

BLUEPRINT FOR AN IPO

BASS BERRY  SIMS

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TABLE OF CONTENTS

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OVERVIEW OF INITIAL PUBLIC OFFERINGS

What are some of the advantages of going public?	1
What are some of the disadvantages of going public?	2
Who are the participants and what are their roles in the IPO process?	4
When should we begin discussions with underwriters?	5
What should we look for in a managing underwriter?	5
After we select a managing underwriter what is the first step in the process?	7
What are the various types of underwriting?	7
How do we determine the price range at which the stock will be sold?	8
How many shares should we sell?	8
How do we prepare a registration statement?	9
What is Due Diligence?	10
How is the SEC involved in the process?	11
What is an “emerging growth company”?	12
Can we request that the SEC review our filing on a confidential basis?	13
Can we hold “test the waters” meetings?	13
What is a roadshow?	13
What steps must we take to comply with FINRA requirements?	14
How does our stock become traded on a national stock exchange?	15
When do we sign the underwriting agreement?	15
How do the underwriters get paid?	15
When do we get paid for our stock?	15
What happens if there is a material misstatement or omission in the registration statement?	15
What is a direct listing?	17

CORPORATE HOUSEKEEPING

Why do companies often engage in recapitalizations prior to commencing an IPO?	18
Should preferred securities be converted prior to our IPO?	18
Is the company’s organizational structure appropriate for that of a public company?	18
Do we need to amend our charter?	19
Should our bylaws be amended?	19
What are management’s primary responsibilities during the planning and preparation phases of the IPO process?	19
What corporate governance concerns should the company address prior to going public?	20
How many independent directors must the company have on its board of directors?	20
What committees should the board of directors establish?	20
Should we adopt a Code of Ethics, and if so, which officers will be subject to its terms?	21
What should we do to protect the directors and officers from liability?	22
How should we prepare for the accounting issues we will face in the IPO?	23
Can we use our current outside accounting firm as our auditor?	23
Is our current or contemplated outside accounting firm eligible to audit our financial statements under Sarbanes-Oxley?	23
What accounting issues are of particular concern in preparing for the IPO?	23
Should the company take steps now to protect its shareholders from future takeover attempts that may not be in their best interests?	24
Are our employment agreements appropriate for those of a public company?	26
We currently provide an employee benefit plan which includes stock options. Should the plan be amended prior to the IPO? ..	26
What new equity compensation plans should we consider?	26
Are there requirements concerning shareholder approval of equity compensation plans?	27

LIMITATIONS ON PUBLICITY DURING THE OFFERING PROCESS

What can we say to the public during the registration process? What is gun-jumping?	28
What is the quiet period?	28
What restrictions are imposed on communications during the quiet period?	28

What penalties could we face if the SEC believes we have jumped the gun?	29
Are there any safe harbors for permissible communications during the pre-filing period?	29
What is the waiting period?	30
What restrictions are imposed on written marketing materials during the waiting period?	31
What restrictions are imposed on oral marketing materials during the waiting period?	31
What about general publicity during the waiting period?	32
How should the company or the underwriters design a “tombstone ad” during the waiting period?	32
What is an internet roadshow?	32
How can bulletin boards and chat rooms be used during the waiting period?	33
What precautions should we take to prevent possible violations of these restrictions?	33

ONGOING DISCLOSURE OBLIGATIONS

What are the documents that are required to be filed with the SEC?	34
What are the obligations of our officers regarding periodic reports?	38
Are there any unstructured disclosure obligations?	39
Are there any limitations imposed on our ability to discuss our company with analysts?	41
What can we do to ensure compliance with Regulation FD?	41
What are the consequences of violating Regulation FD?	42
What can we do to prevent insider trading?	42
What are the penalties for securities fraud?	43
What are the requirements of the Foreign Corrupt Practices Act?	43
What are the requirements of securities laws regarding insider trading?	44
What are the filing obligations under Section 16(a) of the Securities Exchange Act?	45
What are the disgorgement provisions of Section 16(b) of the Securities Exchange Act?	46
Can an insider engage in short sales?	46
Are there any reporting requirements for significant shareholders?	47
After we complete our IPO, can insiders sell their shares?	47
How can an insider sell shares using Rule 144?	48
Can employees sell shares that have been issued pursuant to our employee benefit plans prior to the IPO?	49
What type of document retention policy is required for a public company?	49
Is there a duty to preserve documents?	49
What are the penalties for destroying documents that should have been retained?	49
What are the requirements for a Risk Management Program?	50
What is the Sarbanes-Oxley Act and what did it do?	50
What are the limits imposed on loans to directors and officers?	50
What are the standards for audit committee members imposed by the Sarbanes-Oxley Act?	51
Who is responsible for hiring the independent auditors?	52
What are the whistleblower provisions of the Sarbanes-Oxley Act?	52
Can the audit committee engage outside advisors?	53
What are the requirements for disclosure controls and procedures and internal control over financial reporting?	53
What limits did the Sarbanes-Oxley Act impose on the use of non-GAAP financial information?	54
What steps must be taken if we want to present non-GAAP financial information?	55
How do we comply with Regulation G if we make an oral statement that includes non-GAAP financial information?	56
How does Regulation G affect earnings releases?	57
What disclosure must be made about off-balance sheet financing?	57
Is there liability for improper influence on the conduct of audits?	58
Will our officers forfeit their bonus if a restatement occurs?	59
Are there any other provisions of the Sarbanes-Oxley Act that may affect directors or officers?	59
What is the Dodd-Frank Act and what did it do?	59

APPENDIX A

Sample Timetable For An Initial Public Offering Of Common Stock	62
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ABOUT BASS, BERRY & SIMS' CAPITAL MARKETS PRACTICE

BLUEPRINT FOR AN IPO

An initial public offering (IPO) is a transaction in which a company's securities are offered to the public for the first time. Companies go public to raise capital to fuel growth, pay down debt, and provide liquidity to shareholders, among other things. Going public is a corporate milestone, particularly in the Sarbanes-Oxley Act era of corporate reform.

An IPO is at the same time exciting and very demanding on a company's management team. IPO candidates face for the first time the expansive regulatory scheme administered by the Securities and Exchange Commission (SEC) and must deal with corporate governance processes that are much different than what they had as private companies. Although all issuers and offerings are different, the basic process of going public remains relatively constant.

Bass, Berry & Sims PLC is pleased to discuss the IPO process with you. We hope to help you understand the process of going public and the new challenges that will face your company once its securities are publicly traded.

While we cannot explain every possible issue that will arise during your company's IPO, this text identifies the key players and their roles and details the process of going public and the obligations your company will face after it is public. This text is a summary in nature and is not intended to be legal advice.

OVERVIEW OF INITIAL PUBLIC OFFERINGS

This overview provides an understanding of the key players in the going public process, the role of each player, and a description of the process itself. For a detailed timeline of an IPO, please refer to Appendix A.

What are some of the advantages of going public?

Increased Liquidity.

Through the establishment of a public market for your company's stock, the current shareholders achieve a higher degree of liquidity for their investment. Before going public, a fractional part or even all of a closely-held business is generally an illiquid asset due to the lack of a ready market. Therefore, shareholders who wish to dispose of some or all of their investment must look to private buyers, often at lower valuations. Public ownership can provide a ready market for the disposition of the company's stock subject to both legal and practical limitations, such as those imposed by SEC Rule 144.

Immediately Available Funds.

The median deal size of public offerings since 2005 has been approximately \$110 million, with a number of IPOs ranging in excess of \$1 billion. Your company can use the cash raised in an IPO for any purpose permitted by its charter and properly disclosed in the IPO prospectus, including working capital, repayment of existing debt, acquisition/expansion, marketing, research and development, or diversification of operations.

Improved Access to Capital.

Public companies generally have access to a wider array of financing options than private companies. If a public market is successfully created and the stock performs well in the aftermarket, it may be possible to raise substantial additional equity capital on favorable terms from the public with an additional offering. Accordingly, an IPO increases the range of future financing options available to company management.

Recruitment and Retention of Key Employees.

Publicly traded stock may be used in stock option plans and other stock-based employee compensation plans. Stock options can be used to motivate and reward management and employees, increasing your company's ability to attract and retain its workforce.

Acquisitions.

In addition to being able to use the proceeds from an IPO to acquire another company for cash, publicly traded stock may be an attractive currency from the standpoint of an acquisition target's shareholders. By making acquisitions using stock, your company can expand without depleting its cash reserves.

Prestige.

Public ownership may enhance your company's prestige and allow it to become better known, which could improve your company's business operations. In addition, it is possible that your company's customers and suppliers may become shareholders and thus acquire a vested interest in purchasing your company's products or services.

Investor Wealth.

Finally, a public offering can enhance the net worth of the investors who own closely-held companies. Even if the owners of a closely-held company do not realize immediate profits by going public, the owners can use publicly traded stock as collateral to secure borrowings for other investments.

What are some of the disadvantages of going public?

Expense.

IPOs are costly, and existence as a public company is expensive on an ongoing basis. As for initial costs, the underwriter's commission in an IPO is typically between 4% and 7%. Additionally, the average expenses associated with an IPO, including legal and accounting fees, printing costs, transfer agent fees, SEC registration fees, and stock exchange listing fees, are well over \$3 million.

On an ongoing basis, federal regulatory reporting requirements will result in significantly increased annual administrative, legal, and accounting costs. Recent surveys indicate that the average annual costs for public companies have increased substantially, particularly in connection with establishing and maintaining effective internal control over financial reporting. On average, smaller public companies (companies with under \$700 million of annual revenue) spend approximately \$800,000 per year to comply with Sarbanes-Oxley, while larger companies average compliance costs of over \$5 million per year. Other recurring expenses include the preparation and distribution of proxy materials and annual reports to shareholders; the preparation and filing with the SEC of reports under the Securities Exchange Act of 1934 (Securities Exchange Act); and the expenditure of fees for a transfer agent, a registrar, and a trustee (in the case of an offering involving debt securities); among several others. Your company must also be willing to incur the risk that the offering will not be consummated, resulting in the write off of preliminary expenses, which may be substantial.

There is also a management cost in terms of executive time devoted to the IPO process, which will require intensive efforts by management for approximately six months. After your company goes public, substantial managerial resources must be constantly dedicated to shareholder relations and public disclosure matters.

Compliance with Broad Reporting Requirements.

Once your company goes public, federal securities laws require the disclosure of a wide range of information relevant to the investor. Such information must be disclosed in a timely fashion on an annual and quarterly basis, with certain material events requiring prompt disclosure upon their occurrence. In addition, the stock exchanges require immediate public disclosure of all significant events that could affect an investor's decision to buy, sell or hold the company's stock. Extensive controls and procedures must be implemented, assessed and maintained to ensure proper and timely disclosure of all relevant information. Moreover, management must personally certify as to the accuracy of information in certain periodic reports, including Forms 10-K and 10-Q. The internal control report and the audit of the effectiveness of your internal control by your independent auditor required by the Sarbanes-Oxley Act are expensive and disruptive to the day-to-day running of the business.

The initial prospectus and subsequent SEC filings will reveal significant information about your company that would otherwise not be publicly available, including executive compensation. Public availability of certain information – such as sales, profits, salaries, employee benefits, competitive position, mode of operating, and material contracts – may give competitors an advantage that they would not otherwise have. Access to this information may also affect the relationship of management with employees and outside interest groups. Significant corporate action will be subject to scrutiny by the investment community, shareholders and securities regulators. The adequacy of public disclosure will be judged in hindsight and may be a significant source of public criticism and litigation.

Increased Liability Exposure.

Officers and directors are likely to face enhanced exposure to liability once the company goes public. A public company is generally required to widely disseminate material information about the company, all of which can be viewed in the light of subsequent events, potentially subjecting management to "Monday morning quarterbacking" from analysts, the press and shareholders. Due in part to the growing presence of law firms specializing in securities class actions,

officers and directors are often the subject of class action securities litigation brought by shareholders if a public company's stock price declines in a material fashion. Additionally, the Sarbanes-Oxley Act requires personal certifications by the CEO and the CFO regarding the truth and completeness of certain public disclosures and imposes civil and possible criminal liability on officers of public companies for certain violations.

Restrictions on Insiders.

Federal securities laws place a number of restrictions on the ability of public company "insiders" – such as directors, executive officers, and controlling or major shareholders – to freely sell their shares of the company. Generally, insiders may only sell their securities if they comply with the volume, timing and manner-of-sale limitations under Rule 144, as well as other specifications under the rule. After the IPO, officers, directors and 10% shareholders will be subject to the short-swing profit provisions of Section 16(b) of the Securities Exchange Act that require insiders to return profits from certain purchases and sales of stock during any six-months. Under Rule 10b-5, insiders will also be subject to civil and criminal liability if they trade in company stock on the basis of material nonpublic information. To avoid insider trading violations, many public companies adopt an insider trading policy to establish various restrictions, such as limiting the time-period, during which insiders may sell the company's stock.

Restrictions on Employee Compensation.

Granting stock options to executives and employees when the company is private can act as a major performance and retention incentive since such individuals are often able to realize substantial profits on those grants after the company goes public. However, after such individuals receive their profits, they may be more difficult to incentivize and retain. The proxy advisory firms Institutional Shareholder Services Inc. (ISS) and Glass Lewis are also actively targeting such forms of compensation that it deems overly generous. The accounting benefits once associated with such compensation have also been restricted, by the Financial Accounting Standards Board's (FASB) adoption of FAS 123R (now codified as Accounting Standards Codification (ASC) Topic 718), which requires public companies to reflect stock options and equity incentive awards as expenses.

Loss of Management Flexibility.

As a result of going public, your company may lose some flexibility in management decisions. There are practical, if not legal, limitations on salaries and fringe benefits, relatives on the payroll, and many other operating procedures. Moreover, securities laws and the listing standards of the stock exchanges place certain requirements on the composition and responsibilities of the board of directors and its respective committees. Due to the requirements to comply with formal corporate governance procedures, the ability to act quickly in certain situations may be lost, especially when approval is required by independent shareholders or directors.

Concern over Effect of Actions on Stock Price.

After public ownership is established, company management inevitably will consider the impact of their decisions on the market price of the company's stock. This pressure could cause the company to pursue an unsound business strategy, focusing on short-term profits in order to maintain stock prices rather than on long-range goals.

Potential for Loss of Control.

Existing shareholders incur an immediate dilution of their percentage ownership as a result of a public offering. In the long run, management may risk losing control or even an unfriendly takeover. This risk can be minimized by, among other things, limiting the number of shares sold to the public, seeking to ensure a wide distribution of shares to the public, staggering the terms of directors, entering into voting agreements before the IPO, and adopting a poison pill. Defensive provisions, however, may not be acceptable to the underwriters or, more importantly, potential institutional shareholders and the proxy advisory firms advising them.

Additionally, the NYSE and Nasdaq have adopted rules requiring that a majority of the board must be comprised of "independent directors" and that vital board committees such as the audit, compensation and nominating/governance committees must be comprised of independent directors (subject to certain exceptions).

