filing Form 10-Q for fiscal year 2004 second quarter
September 30, 2004	Fiscal year 2004 third quarter end
November 15, 2004	Deadline for filing Form 10-Q for fiscal year 2004 third quarter
December 31, 2004	Fiscal year 2004 year end
February 14, 2005	Deadline for filing Form 5s[2] and Schedule 13Gs[3]
February 28, 2005	Mail broker solicitations to brokers and central depository systems requesting information as to number of beneficial owners requiring annual reports and definitive proxy materials[4]
March 4, 2005	File preliminary proxy materials, if necessary[5]
March 31, 2005	Deadline for filing Form 10-K for 2004 fiscal year[6]
March 31, 2005	Record date for 2005 Annual Meeting of Stockholders[7]
March 31, 2005	Fiscal year 2005 first quarter end
April 1, 2005	File definitive proxy materials and annual report[8]
April 1, 2005	Mail definitive proxy materials and annual report to stockholders of record and to broker's requesting copies for beneficial owners; file with SEC, on same day, definitive proxy materials and annual report[9]
May 3, 2005	Hold 2005 Annual Meeting of Stockholders
May 16, 2005	Deadline for filing Form 10-Q for fiscal year 2005 first quarter[10]
June 30, 2005	Fiscal year 2005 second quarter end
August 15, 2005	Deadline for filing Form 10-Q for fiscal year 2005 second quarter[10]
September 30, 2005	Fiscal year 2005 third quarter end
November 14, 2005	Deadline for filing Form 10-Q for fiscal year 2005 third quarter[10]
December 31, 2005	Fiscal year 2005 year end

1. In general, the Form 3 must be filed within 10 days after the event by which the person becomes a reporting person (*i.e.*, executive officer, director, 10% holder or other person). (*See* paragraph 2(a) of the General Instructions to Form 3.) However, a reporting person of an issuer that is registering securities for the first time under Section 12 of the Exchange Act must file a Form 3 no later than the effective date of the registration statement. (*See* paragraph 2(b) of the General Instructions to Form 3.)

2. The Form 5 must be filed by each reporting person within 45 days after the company's fiscal year end. General Instructions 1(a) of Form 5. (*See also* Rule 16a-3(f).)

3. Each person who beneficially owns greater than 5% of the company's common stock at the end of the calendar year, who acquired the shares prior to the company's IPO, must report such person's ownership to the SEC on a Schedule 13G filing within 45 days of the end of the calendar year. The 5% stockholder must also provide copies of the Schedule 13G filing to the company and the national securities exchange on which the company's common stock is listed. (*See* Rule 13d-1.)

4. Rule 14a-13 requires the company to contact brokers, dealers, voting trustees, banks, associations or other entities that exercise fiduciary powers in nominee name or otherwise not less than 20 business days prior to the record date of the meeting to determine the number of copies of the proxy materials that these organizations will require for distribution to beneficial owners.

5. Rule 14a-6(a) of Regulation 14A requires the company to file preliminary proxy solicitation materials with the SEC *at least 10 calendar days* prior to the date on which the company first sends or gives the proxy materials to stockholders; *however*, a shorter period may be authorized upon a showing of good cause. ***Please note*** that the company is *not* required to file preliminary proxy materials that relate to an annual meeting of stockholders at which *only* the following "routine" matters will be considered: (1) the election of directors; (2) the election, approval or ratification of accountants; (3) a properly included stockholder proposal (*see* Rule 14a-8); and (4) the approval or ratification of an employee benefit plan (*see* paragraph (a)(7)(ii) of Item 402 of Regulation S-K). If the SEC elects to undertake a complete review of the preliminary proxy materials, the review period may take up to 30 days or more. If the company anticipates a preliminary proxy filing will be required, the timetable for holding the annual meeting should be adjusted accordingly.

6. The company must file its annual report on Form 10-K within 90 days after the end of the fiscal year. (*See* paragraph (A)(1)(b) of the General Instructions to Form 10-K.)

7. All state corporate statutes allow for the use of a record date to establish the persons eligible for notice of and voting at meeting of stockholders. State corporate law generally allows the record date to be fixed in the bylaws of the company or established by resolution of the board of directors. The record date must generally be no more than nor fewer than a fixed number of days before the date of the meeting. Under Delaware law, the record date must not be more than 60 nor less than 10 days before the meeting of stockholders. (*See* Section 213(a) of the Delaware General Corporation Law.)

8. Rule 14a-6(b) requires the company to file the definitive proxy solicitation materials with the SEC no later than the date they are first sent or given to stockholders. Rule 14a-3(c) requires the company to mail to the SEC, solely for its information, the annual report on the date the report is first sent or given to stockholders or the date on which preliminary copies, or definitive copies, if a preliminary filing was not required, of the proxy solicitation materials are filed with the SEC. The definitive proxy materials must be filed within 120 days after the end of the fiscal year covered by the company's annual report on Form 10-K in order to incorporate by reference certain information from the proxy materials into the Form 10-K. (*See* paragraph G(3) of the General Instructions to Form 10-K.)

9. Section 222(b) of the Delaware General Corporation Law requires the company to give written notice of meetings of stockholders not less than 10 days nor more than 60 days before the date of the meeting. In addition, Rule 14a-3(b) requires that the proxy materials be accompanied or preceded by an annual report to stockholders.

10. The company must file its quarterly reports on Form 10-Q within 45 days after the end of each fiscal quarter. (*See* paragraph (A)(1)(b) of the General Instructions to Form 10-Q.)

Appendix E

Summary of Selected SEC Rules Adopted in Response to the Sarbanes-Oxley Act of 2002

On July 30, 2002, the Sarbanes-Oxley Act of 2002 became law. The Act makes a number of significant changes to federal regulation of public company corporate governance and reporting obligations. This Appendix has been designed solely to address certain of these reforms relating to domestic, public companies, as of the date of this publication and does not attempt to address all related applicable laws or regulations. This section was designed solely for overview purposes and therefore deliberately summarizes or paraphrases the applicable statutory and regulatory provisions in order to condense the information presented. As a result, the descriptions contained in this section are necessarily incomplete and this section should not serve as a replacement for consultations with experienced counsel.

1. ***Certification of Principal Executive Officer and Principal Financial Officers.*** Exchange Act rules 13a-14 and 15d-14 require an issuer's principal executive officer(s) and the principal financial officer(s), or persons performing similar functions, to certify in each annual or quarterly report (including any amendments) that:

- the officer has reviewed the report;
- based on the officer's knowledge, the report does not contain any untrue statement of a material fact or omit to state a material fact necessary in order to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by the report;
- based on the officer's knowledge, the financial statements, and other financial information included in the report, fairly present in all material respects the financial condition, results of operations and cash flows of the company as of, and for, the periods presented in the report;

- the signing officers[1]:
  - are responsible for establishing and maintaining disclosure controls *and internal control over financial reporting* for the company;
  - have designed such disclosure controls to ensure that material relating to the company and its consolidated subsidiaries is made known to such officers, particularly during the period in which the periodic reports are being prepared;
  - have evaluated the effectiveness of the company's disclosure controls as of the end of the period covered by the report;
  - *have designed such internal control over financial reporting, or caused such internal control over financial reporting to be designed under their supervision, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles*;
  - have evaluated the effectiveness of the company's disclosure controls and procedures presented in the report such officers' conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by this report based on such evaluation; and
  - have disclosed in the report any change in the company's internal control over financial reporting that occurred during the company's most recent fiscal quarter (the company's fourth fiscal quarter in the case of an annual report) that has materially affected, or is reasonably likely to materially affect, the company's internal control over financial reporting; and
- the signing officers have disclosed to the company's auditors and the audit committee of the board of directors (or persons fulfilling the equivalent functions):

1. Companies may temporarily omit the italicized certifications pertaining to internal control over financial reporting until the SEC requires companies to file their respective management's report on internal control over financial reporting. The management's report will be required by companies that are accelerated filers for fiscal years ending on or after June 15, 2004. All other filers will be required to comply for their fiscal years ending on or after April 15, 2005.

- all significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are reasonably likely to adversely affect the company's ability to record, process, summarize and report financial information; and
- any fraud, whether or not material, that involves management or other employees who have a significant role in the company's internal controls.

- that the report fully complies with the requirements of Section 13(a) or 15(d) of the Exchange Act and that information contained in such report fairly presents, in all material respects, the financial condition and results of operations of the company.

2. ***Management's Report on Internal Control and Auditor Attestation.*** Exchange Act rules 13a-15 and 15d-15 require the management of a public company to assess the company's "internal control over financial reporting"[2] annually and include a report on its assessment in the company's annual report. The management's report on internal control over financial reporting will be required by companies that are accelerated filers for fiscal years ending on or after June 15, 2004. All other filers will be required to comply for their fiscal years ending on or after April 15, 2005.