Pressure to Maintain Growth and Profit Levels.

Finally, once it has gone public, your company and its management will be under considerable internal and external pressure to maintain the growth rate established in previous years or predicted at the time of the IPO. If sales or earnings deviate from the established trend or predictions, shareholders may become apprehensive and sell their stock, thereby driving down its price. As a public company, operating results will be reported quarterly. Investors will begin to evaluate your company on a quarterly rather than an annual basis, which will intensify the pressure and shorten management planning and operating horizons significantly. As suggested above, this pressure may tempt management to make short-term decisions that could have a harmful long-term impact on the company.

Who are the participants and what are their roles in the IPO process?

The Company.

The company that issues the stock in an IPO may be referred to by many different names, including, issuer, registrant and company.

Selling Shareholders.

Selling shareholders are the shareholders who are permitted by the underwriters to sell shares in the IPO.

Management.

The management of your company will be intimately involved in the IPO process. Management will prepare the “due diligence” information, participate in question and answer sessions with the underwriters and the underwriters’ counsel, participate in the drafting of the registration statement, and give the presentations on the roadshow to prospective investors. To no small degree, the success of the IPO will hinge on the management team’s ability to promote the IPO throughout the process.

Directors.

Directors will be required to disclose information about themselves, their business experience, and their relationship with the company. Directors also sign the registration statement.

Underwriters.

Quarterbacking the IPO process will be the managing underwriter(s). They will be responsible for developing the corporate financing structure that will work in the marketplace, assisting in drafting the prospectus, providing advice on the timing of the offering and the ultimate share price, coordinating “test the waters” (TTW) meetings and the roadshow, putting together a group of underwriters to sell the shares (the syndicate), and providing after-market support and advice.

Issuer’s Counsel.

The issuer’s counsel is responsible for drafting the registration statement (together with management, the managing underwriter(s), and underwriters’ counsel) and guiding the registration statement through the SEC review process. Issuer’s counsel will also help the company coordinate activities such as filings with the NYSE or Nasdaq, due diligence, the engagement of a transfer agent and financial printer, and negotiation of the underwriting agreement. Issuer’s counsel will review the company’s organizational and governance documents (including composition of the board and board committees and charters) and recommend actions to prepare the company for its status as a public company. They will also provide ongoing advice to the company regarding its new duties as a public company and will provide representation in case of securities litigation.

Underwriters’ Counsel.

Underwriters’ counsel will conduct due diligence, participate in the drafting of the registration statement, prepare the underwriting agreement and negotiate it with issuer’s counsel, and orchestrate the closing. Underwriters’ counsel will also be responsible for coordination of required filings by the underwriters with FINRA and ensuring that certain securities laws are satisfied.

Patent/Regulatory Counsel.

In certain industries, the company may have special patent, regulatory or other outside counsel that will be asked to provide information in the due diligence process and draft certain sections of the registration statement that relate to their respective areas of expertise. In some instances, patent counsel or regulatory counsel may be asked to render an opinion to the underwriters with respect to certain matters.

Auditors.

The company’s independent auditors audit the financial statements prepared by the company for inclusion in the registration statement and prospectus and audit the effectiveness of the company’s internal control over financial reporting. In addition, the auditors may assist the company in preparing the section of the registration statement entitled “Management’s Discussion and Analysis of Financial Condition and Results of Operations,” commonly referred to as “MD&A.” The auditors will assist in addressing any accounting-related comments from the SEC concerning the registration statement. Finally, the auditors will deliver a “comfort letter” to the underwriters describing certain procedures undertaken by the auditors with respect to the information in the registration statement that is derived from the company’s books and records. The comfort letter is a linchpin of the underwriters’ due diligence and should be an item of particular focus early in the offering process.

Financial Printer.

Issuer's counsel will prepare the first several drafts of the registration statement. However, as the registration statement begins to take its final form, responsibility for printing the registration statement will shift to a financial printer or similar services provider. The financial printer mass produces the preliminary prospectus and final prospectus delivered to investors. The final drafting sessions sometimes take place at the financial printer. The financial printer will also be responsible for preparing the electronic version of the registration statement and its exhibits that must be submitted via the SEC's EDGAR system.

Other Experts.

Depending on the company, a variety of other experts will also need to be assembled to aid in the IPO process. For example, a banknote company may help design stock certificates that meet the requirements of applicable laws and NYSE or Nasdaq rules. An insurance agent will help the company determine the appropriate D&O insurance. Following the IPO, a transfer agent will be responsible for properly documenting all transactions in the company's publicly traded common stock. Other specialists, from those focusing on valuation of the company to public relations consultants, may also prove useful to the company.

When should we begin discussions with underwriters?

The selection of an underwriter is a critical part of planning your company's public offering. It is a courting process that should start at least six months and possibly a year before the offering takes place. You should interview several firms. While you are evaluating various investment banking firms, they in turn will evaluate your company and its likelihood of success as a public company before deciding whether they will undertake the offering. Adequate lead time allows each side to develop the necessary level of comfort and knowledge to create a positive team environment. You need to be able to trust the judgment, competence, commitment, credibility, and honesty of the underwriters.

Initiating an early relationship with several potential underwriters allows you to sell your story over time – and to demonstrate positive milestones. You begin to establish credibility with the underwriters by demonstrating growth factors, upward-trending budgets, product developments, and positive actual results.

Ultimately, your company will seek out the managing underwriters for the offering. The lead underwriter (whose name appears on the bottom left of the cover of the prospectus) typically “runs the books.” The managing underwriters will put together a group or syndicate of other investment banking firms to assist in selling the securities. As the final choice of underwriters gets closer, make sure you meet the key people in the organization – the head of the syndicate department, the head of institutional sales, the individual who will trade your company's stock, the head of the office, and the underwriter's corporate finance team that will work with you in the offering. Get a feel for their philosophy. Make sure you have a philosophical fit, as well as a business fit.

What should we look for in a managing underwriter?

Experience.

Does the underwriter have recognized experience in your industry and in the type of security you want to offer? Were the underwriter's prior transactions ultimately priced within the original, estimated range? What percentage of transactions were completed? How have previously handled issues performed in the aftermarket?

These are all strong indicators of the underwriter's experience. Get a list of the potential underwriter's last 10 offerings. If any were aborted before or after they were filed, find out why. Call or visit the management of several of these companies (your choice, not the underwriter's) to discuss the underwriter's performance before, during and after the offering.

Consider asking the following question regarding the underwriter:

- Were the “test the waters” meetings and the “roadshow” were well orchestrated?
- Did the senior people from the underwriter show up for the meetings or did they just send junior employees?
- Did the underwriter provide the promised aftermarket support?
- Were the promised research reports completed and published shortly after their publication became permissible and quarterly thereafter?

- Will the relationship continue or is the company using different underwriters for later offerings or other projects?
- Would they would use the same underwriter(s) again for their IPO?

What surprised you about the underwriter and the whole process and what made you unhappy?

Reputation.

What is the underwriter's reputation generally and in your industry? In the minds of many, your company automatically will be associated with the underwriter's image. Look for an underwriter who has credibility with investors – institutional and retail. A managing underwriter should also command peer respect in order to be able to put together a strong group to assist in selling and distributing the stock. It is also important that your other professional advisors respect your underwriter.

Distribution Capabilities.

Controlling and influencing the channels of distribution are among the managing underwriter's key tasks. The underwriter needs to generate sufficient market interest to quickly sell out the offering. In certain "boom" markets, this concern may be minimal. When, however, the market is poor and the IPO "window" limited, the ability to do an offering at all may be in jeopardy without a strong managing underwriter leading the charge. It is thus incumbent upon the company to select a managing underwriter with the qualitative and quantitative client base which fits the company's needs. For example, institutional investors tend to be more sophisticated and helpful to the short-term success of the public company but may prove to destabilize over time due to their tendencies toward shareholder activism and willingness to unload their positions in the company. On the other hand, retail investors are more fragmented, but they typically hold stock longer and do not pose as much of an activist threat to the company.

Aftermarket Support.

The underwriter's role is not finished once the offering is completed. The underwriter provides a variety of after-offering services, including performing as a market-maker (i.e., facilitating trading by standing ready to buy and sell the company's stock), purchasing shares for their accounts, bringing the stock to the attention of analysts and investors (including its customers), and facilitating bringing information about the company to the marketplace as a whole. All of this has a direct impact on performance of the company's stock after the offering is completed. The company needs a strong, deep, liquid and orderly market for its shares. This requires a number of well-capitalized market makers, starting with the managing underwriter(s) and the syndicate it (they) assemble(s). The underwriter should also provide ongoing support in getting the company's story to the public (e.g., by taking management on periodic trips to visit key institutions or groups of investors in important geographic areas or holding well-organized investor conferences).

Analyst Support.

There is a benefit to selecting an underwriter with analysts who are well known in and who know the company's industry and who are widely read in the investment community. Does the underwriter have a strong research department with experience in your industry? Has it been long term? Does the managing underwriter carry enough weight with colleagues to get the best analyst coverage for your company? Be sure to find out what the analyst's and underwriter's ties are to your competitors – these can be either plusses or minuses. Knowledgeable analysts may also help you "position" your company in its industry both in the prospectus and in their early research reports. Call some big institutions and check the analyst's reputation.

Additional Capital.

Once your company is public, in most instances it will have increased opportunities to raise additional capital. You may wish to choose an underwriter that has the capacity to grow with your company and to be able to perform larger offerings in the future. You may also wish to choose an underwriter that has a good history with earlier offerings so that your company's IPO is more likely to be a success and people will be more interested in buying its stock or other types of securities when it wishes to go to the market. The numerical track record of earlier offerings by the same underwriter provides some basis for evaluating all aspects of aftermarket support.

Continuing Advice.

In the future, your company may require advice and assistance on investment banking, mergers and acquisitions, corporate cash management, corporate strategy, private placements, investor relations, research and development, partnerships, leasing and so forth. An investment banker with which your company has an ongoing relationship is the logical place to seek such advice, and some underwriters offer a much broader array of such services than others.

Terms and Conditions.

What flexibility is there concerning the number of shares that can be sold by current owners? Is a lock-up required? For how long? How will expenses be allocated (both assuming the deal succeeds and assuming it does not)? Does the underwriter share your company's assessment of its valuation?

After we select a managing underwriter what is the first step in the process?

Once the company has chosen the managing underwriter(s) and has made the decision to proceed with the public offering process, an organizational meeting is usually held to acquaint the key team members with each other, lay out the timetable for the proposed IPO, and allocate responsibilities. A carefully thought out schedule will provide sufficient time for the due diligence process, preparation of a registration statement, and SEC review of and comment on the registration statement. The timetable will culminate in a "roadshow" and pricing that occurs outside of marketing "dead zones," such as the last two weeks in August and the last two weeks in December.

The managing underwriter usually arranges and presides over the organizational meeting. The organizational meeting typically has the following three fundamental parts:

1. A discussion of the offering size, timeline and other mechanics, including an allocation of responsibilities.
2. A brief overview by the company of its business and affairs.
3. A discussion among the parties of any significant issues identified thus far.

For the company, the organizational meeting is the first of many times over the following months when the company's story will be told. The story told at the organizational meeting is typically succinct, but it is an important starting point for the assembled IPO team. For the IPO working group, the organizational meeting usually sets forth the broad themes that form the basis for the drafting of the description of the business in the prospectus and for the oral presentation that the CEO and CFO make repeatedly during the roadshow. The information helps underwriters' counsel understand which areas of the company should be reviewed and how that review should be conducted. Ultimately, the positioning of the company in the IPO forms the basis for the information that the company continues to disseminate after the IPO in analysts' meetings, press releases, and periodic reports.

In addition, the organizational meeting is a good time for the company to raise for consideration and discussion any issues that the company, its counsel and accountants believe may have an impact on the offering process. It is best for the company to meet together with its counsel and accountants one or more times in advance of the organizational meeting to try to identify any issues. Underwriters and their counsel appreciate when companies are forthcoming about issues that may impact the public offering process because it provides underwriters the time to address these issues and contributes to the formation of a relationship of trust with the management team. When significant issues that should have been identified early by the company and its representatives are uncovered by the underwriters or their counsel during the course of due diligence (or later), the IPO process may be delayed or even derailed. Similarly, issuers expect the underwriters and their counsel to prepare themselves ahead of the organizational meeting by learning about the company and its industry, surveying the regulatory landscape applicable to the company, and understanding the market for the company's stock.

What are the various types of underwriting?

With respect to the type of underwriting, your managing underwriter will propose one of two types:

1. **Firm Commitment**, which means the underwriter agrees to buy all of the issue and thereby assumes the risk for any unsold securities. This is certainly the preferred option from the company's perspective – and the most frequently used. The commitment is not made until the exact offering price is set, which is just prior to the effective time of the prospectus. This way, the issue can be priced according to current market conditions.
2. **Best Efforts**, which means the underwriting firm agrees to use its best efforts to sell the issue but is not obligated to purchase unsold securities.

Generally, IPOs are conducted on a firm commitment basis.

How do we determine the price range at which the stock will be sold?

Typically, the underwriters and the company will agree on a range of prices at the outset which will be refined before filing, with the exact price of the shares determined just prior to commencement of the offering, based on the market and reaction of potential purchasers to the offering. The ability of management and the underwriters to reach a meeting of the minds on the valuation model should be considered a critical element at this stage of the process.

Your company should bear in mind that early indications and promises are not contractual obligations. Ultimately, “the market” prices the issue, not the underwriter, and once you have spent the upfront costs, you are often stuck with what the underwriter determines the market to be (earlier promises notwithstanding). The ultimate price will be determined on the basis of market conditions prevailing at the time of pricing and demand for the company’s stock, that is, how successful the underwriters have been in selling the stock and filling their book (non-binding indications of intent to purchase the shares).

The highest price is not necessarily the most appropriate choice. It is important for companies to satisfy future investors in the marketplace and a fully-priced offering runs a greater risk of the price declining, thereby rendering investors immediately unhappy. Most underwriters will deliberately price an issue somewhat below the maximum amount for which it could be sold in order to permit a small increase in price immediately after the offering. This creates immediate goodwill with investors, provides a cushion should the company or the overall market do poorly in the near future, and enhances the opportunities for the company to raise capital at a later time. Remember, however, that the underwriter serves two clients, the company and its usual (and other) investors. It must satisfy both and therefore is not solely on the company’s side.

Once the registration statement has become effective and the deal has priced (including signing of the underwriting agreement), trading in the stock will typically commence the morning after the pricing. Before the opening of trading, the syndicate sales force will frequently call customers to confirm the sales.

How many shares should we sell?

In advance of the organizational meeting, the company and the managing underwriters should determine the amount of money that the company wishes and is likely to be able to raise in the IPO and the approximate number of new shares it will need to issue in order to do so. In making these decisions, the company should bear in mind that it will be required to disclose the proposed uses of the funds in the prospectus.

The managing underwriter’s valuation of the company and the number of shares currently outstanding, after giving effect to any pre-offering recapitalizations, determines the approximate number of new shares (called primary shares) that the company will need to issue in order to raise the funds that it wants. In addition, the company and its underwriters must decide whether or not current shareholders will be permitted to sell any of their stock (called secondary shares) in the offering. The total size of the offering is the sum of the primary shares and the secondary shares to be offered. The managing underwriter will typically recommend that the company recapitalize before the offering so that the offering price per share falls within a range that the managing underwriter determines is most marketable.

The number of primary shares in an IPO has historically averaged between 15% and 25% of the company’s total shares, calculated on a fully diluted basis after giving effect to the offering. The number of secondary shares that may be included in an IPO is usually subject to significant marketing constraints, and the underwriters often discourage the inclusion of secondary shares. Potential investors often view an IPO unfavorably if insiders use it to reduce their interest in the company significantly. The managing underwriter advises the company of how many shares, if any, may be sold by corporate insiders without negatively affecting the marketing effort. Except to the extent that selling shareholders are permitted to include shares in the offering, the managing underwriter will require existing shareholders to waive any registration rights as a condition to the IPO.

Another important factor to be considered in determining the size of the offering is the float – that is, the number of shares that will be available for trading in the public market after the offering. In general, issues with a large float have greater liquidity, while issues with a small float have greater volatility. Many institutional investors have internal guidelines that permit them only to purchase securities that have a specified quantitative and qualitative minimum

float. The managing underwriter provides the company with guidance in determining how large a float is desirable to market the offered securities. Typically, the managing underwriter will want to ensure that the IPO involves shares having a value of at least \$40-\$50 million in order to create a sufficient float following the offering to result in a liquid market. Other factors to consider in determining the size of the offering include the intended use of the capital raised by the company, the dilution to existing shareholders, and the potential earnings per share (EPS) resulting from the total number of shares outstanding.

Most firm commitment underwritings include an over-allotment option (sometimes referred to as the “green shoe” because the Green Shoe Company was the first issuer to provide such an option), under which the company or the selling shareholders or both grant a 30-day option to the underwriters to purchase additional shares (generally 15% of the number of shares sold in the offering) on terms identical to those on which the original shares are sold. The over-allotment option is of substantial use in ensuring the success of an IPO, as it enables the underwriters to over-allot the shares they are purchasing from the company in order to create excess market demand and to satisfy this demand through the exercise of the over-allotment option.

How do we prepare a registration statement?

Once the determinations as to the managing underwriter and type of security to be issued have been made, focus will shift to preparing and filing a registration statement with the SEC. The registration statement is a disclosure document that consists of two parts. Part I of the registration statement is the prospectus, the legal offering document which is the only part of the registration statement that normally goes public offerees of the securities. Part II of the registration statement contains supplemental information that is available for public inspection (including copies of the company’s material contracts). Usually, the company and its counsel prepare the initial draft of the registration statement.

The typical registration statement is a fairly stylized document, and from the front to back cover there is a customary sequence for organizing the material. In general, the registration statement requires a description of the company’s business, risks relating to the investment, and the intended use of proceeds from the IPO. Other matters required to be disclosed in the prospectus include the following:

- Details of the underwriting.
- The plan for distributing the securities.
- Capitalization.
- Pending legal proceedings.
- Competition.
- Description of the securities being registered.
- Identification of directors and officers.
- A description of any options to purchase securities.
- Disclosure of certain corporate governance structures.
- A list of the principal holders of the company’s securities.

There are also detailed requirements regarding the company’s financial information, including the need for comprehensive audited financial statements and management’s discussion and analysis of current and historical operating results.

Two portions of the registration statement drawing recent attention are those relating to management’s discussion and analysis (MD&A) and compensation discussion and analysis (CD&A). Effective MD&A should provide investors with the information needed to understand, from the perspective of management, the company’s financial results and position in the market. This entails disclosure of critical accounting policies, liquidity and capital resources, transactions with non-independent parties, trading activities involving non-exchange trade contracts, and off-balance sheet arrangements. Similarly the Compensation Disclosure Rules require the company to provide investors with an overview of executive compensation as well as evidence to support the rationale behind it.

The most common registration form is Form S-1, which provides, often by reference, the registration requirements. Most registration requirements are set forth specifically in Regulation S-K (for non-financial information) and Regulation S-X (for financial information).

There are two generally conflicting purposes to the registration statement. On one hand, the prospectus is a selling document used by the underwriters to sell the securities to the public. From this point of view, it is desirable to present the best possible image of the company and its prospects. On the other hand, the prospectus is also a disclosure document. In order to protect against liability of the issuer and its controlling persons to investors, there is a tendency to resolve all doubts against the company and to disclose items that may put the company in a more unfavorable light than management feels is justified. In balancing these purposes, established underwriters and experienced counsel, guided at least in part by their knowledge of SEC staff attitudes, traditionally lean to a conservative presentation, avoiding strongly positive adjectives and bullish predictions.

After the initial draft of the registration statement is prepared and circulated to the working group, the group will meet several times to discuss and revise the document. The drafting process is designed to prepare a prospectus that reflects the most accurate and complete picture of the company and, with substantial guidance from the underwriters, to position the company in its market appropriately. Throughout the drafting process, it may be useful to bear in mind the SEC's "plain English" rule. Recognizing the need for information to be presented in a form that investors can understand, the rule requires companies to use short and definitive sentences, active voice, tables and bullet-points, and to avoid jargon and multiple negatives.

What is Due Diligence?

Due diligence is a reasonable investigation undertaken to gather information for the registration statement, to be sure material information is included in the prospectus, to confirm that accuracy of such information, and to provide reasonable grounds for a belief that there has been no material misrepresentation or omission. Complete candor from management is necessary to ensure that the diligence process serves its purpose. The process is primarily carried out over the first 60 days, and it requires time, patience and cooperation. Effective due diligence gives the underwriters a better understanding from which to present the company to investors and reduces the risk of potentially costly misrepresentations and omissions.

The due diligence process typically starts with interviews of management concerning key areas of the company's business, products, finances, risks and other material information. The underwriters and their counsel will typically ask numerous questions that are designed to enable them to understand the company and paint a full and clear picture of the company. In addition to interviews, underwriters' counsel will compile a comprehensive request list for documents pertaining to your company. For example, you will need to provide corporate documents such as articles of incorporation, minutes of board meetings, detailed records of the company, a current list of shareholders, and so on. The underwriters will also request revenue-related information – a list of your top customers and suppliers and any contracts or agreements with them – as well as documents regarding material assets and liabilities.

The relevant due diligence information will be gathered and posted to a secure online data room so that parties who are granted access, such as the lawyers and management team, will be able to access the due diligence materials in an expedient and cost-efficient manner.

As part of due diligence, the underwriters' counsel will do a thorough review of your intellectual property and your material assets. They will investigate all financial information and corporate financing and securities matters, as well as your insurance coverage and claims, litigation and tax matters. They will also want to satisfy themselves that your company is in compliance with relevant governmental regulations. They will assess whether you are in a position to immediately comply with the mandates of the Sarbanes-Oxley Act after becoming public. Finally, they will look at your employment status – a list of employees, an organizational chart, your benefit plans, any collective bargaining agreements, and details of union activities. This investigation will also include meetings with your auditors, your company lawyers and, in certain circumstances, other professionals, such as your customers.

Generally, underwriters' counsel prepares a questionnaire for officers and directors of the company (D&O Questionnaires), and the issuer's counsel advises the officers and directors with regard to their completion of such D&O Questionnaires. In addition to seeking general information about the company, the D&O Questionnaire may question statements included in the prospectus, management background and experience, terms of employment

contracts, and compensation. To the extent qualitative information is included in the prospectus, underwriters will request credible backup from reliable sources to substantiate such information. The process may even include extensive background checks on company executives by private investigators. Your officers and directors must be prepared to answer all questions openly and honestly. The lawyers will seek to verify information and identify any inconsistencies, misstatements or omissions.

Your company can expect the underwriters' due diligence efforts to be comprehensive, in part because the underwriters have a vested interest in conducting effective due diligence, namely the avoidance of liability.

Section 11 of the Securities Act imposes liability for material omissions or misstatements in a registration statement on, among others, the issuer, all persons who sign the registration statement (which includes all directors), and all underwriters. While issuers are subject to strict liability, Section 11 (and to a narrower degree Section 12) of the Securities Act provides the so-called "due diligence defense" to underwriters. To benefit from the due diligence defense under Section 11, underwriters have the dual obligations of making a reasonable investigation into the facts, and responding in a prudent way to what is known or suspected – in short, a duty to take reasonable steps to assure that the complete truth is told by the prospectus. The standard to successfully invoke the due diligence defense under Section 12 is similar, although it focuses on "reasonable care" as opposed to "reasonable investigation."

Since the passage of Sarbanes-Oxley legislation and regulations, additional emphasis has been placed on the due diligence process. Companies have been exposed to closer scrutiny of financial statements to assure that there are no off-balance sheet liabilities or undisclosed contingent liabilities. The due diligence process typically focuses on the company's system of internal controls over financial reporting and any loans that have been made to executives or directors. Underwriters have been increasingly interested in conflict of interest transactions, any direct or indirect relationships between the company and its directors that are expected to be classified as independent, and any relationships between the company and its accountants. Finally, the underwriters often attempt to satisfy themselves that the company has a fundamental culture of unquestionable integrity (as opposed to evidence of corner-cutting, revenue manipulation, earnings management, sloppy controls or lack of respect for legal compliance).

Shortly before preparation of the final prospectus, your working group of advisors will hold a meeting to update the due diligence. This "bring-down" due diligence will focus on recent results and developments. This session will provide all parties an opportunity to raise any lingering questions they have about the offering – or your company – and to establish due diligence defenses.

How is the SEC involved in the process?

Once the registration statement is finalized, it is printed and submitted electronically to the SEC. Based on the company's SIC code, the SEC will route the registration to the appropriate industry-related division within its Division of Corporation Finance. The SEC then assigns an examiner and staff accountant to the registration statement. There is a brief pause in the process after you submit the registration statement while the SEC conducts its first regulatory review. Between 30 and 35 days after filing (the SEC's stated objective is 30 days, but they sometimes take up to 35 days), the SEC will provide its initial comments to the registration statement via a "comment letter." Before the effectiveness of the registration statement and the sale of securities to the public, the company must adequately address the SEC's comments.

The SEC's primary focus is whether the prospectus contains adequate disclosure. Even though the working group of experienced professionals has satisfied itself that the document contains full, true and plain disclosure of all material facts relating to the securities offered, prospectus writing is a subjective process. There are usually a number of questions or comments that require clarification from the company, your lawyers or your auditors. For example, the SEC may ask for supplemental information concerning qualitative factual assertions regarding the company's market position, competitive status or products.

Typically, the company's responses are submitted to the SEC through the filing of amendments to the registration statement. Accompanying the amendment is a letter from the company's counsel describing the changes to the prospectus and providing any supplemental information requested by the SEC. The letter and all supplemental information must be electronically filed. In certain instances, the company may believe the SEC's comments are inappropriate. In such cases, the company's counsel may request a telephonic or in-person meeting with the staff to discuss the comments, the company's concerns about the comments, and possible resolutions to the comments.

After submitting the first amendment to the registration statement and related response to SEC comments, the company can expect at least one more comment letter addressing matters that the SEC staff believes were not adequately resolved in the first response. While an appeals process associated with SEC comment requests is available to an issuer, comment letters and responses are generally circulated until the SEC deems all comments adequately addressed. It should be noted that the SEC comment letters and the responses thereto are publicly available after the completion of the IPO unless the company requests and the SEC grants confidential treatment to certain responses under the Freedom of Information Act (FOIA).

During the comment and response process, the company faces the question of when to issue a preliminary prospectus, also known as a “red herring.” Though the company may benefit from providing the preliminary prospectus to as many investors as early as possible, it must be careful not to circulate the document too early. If the preliminary prospectus is circulated before the SEC’s final round of comments, and those comments require the company to disclose information that is materially different than that they disclosed in the preliminary prospectus, then the company may be required to amend or even recirculate its preliminary prospectus. Recirculation of the preliminary prospectus is expensive, could delay pricing, and could be construed negatively by the marketplace. In order to avoid the risk of recirculation and other pricing delays, the company and underwriters are well advised to delay marketing the offering until all comments that could materially affect the disclosure are cleared.

After the SEC determines that all responses to its comments are satisfactory, the company may request acceleration of the effectiveness of the registration statement. So long as such request is submitted to the SEC at least 48 hours in advance of the desired effective date, the SEC staff typically will declare the registration statement effective as of the date requested. Provided all other registrations and applications, such as those with the NYSE or Nasdaq and FINRA have been timely filed and granted, actual selling to the general public may begin.

What is an “emerging growth company”?

The Jumpstart Our Business Startups Act (JOBS Act) was signed into law in April 2012 and included a number of provisions intended to reduce the costs and risks associated with IPOs for “emerging growth companies” (EGCs), which are generally defined as companies with gross annual revenue of less than \$1.07 billion during their most recently completed fiscal year. In particular, the JOBS Act, as amended by the Fixing America’s Surface Transportation Act of 2016 (FAST Act), made significant changes to the IPO process, IPO registration statement disclosure requirements, and post-IPO reporting and other requirements for EGCs by, among other things, permitting the following:

- EGCs to confidentially submit draft IPO registration statements and subsequent amendments to the SEC for confidential nonpublic review, provided the initial confidential submission and all amendments are publicly filed at least 15 days before the IPO “roadshow,” or, if an EGC elects not to conduct a “roadshow,” at least 15 days before the effectiveness of the registration statement.
- Oral and written communications between the EGCs and certain institutional investors before and after filing a registration statement to “test the waters” to determine whether such investors might have an interest in a contemplated securities offering.
- EGCs to comply with reduced disclosure requirements in IPO registration statements, including two years of required audited financial statements instead of three years, reduced “smaller reporting company” executive compensation disclosures, the initial omission of certain financial information from the registration statement filed with the SEC so long as the registration statement is properly amended before distributing a preliminary prospectus to investors, and the ability to delay complying with new or revised accounting standards that do not yet apply to private companies; investment banks participating in the offering to publish or distribute a research report about an EGC that proposes to file a registration statement, without having such research report deemed to be a prospectus or an “offer” under the Securities Act.
- Newly public EGCs to gradually “phase-in” certain post-IPO disclosure and other requirements for as many as five years, including auditor attestations of internal controls under Section 404(b) of the Sarbanes-Oxley Act, say on pay votes, full executive compensation disclosures, and compliance with new or revised accounting standards that do not yet apply to private companies.

Can we request that the SEC review our filing on a confidential basis?