In addition, the company's independent auditor must issue an attestation report on management's assessment and the company must include the attestation report as part of the company's annual report. The management report must include the following elements:

2. The SEC defines "internal control over financial reporting" as a process designed by, or under the supervision of, the issuer's principal executive and principal financial officers, or persons performing similar functions, and effected by the issuer's board of directors, management, and other personnel, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles and includes those policies and principles that: (1) pertain to the maintenance of records that in reasonable detail accurately and fairly reflect the transactions and dispositions of the assets of the issuer; (2) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that receipts and expenditures of the issuer are being made only in accordance with authorizations of management and directors of the issuer; and (3) provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use or disposition of the issuer's assets that could have a material adverse effect on the financial statements.

- *Responsibility.* The report must include a statement regarding management's responsibility for establishing and maintaining the company's internal control over financial reporting.
- *Framework for Evaluation.* The report must include a statement identifying the framework management used to evaluate the effectiveness of the company's internal control over financial reporting. The rules do not require a specific framework but rather set forth guidelines by which a suitable framework will be judged. Management's evaluation process, however, should be sufficient to support management's conclusion about the effectiveness of internal control over financial reporting. The most commonly used internal control framework in the U.S. is that of The Committee of Sponsoring Organizations of the Treadway Commission.
- *Assessment of Effectiveness.* The report must include management's assessment, as of the end of the most recent fiscal year, of the effectiveness of the company's internal control over financial reporting. Management may not rely on the company's independent auditors to perform the required assessment, although management should coordinate with the independent auditors in making the assessment. Management's report must also include disclosure of any "material weaknesses" identified by management in such controls.[3] If management has identified material weaknesses in its internal control, it may not declare that its internal control is effective is effective. The SEC has stated that a company's independent auditors may assist management in documenting internal control over financial reporting without impairing its independence. However, management: (1) must be involved throughout the process; (2) cannot delegate its responsibilities to assess its internal control over financial reporting to the auditors; and (3) must make all decisions. A company may not disclose that its internal controls over financial reporting are effective if it has identified one or more material weaknesses.

3. The SEC defines "material weakness" as deficiencies in the design or operation of internal control that could adversely affect a company's ability to record, process, summarize and report financial data consistent with assertions of management in the company's financial statements.

The SEC does not provide specific procedures for conducting management's assessment. However, the SEC does suggest that the company (1) should document its evaluation to enable it to provide reasonable support for its conclusions regarding the effectiveness of the internal controls and (2) the procedures should be broad enough to evaluate the design of the internal control over financial reporting and to test the operating effectiveness of such controls. (Please note that some auditing firms suggest that companies should begin to conduct an assessment at least 90 days prior to the fiscal year end to allow ample time for the auditor attestation process and for corrective action, if any, to be taken).

- *Auditor's Attestation.* The management report must contain a statement that the company's independent auditors have issued an attestation report on management's assessment of the company's internal control over financial reporting. This attestation report must be included in the annual report.

Although the SEC rules do not require management to conduct an extensive quarterly evaluation of internal control over financial reporting, if there is a change that would materially affect, or is likely to materially affect, the company's internal control over financial reporting in any fiscal quarter, management must evaluate the change and disclose that evaluation in the company's quarterly report.

3. *Disclosure Controls and Procedures.* Exchange Act rules 13a-15 and 15d-15 require public companies to establish and maintain "disclosure controls and procedures" designed to ensure that information required to be disclosed in SEC reports is recorded, processed, summarized and reported, in the time periods specified by the SEC. Accordingly, the new rules require each public company to:

- design its disclosure controls and procedures;
- establish and maintain disclosure controls and procedures;
- evaluate the effectiveness of the disclosure controls and procedures at least every 90 days; and
- report the certifying officers' conclusions on the effectiveness of the disclosure controls and procedures in each periodic report.

The SEC has not mandated any particular procedures for conducting the review and evaluation required in connection with the required certifications, but expects each company to develop a process that is consistent with its business and internal management and supervisory practices. However, the SEC recommends that companies create a disclosure committee with responsibility for considering the materiality of information and determining disclosure obligations on a timely basis. The SEC suggests that the committee include the principal accounting officer or controller, the general counsel or other senior legal official with responsibility for disclosure matters, the principal risk management officer and the chief investor relations officer. The SEC further recommends that the committee report to senior management, including the principal executive and financial officers. Item 307 of Regulation S-K also requires a public company to include in its annual reports on Form 10-K and Form 10-KSB, and quarterly reports on Form 10-Q and Form 10-QSB the conclusions of its CEO and CFO regarding the effectiveness of the company's disclosure controls and procedures.

4. ***Earnings Releases must be reported on Form 8-K.*** Under Item 12 of Form 8-K (Item 2.02 under the SEC's amended Form 8-K, effective August 23, 2004), all public releases or announcements (including oral announcements or releases) disclosing material, non-public information regarding results of operations or financial condition for a completed fiscal period must be "furnished" with the SEC (rather than filed) on Form 8-K within 5 business days of public announcement. (Please note that effective August 23, 2004 the 5 business day requirement will be shortened to four business days pursuant to the SEC's amended Form 8-K). The impact of "furnishing" rather than "filing" the information is that the submission is not subject to the liability provisions of Section 18 of the Exchange Act nor will the furnished information be incorporated by reference into any registration statement, proxy statement or other report unless the company specifically incorporates such information into those documents by reference. Repetition of previously disclosed information does not trigger this Form 8-K reporting requirement. However, if a subsequent release or announcement contains additional material, non-public information, then the company is required to submit the new release or announcement on Form 8-K. In addition, the SEC has provided a limited exception to the filing obligation for material, non-public information regarding historical

operating results or financial condition disclosed orally, telephonically or by webcast, broadcast or similar means *within 48 hours* of the initial release that triggers the Form 8-K requirement if:

- the oral information is provided as part of a presentation that is "complementary to" the written information;
- the related written release or announcement has been furnished to the SEC on Form 8-K prior to the presentation;
- the presentation is accessible to the public by dial-in conference call, webcast or similar technology;
- the financial and statistical information contained in the presentation is posted on the company's web site along with any information that would be required under Regulation G (the SEC's regulation concerning non-GAAP financial measures discussed below); and
- the presentation was announced by a widely disseminated press release that included information as to how to access the presentation and information about the location of the company's web site.

5. ***Disclosure of Non-GAAP Financial Information.*** SEC Regulation G imposes heightened disclosure requirements when a public company uses "non-GAAP financial measures"[4] in public announcements generally (including oral announcements) and in SEC filings (including registration statements on Form S-1 and SB-2 in connection with an IPO).

When a public company (or any person acting on behalf of the company) makes a public announcement or disclosure of any material information that contains a non-GAAP financial measure, Regulation G requires that the non-GAAP financial measure contained in such public disclosures to be accompanied by:

4. The SEC defines a "Non-GAAP Financial Measure" as (subject to specified exclusions) a numerical measure of a company's historical or future financial performance, financial position or cash flows that (1) excludes amounts, or is subject to adjustments that have the effect of excluding amounts, that are included in the most directly comparable measure calculated and presented in accordance with GAAP in the company's statement of income, balance sheet or statement or statement of cash flows (or equivalent statements); or (2) includes amounts, or is subject to adjustments that have the effect of including amounts, that are excluded from the most directly comparable measure so calculated and presented in accordance with GAAP.

- the most directly comparable financial measure calculated and presented in accordance with GAAP; and
- a quantitative reconciliation (by schedule or other clearly understandable method), of the differences between the non-GAAP financial measures presented and the most directly comparable GAAP financial measure.

For non-GAAP financial measures disclosed orally, telephonically, in a webcast or broadcast or by similar means, a company may satisfy the requirement that the corresponding GAAP information and reconciliation accompany the non-GAAP financial measures if the company posts the accompanying information on its web site. However, the information must be posted on the company's web site at the time that the oral non-GAAP financial measure is used and the location of the comparable GAAP financial measure and reconciling information must be disclosed during the presentation of the non-GAAP financial measure.

Regulation G exempts financial information presented in connection with a proposed business combination transaction if the disclosure is contained in a communication that is subject to SEC's communication rules applicable to business combination transactions.

In addition, amendments to Item 10 of Regulation S-K and Item 10 of Regulation S-B require companies using non-GAAP financial information in filings with the SEC (including registration statements of Form S-1 in connection with an IPO) to provide:

- a presentation, with equal or greater prominence, of the most directly comparable GAAP financial measure;
- a quantitative reconciliation (by schedule or other clearly understandable method) of the differences between non-GAAP financial measures with the most directly comparable GAAP financial measures;
- a statement describing the reasons why the company's management believes the non-GAAP financial information provides useful information to investors; and
- a statement disclosing the additional purposes, to the extent material, if any, for which the company's management uses the non-GAAP financial measure that are not otherwise disclosed.