In 2017, the staff of the SEC's Division of Corporation Finance announced that, as part of the Division's ongoing efforts to facilitate capital formation, all issuers are permitted to submit draft registration statements relating to IPOs and Exchange Act Section 12(b) registration (e.g., spin-offs) to the staff for nonpublic (i.e., confidential) review. Previously, the nonpublic review was available only to EGCs, as authorized by the JOBS Act, and in certain circumstances to foreign private issuers. Confidential submission of registration statements makes it possible for companies to avoid alerting the market of offering plans before the company is certain that it will move forward with any offering. Specifically, the SEC will grant nonpublic review of a company's filings in the following scenarios:

Securities Act IPOs and initial registrants. For initial Securities Act registration statements, the SEC will confidentially review the applicable registration statement (e.g., Form S-1 and S-11 for REITS), provided the issuer confirms in a cover letter that it will publicly file the registration statement and nonpublic draft submissions at least 15 days before any roadshow. If there is no roadshow, the issuer must confirm that it will make such public filings at least 15 days before the effective date of the registration statement.

- **Initial registration of a class of securities under Exchange Act Section 12(b).** The SEC will confidentially review draft registration statements in connection with an issuer's initial registration under Section 12(b) of the Exchange Act for listing on a national securities exchange (e.g., Form 10 in connection with a spin-off), provided the issuer confirms in a cover letter that it will publicly file its registration statement and nonpublic draft submissions at least 15 days before the anticipated effective date of the registration statement for the listing of its securities on a national exchange.
- **Securities Act offerings within one year of an IPO or Section 12(b) registration.** The SEC will confidentially review draft registration statements filed within one year after an IPO or Section 12(b) Exchange Act registration, provided the issuer confirms in its cover letter that it will publicly file its registration statement and nonpublic draft submission such that the registration statement is publicly available on the EDGAR system at least 48 hours before any requested effective time and date. Unlike an initial registration, this confidential review by the SEC is limited to the initial submission of a registration statement and does not extend to any revisions.

Although an issuer should ensure the substantial completeness of any submitted registration statement, the Division's new policy also provides the staff will not delay processing the registration statement if the issuer omits financial information that it reasonably believes will not be required at the time the registration statement is publicly filed. (Note EGCs are granted further accommodation in this regard as the JOBS Act provides that an EGC may omit financial information that it reasonably believes will not be required to be included in the registration statement at the time of the contemplated offering.)

Can we hold "test the waters" meetings?

In September 2019, the SEC adopted a new rule that allows issuers, or any person authorized to act on behalf of an issuer (i.e., an underwriter) to engage in oral and written communications with potential investors to determine whether such investors might have an interest in a contemplated securities offering, either before or following the date of filing of a registration statement with the SEC. Previously, this "test the waters" accommodation was available only to EGCs, as authorized by the JOBS Act. The new rule (Rule 163B under the Securities Act) limits such oral and written communications only to qualified institutional buyers (QIBs) and institutional accredited investors (IAs), as defined in the rule, and there are no filing or legending requirements. The specific timing of "test the waters" meetings will vary, with most "test the waters" meetings typically taking place after confidential submission of the registration statement but before public filing.

What is a roadshow?

After your company is confident that all SEC comments have been fully addressed and the completion of your "test the waters" meetings, if any, it is time to take your story on the road to the broader investment community. Not only do you have a narrow window of time to do so, but you must also respect strict rules about the ways and means of marketing your offering. Your primary source of information is the preliminary prospectus. The specific limitations on what you can say and when you can say it are described below.

Armed with the preliminary prospectus, your company's key executives and your managing underwriter will go on a whirlwind tour known as the roadshow – a series of presentations to the investment community that typically takes place in a number of different cities over a two-week period. The roadshow itself usually includes a prepared presentation – showcasing the company's vision, its competitive position, its unique attributes and financial performance – followed by a question and answer period. This is the core of the selling effort. The greater interest you build, the higher the expected pricing or market value of your company.

The roadshow also gives you an opportunity to showcase the strength of your management team – its leadership ability, vision and integrity. The way the roadshow is conducted speaks volumes about the way your company approaches business.

Often, the competition for investor interest is fierce, so a great deal of emphasis is placed on the roadshow. In fact, because the roadshow can be one of the most important elements in a successful offering, you should consider calling your public relations or investor relations firm for assistance. Your managing underwriters will provide a great deal of assistance in the roadshow presentation.

As excited as you are about your IPO, you must be very careful about inadvertently disclosing confidential information during this pre-selling period. Remember to use and discuss only the information already made public through the preliminary prospectus. You must be guarded, even in casual conversation with family and friends, about revealing any new information. It is important that you keep confidential company information confidential.

Under SEC rules, a "live roadshow" is not a written communication and therefore it is not required to be filed as a free writing prospectus. Likewise, slides or other materials presented as part of the roadshow are not considered written communications so long as they are presented only with the roadshow and the audience members are not allowed to retain copies of the materials.

What steps must we take to comply with FINRA requirements?

Before the SEC will declare a registration statement effective, FINRA must approve the underwriting arrangements. According to SEC rules relating to the acceleration of effectiveness of the registration statement, the company must inform the SEC whether FINRA has conducted a review of the underwriting agreements and whether FINRA has approved the underwriting agreements. Pursuant to FINRA rules, FINRA must review the terms of the transaction and have no objections to the underwriting and other arrangements before the offering can commence.

The company will be required to provide substantial documentation to assist FINRA in its review of the offering. FINRA will require three copies of all documents dealing with the offering and any underwriting arrangements. The company will also be responsible for providing FINRA with updates anytime these documents are revised, amended or updated.

Additionally, FINRA will require detailed disclosure of information regarding underwriting arrangements and any relationships between the company, officers, directors and stockholders and any relationship between stockholders and FINRA members (including underwriters). The disclosure of these materials may be based on the member's or its counsel's reasonable inquiry into the background of the stockholders of the company and any transactions between the company and the underwriters and related persons. FINRA will not accept disclosure based on the knowledge of the company. Typically the company's stockholders, officers and directors will be required to complete a detailed questionnaire. The underwriters' counsel and company counsel should work together to generate a questionnaire that provides FINRA with the required information. As a practical matter, to avoid the offering being delayed by information collection, the FINRA questionnaire should be created and sent out early in the process.

FINRA's review of the underwriting arrangements assesses whether the fees being charged by the underwriters are reasonable. FINRA rules prohibit a member or person associated with a member from receiving compensation or participating in a public offering of securities if the underwriting compensation in connection with the public offering is unfair or unreasonable. Reasonableness depends on the size of the offering, the amount of risk assumed by the underwriter, the type of securities being offered, and other relevant factors and circumstances surrounding the transaction. FINRA will review the underwriting discount, commission charged in connection with the IPO and all items of value received or to be received by the underwriters or related persons deemed to be involved in the offering.

Underwriting agreements will be reviewed for other unreasonable terms, including unreasonable reimbursement of expenses and unreasonable rights of first refusal to underwrite future offerings. FINRA will also conduct a review for potential conflicts of interest.

How does our stock become traded on a national stock exchange?

To be traded on either the NYSE or Nasdaq, your company must file an application and satisfy certain specified criteria, including financial as well as corporate governance requirements. In addition, the company must have registered its stock under the Securities Exchange Act and met certain FINRA requirements as described above.

Company counsel will prepare documents for registration under the Securities Exchange Act during the IPO process which will be filed with the SEC and become effective the same time the company's registration statement becomes effective under the Securities Act. Additionally, company counsel will prepare the required NYSE or Nasdaq application.

When do we sign the underwriting agreement?

The underwriting agreement will typically be signed after the offering is priced and the SEC has declared the registration statement effective. Although the terms of the underwriting agreement will have been negotiated ahead of time, the obligations do not become binding until the final stages of the offering process. Even then, most underwriting agreements provide the underwriters with the right to terminate the offering if certain specified events (or outs) occur.

How do the underwriters get paid?

Except for reimbursement for certain fees paid by the underwriters, the underwriters are not paid directly by the company. In the typical firm commitment underwriting, the underwriters purchase the shares from the company at a discount to the offering price of the shares to the public (typically between 4% and 7%).

When do we get paid for our stock?

The underwriters pay for the shares they have purchased at closing, which will generally occur three business days after pricing. Typically, the underwriters have 30 days to exercise their over-allotment option. If the underwriters exercise their over-allotment option, the over-allotment shares will be purchased at the over-allotment closing, which will generally occur three business days after exercise of the option.

What happens if there is a material misstatement or omission in the registration statement?

Section 11 of the Securities Act imposes liability for any "material" misstatement or omission in the registration statement on the issuer, its directors and its officers who sign the registration statement (namely the principal executive officer, the principal financial officer and the controller or principal accounting officer), the underwriters and any accountants, engineers, or other experts who have consented to be named as having prepared or certified a part of the registration statement. While there is authority to the contrary, a selling shareholder that participates in the distribution of securities to the public may be deemed an underwriter.

"Material" in this context refers to information as to which there is a substantial likelihood that a reasonable investor would attach importance in determining whether or not to purchase the shares. A plaintiff need not prove intent to deceive (scienter), reliance or negligence, but instead only the existence of a misstatement of a material fact or the omission of a material fact necessary to prevent the statements made from being misleading. However, damages are not recoverable to the extent that the defendant proves the damages did not result from the misstatement or omission.

There are affirmative defenses to liability, including proof that the purchaser knew of the misstatement or omission, which is usually impractical to establish in a broadly marketed public offering. For persons other than the issuer, "due diligence" is also a defense as discussed above.

A purchaser of securities registered under the Securities Act who is successful in his or her suit is entitled to damages equal to the excess of the purchase price (not exceeding the original public offering price) over the value of the securities at the time of the lawsuit. If the securities have been disposed of in the open market before the bringing of

the lawsuit, the measure of damages is the purchase price less the resale price. Assuming that none of the potentially liable persons noted above has acted fraudulently, each of the potentially liable persons other than outside directors may be held responsible for all damages but may recover contribution from any other party who would have been liable to make the same payment. Outside directors are liable only according to their relative fault, unless they knowingly violated the securities laws.

The issuer itself is strictly liable (i.e., without regard to fault or due diligence) for any material misstatement, misleading statement, or material omission in the registration statement. The officers of the issuer required to sign the registration statement and the current and any named future directors (whether or not they actually sign), as well as underwriters and experts, have the benefit of a due diligence defense.

Section 12(a)(2) of the Securities Act supplements Section 11. It imposes liability on any person who offers or sells a security in a public offering by means of a prospectus or oral communication which includes an untrue statement of a material fact or omits to state a material fact necessary to make the statements therein, in light of the circumstances under which they were made, not misleading. A person may avoid liability by proving that he or she did not know, and in the exercise of "reasonable care" could not have known, of the untruth or omission. As with Section 11 liability, a plaintiff in an action under Section 12(a)(2) need not prove scienter, reliance or negligence but merely misstatement or omission. However, as with Section 11 liability, damages are not recoverable to the extent the defendant proves the damages did not result from the misstatement or omission. Moreover, Section 12 liability is narrower than Section 11 because of the privity requirement. For Section 12 liability to be found, the securities must have been purchased directly by the plaintiff from the defendant.

Unlike Section 11, Section 12(a)(2) extends to oral statements made in the course of the public offering, including those made in the roadshow and private meetings with large potential investors. Also in contrast to Section 11, Section 12(a)(2) liability extends functionally to those who offer or sell the securities. The U.S. Supreme Court has construed liability to include not only the persons who pass title to the securities, such as the issuer or underwriters in a primary offering, but also others who actively participate in the solicitation and have a financial interest in the sale. Thus, directors, officers (including those who are not registration statement signatories) and principal shareholders of an issuer have been held liable as "sellers" where they authorized the promotional efforts of the underwriters, helped prepare the offering documents, and worked closely with the underwriters in conducting due diligence meetings or roadshow meetings with prospective investors. Moreover, as under Section 11, Section 12(a)(2) liability may extend to "control persons" unless those persons prove that they had no knowledge or reasonable grounds to believe in the existence of the facts giving rise to the liability of those that they controlled.

Anyone who is deemed to be a "seller" may be liable to the purchaser for the consideration paid for the security, with interest, less any income received thereon (if the purchaser tenders the security to the seller) or damages (if the purchaser no longer owns the security).

Rule 159, adopted by the SEC in 2005, interprets Section 12(a)(2) such that any information conveyed to a purchaser after the time of sale will not be taken into account. Thus, after a purchaser has agreed to buy a security, any additional information conveyed to the investor after the time of sale will be excluded. Therefore, it is important that the company, underwriters and their respective counsel stay in contact with the potential investor throughout the offering process to ensure that all material information is conveyed to the investor before the time of sale.

An issuer and its directors and officers may also face liability under Section 17(a) of the Securities Act for misstatements, misleading statements and omissions in the IPO registration statement, although these provisions are narrower than Sections 11 and 12(a)(2). Section 17(a) imposes liability on any person who commits fraud in connection with the offer or sale of a security, or obtains money or property in connection with the offer or sale of a security by means of any untrue statement of a material fact or any omission to state a material fact necessary to make the statements therein, in light of the circumstances under which they were made, not misleading. Rule 10b-5 under the Securities Exchange Act, which is similar in scope, is discussed in more detail elsewhere in this text.

The majority of courts have held that Section 17(a) does not provide a private right of action and is enforceable only by the SEC. The U.S. Supreme Court has held that the SEC does not need to prove scienter to establish a Section 17(a) violation. Mere negligence will suffice. Those courts that do not recognize a private right of action under Section 17(a) have required proof of scienter, reliance, causation and materiality. Rule 10b-5 may also be the basis of either SEC enforcement or a private cause of action if the plaintiff is either a buyer or a seller of a security.

Section 15 of the Securities Act provides that a person controlling any person liable under the Securities Act may be liable jointly and severally and to the same extent as its controlled person for violations of the Securities Act.

For a plaintiff to have a prima facie case that the defendant is liable as a “control person,” the plaintiff typically must show that the defendant met the following criteria:

1. Had actual power or influence over the controlled person.
2. Had knowledge of or reasonable grounds to believe in the facts underlying the misconduct or culpably participated in the alleged illegal activity.

The more actively involved in a company’s affairs a person becomes, the greater the risk that such person will be subject to liability based on the company’s actions. Courts have held that one director of a company may be a control person while other directors of the same company are not, depending upon each director’s knowledge of the facts on which liability is based.

The liability of the control person will not necessarily be coextensive with that of the controlled person. A control person may avoid liability if he or she establishes that he or she had no knowledge of or reasonable grounds to believe in the existence of the facts upon which liability is based.

What is a direct listing?

A direct listing is an alternative to a traditional IPO that foregoes a traditional underwriter and issuance from the issuer in conjunction with the listing. This structure is most often utilized by companies that are not looking to raise any money as part of their IPO and listing process but rather only seek to list on a public stock exchange so that private investors and employees can more easily sell their interests.