Amendments to Item 10 of Regulation S-K and Item 10 of Regulation S-B also specifically prohibits the use of the following non-GAAP financial measures in filings made with the SEC:

- Excluding charges or liabilities that required, or will require, cash settlement, or would have required cash settlement absent an ability to settle in another manner, from non-GAAP liquidity measures, other than EBIT and EBITDA;
- Adjusting a non-GAAP performance measure to smooth or eliminate non-recurring, infrequent or unusual items, when (1) the charge or gain is reasonably likely to recur within two years or (2) there was a similar charge or gain within the prior two years;
- Presenting non-GAAP financial measures on the face of financial statements prepared in accordance with GAAP or the accompanying notes;
- Presenting non-GAAP financial measures on the face of any pro forma financial information required to be disclosed by Article 11 of Regulation S-X; and
- Using titles or descriptions for non-GAAP financial measures that are the same as, or confusingly similar to, titles or descriptions used for GAAP financial measures.

6. *Disclosures Regarding Audit Committee Financial Expert.* The SEC expanded Item 401 of Regulation S-K and Regulation S-B to require public companies to disclose whether at least one member of the audit committee of its board of directors qualifies as an audit committee financial expert (described below), as determined by the board of directors. In addition to this disclosure, the SEC rules require that:

- if the company discloses that it has at least one audit committee financial expert, it must disclose the name of the expert and whether that person is independent of management as that term is defined for audit committee members under the company's relevant listing standards;
- if the company discloses that it does not have at least one audit committee financial expert, it must explain why it does not have one; and

- if the board of directors has determined that it has more than one audit committee financial expert serving on its audit committee then it may, but is not required to, disclose the names of those additional persons, but if it does disclose the names, it must indicate whether they are independent.

Revised Item 401 of Regulation S-K and S-B requires companies to include the disclosure in their annual reports on Forms 10-K and 10-KSB.

The SEC defines "audit committee financial expert" as a person who has each of the following attributes acquired through relevant experience:

- an understanding of generally accepted accounting principles and financial statements;
- the ability to assess the general application of such principles in connection with the accounting for estimates, accruals and reserves;
- experience preparing, auditing, analyzing or evaluating financial statements that present a breadth and level of complexity of accounting issues that are generally comparable to the breadth and complexity of issues that can reasonably be expected to be raised by the company's financial statements, or experience actively supervising one or more persons engaged in such activities;
- an understanding of internal controls and procedures for financial reporting; and
- an understanding of audit committee functions.

The audit committee financial expert must have acquired the above-referenced attributes through at least one of the following ways:

- Education and experience as a principal financial officer, principal accounting officer, controller, public accountant or auditor or experience in one or more positions that involve the performance of similar functions;
- Experience actively supervising a principal financial officer, principal accounting officer, controller, public accountant, auditor or person performing similar functions;

- Experience overseeing or assessing the performance of companies or public accountants with respect to the preparation, auditing or evaluation of financial statements; or
- Other relevant experience.[5]

7. *Director Nominations.* The SEC amended Item 7 of Schedule 14A to require a company to disclose in its proxy materials, where action is to be taken with respect to the election of directors, whether its board of directors has a nominating committee and, if so, whether and how the committee accepts recommendations for nominees from security holders. The revised Item 7 also requires a description of the following:

- If the company does not have a nominating committee or a committee performing similar functions, the basis for the board's view that it is appropriate for the company not to have such a committee, as well as the names of directors who participate in the director nomination process;
- Whether the nominating committee has a charter, and if so, where a copy of the charter is available (either on the company's web site or as an appendix to the proxy statement);
- Information regarding the independence of members of the nominating committee;
- Whether the nominating committee has a policy regarding the consideration of director candidates submitted by security holders; if so, a description of the material elements of that policy; and if not, the basis for the board's view that it is appropriate for the company not to have such a policy;
- The procedures by which security holders may, if permitted, submit names of director candidates for consideration by the nominating committee;
- Information regarding specific, minimum qualifications, if any, for nominees to the board of directors and specific qualities or skills that the nominating committee believes are necessary for one or more of the company's directors to possess;

5. If a person qualifies as an audit committee financial expert solely though other relevant experience, Item 401 requires that the company disclose such other relevant experience.

- The process by which the nominating committee identifies and evaluates director candidates, including differences between candidates submitted by security holders and candidates submitted by other means;
- The category of the persons or entities who nominated each nominee (except nominees who are executive officers or who are standing for reelection) approved by the nominating committee for inclusion on the company's proxy card by one or more of the following categories: security holder, non-management director, CEO, other executive officer, third-party search firm, or another specified source;
- The function of any paid third party who identifies or assists in identifying or evaluating potential nominees; and
- If the nominating committee does not nominate a candidate recommended by a security holder or group of security holders who either individually or in the aggregate beneficially own greater than five percent (5%) of the company's voting stock for at least one year as of the date of the recommendation, certain information concerning the security holder(s) who nominated the candidate and the candidate (provided that the security holder(s) and the candidate give consent to be named).

In addition, the SEC has amended Form 10-Q, Form 10-QSB, Form 10-K and Form 10-KSB to require a company to disclose any material changes to the procedures by which its security holders may recommend nominees to the board in its quarterly or annual report.

8. *Disclosure Regarding Security Holder Communication with the Board of Directors.* The SEC has amended Item 7 of Schedule 14A to require a description of the means, if any, by which security holders may communicate with members of the board of directors. Specifically, the new disclosure rules require a company to disclose in its proxy materials, where action is to be taken with respect to the election of directors, whether or not there is a process by which security holders may communicate with the board of directors and, if not, the basis for the board's view that it is appropriate for the company not to have such a process. If such a process exists, companies must disclose:

- the manner in which security holders can send such communications to the board (and if applicable, to specified board members); and
- if all such communications are not sent directly to board members, information regarding the process for determining which communications will be sent to board members.

The new rules also require disclosure of whether a company has a policy regarding the attendance of directors at annual security holder meetings and the number of directors who attended the prior year's annual meeting.

A company may satisfy the new disclosure requirements regarding security holder communication with the board of directors either by including the disclosure in its proxy statement or by indicating in its proxy statement where such disclosure may be found on its web site.

9. *Disclosure Regarding Code of Ethics.* The SEC has created a new Item 406 of Regulation S-K and Regulation S-B to require public companies to disclose:

- whether the company has adopted a written code of ethics that applies to the company's principal executive officer, principal financial officer, principal accounting officer or controller, and persons performing similar functions; or
- if the company has not adopted a code of ethics, the reasons it has not done so.

Companies must include such disclosure in their annual reports on Forms 10-K and 10-KSB. In addition to requiring disclosure regarding the adoption of an ethics code, the SEC requires that companies make their codes of ethics publicly available by one of the following three alternative methods:

- as an exhibit to their annual report;
- on their web site (provided that a company choosing this option also must disclose its web site address and intention to provide disclosure in this manner in its annual report); or

- by means of an undertaking in their annual report to provide a copy of the code of ethics to any person without charge upon request.

Public companies must report on Form 8-K (1) any amendment to the company's code of ethics that applies to the specified officers; or (2) any waiver of a provision of a code of ethics (*i.e.,* a material departure from a provision of the code of ethics) granted to a specified officer, including the name of the officer to whom the waiver was granted. As an alternative to providing the required disclosure on a Form 8-K, a company may use its own public web site as a method for disseminating the disclosure about amendments to, or waivers of, its code of ethics. However, a company may take advantage of the web site option only if it had previously disclosed in its most recently filed annual report:

- that it intends to disclose these events on its public web site; and
- its public web site address.

If a company elects to disclose this information on its web site, it must do so within the five business day time period that the SEC requires for Form 8-K filings. (Note: Effective August 23, 2004, this 5 business day requirement will be shortened to 4 business days under the SEC's amended Form 8-K). In addition, SEC rules require a company electing to provide web site disclosure to make the disclosure available on its web site for a period of at least 12 months after it initially posts the disclosure. After the 12-month posting period, the company must retain this disclosure for a period of not less than five years and make it available to the SEC upon request.

10. ***The Sarbanes-Oxley Act enhanced auditor independence requirements.*** Financial statements filed with the SEC must be certified by independent accountants. In January 2003, the SEC approved new rules to strengthen its existing requirements regarding auditor independence. Accordingly, the auditing firm selected by the company's audit committee to prepare financial statements to be filed with the SEC (including financial statements included in registration statements in connection with an IPO) must satisfy the SEC's additional independence requirements. The SEC's additional rules regarding auditor independence are summarized below:

Required Communication with Audit Committee. SEC rules require that the issuer's independent accountants inform the audit committee of the following items with the SEC:

- critical accounting policies and practices;
- alternative accounting treatments for both specific transactions and general accounting policies; and
- other material written communications with management, including, among others:
  - management representation letters;
  - reports on observations and recommendations on internal controls;
  - schedules of unadjusted audit differences, and a listing of adjustments and reclassifications not recorded, if any;
  - engagement letters; and
  - independence letters.