There are numerous potential advantages to this structure. First, since no underwriter is involved, the issuer is able to avoid paying the underwriter discount (typically 7% of an IPO), with the price determined by market supply and demand rather than the underwriter’s estimate. Second, once the stock is listed, the public can immediately purchase shares from existing investors, giving the existing investors immediate liquidity. Third, since the issuer does not issue additional shares as part of the direct listing, the listing does not result in dilution for major shareholders.

Although there are advantages to a direct listing, there are considerable, corresponding risks of increased price volatility. Since no underwriter is involved to measure and estimate investor demand in the initial listing, the market demand may fluctuate wildly over the course of the first few weeks of trading. Further, by omitting the underwriter of a traditional IPO, a direct listing does not benefit from a stabilization agent if demand proves less than expected, and there is no underwriter to sell green shoe shares if investor demand exceeds expectations. Lastly, since direct listings do not include lock-ups of directors, officers or significant shareholders, it is possible for insiders and major shareholders to dump a large amount of shares onto the market shortly after completion of the direct listing.

CORPORATE HOUSEKEEPING

It is often necessary for a company to make changes in its capital structure and corporate organization so that it will be well organized from both a legal and business perspective before commencing an IPO. Changes in the federal securities laws and the listing standards of the national securities exchanges and national stock markets have heightened the importance of reviewing and making appropriate changes to corporate governance standards to ensure compliance with these legal requirements and listing standards following the IPO. This section addresses these and other “corporate housekeeping” issues that a company should tend to in preparation for its IPO.

Why do companies often engage in recapitalizations prior to commencing an IPO?

Companies will often engage in recapitalizations to achieve a target price range for the company’s stock. Stocks priced below \$10 per share are often viewed as speculative stocks and the policies of some institutional investors prohibit purchases of stocks priced below \$10. A price set too high will limit the number of investors by making purchases of round lots (100 shares) too expensive. Underwriters generally prefer that the IPO price fall between \$10 and \$20 per share. Further, the national securities exchanges set a price per share floor and minimum number of shares for public offerings of listed securities. Because many companies, before going public, have either issued a very small number of shares or issued a very large number of shares in connection with prior financings, the number of outstanding shares may be too high or low for the per-share offering price to fall within the optimal range. In this case, the company, usually with the assistance of the underwriters, may adjust the number of outstanding shares through a recapitalization such as stock split, reverse stock split, or other reclassification of shares in order to achieve an appropriate per-share offering price.

Should preferred securities be converted prior to our IPO?

Typically, charter provisions designating the rights and preferences of preferred stock provide for automatic conversion of the stock upon the happening of certain listed events, which may include the completion of a firm commitment underwritten public offering. In conjunction with or as an alternative to automatic conversion, issuers sometimes retain the right to require conversion. These mechanisms are employed so that the issuer will no longer be bound to provide the special rights associated with preferred securities once the issuer’s success in the marketplace has enabled it to raise capital through an IPO, and so that potential IPO investors will not be concerned with the rights and privileges of the preferred shareholders. If automatic conversion or redemption mechanisms are not in place at the time of the IPO, negotiations should ensue with the preferred stockholders to accomplish conversion of the preferred securities. If the IPO is consummated with preferred securities outstanding, Rule 144 lessens dilution concerns by providing, generally, that preferred shares may not be sold for a period of time following the offering.

Is the company’s organizational structure appropriate for that of a public company?

The preferred structure for a business anticipating an IPO is that of a single corporation or a corporation with subsidiaries. The investing public easily understands either of these structures and they can be simply described in the registration statement. A simple structure also creates a more transparent composition for prospective investors, leaving no place to hide insider transactions. If the potential issuer is organized through affiliated brother/sister corporations with common ownership, with a partnership, trust or other combination of miscellaneous business entities, it may be necessary to make some basic structural changes at the outset of the transaction. This can be accomplished through a series of mergers, re-incorporations, liquidations, or capital contributions. In some cases, a new corporate entity may be carved out containing the business to be marketed to the investment community. In other cases, it may be necessary to segregate the exiting lines of business of the issuer by creating divisions or subsidiaries.

Do we need to amend our charter?

Amendment of the company's charter, if needed, is a "corporate housekeeping" task that is especially important to accomplish before going public, as the difficulty involved and the amount of time and money required to obtain necessary shareholder approvals may increase exponentially following an IPO. During the planning phase, the company should review its charter; all amendments thereto and restatements thereof; and its bylaws, as amended, for compliance with applicable law as well as for suitability for the company's needs following the IPO.

In order for the charter to suit a company's post-IPO needs, it must provide for a number of shares of authorized capital stock that significantly exceeds the number of shares offered in the IPO. This will be necessary to cover outstanding warrants and options, future offerings, and other potentially unforeseen needs that the company may have for further issuances. If the company's charter does not contain adequate provisions for these events, an amendment should be made to increase the number of shares of authorized capital stock. Keep in mind, however, that the taxation schemes in some states, including Delaware, key off the number of shares of authorized capital stock. Thus the issuance of a large number of unnecessary shares in these jurisdictions could be costly.

Charter amendments that the company should consider include:

- The removal of provisions relevant only to a private company.
- Removal of provisions that restrict the structure, duration, or purpose of the company.
- Addition of provisions authorizing "blank check" preferred stock.
- Adoption of anti-takeover provisions.
- Amendments regarding the composition, size and protection of the board of directors.
- Change of the issuer's name, if necessary, for ease of marketing.
- Possibly, change of the state of incorporation for more corporate flexibility and predictability.

Elimination of preemptive rights, rights of first refusal, and cumulative voting provisions should also be considered if permitted by applicable law, as such provisions may significantly complicate the capital structure of the company following the IPO.

Should our bylaws be amended?

The bylaws must be amended to parallel any changes in the charter. In addition, many of the provisions regarding delegation of control among management and shareholders in a private company may no longer be applicable when the issuer goes public. Other changes that may need to be made include the following provisions:

- Allow the amendment of the bylaws without shareholder approval.
- Increase the size of the board of directors.
- Specify advance notice procedures related to shareholder meetings.
- Allow proxy voting by shareholders.
- Institute quorum requirements for shareholders' meetings.

It may be possible to implement some or all of these changes without shareholder approval. However, the better practice is to submit a restated version of the bylaws for shareholder ratification in conjunction with the charter amendments.

What are management's primary responsibilities during the planning and preparation phases of the IPO process?

Before selecting the team of outside experts to take a company public, the top management of the company must commit themselves to take on the responsibility and dedicate the time necessary to take the company public and maintain it as a public company after the offering. The company's CEO and other advisors will play a key role in

establishing the team of experts and must make crucial decisions throughout the process based on the input of those team members. The company's executives should, in anticipation of going public, address the "corporate housekeeping" issues discussed elsewhere in this section. The company should also consider implementing corporate communication policies and establishing investor and public relations programs.

These and other IPO-related responsibilities will require significant diversion of top management's attention from the usual duties of management of the company's business. Thus, it is also important that senior management prepare for the IPO process by assembling a team of trusted and qualified "lieutenants" and ensuring that they stand ready to operate the company during periods when senior management's attention may be dedicated almost exclusively to the IPO effort.

What corporate governance concerns should the company address prior to going public?

The company should work with its legal team to ensure compliance with the many corporate governance standards imposed by the SEC and the NYSE or Nasdaq. Private companies will become subject to the Sarbanes-Oxley Act upon filing a registration statement with the SEC in anticipation of an IPO, and companies listing on the NYSE or Nasdaq are permitted to phase in their compliance with board and committee independence requirements by having one independent member at the time of listing, a majority of independent members within 90 days of listing, and fully independent committees and an independent board within 12 months of listing. Preferably, however, the company should be in compliance with the listing requirements, regardless of their effective dates, in advance of the IPO. Making the required changes would likely be more time-consuming and costly following the IPO and the IPO price may be negatively affected if the company's corporate governance standards fail to show Sarbanes-Oxley and listing standard "readiness." The following sections include examples of areas that have been affected by Sarbanes-Oxley, by SEC rulemaking, or by the listing standards of the Nasdaq and NYSE.

How many independent directors must the company have on its board of directors?

SEC, NYSE and Nasdaq rules and regulations mandate that public company boards of directors be comprised of at least a majority of independent directors. However, NYSE rules provide that controlled companies are subject to an exemption from the independence rule and may elect not to comply. A controlled company is a listed company of which more than 50% of the voting power is held by an individual, group or another company.

Under the definitions of "independence" in the Nasdaq and NYSE rules, certain employment, family and business relationships, as well as certain compensation committee interlocks, taint the independence of directors. The "independence" definitions are narrow and essentially require that directors be truly free of any relationship or transaction that could interfere with the director's exercise of independent judgment in carrying out his or her responsibilities to the company.

What committees should the board of directors establish?

To comply with SEC rules and NYSE listing standards, the board of directors should establish, at a minimum, an audit committee, a compensation committee, and a nominating/corporate governance committee. Nasdaq does not specifically require a nominating committee but does require at a minimum that nominations be undertaken by only the independent members of the board of directors. Each board committee should have a written charter that complies with applicable exchange and securities guidelines.

The Audit Committee.

The audit committee must be comprised entirely of independent directors and must have at least three members, all of whom meet the applicable financial literacy requirements. There are no controlled company exemptions to these requirements. The audit committee is responsible for oversight of the company's financial condition and disclosure of operating results. This includes responsibilities such as reviewing the independence of the outside auditor, overseeing management of both internal and outside auditors in connection with financial reporting matters, and overseeing the process by which the company's financial statements are prepared to fairly represent its financial condition and

operating results. The composition of audit committees and the independence and experience of their members is subject to extensive rulemaking by the SEC, Nasdaq and NYSE. These rules are described in more detail elsewhere in this document.

The Compensation Committee.

The increasing level of public and judicial attention given to public company executive compensation, as well as the SEC proxy rules and the listing standards of Nasdaq and NYSE, requires that the company establish an independent compensation committee to objectively and fairly evaluate the performance of the company and its officers. The NYSE and Nasdaq listing standards require that all members of the compensation committee be independent directors. However, under the NYSE's controlled company exemption, a controlled company is not required to have a compensation committee, or, if it does have compensation committee, to have such committee be composed solely of independent directors. Despite this exemption, most controlled companies have a compensation committee comprised solely of independent directors. A large majority of such companies have a compensation committee of between three to five members.

The compensation committee must publish a report on its policies and its review of executive compensation in the annual proxy statement. Its duties should also include establishment and implementation of performance-based compensation systems and policies that seek to enhance long-term shareholder value.

The Nominating/Corporate Governance Committee.

The NYSE listing standards require that companies have a nominating/corporate governance committee composed entirely of independent directors, and that the committee adopt a written charter to address its purpose, goals, responsibilities and annual performance. However, under the NYSE's controlled company exemption, a controlled company is not required to have a nominating/corporate governance committee, or, if it does have a nominating/corporate governance committee, to have such committee be composed solely of independent directors. Despite this exemption, approximately 85% of controlled companies have either a nominating or a corporate governance committee, 24% of which were comprised of independent directors. On average, 3.5 members served on each nominating/corporate governance committee.

The nominating/corporate governance committee's responsibilities should include the following, among others:

- Identifying and selecting director nominees for each annual meeting of shareholders.
- Developing and recommending a set of corporate governance principles for the company and its executives that comply with the rules of the SEC and the applicable listing standards.
- Annually reviewing the performance of the members of the board of directors and its committees before nominating them for re-election.
- Periodically reviewing board composition to determine whether additional board members with different qualifications or areas of expertise are needed.
- Working with management in attracting candidates with the appropriate qualifications.

Technically, the Nasdaq listing standards require that directors be selected by a nominations committee or the independent directors constituting a majority of the independent directors. To satisfy this requirement, the vast majority of Nasdaq-listed companies establish a nominating committee.

Should we adopt a Code of Ethics, and if so, which officers will be subject to its terms?

The Sarbanes-Oxley Act required the SEC to adopt rules requiring a company to disclose whether or not it has a code of ethics for its senior financial officers, and if it has no code to explain why. In response, the SEC adopted rules requiring any public company to disclose whether it has adopted a code of ethics that applies to the company's principal executive officer, principal financial officer, principal accounting officer, or controller or persons performing similar functions. If a company has not adopted a code of ethics, it must explain why it has not done so. Note that the SEC expanded the requirement so that the code must also cover the CEO in addition to the company's financial officers in order to qualify.

An acceptable code of ethics for SEC purposes must consist of written standards that are reasonably designed to deter wrongdoing and to promote the following:

- Honest and ethical conduct, including the ethical handling of actual or apparent conflicts of interest between personal and professional relationships.
- Full, fair, accurate, timely, and understandable disclosure in reports and documents that a company files with the SEC and in other public communications made by the company.
- Compliance with applicable governmental laws, rules and regulations.
- The prompt internal reporting to an appropriate person or persons identified in the code of violations of the code.
- Accountability for adherence to the code.

A company may have separate codes of ethics for different types of officers. Also, the five requirements set forth above may be embedded in a broader code that addresses additional subjects and applies to additional persons.

The code of ethics must be filed as an exhibit to the Form 10-K or posted on the company's website, provided that the address of the website and notice that it is posted there are disclosed in the Form 10-K, or a company may undertake in the Form 10-K to provide a copy of the code to any person that requests it without charge. Any amendment to, or waiver from, any of the five elements set forth above in a company's code of ethics must be disclosed on Form 8-K filed within five business days of the amendment or waiver or on the company's website, provided the company has previously disclosed the website address in its Form 10-K along with a notice that it plans to use its website for this purpose.

What should we do to protect the directors and officers from liability?

Risk management policies and practices will become very important when the company goes public. Public company directors and officers are often faced with potential liability from various sources such as shareholder suits on behalf of the corporation and third-party suits alleging harm caused by the actions or omissions of the directors and officers. Providing adequate indemnification and insurance to officers and directors is an important part of attracting and retaining a talented and experienced management team.

Indemnification of officers and directors is governed by both state law and the charter and bylaws of the company. Indemnification statutes in all states provide generally that corporations are required to provide indemnification to their directors and officers who succeed on the merits of cases brought against them. These statutes also generally provide that corporations may not provide indemnification to directors and officers who are unsuccessful in their defenses. Typically, the statutes give boards of directors broad discretion within these parameters to set terms and conditions for indemnification and advancement of fees and expenses in the company's charter and bylaws.

This issue of indemnification has become more of a challenge for public companies in the wake of the Enron, WorldCom and other financial scandals. Companies usually manage their indemnification obligations through directors' and officers' insurance policies, or "D&O" policies. Premiums on these policies are significant and many restrictions have been placed on coverage. This creates a substantial burden on public companies to balance their efforts to retain top management with management's exposure to potential indemnification obligations. If the company has not considered procuring a D&O policy, including "side A" coverage for directors (that is, personal coverage for directors for claims made against them if those claims are not indemnifiable by the corporation), it should do so before going public. The company should carefully assess its risks in this area, explore all available policy options, and review the terms of potential policies closely. The financial resources of the policy underwriters is one crucial factor to examine in this analysis, as is the policy's definition of a covered claim, and the carrier's claims-handling reputation.