Prohibited Non-Audit Services. Section 2-01 of Regulation S-X lists nine types of non-audit services that an independent auditor may not provide to its audit clients:

- bookkeeping services;
- financial information system design and implementation;
- appraisal or valuation services, fairness opinions, or contribution in-kind reports;
- actuarial services;
- internal audit outsourcing services;
- management functions or human resources;
- broker/Dealer, investment adviser, or investment banking services;
- legal services and expert services unrelated to the audit; and

- any other service that the Public Accounting Oversight Board determines by regulation to be impermissible.[6]

Pre-Approval of Services. Section 2-01 of Regulation S-X requires that all audit and permissible non-audit services performed by the independent auditor are either:

- pre-approved by the audit committee; or
- approved pursuant to pre-approval policies and procedures established by the company's audit committee that are detailed as to the particular service to be rendered and do not delegate approval authority to management.[7]

In addition to the pre-approval requirements described above, Item 14 of Form 10-K and Form 10-KSB and Item 9 of Schedule 14-A require a company to provide disclosure in its proxy statement (or Form 10-K if no proxy is filed) regarding the audit committee's pre-approval of services provided by the independent accountant, as well as the types of services performed. If a company uses pre-approval policies and procedures, it must either describe or provide a copy of such policies and procedures. Additionally, Item 9 of Schedule 14-A requires the company to disclose what percentage of the total fees paid to the independent accountants were approved pursuant to the limited *de minimis* exception to the requirement for pre-approval of all audit and permissible non-audit services. This disclosure must also include fees paid to the independent accountant for the two most recent fiscal years in each of the following categories, as well as a description of the services rendered in the last three categories: (1) audit fees; (2) audit-related fees; (3) tax fees; and (4) all other fees.

Audit Partner Rotation. Under Section 2-01 of Regulation S-X, an independent public accounting firm may not provide audit services to an issuer if the lead (or coordinating) audit partner (having primary responsibility for the audit), or the audit partner responsible for reviewing the audit, has performed audit services for the issuer in each of the issuer's five previous fiscal years. Section 2-01 of Regulation S-X subject these

6. An audit committee may allow an independent accountant to provide one of the first five prohibited non-audit services listed above in very limited circumstances where it is reasonable to conclude that the results of these services will not be subject to audit procedures during an audit of the audit client's financial statements.

7. The requirement for pre-approval of all audit and permissible non-audit services are subject to a very limited "de minimis exception."

audit partners to a five-year time-out period before they may again work on the audit engagement. Certain other audit partners are subject to a seven-year rotation period and a two-year time-out period.

Cooling-off period. The SEC amended Section 2-01 of Regulation S-X to require a cooling off period of one year before members of the audit engagement team begin employment for an audit client in the following positions: (1) Chief Executive Officer; (2) Controller; (3) Chief Financial Officer; (4) Chief Accounting Officer; (5) member of the board of directors; (6) General Counsel; and (7) other financial positions with a financial oversight role.

Compensation. Pursuant to Section 2-01 of Regulation S-X, an accountant is not independent if a partner (other than a specialty partner) earns or receives compensation (construed broadly) at any point during the audit and professional engagement based on the audit partner selling engagements to the audit client with respect to services other than audit, review and attestation services.

Appendix F

Sample Plain English Comments from the SEC

Below is a list of sample SEC comments that were released publicly by the SEC in its June 1999 Staff Legal Bulletin regarding Plain English disclosure (originally issued in September 1998 and updated in June 1999).

Entire prospectus. The following SEC comments were applicable to the entire prospectus:

#1 Do not use "Company" to refer to your company. Instead, use your actual company name or a shortened version of it throughout your prospectus.

#2 Throughout your prospectus, you are capitalizing terms that you are using for their common meanings. For example, you capitalize "Common Stock," "Preferred Stock," "Registration Statement," "Prospectus," "Merger Agreement," etc.

#3 Do not define terms in parenthetical phrases when the meanings are clear from their context. For example, you define The X Company, Inc., as ("X Company"). Similarly, you define the Securities and Exchange Commission as ("SEC"), the Internal Revenue Service as ("IRS"), and Securities Exchange Act as (the "Exchange Act").

#4 Many of the terms you use are unique to this prospectus. Eliminate this over-reliance on defined terms. Instead, disclose material information in a clear, concise, and understandable manner.

#5 If you choose a shortened name or abbreviation, ensure its meaning is clear from the context. For example, consider using "Hard Disk Drive Group" as the shortened name of "Hard Disk Drive Group Company, Inc." rather than "HDDG" since the meaning of this abbreviation is unclear without the benefit of a parenthetical definition.

#6 The term "such" is typically legalese for "this," "these," or "the." Please replace this term throughout your prospectus with a concrete, everyday word that means the same thing.

#7 Replace embedded lists of information in paragraph form with bullet points. Also, use bullet points, regular numbers, or letters instead of small Roman numerals in parentheses.

#8 Eliminate parenthetical phrases that disrupt the flow of information and make sentences very long. If the information in the parenthetical phrase is part of the sentence, merely set it off by commas. If the parenthetical phrase does not fit as part of the sentence, include it in its own sentence.

#9 Minimize the use of footnotes where possible. For example, if the text in a footnote applies to the entire table, include the text in the narrative discussion that precedes the table. Also, if a number of footnotes repeat the same text, consider moving this text to the introductory paragraph or adding a column to the table that includes this information.

#11 Eliminate all unnecessary redundancy throughout your prospectus.

#12 Currently, your prospectus is written from the perspective of someone who is already quite familiar with the transaction and the entities involved. For example, throughout your prospectus, you make several references to "certain circumstances," "certain matters," "certain amendments," "certain persons," and "certain extraordinary matters." Replace the term "certain" with a brief description of what makes the information qualify as "certain."

Cover, summary and risk factors. The following SEC comments are applicable to the forepart of the prospectus (the cover page, summary section, and the risk factors section):

#13 The forepart of your prospectus contains a lot of jargon, technical terms, and legalese. For example:

- Jargon/technical terms – proprietary drug, intravenous solutions, logistics capabilities, coordinated manufacturing and distribution efforts, proprietary medicines, vertically integrated, cost-efficient providers, revenue synergies, lower margin products utilization realigning sales forces, centralized management information systems, profit-enhancing synergies, global platform

- Legalese – definitive agreement, consummation, those preceded by, herein set forth, under, by such, forward-looking statements, without limitations, cease to conduct, completion of the combination, commencing hereinafter, so surrendered, defeased, as amended, qualified in its entirety

Eliminate the legalese and industry jargon from the forepart of your prospectus. Instead, explain these concepts in concrete, everyday language. Further, place any industry terms you use in context so those potential investors who do not work in your industry can understand the disclosure.

#14 The forepart of your prospectus contains many defined terms. The meanings of the terms you use in the forepart of your prospectus must be clear from the context. Accordingly, eliminate the defined terms throughout the forepart of your prospectus and use terms whose meanings are clear from the context instead.

Cover page. The following SEC comments are applicable to the cover page of the prospectus:

#15 Your cover page exceeds the one page limit imposed by securities regulations. Much of the information you include here is very detailed and is repeated in the summary. Move the information that is not required by the securities regulations to be on the cover page or is not key to an investment decision off the cover page.

#16 Limit the cover page to the information that is required by the securities regulations and other information that is key to an investment decision.

#17 Using [all capital letters] [and] [cascading margins] impedes the readability of the text on the cover page. Revise text written in all capital letters and eliminate cascading margins from your cover page.

#18 The text on your cover page is dense and the margins are quite narrow. This is because you are including much more information than is required by securities regulations. As a result, your cover page is not visually inviting. The layout of your cover page must highlight the information required by the securities regulations and encourage investors to read your prospectus. Move

any information that is not required or is not key to an investment decision off the cover page. Then, surround the remaining information with ample white space and use wider left and right hand margins.

Summary. The following SEC comments relate to the summary section in the front part of the prospectus:

#19 The introductory paragraph to your summary states that the summary is not complete. A summary, by its very nature, does not and is not required to contain all of the detailed information that is in the prospectus. However, if you have elected to include a summary in your prospectus, it must be complete. Do you mean to say that, because this is a summary, it may not contain all of the information that is important to your investors? Delete the reference to an incomplete summary from your prospectus.

#20 We note your summary contains a lengthy description of the company's business and business strategy. Further, we note the identical disclosure appears later in your prospectus. In the summary, you are to carefully consider and identify those aspects of the offering that are the most significant and determine how to best highlight those points in clear, plain language. The summary should not include a lengthy description of the company's business and business strategy. This detailed information is better suited for the body of the prospectus. If you want to highlight key aspects of your business strategy, consider listing these in a bullet-point format, with one sentence per bullet point.

Risk factors. The following SEC comments pertain to the risk factors section of the prospectus:

#21 We note in the introductory paragraph to your risk factors section you state that this section is not complete, that there may be risks that you do not consider material now but may become material, or there may be risks that you have not yet identified. You must disclose all risks that you believe are material at this time. Delete this language from your introductory paragraph.

#22 Currently, it appears you are including more than one risk factor under one subheading. In order to give the proper prominence to each risk you present, we suggest you assign each risk its own descriptive subheading.

#23 Present the risks in more concrete terms. For example, in the first risk factor on page **, you discuss the risks due to the "costs" associated with the benefit plans. So investors can better understand these risks, clearly state that the "costs" are not expenses of running those plans, but rather the added compensation expense that stems from the shares purchased or granted to employees and executives under those plans.

#24 In each risk factor, get to the risk as quickly as possible and provide only enough detail to place the risk in context. Where you repeat later in the prospectus the details you currently include in your risk factors section, eliminate the extensive detail here. Instead, include a very brief overview to place the risk in context and provide a specific cross reference to the more detailed discussion elsewhere in the prospectus.

#25 Provide the information investors need to assess the magnitude of the risk.

#26 The securities regulations state that issuers should not "present risk factors that could apply to any issuer or to any offering." If you elect to retain these and other general risk factors in your prospectus, you must clearly explain how they apply to your industry, company, or offering.

#27 Revise each subheading to ensure it reflects the risk that you discuss in the text. Many of your subheadings currently either merely state a fact about your business or describe an event that may occur in the future. Succinctly state in your subheadings the risks that result from the facts or uncertainties.

#28 The subheadings in your risk factors section are too vague and generic to adequately describe the risk that follows. Revise your risk factor subheadings so they reflect the risk that follows. As a general rule, your revised subheadings should work only in this prospectus. If they are readily transferable to other companies' offering documents, they are probably too generic.

#29 To the extent possible, avoid the generic conclusion you make in most of your risk factors that the risk discussed would have a material adverse effect on your [operations] [financial condition]

[business]. Instead, replace this language with specific disclosure of how your [operations] [financial condition] [business] would be affected.

Body of the prospectus. The following SEC comments are applicable to body of prospectus

#30 Avoid relying on defined terms as a primary means of explaining information in the prospectus. We note that the body of your prospectus contains a large number of defined terms. Most of these are terms that you created solely for use in this prospectus. Revise your prospectus to eliminate your over-reliance on defined terms.

#31 If you must include technical terms in the body of your prospectus that are understood only by industry experts, you must make every effort to concisely explain these terms where you first use them. Where this is simply not possible, explain these terms in a glossary. In addition, do not use technical terms or industry jargon in your concise explanations. You should not use a glossary to define commonly understood abbreviations, like SEC, or acronyms, like NASDAQ. Further, you should not use a glossary to define terms that you have created solely for the purpose of your registration statement. We urge you not to create a vocabulary that is unique to your offering.

#32 You must avoid copying complex information directly from legal documents without any clear and concise explanation of this information. Rewrite this disclosure so it is clear, concise, and understandable. If you believe the language as it appears in the underlying legal documents is indispensable to your prospectus, you must present it clearly, using bullet lists and concise sections and paragraphs, and explain what it means to investors.

Glossary

The definitions below are intended to convey plain English explanations of certain terms. For technically complete, legally precise definitions, experienced counsel should be consulted.

The definitions of many of the words and phrases in this Glossary use other defined words and phrases. Terms in a given definition that themselves (or variations thereof) appear elsewhere under their own listings are italicized.

Accelerated Filer. A public company that meets the following conditions as of the end of its fiscal year:

- The company's common equity public float was $75 million or more as of the last business day of its most recently completed second fiscal quarter;
- The company has been subject to the reporting requirements of Section 13(a) or 15(d) of the *Exchange Act* for a period of at least 12 calendar months;
- The company has previously filed at least one annual report pursuant to Section 13(a) or 15(d) of the *Exchange Act*; and
- The company is not eligible to use *Form 10-KSB* and *Form 10-QSB* (*i.e.,* it is not a *small business issuer*).

Acceleration Request. A written (or, in some cases, oral) request to the SEC to declare a *registration statement* effective at a certain date and time. The SEC requires that the request be delivered at least two business days prior to the anticipated effective date.

Affiliate. A person or entity that directly or indirectly controls, is controlled by, or is under common control with, a company. Examples of affiliates include executive officers, directors, large stockholders, subsidiaries and sister companies.

Aftermarket. Trading on stock exchanges and over-the-counter markets in a company's stock after an *initial public offering*.

Aggregate Offering Price. The total offering price of an offering to the public, which is equal to the number of offered shares multiplied by the price per share to the public.

American Depositary Receipts (ADRs). Negotiable instruments, created by a U.S. bank, that evidence ownership of a specified number of shares of a foreign security held in a depositary in the issuing company's country of domicile. The certificate, transfer, and settlement practices for ADRs are identical to those for U.S. securities. U.S. investors often prefer ADRs to direct purchase of foreign shares because of the ready availability of price information, lower transaction costs, and timely dividend distribution.

American Stock Exchange (Amex). The second-oldest U.S. stock exchange, located on Wall Street in New York City. The Amex typically lists small to medium cap stocks of younger or smaller companies. The Amex is the only primary exchange that offers trading across a full range of equities, options and exchange traded funds (ETFs). The Amex is also one of the largest options exchanges in the U.S., trading options on broad-based and sector indexes as well as domestic and foreign stocks.

Analyst. A person with expertise in evaluating financial investments. An analyst performs investment research and makes recommendations to institutional and retail investors to buy, sell, or hold; most analysts specialize in a single industry or business sector.

Annual Report. A report containing financial statements and certain other information required by *SEC* regulations which is distributed to stockholders on an annual basis. One method of satisfying the annual report requirement is to distribute a copy of the company's *Form 10-K*, which is often accompanied by a letter from the CEO, and is commonly referred to as a "10-K wrap."

Banknote Company. A public company must provide a physical certificate of ownership to holders of the company's stock who request it. A banknote company specializes in the design and printing of stock certificates.

Beneficial Ownership. The beneficial owner of a security includes any person who directly or indirectly, through any contract, arrangement, understanding, relationship or otherwise, has or shares voting or investment power with respect to such security. A person or entity may be the beneficial owner of a security even though title may be in another name for safety, convenience or otherwise (such as when securities beneficially owned by an individual are held by a *broker* in street name). There may be more than one beneficial owner of a single security.

Best Efforts Offering. As opposed to a *firm commitment underwriting,* refers to an offering where the *underwriters* do not purchase the securities from the issuer or resell them to the public. In a best efforts offering, *underwriters* act only as an agent of the issuer in marketing the securities to investors. Most best efforts offerings today are handled by investment banks specializing in lesser known or more speculative securities.

Blue Sky Laws. State securities laws loosely analogous to the federal securities laws. The term is said to have originated with a judge who asserted that a particular stock offering had as much value as a patch of blue sky.

Broker. An individual or firm that trades securities for buyers or sellers in exchange for a commission.

Capitalization. The total amount of a company's outstanding debt and equity securities. The term also is commonly used to refer to the capital (debt and equity) structure of a company.

Charter Documents. A company's basic incorporation documents, including the Articles or Certificate of Incorporation and the Bylaws.

Cheap Stock. The term used to describe securities, most commonly stock options, granted to employees, directors, consultants or other service providers with an exercise price below the fair value of the underlying security as of the date of grant. The SEC generally views the difference in exercise price and fair market value (measured as of the date of grant) as compensation and requires that the company record a corresponding compensation expense.

Closing. The closing of an offering is held on the third or fourth business day following the effective date. At the closing, the company delivers the registered securities to the underwriters in exchange for the net offering proceeds.

Comfort Letter (or "cold comfort" letter). A letter written by the company's accountants and delivered to the underwriters and the company's board of directors as part of the due diligence process. The comfort letter gives assurance to the underwriters and the company's board of directors that the financial information included in the registration statement corresponds to the audited and unaudited financial statements and other financial records of the company and may also discuss the results of certain additional agreed upon procedures.

Confidential Treatment. The method whereby a company can request that certain sensitive or confidential information contained in exhibits to filings made with the SEC be redacted from the documents and not made available to the public. Typical examples of the type of information for which confidential treatment may be sought include financial information (such as pricing terms, royalty rates and milestone payments) and trade secrets (such as technical specifications).

CUSIP Number. CUSIP is an acronym for the Committee on Uniform Security Identification Procedures. This committee was established in 1964 by the American Bankers Association's Department of Automation to create a uniform security identification system. The CUSIP Service Bureau, operated by Standard & Poor's, administers this system assigns unique numbers (CUSIP numbers) and standardized descriptions of securities, both of which are critically important for the accurate and efficient clearance and settlement of securities transactions.

Dealer. Individual or entity acting as a principal in a securities transaction.

Depository Trust Company (DTC). DTC provides a central securities certificate depository through which brokers deliver securities by computerized bookkeeping entries, vastly reducing physical transfer of stock certificates

Directed Shares. Refers to shares of stock sold in an initial public offering which are directed to certain individuals by the company.

Director and Officer (D&O) Liability Insurance. A form of insurance against liability asserted against directors and officers of a company and incurred by such persons in those capacities or arising out of such persons' status as directors and officers of the company.