SEC guidelines have further compounded the difficulty already faced by public companies in maintaining D&O insurance. The guidelines allow the SEC to share internal investigation reports resulting from the company's "self-policing" efforts with a company's D&O carrier. This has created a risk that D&O carriers, who generally include exclusions in their policies for "deliberate fraud," will use these reports as the basis for a rescission claim. Additionally, in some recent enforcement cases, the SEC has conditioned settlement of the case on the officer or director not seeking indemnification for any civil money penalty paid to the SEC.

How should we prepare for the accounting issues we will face in the IPO?

Many complex and difficult accounting issues may arise when a company decides to go public. The SEC applies a high level of scrutiny in examining financial statements and the auditing and reporting practices behind such statements. In order to prevent delay or indefinite postponement of the IPO due to accounting issues, the company and its outside auditor should take care to discover any potential accounting issues as early in advance of the IPO as possible. If particularly thorny accounting issues are identified, consideration should be given to a pre-filing conference with the SEC.

Can we use our current outside accounting firm as our auditor?

The company must use a registered public accounting firm and should consider engaging a national accounting firm to act as its outside auditor if it has not already done so. If the company's financial statements have not been audited by nationally recognized accountants, the company should have its past three years, or ideally its past five years, of financial statements audited by a national firm. In addition to the substantial knowledge regarding SEC procedures, Regulation S-X disclosures, preparation of comfort letters, and the institution of financial controls that these firms provide, their audits can also lend substantial credibility to the offering. The company should address these considerations very early in the planning process, as the audit process is likely to be time-intensive.

Is our current or contemplated outside accounting firm eligible to audit our financial statements under Sarbanes-Oxley?

The independence of the auditor should also be ensured by the company before the auditing process begins. Pursuant to its Sarbanes-Oxley authority, the SEC adopted extensive rules addressing the issue of auditor independence. Under these rules, certain relationships may render an accounting firm ineligible to audit a company's financial statements. The rules require disclosure of fees billed by the auditor for audit and non-audit services and certain non-audit services are prohibited. Billing for non-audit services in excess of billing for audit services raises concerns regarding auditor independence with the SEC and with investors and thus could create problems for the IPO. The SEC has also implemented a rule prohibiting lead and concurring partners of the outside auditor from providing audit services for more than five consecutive years, even if the company was private for a large part of the five years.

What accounting issues are of particular concern in preparing for the IPO?

After selecting the auditor, the company's accounting policies and practices and internal control over financial reporting should be carefully and thoroughly reviewed by the auditor. The review should include issues related to acquisitions, mergers, pro forma financial statement preparation, and management letters. The auditor should also review whether the company is subject to segment reporting requirements and whether the company's revenue recognition practices are in line with those of its peers. Classifications of items within the income statement are closely reviewed by the SEC, and should thus also be closely reviewed by the auditors. The auditor should also be consulted for a review of the accounting principles and practices that the company has used as a private company to determine whether these principles and practices will be appropriate to follow as a public company. Any significant deficiency or material weakness in internal control over financial reporting should be addressed.

An accounting issue that the SEC often raises in its comment letters is "cheap stock." Cheap stock issues arise when a company has granted stock or stock options to its employees or customers at exercise prices deemed to be below the fair market value of the underlying shares at the time of grant, and the price range for the IPO exceeds the exercise price of the options. When the difference between the IPO price and the exercise price is high, the SEC often forces companies to record the amount of the difference as unearned compensation (in the case of employee grants) or sales expenses (in the case of customer grants). If the company is required to record the "cheap stock" as unearned compensation or sales expense, its earnings could be negatively impacted, and restatement of its historical financial statements could be required. "Cheap stock" comments from the SEC have the potential to significantly disrupt or delay the IPO process.

Grants of stock or options made in the one year, and in some cases, for a period of up to two years before the IPO, have been scrutinized by the SEC. To minimize the possibility of drawing a cheap stock comment from the SEC, the company should carefully consider the fair market value of its stock before making stock and option grants, preferably by seeking an independent appraisal to support pricing, and should consult with its outside auditors both at the time of making the grants and at the time of reporting the grants in the financial statements. In preparing for the IPO, the company and its IPO experts must be aware of the existence of any cheap stock issues and must be prepared to proactively support and defend past pricing of stock and option grants to the SEC.

Finally, difficult accounting issues may be posed by any reorganization or recapitalization of the company done in preparation for the IPO. Thus, the independent auditors should preferably be on board with the company at the outset of any reorganization or recapitalization to advise as to how the contemplated transactions may affect the company's financial statements.

Should the company take steps now to protect its shareholders from future takeover attempts that may not be in their best interests?

Before going public, companies are advised to analyze whether they should adopt mechanisms to ward off unwelcome takeover attempts. The following two factors make it important for the company to do this before rather than after the IPO:

1. The investor relations problem posed by the public's general belief that the adoption of anti-takeover measures by public companies is simply a means to entrench the incumbent management at the expense of shareholder value.
2. The increased difficulty, time and expense involved in obtaining shareholder approval for charter amendments, which may be necessary for certain anti-takeover measures, following the IPO.

If the company's charter does not contain anti-takeover measures, it should consult with its IPO team, particularly its counsel and underwriters, regarding adoption. The attorneys will work to ensure that any contemplated anti-takeover measures comply with state corporate laws, and that, if adopted, they are adequately disclosed in the registration statement. The underwriters should be consulted regarding the effect of the anti-takeover provisions on the per-share IPO price, as the existence of such provisions could depress the per-share IPO price. In evaluating such mechanisms, the company should be aware that institutional shareholders generally are resistant to such mechanisms.

Recently, activist shareholders have experienced increasing success in pressuring public companies to remove anti-takeover provisions. In fact, some managing underwriters are encouraging IPO companies not to adopt anti-takeover provisions or eliminate existing defensive mechanisms. Managing underwriters are basing their guidance on the perceived effect anti-takeover defenses have on the marketing and pricing of an IPO. At the very least, the company should consult with the IPO team before electing to adopt or eliminate anti-takeover provisions.

The following are a few examples of anti-takeover measures that you may want to consider:

State Law Shareholder Protection Provisions.

There are several shareholder protection provisions that may either be drafted into the company's charter or that may apply by operation of state law if the charter does not expressly provide that the company has chosen not to be governed by the provisions. Under other state's laws, protections apply if the company opts into the provisions. These are non-shareholder constituency provisions, control share acquisition provisions, and business combination provisions. Non-shareholder constituency provisions allow the board to consider the interests of parties other than shareholders, such as employees or customers, when responding to a takeover bid. Control share acquisition provisions generally suspend the voting rights of shareholders who acquire a block of shares that gives them share ownership above a certain threshold. Once the voting rights have been suspended under the provision, generally a majority or, in some states, a supermajority vote of the other shareholders is required to approve reinstatement of voting rights. Business combination provisions generally provide that a business combination (for example, a merger) cannot be effected within a fixed period of time after a purchaser acquires a specified ownership level in the company without board approval. If these provisions are present in the law of the state of the company's incorporation, the company will need to consider whether to "opt out" or "opt in" before going public, as charter amendments may be required and shareholder approval will be more difficult to obtain following the IPO.

Staggered Board of Directors.

Having “classified” or “staggered” boards of directors is a key form of protection from takeovers. If a shareholder quickly acquires a controlling number of shares, that shareholder will be prevented from taking immediate control of the company through the election of the board of directors because all of the directors will not stand for election at the first annual meeting following the acquisition.

Requirement of Cause for Removal of Directors.

Many companies also protect the composition of the board by providing in the charter that the directors may be removed from office only for cause.

Supermajority Voting Requirements.

In some states, public companies may provide in their charters that certain corporate actions (such as the amendment of charter or bylaws) may be taken only upon a supermajority (such as the 2/3) vote of all of the shares entitled to vote. It may be advisable for the company to require such a “supermajority” vote in order to amend or remove any anti-takeover measures that it chooses to add to the charter before the IPO.

Removal of Right of Shareholders to Call Special Meetings.

Shareholder meeting provisions often provide a vehicle for takeover bidders to initiate proxy contests by calling a special meeting. Removing these provisions from your charter will eliminate the potential for a takeover bidder to initiate a proxy contest outside of the context of the annual meeting.

Removal of Right of Shareholders to Act by Written Consent.

For reasons of convenience, many private companies have provisions in their charters allowing the shareholders to act by written consent. This feature may be especially convenient in taking the actions necessary to prepare for the IPO. However, the company should consider eliminating these provisions after the closing of the IPO. Eliminating these provisions would create a requirement that shareholder action is taken only at shareholders’ meetings. As the validity of any action taken at these meetings requires the expiration of certain statutory notice periods before the meetings, taking this step will help to ensure sufficient time for shareholders to consider the arguments of both sides in the event of a contested shareholder vote.

Limitation on Right of Shareholders to Change the Number of Directors or Fill Vacancies on the Board of Directors.

Many companies also attempt to protect the composition of the board by limiting the possibility that a hostile bidder could lead the shareholders to take control of the board by voting to increase the size of the board and then filling the resulting vacancies. This may be done in some states by providing in the charter that the authorized number of directors may not be changed without a resolution of the board of directors, and by providing that vacancies must be filled by majority vote of the then-remaining directors, even if the number of remaining directors does not constitute a quorum.

Special Procedures for Shareholder Proposals and Director Nominations.

Public companies should include in their bylaws provisions that require a reasonable period of advance notice to the company of a shareholder proposal or director nomination that the shareholder wishes to present at the annual meeting.

Adoption of “Poison Pill.”

Since they were originally developed in the early 1980s, shareholder rights plans, or poison pills, have become recognized as a legal and effective way of deterring coercive or abusive takeover tactics and centralizing power in the board of directors in the event of a hostile takeover. Under the typical modern plan, “rights” are granted to shareholders upon the plan’s adoption to buy additional stock of the company at a substantial discount if a person acquires a specified ownership percentage of the company (often, 15% or 20%). Shareholder rights plans do not preclude unsolicited offers (the board of a target is required to comply with its fiduciary duties in considering any offer irrespective of whether a plan is in place). In addition, a rights plan does not prevent a proxy contest that, if successful, could result in the election of acquiror-friendly directors who could terminate the plan.

Poison pills, along with classified boards, are widely regarded as the two most effective takeover defenses, especially when used in combination. Unlike classified boards, shareholder rights plans generally can be adopted by a board of directors without shareholder approval, often within a few days from the time a threat arises.

As the current era of shareholder activism and focus on corporate governance “best practices” has emerged, U.S. public companies have been under significant pressure from activist shareholders and proxy advisory services to dismantle takeover defenses, including shareholder rights plans. For example, ISS, which wields significant influence among many institutional shareholders, is opposed to the adoption of shareholder rights plans without shareholder approval and also advocates that plans include certain features favored by ISS. Under its proxy voting guidelines, ISS will recommend withhold or against votes for all directors (except new nominees) of any company that adopts or renews a poison pill without shareholder approval and does not commit to put the plan to a shareholder vote within 12 months of adoption (provided that the board has not yet received a withhold recommendation on this issue).

Your company should be aware that groups advising shareholders, such as ISS, will likely recommend that shareholders vote against or withhold their vote from proposals, or all nominees of the board of directors (except for new nominees who are to be considered on a case-by-case basis), as the case may be, if, before or in connection with the company’s IPO, the company or its board of directors adopted certain anti-takeover measures that ISS considers to be materially adverse to shareholder rights, such as certain of those described above. Your company, with advice from counsel, should carefully weigh the pros and cons of adopting various anti-takeover measures.

Are our employment agreements appropriate for those of a public company?

As the terms of material employment agreements must be disclosed in the registration statement, the terms of these agreements should be reviewed closely, with particular emphasis on whether the market will perceive their terms, including compensation, to be reasonable. For example, lucrative employment arrangements between the company and its major shareholders will not be received favorably by potential investors in a public company and should be re-negotiated if at all possible. On the other hand, if the loyalty of critical employees is not fostered because they are not parties to employment contracts, thought should be given to negotiating these agreements. Because the pre-IPO board of directors and management inevitably loses a degree of control over the company as a result of the IPO, senior management and the board of directors should consider whether severance protection is warranted.

We currently provide an employee benefit plan which includes stock options. Should the plan be amended prior to the IPO?

Amending an employee benefit plan is much simpler while the company is private and the stockholder approval process is less cumbersome. Thus, before the IPO, the company should engage in an assessment of its current plans to determine the following:

- Does the plan provide adequately for employee incentives?
- Does the plan provide for an adequate number of shares? Is the plan overly generous, creating a negative overhang over the market?
- Does the plan satisfy the most current requirements of the securities laws, particularly the Section 16 short-swing trading rules?

The answers to these questions will likely cause the company to consider amending its current plan or adopting a new plan.

What new equity compensation plans should we consider?

The company should consider adding the following plans, which may help the company retain employees, provide greater flexibility in compensation awards, and compensate non-employee directors. The company should also consider the impact of recent changes in accounting for stock option grants in determining the nature of its equity awards and plans.

Employee Stock Purchase Plan.

These plans allow employees to purchase stock at a small discount from its market price with favorable tax treatment. Such a plan offered to employees before the IPO is very effective in employee retention if and when the company’s stock price rises after the IPO.

“Omnibus” Plan.

A broad plan that provides for restricted stock purchases, bonus stock awards, and stock appreciation rights gives management a great deal of flexibility in compensating employees.

Are there requirements concerning shareholder approval of equity compensation plans?

Your company should be aware that the NYSE and Nasdaq listing standards require shareholder approval for material changes to equity compensation plan benefits, and eliminate most exceptions to shareholder approval requirements for equity compensation grants. While certain “grandfathering” exceptions may apply, you should closely review all equity compensation plans that have not been approved by the shareholders to determine the extent and duration of any applicable exception. In formulating new equity compensation plans, or amending current plans, your company should consult its counsel, particularly given the heightened focus and new rules surrounding executive compensation.

LIMITATIONS ON PUBLICITY DURING THE OFFERING PROCESS

The federal securities laws impose numerous restrictions on a company's ability to communicate with the public during the IPO process. These restrictions are described below.

What can we say to the public during the registration process? What is gun-jumping?

The federal securities laws were drafted specifically with the purpose of limiting the kind and amount of pre-offering publicity permitted in registered public offerings of securities. Specifically, the laws are intended to prevent issuers from "conditioning the marketplace" with information and hype about an issuer in a way that influences investor sentiment about the issuer before the investor has been given the opportunity to receive and review the prospectus mandated by the SEC's rules. The SEC enforces these rules strictly and has forced issuers to delay their IPOs while the marketplace "cools off" from the impermissible publicity. Issuers that engage in this behavior are said to have "jumped the gun."