Director and Officer (D&O) Questionnaire. A questionnaire distributed by the company to its directors and officers during the early stages of a public offering. The questionnaire solicits information regarding executive compensation, securities ownership and insider transactions. The D&O Questionnaire aids the company in the due diligence process and confirms data that is disclosed in the registration statement.

Division of Corporation Finance. The division of the SEC that reviews registration statements filed pursuant to the Securities Act.

Due Diligence. A fact-finding process conducted by various working group members to verify the accuracy and completeness of the registration statement.

Earnings Per Share (EPS). Net income of a company for a specified period of time divided by the number of equity securities outstanding at such time. Fully diluted EPS assumes the exercise or conversion of certain warrants, options and convertible securities into common stock.

EDGAR System. The Electronic Data Gathering, Analysis, and Retrieval system, which is an electronic system implemented by the SEC for the receipt, acceptance, review and dissemination of documents submitted in electronic format.

EDGAR Filer Manual. The manual prepared by the SEC setting out the technical format requirements for EDGAR filings. *See also Regulation S-T.*

Effective Date. The date of the SEC order declaring the registration statement for a public offering to be effective, at which time the sale of shares to the public can commence.

Electronic Communication Networks (ECNs). In addition to traditional market makers, the NASDAQ network also includes other broker-dealers operating as Electronic Communication Networks, or ECNs, which provide electronic facilities for investors to trade directly with one another without going through a market maker. ECNs operate as order-matching and order-routing mechanisms and do not maintain inventories of securities themselves.

Equity. Represents the ownership interest of stockholders in a company.

Exchange Act. *See* Securities Exchange Act of 1934, as amended.

Final Prospectus. The offering document sent to all purchasers of the company's stock in and immediately following a public offering. The final prospectus is an updated version of the preliminary prospectus, contains all final offering information (such as pricing and underwriting details) and reflects amendments to the registration statement subsequent to the date of the preliminary prospectus.

Financial Printer. A printer that specializes in printing financial documents, such as registration statements and other documents filed pursuant to the Securities Act and the Exchange Act.

Firm Commitment Underwriting. As opposed to a best effort offering, the firm commitment underwriting refers to an underwriting where the underwriters commit to purchase shares from the company at a negotiated discount and then resell the shares to the public.

Flipping. The practice of an investor buying stock in an IPO at the offering price and quickly selling it for a profit when it starts trading. Though it became common during the Internet boom of the late 1990s, this practice is generally discouraged by the company and its underwriters, who seek investors willing to make a long-term commitment to the company.

Foreign Private Issuer. Any foreign issuer other than a foreign government, except an issuer meeting the following conditions: (1) more than 50% of the outstanding voting securities of such issuer are owned by U.S. residents; and (2) any of the following: (i) the majority of the executive officers or directors are U.S. citizens or residents; (ii) more than 50% of the assets of the issuer are located in the U.S.; or (iii) the business of the issuer is administered principally in the U.S. Foreign private issuers are subject to somewhat narrower disclosure obligations than U.S. issuers. *See also Form 20-F* and *Form F-1.*

Form 3. Used to report initial beneficial ownership of securities. A Form 3 must be filed by all Section 16 insiders within 10 days after such person becomes a Section 16 insider, except in connection with the initial registration of securities under the *Exchange Act* when the report is due on the effective date of the *registration statement.* Required pursuant to Section 16 of the Exchange Act.

Form 4. Used to report changes in beneficial ownership of securities. Section 16 insiders must file a Form 4 by the end of the second day following the day on which a reportable change in such person's beneficial ownership of securities occurred, except where extensions may be available in connection with a Rule 10b5-1 trading plan or for transactions eligible for deferred reporting on Form 5. Required pursuant to Section 16 of the Exchange Act.

Form 5. Used to report beneficial ownership of securities annually. Section 16 insiders must file a Form 5 on or before the 45th day after the end of the reporting company's fiscal year to report certain transactions in

such company's equity securities. However, if each of such transactions has been reported on a previous Form 3 or Form 4, no Form 5 need be filed. Required pursuant to Section 16 of the Exchange Act.

Form 8-A. A form of registration statement used to register securities pursuant to the Exchange Act.

Form 8-K. The prescribed form for current reports of certain specified events, such as a change in control, significant acquisition or disposition of assets, bankruptcy or receivership, or a change in accountants. The Form 8-K may also be used to voluntarily report other important events.

Form 10-K. An annual report on Form 10-K is required to be filed by a reporting company within 90 days after the end of each fiscal year, unless the reporting company is an *accelerated filer* subject to accelerated filing deadlines as discussed in ***Appendix E***. The Form 10-K consists of the cover page, Part I (information relating to the company's business, property and legal proceedings), Part II (financial information), Part III (information relating to the Company's directors, officers and principal stockholders) and Part IV (exhibits and financial statement schedules). *See also Annual Report.*

Form 10-KSB. Form 10-KSB, which has more simplified disclosure requirements than Form 10-K, may be used by *small business issuers* in lieu of the Form 10-K.

Form 10-Q. Reporting companies are required to file quarterly reports on Form 10-Q within 45 days after the end of each of the first three quarters of each fiscal year, unless the reporting company is an *accelerated filer* subject to accelerated filing deadlines as discussed in ***Appendix E***. The Form 10-Q is less comprehensive than the *Form 10-K*.

Form 10-QSB. Form 10-QSB, which has more simplified disclosure requirements than *Form 10-Q*, may be used by *small business issuers* in lieu of the *Form 10-Q.*

Form 20-F. Form 20-F may be used by *foreign private issuers* both to register securities under the *Exchange Act* and as an annual report which must be filed within six months after the end of each fiscal year.

Form F-1. Form F-1 is used by *foreign private issuers* to register shares pursuant to the *Securities Act.*

Form S-1. The basic *registration statement* form used to register securities pursuant to the *Securities Act* when no other form is authorized or prescribed. The Form S-1 *registration statement* is the form most commonly used in connection with an *IPO*. The Form S-1 requires comprehensive disclosure about the company and does not permit *incorporation by reference* of documents or information.

Form S-2. The Form S-2 *registration statement* is available for any company that has been subject to the reporting requirements of the *Exchange Act* for at least 36 months and has filed all required reports pursuant to the *Exchange Act* in a timely manner for at least the preceding 12 months and any portion of the month preceding filing of the *registration statement.* Form S-2 allows the *incorporation by reference* of certain required information from documents previously filed pursuant to the *Securities Act* or the *Exchange Act.*

Form S-3. The Form S-3 *registration statement* is available for any company that has been subject to the reporting requirements of the *Exchange Act* for at least 12 months and has filed all required reports pursuant to the *Exchange Act* in a timely manner for at least the preceding 12 months and any portion of the month preceding filing of the *registration statement.* Depending on the type of offering, there may be additional financial thresholds and other requirements. As compared to Form S-2, Form S-3 allows a greater level of *incorporation by reference* of certain required information from documents previously filed pursuant to the *Securities Act* or the *Exchange Act.*

Form S-4. The Form S-4 *registration statement* is used to register securities issued by *reporting companies* in connection with certain business combinations, reclassifications, mergers, consolidations and asset transfers.

Form S-8. The Form S-8 *registration statement* may be used by *reporting companies* to register securities to be offered pursuant to employee benefit plans.

Form SB-1. The Form SB-1 *registration statement* may be used in lieu of *Form S-1* by a *small business issuer* to register up to $10 million in securities if it has not registered more than $10 million in the preceding 12 months (other than securities registered on a *Form S-8*), including securities in the offering being registered.

Form SB-2. The Form SB-2 *registration statement* may be used by a *small business issuers* to register securities, without the offering amount limitations of *Form SB-1.*

GAAP (Generally Accepted Accounting Principles). Rules and procedures generally accepted within the accounting profession. The Financial Accounting Standards Board (FASB) is the body primarily responsible for developing rules governing U.S. generally accepted accounting practices.

Green Shoe. This term refers to the option typically granted to the underwriters to cover over-allotments in the offering. This name derives from the fact that the over-allotment option technique was first used in a public offering of the securities of The Green Shoe Company. *See Over-allotment option.*

Gross Proceeds. Offering proceeds before *underwriting discounts and commissions* are deducted.

Hot Issues. A hot issue is an *IPO* that trades up in the *aftermarket* in the period immediately following initial sales of the stock. Special *NASD* rules apply to the distribution of hot issues.

Incorporation by Reference. Certain forms filed under the *Securities Act* and *Exchange Act* enable the incorporation of certain required disclosure documents and information by reference to other previously filed documents and information, thereby simplifying the registration or filing process.

Independent Director. *See* the discussion of various standards for determining director independence in ***Appendix E***. In general, an independent director is a person other than an officer or employee of the company or its subsidiaries or any other individual having a relationship, which, in the opinion of the company's board of directors, would interfere with the exercise of independent judgment in carrying out the responsibilities of director.

Initial Public Offering (IPO). The process of a company registering shares of its capital stock with the SEC and offering the shares to the public for the first time.