At the same time, the SEC recognizes the legitimate need of issuers to promote themselves in the marketplace, to establish brand identity, to develop name recognition among suppliers and customers, and otherwise to carry out their business objectives. In 2005, the SEC liberalized communication restrictions; however, for the most part, the new rules benefit mature, seasoned companies doing follow-on and secondary securities offerings, and do not significantly reduce communications restrictions for IPO companies.

It is very important to ensure that a company's promotional activities fall within the range of what the SEC considers acceptable publicity. In this regard, the Securities Act and the SEC focus on three distinct periods of time within the registration period: (1) the pre-filing or "quiet" period, (2) the waiting period, and (3) the post-effective period.

What is the quiet period?

The quiet period is the period between the tentative engagement of an underwriter by the company and the public filing of the registration statement is commonly referred to as the "pre-filing" or "quiet" period.

What restrictions are imposed on communications during the quiet period?

Pursuant to Section 5(c) of the Securities Act, it is unlawful to offer to sell or offer to buy any security unless a registration statement has been filed. The federal securities laws therefore prohibit the making of any offer until the filing of the registration statement. The term "offer" is defined and interpreted very broadly, with the effect that any pre-filing publicity constitutes gun-jumping if it cannot be justified on the grounds that it was made for the permissible purposes of building identity in the business marketplace. Impermissible purposes may be found even in publicity that makes no reference to the IPO.

This restraint on publicity may seem unfair to issuers, and in some circumstances it is. Consider a company that finds itself the target of negative publicity on an online bulletin board or chat room – to respond might be deemed gun-jumping, yet not to respond may be corporate suicide. The SEC's treatment of gun-jumping issues fortunately seems to recognize the need for companies, especially newly formed companies, to promote and defend themselves.

The line between dissemination of factual information and solicitation is very fact-specific and can easily, though often inadvertently, be crossed. In an effort to clarify this distinction, the SEC has issued a set of guidelines to aid companies in evaluating their communications during the time they are within the pre-filing period.

Although warning issuers not to initiate publicity when in registration, the SEC suggested that, to encourage the flow of factual information to shareholders and investors, issuers should continue to take the following actions:

1. Advertise products and services.
2. Send out customary quarterly, annual and other periodic reports to shareholders.
3. Publish proxy statements and send out dividend notices.
4. Issue press releases regarding factual business and financial developments.
5. Hold regular shareholders' meetings in which they may answer inquiries as to factual matters.

Issuers are further permitted to answer unsolicited factual inquiries from securities analysts, financial analysts, the media, shareholders and others. Note, however, that the need for communications flow for a private company is substantially less than that for a public company.

Most companies now have websites and make available large amounts of information through these sites. While practices vary as to the pre-clearance and posting of information on websites, most sites contain a mixture of sales, marketing and investor information from a variety of sources inside and outside of the company. During the period leading up to and during the IPO process, the company's website should be monitored carefully to determine if any of the information present in or linked to the site may influence investor decisions about the company's IPO. Companies establishing websites shortly before or during the IPO process may face similar issues and should discuss with their counsel the timing issues involved.

During the pre-filing period, you should review with company counsel any and all public communications before release and consider carefully the need and justification for publicity.

What penalties could we face if the SEC believes we have jumped the gun?

The SEC typically asks a company to delay its offering (normally for a few weeks) or asks that the company disclose the information from the impermissible publicity in the statutory prospectus as well as include a risk factor that purchasers may have rescission rights (or damages if the securities are no longer owned). Additionally, the company may be subject to claims by investors to rescind their purchases of the company's securities.

These remedies can be disruptive to an offering but are preferable to the alternative, the SEC staff bringing a formal enforcement action (which the staff normally will not do except in egregious cases).

An example of gun-jumping occurred in Google's IPO. Before Google priced its \$1.9 billion IPO, Playboy magazine published an interview that the company's founders had given months earlier. Because the interview occurred before Google filed its registration statement, the SEC required Google to amend its registration statement to include the text of the Playboy article and to reconcile some discrepancies between the article and information in the registration statement. Similarly, less than a week before the planned IPO of Salesforce.com, the CEO of Salesforce.com gave an interview to The Wall Street Journal. As a result, the SEC determined that Salesforce.com had violated its gunjumping rules and delayed Salesforce.com's IPO for more than a month.

Are there any safe harbors for permissible communications during the pre-filing period?

The SEC has enacted the following three safe harbors for dissemination of information during the pre-filing period.

Rule 163A.

This rule provides the company with a non-exclusive safe harbor for certain communications made more than 30 days before the filing of a registration statement. The safe harbor is subject to all of the following conditions:

- The communication may not refer to the securities offering that is the subject of the registration statement.
- The communication must be made by or on behalf of an issuer, meaning that the issuer must authorize or approve the Rule 163A communication.
- The issuer must take "reasonable steps within its control" to prevent further distribution of the information during the 30 days before filing the registration statement.

Adopted in 2019, Rule 163B is a non-exclusive safe harbor that allows issuers, or any person authorized to act on behalf of an issuer (i.e., an underwriter) to engage in oral and written communications with potential investors to determine whether such investors might have an interest in a contemplated securities offering, either before or following the date of filing of a registration statement with the SEC. Previously, this “test the waters” accommodation was available only to EGCs, as authorized by the JOBS Act. The new rule (Rule 163B under the Securities Act) limits such oral and written communications only to qualified institutional buyers (QIBs) and institutional accredited investors (IAIs), as defined in the rule. Under Rule 163B, there are no filing or legending requirements.

Rule 135.

This rule provides that a notice of a proposed offering (in the form of a press release or written communication to security holders or employees) is not deemed an “offer to sell” if it states that the notice does not constitute an offer of any securities for sale and the notice contains no more than the following information:

- Name of the issuer.
- Title, amount and basic terms of the securities offered (these should be very limited).
- Amount to be offered by selling shareholders if any.
- Anticipated timing of the offering.
- A brief statement with respect to the manner and purpose of the offering (these should be very limited), without naming the underwriters.
- In the event of a rights offering or other special offering, certain information to alert security holders.

Note that companies normally do not use a pre-filing notice unless they conclude that the upcoming offering is a material development that should be disclosed to investors (clearly, this rationale does not apply to companies going public since they do not yet have any duties to disclose).

Rule 169.

This rule permits a company to release or disseminate factual business information about the company at any time, including before or after the filing of a registration statement. The safe harbor is subject to the following conditions:

- The company has previously released or disseminated similar types of information in the ordinary course of its business.
- The timing, manner and form in which the information is released or disseminated is consistent in material respects with similar past releases or disseminations.
- The information is released or disseminated for intended use by persons, such as customers and suppliers, other than in their capacities as investors or potential investors in the company’s securities, by the company’s employees, or agents who historically have provided such information.

The Rule 169 safe harbor does not extend to forward-looking information regarding the company. Perhaps most importantly, the information released or disseminated must not be offering related.

What is the waiting period?

A brief lull will usually follow the filing of the IPO registration statement, as the SEC and other regulators begin the process of reviewing the various filings made. There is likely to be an initial flurry of media inquiries upon the release of a limited news announcement permitted by SEC rules regarding the filing and as the news services pick up the filing from the SEC’s EDGAR system. This period following the public filing of the registration statement and before the SEC declares the registration statement effective is called the waiting period. During the waiting period, the parties amend the registration statement as necessary to respond to comments from the SEC and FINRA, prepare for and conduct the roadshow and other marketing efforts, and formalize underwriting and syndicate arrangements. During the waiting period, offers but not sales of the company’s securities are allowed. The methods of making offers during the waiting period are highly regulated.

What restrictions are imposed on written marketing materials during the waiting period?

During the waiting period, the company's stock may be marketed to prospective investors orally and by means of the preliminary prospectus or the free-writing prospectus, but no other written materials may be used. Not only is the term "offer" broadly interpreted, but a variety of forms of communication are deemed "written." For example, notices, circulars, and newspaper and magazine advertisements are considered to be writings, as are radio, television advertisements, emails, websites, CD-ROMs, and audiotapes. It is important to note that offers by means of radio or television broadcasts or by audio or video recordings are not permissible during the waiting period. Visual presentations, such as slides or PowerPoint presentations, used but not distributed as live roadshows are considered oral communications and are not subject to filing, legending, or record retention requirements. To avoid the restrictions against written communications presenters should refrain from handing out copies of the slides.

Following the filing of a registration statement with a price range, the company and other offering participants are permitted to make offers outside of the statutory prospectus; these offers are commonly referred to as "free-writing prospectuses." A free-writing prospectus is defined as any written communication that constitutes an "offer to sell" that is not a statutory prospectus. Free-writing prospectuses can take any form and are not constrained by informational guidelines applicable to other prospectuses. The free-writing prospectus must contain a specified legend. Typically, the free-writing prospectus must be filed with the SEC on or before the date that it is first used. The use of a free-writing prospectus must be preceded or accompanied by the most recent statutory prospectus containing the price range with limited exceptions. Thus, for all intents and purposes, a broadly disseminated free-writing prospectus will have to be in electronic form and contain a hyperlink to the statutory prospectus. Importantly, the free-writing prospectus, per SEC requirements, must not conflict with the registration statement. Any free writing prospectus must be retained by the issuer or offering participants using them for three years following the initial bona fide offering of the securities.

Despite these rules, underwriters generally prepare internal sales memoranda for the reference of their internal sales forces. These memoranda are not to be distributed outside of the underwriters' offices, however, and are neither shown nor read to potential purchasers of stock in the IPO.

What restrictions are imposed on oral marketing materials during the waiting period?

Although oral offers regarding the company's stock are permitted once the registration statement is filed, the content of oral communications must be carefully considered. Generally speaking, issuers are permitted to cover only the information included in the preliminary prospectus, because to provide more information to some investors would be fundamentally unfair to the other investors. To use the SEC's terms, it would constitute "selective disclosure." Companies often provide more detail about matters discussed in the preliminary prospectus, but when doing so, they must not selectively disclose material information not included in the prospectus, such as projected revenue or earnings.

The typical oral communication is a roadshow, which is normally conducted live, in-person and to a limited audience. This form of communication is considered oral communication and does not have to be filed with the SEC. The caveat being that a roadshow that does not originate live, in real-time to a live audience normally would need to be filed as a free-writing prospectus. However, a company may avoid the filing requirement by making at least one version of a bona fide electronic roadshow readily available without restriction electronically to any potential investor.

The tale of Webvan Group Inc.'s IPO in 1999 should serve as a cautionary note on the roadshow. During the Webvan roadshow, the financial media became aware that the story being told in the roadshow included unpublished information not included in the preliminary prospectus. According to media reports, the SEC required Webvan to include the unpublished information in its registration statement and to recirculate the preliminary prospectus to all investors, and further imposed a cooling-off period before allowing Webvan to go public.

What about general publicity during the waiting period?

Restrictions on marketing the IPO tend to affect the company's other advertising and publicity campaigns during the waiting period even to a greater degree than before the initial filing of the registration statement. Advertising and publicity campaigns, whether or not targeted at the investment community, may raise publicity issues during the waiting period, especially if the level of advertising and publicity increases from pre-filing levels. Interviews with senior management, appearances at conferences, and speeches at trade shows may all raise issues. Any proposed publicity regarding the company or its senior executives should be discussed with the company's counsel before proceeding, and the same rules that applied to the company's website during the pre-filing period should be followed through the waiting period. Obviously, a company cannot completely prevent third parties from publishing stories about the company during the waiting period, but the company should be careful about cooperating with these third parties. Cooperation may lead to a conclusion that the company was in fact the "source" of the story.

In considering publicity issues, both before filing and in the waiting period, the purest of intentions may be misunderstood by the SEC or by disgruntled investors after the closing of the IPO. Because neither the SEC nor these investors can be consulted ahead of time, companies should err on the side of caution.

How should the company or the underwriters design a "tombstone ad" during the waiting period?

Rule 134 allows the so-called "tombstone" advertisements and explicitly permits companies to disclose the most basic terms of the offering, including:

- The information allowed in a Rule 135 release.
- A brief indication of the general type of business of the issuer.
- The price of the securities or, if the price is not known, the method of its determination or the probable price range of the securities as specified by the issuer or the managing underwriter.
- The names of the managing underwriters.
- The approximate date upon which it is anticipated the proposed sale to the public will commence.
- Certain other limited information, as applicable to the particular company or security being offered.

The SEC staff strictly enforces Rule 134 and may raise questions if the business description is not extremely bland. A description of a company in a tombstone ad should not contain adjectives or forward-looking information. For example, terms such as "leading provider" or "expected to expand into" should be avoided.

To the extent the company elects to make a tombstone advertisement in reliance on Rule 134, certain items, such as the following, will be required in the advertisement:

- Use of the offering proceeds.
- Legend stating that the registration statement is not yet effective, offers can't be accepted yet, and the communication is not an offer.
- The name and address of the person from whom a preliminary prospectus can be obtained.

The consequences of not complying with Rule 134 are grave and the SEC staff may force the company to include a risk factor in its prospectus stating that buyers have rescission rights based on a probable Section 5 violation.

What is an internet roadshow?

While a live, real-time roadshow, even one transmitted electronically, is considered to be an oral communication, a prerecorded electronic roadshow is considered a written communication, and is therefore also considered a free writing prospectus and must include the boilerplate legend required by Rule 433. For an IPO, an electronic roadshow is not required to be filed as a free writing prospectus under Rule 433 if the issuer makes at least one "bona fide" version of the electronic roadshow electronically available to all potential investors without restriction. The bona fide

version must cover the same general areas as the other version regarding the issuer, its management, and the securities being offered; however, it need not address all the same subjects or provide exactly the same information as the other versions of the electronic roadshow and does not need to provide an opportunity for questions and answers or other interaction even if other versions of the electronic roadshow provide those opportunities.

If an electronic roadshow is not subject to filing, materials such as visual aids and slideshows provided in connection with the electronic roadshow are also not subject to filing if such materials are provided simultaneously with and only as part of the electronic roadshow. To the extent such materials are provided separately or are designed to be copied by the audience separately from the electronic roadshow, they will be considered free writing prospectuses.

How can bulletin boards and chat rooms be used during the waiting period?

During the waiting period, issuers may be unfairly constrained from responding to negative publicity on online bulletin boards and in online chat rooms. As is the case in the pre-filing period, however, the SEC has tended to be somewhat understanding of these issues and may permit responses to negative publicity so long as the responses are consistent with the disclosure in the prospectus.

What precautions should we take to prevent possible violations of these restrictions?

In general, a company should adhere to the following guidelines during the registration period:

- All communications with the media should be conducted through a single individual (or a very limited number of individuals), to which all requests for information should be directed.
- Advertising, publicity, and other promotional activity should be service-oriented and consistent with past practices. Such activity may focus on the company's history or its reputation for high-quality services.
- Under no circumstances should the company disclose its financial condition, historical or potential growth rate, other financial projections, or its earnings per share.
- Advertising, publicity, and other promotional activity should be directed toward customers and potential customers and not toward potential investors. The company should avoid media that are clearly oriented toward the investment community.
- The company should avoid addressing groups of securities analysts or other investment professionals.
- It is advisable for the company to avoid circulating advertising or other written materials to potential investors, securities analysts, or other investment professionals even when such persons have received a copy of a prospectus filed with the SEC.
- The company must not mention the public offering in advertising materials and should avoid volunteering information about the public offering to the press or other media.
- When approached with a question about the offering, the company should explain that it is legally barred from discussing the offering with the press or other media.