Insider. Generally, an insider is a person with access to material information relating to a company before it is announced to the public, and who has a duty to the issuer not to misuse such information. The term includes, but is not necessarily limited to, directors, officers and key employees.

Institutional Investors. Organizations whose primary purpose is to invest their own assets or those entrusted to them by others, the most common of which are employee pension funds, insurance companies, mutual funds, university endowments, and banks.

IPO. *See Initial Public Offering.*

Lock-Up Agreement. An agreement between a company or the *underwriters* on the one hand, and a stockholder on the other hand, whereby the stockholder agrees that it will refrain from reselling its shares for a specified period of time after the effective date of a *registration statement. See also Overhang Analysis.*

Management's Discussion and Analysis of Financial Condition and Results of Operations (MD&A). The section of the *registration statement* discussing and analyzing the company's financial condition, changes in financial condition and results of operations. The MD&A typically includes period-to-period comparisons of the three most recent fiscal years and the current fiscal year to date compared to the corresponding prior year period.

Management Interviews. *Due diligence* meetings conducted by the *managing underwriters* where members of the company's management team make presentations and answer questions about the company.

Managing Underwriters. The *underwriters* who, singly or together with co-managers, participate in the preparation of the *registration statement,* conduct portions of the *due diligence* and conduct the *road show*.

Market Capitalization. The value of a company as determined by the market price of its issued and outstanding common stock. It is calculated by multiplying the number of outstanding shares by the current market price of a share.

Market Makers. The NASD member firms that use their own capital, research, retail or systems resources to represent a stock and compete with each other to buy and sell the stocks they represent. Market makers, also known as dealers, provide liquidity (the ability of a security to absorb a

large amount of buying and selling without substantial movement in price) by standing ready to buy or sell securities at all times at publicly quoted prices for their own account and by maintaining an inventory of securities for their customers. There are over 500 member firms that act as Nasdaq market makers.

MD&A. *See Management's Discussion and Analysis of Financial Condition and Results of Operations.*

NASD. *See National Association of Securities Dealers.*

NASD Questionnaire. A questionnaire distributed by underwriters' counsel to the directors, officers and security holders of a company in connection with a public offering in order to gather and confirm information that must be provided to the *NASD.*

National Association of Securities Dealers (NASD). The NASD, which operates subject to the oversight of the SEC, is the largest *SRO* in the U.S. with a membership that includes nearly every broker-dealer that engages in the securities business with the U.S. public. NASD registers member firms, writes rules to govern their behavior, examines them for compliance and disciplines those that fail to comply.

Nasdaq National Market. The highest tier on the *NASDAQ* market, and it consists of more than 3,000 companies that have a national or international shareholder base, have applied for listing, meet stringent financial requirements and agree to specific corporate governance standards. *See also NASD, Nasdaq Stock Market, Inc. and Nasdaq SmallCap Market.* The listing requirements of The Nasdaq National Market are set forth in ***Appendix A***.

Nasdaq SmallCap Market. The lower tier of the *NASDAQ* market, and it is comprised of more than 1,400 companies that desire the sponsorship of Market Makers, have applied for listing and meet specific and financial requirements. *See also NASD, Nasdaq Stock Market, Inc. and Nasdaq SmallCap Market.*

Nasdaq Stock Market, Inc. (NASDAQ). Operates the *Nasdaq Stock Market*, one of the world's largest electronic screen-based equity securities markets, and the *Nasdaq SmallCap Market*; it also operates the *Over-the-Counter Bulletin Board*. *See also NASD, Nasdaq Stock Market, Inc. and Nasdaq SmallCap Market.*

Net Proceeds. *Gross proceeds* of an offering less the *underwriting discounts and commissions* and offering expenses.

New York Stock Exchange (NYSE). The oldest and largest U.S. stock exchange, located on Wall Street in New York City. Tracing its origins back to 1792, the NYSE is one of the few remaining financial markets to use a physical trading floor to conduct trading. Representatives of buyers and sellers, known as specialists, meet and shout out prices in an "open outcry system." The NYSE is also known as "the Big Board" and "the Exchange." The listing requirements of the NYSE are set forth in ***Appendix A.***

No-Action Letter. *See "SEC No-Action" Letter.*

NYSE/NASD IPO Advisory Committee. The NYSE and NASD convened the IPO Advisory Committee in October 2002 at the request of the Chairman of the SEC, to "review the IPO underwriting process, particularly price setting and allocation practices, in light of recent experience, and to recommend to the securities industry community such changes as may be necessary to address the problems that have been observed." On May 29, 2003, the Committee issued a report with 20 recommendations for the *SROs* and the SEC.

Options. Options are securities giving the holder the right to purchase securities of the company at a certain price.

Over-the-Counter (OTC) Bulletin Board Market. An electronic screen-based market maintained by *NASDAQ* for equity securities that, among other things, are not listed on *The Nasdaq Stock Market* or any primary U.S. national securities exchange. Companies do not list on the OTC Bulletin Board; rather, *NASD* members may post quotes only for companies that file periodic reports with the *SEC* or with a banking or insurance regulatory authority.

Over-allotment option. The option granted in an *initial public offering,* or other underwritten securities offering, by the company, *selling stockholders* or both to the *underwriters* to purchase additional shares, to cover over-allotments identical terms to those on which the original shares were sold to the underwriters. Also known as the *Green Shoe.*

Overhang Analysis. An analysis of the number of outstanding shares of a company's stock that become freely tradeable at particular intervals following the IPO.

Periodic Reporting Requirements. The ongoing requirements applicable to *reporting companies* to make filings pursuant the *Exchange Act,* including quarterly reports on *Form 10-Q* and annual reports on *Form 10-K.*

Plain English Disclosure. The SEC requirement for the orderly and clear presentation of complex information contained in *registration statements*. The rule requires companies to write the cover page, summary and *risk factors* sections of *registration statements* in "plain English."

Poison Pill. A type of strategic defensive measure that is designed to delay the timing and raise the cost of an unsolicited or hostile acquisition and thereby encourage would-be suitors to negotiate with the company's board of directors. A poison pill is typically implemented by means of a stockholder rights plan.

Preliminary Prospectus. The offering document used by the company and the *underwriters* to market a public offering. The preliminary prospectus is essentially Part I of the *registration statement* and may omit certain information relating to the offering (such as the final offering price). Also known as the *Red Herring* because of the red ink used on the front page, which indicates that some information, including the price and size of the offering, is subject to change.

Prospectus. *See Final Prospectus* and *Preliminary Prospectus.*

Proxy Statement. A document containing information prescribed by SEC regulation that must be provided to stockholders in connection with the solicitation of their votes.

Public Offering Price. The price at which a new issue is offered to the public by underwriters.

Quiet Period. Extends to the 25-day period following the *effective date* of a *registration statement* in connection with an *IPO* (or 90-day period if, following the *IPO*, the company is not listed on a stock exchange or over-the-counter market).

Red Herring. *See Preliminary Prospectus.*

Registrar and Transfer Agent. An agent, usually a commercial bank, appointed by a company to maintain records of security owners, to cancel and issue certificates and to resolve problems arising from lost, destroyed or stolen certificates.

Registration Rights. Contractual rights to participate in or require a public offering of equity securities.

Registration Statement. The document that must be filed with the *SEC* to register shares of a company's stock in connection with a public offering. *See also Form F-1, Form S-1, Form S-2, Form S-3, Form S-4, Form S-8, Form SB-1* and *Form SB-2.*

Regulation AC (Analyst Certification). An SEC rule that requires that brokers, dealers and certain persons associated with a broker or dealer include in research reports certifications by the research analyst that the views expressed in the report accurately reflect his or her personal views, and disclose whether or not the analyst received compensation or other payments in connection with his or her specific recommendations or views.

Regulation BTR (Blackout Trading Restriction). An SEC rule that addresses the operation of Section 306(a) of the *Sarbanes-Oxley Act* and its prohibition against trading in issuer equity securities by an issuer's directors and executive officers during a pension plan blackout.

Regulation FD (Fair Disclosure). An SEC rule that provides that when an issuer, or person acting on its behalf, discloses material, non-public information to certain enumerated persons (in general, securities market professionals and holders of the issuer's securities who may well trade on the basis of the information), it must make public disclosure of that information.

Regulation G. An SEC rule that requires public companies that disclose or release non-GAAP financial measures to include, in that disclosure or release, a presentation of the most directly comparable GAAP financial measure and a reconciliation of the disclosed non-GAAP financial measure to the most directly comparable GAAP financial measure.

Regulation S-B. An SEC rule that sets forth the disclosure requirements applicable to the content of the non-financial statement portions of *registration statements* and other filings under the *Securities Act* and the *Exchange Act* made by *small business issuers*.

Regulation S-K. An SEC rule that sets forth the disclosure requirements applicable to the content of the non-financial statement portions of *registration statements* and other filings under the *Securities Act* and the *Exchange Act.*

Regulation S-T. An SEC rule that sets forth the format and other technical requirements for documents filed with the *SEC* in electronic, or *EDGAR*, format. *See also EDGAR Filer Manual.*

Regulation S-X. An SEC rule that sets forth the form and content of and requirements for financial statements included with *registration statements* and other filings under the *Securities Act* and the *Exchange Act*.

Reincorporation. The process of changing the jurisdiction of incorporation of a company (often to Delaware).

Reporting Company. Any business entity that (1) has filed a *registration statement* pursuant to the *Exchange Act* which has become effective, or (2) has become required to file *periodic reports* pursuant to the *Exchange Act* because such business entity has exceeded certain maximum thresholds regarding the number of equity holders and amount of assets.

Restricted Securities. Securities of a company acquired directly or indirectly from the company in a transaction or chain of transactions not involving any public offering. Restricted securities may only be resold in the public markets by way of a registered offering or exemption pursuant to the *Securities Act. See also Rule 144.*

Risk Factors. The portion of a *registration statement* that sets forth the principal risks faced by the company and other factors that make the purchase of stock in the offering speculative or high risk.

Road Show. The presentations made by the executive management of the company, during a public offering, in one-on-one or group presentations, to prospective purchasers of securities in the public offering, typically institutional investors. The road show for an IPO typically lasts from one to three weeks.

Rule 144. An SEC rule that provides a "safe harbor" that sets forth the conditions whereby a holder of unregistered securities may make a sale in the *aftermarket* without registration under the *Securities Act*. Rule 144 requires that no security purchased through a private placement may be sold for at least one year after the date of purchase. Thereafter, securities

may be sold in broker's transactions subject to certain volume limitations and other requirements. The restrictions of Rule 144 for non-*affiliates* of the company lapse after the securities have been held for two years after the date of purchase. Stockholders making resales of unregistered securities without complying with the Rule 144 requirements bear a high burden of proof in establishing compliance with the federal securities laws.

Rule 701. Rule 701 under the *Securities Act* sets forth the conditions whereby a holder of unregistered securities received pursuant to a written compensatory benefit plans may resell such securities in the public markets without registration under the *Securities Act*. In some cases, Rule 701 may allow resale prior to the date that would otherwise be allowed under Rule 144.

Sarbanes-Oxley Act of 2002. An Act that made a number of significant changes to federal regulation of public company corporate governance and reporting obligations.

Schedule 13D. *See Section 13.*

Schedule 13G. *See Section 13.*

SEC. *See Securities and Exchange Commission.*

SEC "No-action" Letter. A letter that is issued by the SEC stipulating that it does not object to a course of action proposed by a registrant. If the staff of the SEC issues such a letter, it generally confirms in the letter that it will not recommend that the SEC take enforcement action relating to the proposed action. Also, the SEC generally states specifically that the positions discussed in the letter are based on the specific facts and circumstances set forth in the request from the registrant, and that any different facts or circumstances may require a different conclusion.

Secondary Offering. The portion of a registered offering being offered and sold by *selling stockholders.*

Section 13. Section 13 of the *Exchange Act*, which requires that any holder of more than 5% of any class of registered equity securities report such ownership on a *Schedule 13D* or *Schedule 13G.*

Section 16. Section 16 of the *Exchange Act*, which requires the periodic disclosure of equity ownership (and changes in ownership) of *Section 16 insiders.* Section 16 also requires the disgorgement of any profits ("short-swing" profits) realized by *Section 16 insiders* from the purchase and sale,

or sale and purchase, of equity securities of the company in any 6-month period. *See also Form 3, Form 4, Form 5, Section 16 Insider* and *Short Swing Profits*.

Section 16 Insider. Any executive officer, director or *beneficial owner* of greater than 10% of a class of registered equity securities. *See also Form 3, Form 4, Form 5, Section 16* and *Short Swing Profits.*

Securities Act. The Securities Act of 1933, as amended, which is the federal statute prohibiting the offer or sale of a security (except certain exempt securities or in certain exempt transactions) unless the security has been registered with the *SEC*, and imposing *prospectus* delivery requirements. The Securities Act also contains antifraud provisions prohibiting false representations and disclosures. Enforcement responsibilities were assigned to the *Securities and Exchange Commission* by the *Exchange Act.*

Securities and Exchange Commission (SEC). The federal agency created by the *Exchange Act* to administer the *Exchange Act* and the *Securities Act.* The statutes administered by the SEC are designed to promote full public disclosure and protect the investing public against fraudulent and manipulative practices in the securities markets

Securities Exchange Act. The Securities Exchange Act of 1934, as amended, which is the federal statute regulating reporting obligations of *reporting companies*, tender offers, certain trading practices and insider trading. It created the *Securities and Exchange Commission* to enforce both the *Securities Act* and the *Exchange Act* and requires that public companies enter its continuous disclosure system and file annual and quarterly reports and *proxy statements* with the *SEC.* The Exchange Act also establishes a self-regulatory system for the supervision of the trading markets and gives the *SEC* oversight jurisdiction over stock exchanges and the *NASD*.

Self-Regulatory Organization (SRO). A non-government organization that has statutory responsibility to regulate its own members through the adoption and enforcement of rules of conduct for fair, ethical and efficient practices. Examples include the NASD and the national securities and commodities exchanges (for example, the NYSE).

Selling Group. A group of *dealers* and *underwriters* selected by the *managing underwriters*, as the agent for the other *underwriters,* to market shares in a public offering.

Selling Stockholder. A stockholder of a company that is selling shares in a registered public offering. *See also Secondary Offering.*

Short-Swing Profits. Profits realized from the purchase and sale, or sale and purchase, of an equity security of a *reporting company* by a *Section 16 insider* in any 6-month period. *Section 16* of the *Exchange Act* requires the disgorgement of short-swing profits realized by such persons.

Small Business Issuer. A U.S. or Canadian issuer having annual revenues and a public float of less than $25 million. Small business issuers qualify for simplified disclosure requirements under certain circumstances. *See also Regulation S-B, Form SB-1* and *Form SB-2.*

Standard Industrial Classification (SIC). Code used to classify entities by the type of economic activities in which they are engaged.

Stock Split. An increase or decrease in the total number of outstanding shares of capital stock. An increase in the total number of outstanding shares is called a "forward split," and a decrease is called a "reverse split." For example, a "2-for-1 stock split" would double the total number of outstanding shares of capital stock of a company; each stockholder would be entitled to two shares for each one share he or she owns. A "1-for-3 reverse stock split" would reduce the total number of outstanding shares of capital stock of a company to one-third of that total number; every three shares of stock held by a stockholder would become one share after the reverse split. Stock splits are effected in two ways: (1) as a stock dividend or (2) as a stock split whereby the certificate of incorporation is amended. A stock dividend is the payment of additional shares to existing holders and can only be used to effect a forward split. A stock dividend can often be effected by resolution of the board of directors, and without the need for stockholder approval. A stock split is the division or combination of existing shares into new shares and requires both the resolution of the company's board of directors and the filing of an amended certificate of incorporation (which typically requires stockholder approvals).

Syndicate. A group of *underwriters* selected by the *managing underwriters t*o market and sell shares in a registered public offering.

Ticker Symbol. A three or four letter abbreviation used to identify a security whether on the floor, a TV screen, or a newspaper page. Ticker symbols are part of the lore of Wall Street and were originally developed in the 1800s by telegraph operators to save bandwidth. One-letter symbols

were therefore assigned to the most active stocks. Railroads were the dominant issues at the time, so they retain a majority of the one-letter designations. Ticker symbols today are assigned on a first-come, first-served basis. Each marketplace – the *NYSE*, the *Amex*, *NASDAQ* and others – allocates symbols for companies within its purview, working closely to avoid duplication. A symbol used for one company cannot be used for any other, even in a different marketplace.

Transfer Agent. A Transfer Agent keeps a record of the name of each registered stockholder, his or her address and the number of shares owned, and ensures that the certificates presented for transfer are properly cancelled and that new certificates issued in the name of the new owner.

Underwriter. An investment bank that offers or sells securities to investors in a public offering on behalf of the company in either a *firm commitment underwriting* (which is most typical) or a *best efforts offering*. The Securities Act defines *underwriter* much more broadly, so as to encompass many other participants in a distribution of securities.

Underwriting Agreement. In a registered offering, the principal agreement between the company and the *underwriters* stating the relationship between the parties. The underwriting agreement contains an agreement to sell and buy the offered shares, the *underwriting discount and commission*, representations and warranties of the parties, certain covenants, expense allocation and indemnification provisions.

Underwriting Discount and Commission. A percentage of the *gross proceeds* of an *initial public offering* that constitutes the compensation paid to the *underwriters* for marketing and selling the offering.

Waiting Period. The period of time between the filing of the *registration statement* and the *effective date*.

Working Group. Consists of key company executives and employees, the company's board of directors, the *managing underwriters,* the company's counsel, the underwriters' counsel, the company's auditors, the financial printer and other parties. Members of the working group have various responsibilities in connection with preparing the *registration statement*, including the *prospectus*, and marketing and selling the company's stock to investors.

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