ONGOING DISCLOSURE OBLIGATIONS

The federal securities laws regulate disclosure of information concerning public companies in several ways, including mandating the following two types of disclosure:

1. Periodic reporting of business and financial information (on Forms 10-Q, 10-K, etc.).
2. Continuous disclosure of material information about the company.

Issuers satisfy the periodic reporting obligation by submitting timely and accurate reports to the SEC. The continuous disclosure obligation can be more cumbersome. Generally, the securities laws require full and prompt disclosure of all material information concerning public companies. Of course, your company will not wish to publicly announce news when doing so would be premature or would be contrary to its best interests, and the securities laws contain allowances for such situations. At the same time, however, federal securities laws prohibit companies and their employees from selectively disclosing material nonpublic information to particular persons (such as shareholders, analysts or reporters) at any time. Material nonpublic information should be released only to those with a clear “need to know,” and as soon as such information goes beyond this group, it should be widely disseminated to the public.

What are the documents that are required to be filed with the SEC?

As a condition to listing on the NYSE or Nasdaq, your company must be registered under the Securities Exchange Act. This is a different registration process from the registration that your company undertakes pursuant to the Securities Act. A Securities Act registration applies only to a specific amount of securities being registered for a particular public distribution. By contrast, the Securities Exchange Act registration occurs just once with respect to an entire class of securities, regardless of the number of times securities of that class are issued or distributed.

Following the effectiveness of the registration under the Securities Exchange Act (generally on Form 8-A), your company will be obligated to file periodic disclosure documents under Section 13(a) of the Securities Exchange Act. These disclosure documents are described below:

Form 10-K.

Form 10-K is an annual report that discloses comprehensive information about a company. The due date for such filings depends on which of the following three categories of filers the issuer falls into.

1. Accelerated filers are those who have a public float of at least \$75 million but less than \$700 million, that have been subject to the Securities Exchange Act’s reporting requirements for at least one year, and that have filed at least one Form 10-K. For these companies, the filing deadline is 75 days after year-end.
2. Large accelerated filers are those companies that have a public float in excess of \$700 million who meet the other requirements of the accelerated filer tests. For these companies, the filing deadline is 60 days after year-end.
3. Non-accelerated filers are those who do not meet the above criteria in which case such filings are due 90 days after year-end.

In each of the three cases, if the due date is not a business day, the report is due on the following business day.

Form 10-K must include audited balance sheet information for the company’s last two year-ends and audited income statement information for the last three years. It also must include MD&A in order to help investors understand the financial affairs of the company through management’s eyes. Among other items, the MD&A must include a discussion of currently known trends, events or uncertainties that are reasonably likely to have a material effect on the company’s results of operations or financial affairs in the future. Management must pay careful attention to the MD&A section especially since the SEC has emphasized that it expects more than a mathematical comparison of numbers that appear in financial statements. Importantly, liability can attach to the narrative discussion as well as the numbers presented in the MD&A. Form 10-K must also include management’s report evaluating the effectiveness of the company’s internal control over financial reporting as well as the external auditor’s report on its assessment of the management report and its own audit of the internal control. Any significant deficiencies or material weaknesses must also be disclosed and discussed. In addition, it must also provide a narrative description of the company’s

business, properties, management, principal shareholders, remuneration of management, certain market information and shareholder information, transactions between the registrant and management or principal shareholders, and other material events including pending legal proceedings. Form 10-K must also include a narrative analysis of the company's liquidity and capital resources. The company is required to disclose any noncompliance by insiders with respect to their reporting obligations under Section 16(a) of the Securities Exchange Act. Form 10-K must also disclose risk factors. Any material changes to the company's risk factors must be disclosed in the company's 10-Q discussed below.

There are optional provisions for the integration of Form 10-K with the annual report to shareholders. In order to take advantage of such integration provisions, the annual report must be mailed to shareholders and filed with the SEC before the filing of Form 10-K. If Form 10-K is integrated with the annual report to shareholders, then disclosures in the annual report, including the audited financial statements, may be omitted from Form 10-K. In addition, information about management may also be omitted if it is included in a proxy statement that is sent to shareholders within 120 days after fiscal year-end.

Form 10-K must be signed not only by your company as the registrant but also on behalf of your company by the principal executive officer, the principal financial officer, the principal accounting officer, and a majority of the board of directors. As there may be instances where it is extremely difficult to have either a majority of the board or the required officers available for manual signature at the times the signatures are required, powers of attorney may be utilized to authorize one or two persons to sign the Form 10-K on behalf of others.

All directors have liability for the Form 10-K's accuracy, so all directors, not only those who intend to sign, should review it before filing. In addition to being signed, Form 10-K must be certified by the company's principal executive officer and principal financial officer.

Form 10-Q.

Form 10-Q is a quarterly report containing unaudited financial statements, an MD&A section, a quarterly assessment of internal control over financial reporting and certain other information. Events such as commencement of significant litigation and votes of shareholders, which occur during the quarter must also be reported on Form 10-Q. The due date of quarterly reports varies according to the category of filers into which your company falls. Accelerated and large accelerated filers (as discussed above) must file quarterly reports within 40 days after the quarter-end. Non-accelerated filers, on the other hand, must file quarterly reports within 45 days after their quarter-end.

The first quarterly report of your company is due by the later of:

- 45 days after the effectiveness of Form 8-A (or Form 10) which registers the company's securities under the Securities Exchange Act.
- The date on which the Form 10-Q filing would have been required if your company had been required to make a Form 10-Q filing as of its last fiscal quarter.

No report on this form is required for the fourth fiscal quarter, which is covered in the Form 10-K report. Any quarterly reports must be signed by an authorized officer on behalf of your company. Again, in each of the three cases, if the due date is not a business day, the report is due on the following business day.

Form 8-K.

Form 8-K is a current report that is filed only when a reportable event occurs. Reportable events that require a filing are referred to as Items and include the following:

ITEM	DESCRIPTION
1.01	Entry into a Material Definitive Agreement
1.02	Termination of a Material Definitive Agreement
1.03	Bankruptcy or Receivership
1.04	Mine Safety - Reporting of Shutdowns and Patterns of Violations
2.01	Completion of Acquisition or Disposition of Assets
2.02	Results of Operations and Financial Condition
2.03	Creation of a Direct Financial Obligation or an Obligation Under an Off-Balance Sheet Arrangement of a Registrant

ITEM	DESCRIPTION
2.04	Triggering Events that Accelerate or Increase a Direct Financial Obligation or an Obligation under an Off-Balance Sheet Arrangement
2.05	Costs Associated with Exit or Disposal Activities
2.06	Material Impairments
3.01	Notice of Delisting or Failure to Satisfy a Continued Listing Rule or Standard; Transfer of Listing
3.02	Unregistered Sales of Equity Securities
3.03	Material Modifications to Rights of Security Holders
4.01	Changes in Registrant's Certifying Accountant
4.02	Non-Reliance on Previously Issued Financial Statements or a Related Audit Report or Completed Interim Review
5.01	Changes in Control of Registrant
5.02	Departure of Directors or Certain Officers; Election of Directors; Appointment of Certain Officers; Compensatory Arrangements of Certain Officers
5.03	Amendments to Articles of Incorporation or Bylaws; Change in Fiscal Year
5.04	Temporary Suspension of Trading Under Registrant's Employee Benefit Plans
5.05	Amendments to the Registrant's Code of Ethics, or Waiver of a Provision of the Code of Ethics
5.06	Change in Shell Company Status
5.07	Submission of Matters to a Vote of Security Holders
5.08	Shareholder Director Nominations
7.01	Regulation FD Disclosure
8.01	Other Events
9.01	Financial Statements and Exhibits

Except in the case of certain circumstances (including, without limitation, Regulation FD disclosures, earnings announcements, and voluntary disclosures), Form 8-K must be filed with the SEC within four business days of the occurrence of a triggering event.

Item 2.02 and 7.01 disclosures are deemed to be “furnished” and not to be filed unless the registrant specifically states that the information is to be considered “filed” under the Securities Exchange Act or incorporates it by reference into a filing under the Securities Act or the Securities Exchange Act. This means that the disclosures are not incorporated by reference in registration statements on Form S-3 and other Securities Act filings that incorporate Securities Exchange Act filings by reference and which means that the liability provisions of the Securities Act (which can impose strict liability) are not applied to the disclosures. While this result is favorable, the detriment of non-incorporation by reference is that if the information is not included in Securities Act filings, the Securities Act filing may be false and misleading for failing to state a material fact.

If a Form 8-K is required with respect to the acquisition of a business, separate financial statements and pro forma financial statements prepared as if the acquisition occurred at the beginning of the last full year must be filed under Item 9.01. They are due 71 days after Form 8-K is initially due (approximately 75 days after the reported acquisition). During this 71-day extension period for filing financial statements, the company will be deemed to be in compliance with the reporting obligations of the Securities Exchange Act but may be foreclosed from selling securities to the public pursuant to a registration statement under the Securities Act. In general, no registration statement will be declared effective, and sales of securities under an already-effective registration statement must cease until the financial statements are filed.

Item 2.02 requires companies to furnish each oral or written release of quarterly or annual financial information to the SEC on Form 8-K, even if it has been widely disseminated by press release or otherwise. As described below, advance preparations may be necessary to avoid having to file a second Form 8-K for any additional material information disclosed during a company's investor conference call, even if the call-in or webcast information was publicized in compliance with Regulation FD.

Most companies follow their earnings release with an investor conference call, which is publicly accessible by call-in or webcast, the details of which are published in advance. This ensures compliance with Regulation FD's public

dissemination mandate for any additional material information that may be disclosed in the call and avoids the need for another press release for the new information under Regulation FD. Under Item 2.02 of Form 8-K, however, avoiding an additional Form 8-K filing for any new information disclosed in the call will require the following:

- Any additional, complementary financial or statistical information that may be disclosed on the call must be identified and posted on the company's website.
- The press release announcing the investor call (or the earnings release) must include instructions on when and how to access the information on the website.
- Before the investor call occurs:
 - The original earnings release must have been furnished to the SEC on Form 8-K.
 - The additional information must have been posted on the website.
- The investor call must occur within 48 hours after the original earnings release. (Website accessibility or taped replays may continue thereafter.)

If any of those steps are not followed, or if more information is disclosed on the call than anticipated, an additional Form 8-K with the information disclosed in the phone call that was not in the original Form 8-K will have to be furnished to the SEC, and any steps needed to comply with Regulation FD will have to be taken.

If a Form 8-K is being furnished to the SEC under Item 2.02 and it is also used to comply with Regulation FD, it should be indicated that the information is also being filed or furnished under Item 7.01 or Item 8.01, as the case may be.

Reports to Shareholders.

The annual report to shareholders is one of the most important recurring items of communication to investors. Under the SEC proxy rules, specifically Rule 14a-3, the annual report to shareholders must be distributed with or before the solicitation of proxies for the annual election of directors. The annual report to shareholders is often characterized as a "free writing" document, in the sense that it is not required to be filed with or reviewed by the SEC before its distribution to shareholders, although it must be submitted to the SEC after distribution. On the other hand, the annual report to shareholders, like all other financial communications, can be a source of significant legal liability if it contains a material misstatement or omission. Furthermore, Rule 14a-3 specifies the following information that must appear in the annual report to shareholders:

- Audited financial statements.
- Supplementary financial information and other financial data.
- Changes in and disagreements with accountants.
- Quantitative and qualitative disclosures about market risk.
- Management's discussion and analysis of financial condition and results of operations.
- Description of business.
- Description of industry segments, domestic and foreign operations.
- Name and occupation of directors and officers.
- Market price of and dividends on common stock.

An increasing number of public companies use a 10-K "wrap" approach for their annual reports in which the company's annual report on Form 10-K is included with a summary report provided to a company's shareholder (typically, companies using a 10-K wrap approach include limited additional information in this summary report other than what is included in Form 10-K).

Proxy Statements.

Pursuant to Section 14 of the Securities Exchange Act, all proxy solicitations must be conducted under the SEC's detailed proxy rules found in Regulation 14A. Proxy disclosure materials must be pre-filed with the SEC a minimum of 10 days before public dissemination. However, preliminary proxy materials may not need to be filed in instances where the only matters at the annual meeting to be acted on are the election of certain directors; selection of auditors; the approval, ratification, or amendment of certain employee benefit plans; and say on pay and/or certain shareholder

proposals. These rules are applicable whenever proxies are solicited from the shareholders, including, but not limited to, the proxy solicitation before the annual meeting of shareholders. Your company may also incorporate certain information contained in its proxy statement for its annual meeting of shareholders into its Form 10-K if it files the proxy statement with the SEC not later than 120 days after the end of the fiscal year covered by Form 10-K.

Additionally, if your company conducts any proxy solicitation, it must comply with the E-Proxy Rules which require posting proxy materials on the internet and choosing among the three delivery options for delivering proxy materials. First, there is a notice and access option whereby your company may satisfy E-Proxy delivery requirements by delivering a Notice of Internet Availability of Proxy Materials to shareholders at least 40 calendar days before the annual meeting date and posting proxy materials on a website. Second, your company may choose the full set delivery option by using existing methods of delivering copies of proxy materials in paper format; however, they must also post copies of such materials on the internet. Third, your company may choose the hybrid option where notice and access are used for certain shareholders and the full set delivery option is used for other shareholders.

What are the obligations of our officers regarding periodic reports?

As mentioned above, each Form 10-K and Form 10-Q filed must include certifications of your company's principal executive officer and principal financial officer as to the accuracy of the respective report. In particular, each principal executive officer and principal financial officer must certify that:

Section 302 Certifications.

- I have reviewed the report.
- To my 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.
- To my 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.
- I am responsible for establishing and maintaining disclosure controls and procedures and internal control over financial reporting; I have designed such disclosure controls and procedures or caused such disclosure controls and procedures to be designed under my supervision to ensure that material information relating to the company and its subsidiaries is made known to such officers; I have designed such internal control over financial reporting or caused such internal control to be designed to provide reasonable assurance regarding reliability of financial reporting in preparation of financial statements in accordance with GAAP; I have evaluated the effectiveness of the company's disclosure controls and procedures at least 90 days before the filing of the report and I have presented in the report my conclusions as to the effectiveness of the disclosure controls and procedures based on that evaluation and have disclosed in the report any change in the company's internal control over financial reporting that occurred during the most recent fiscal quarter that has materially affected, or is reasonably likely to materially affect, the company's internal control over financial reporting.
- I have disclosed to the auditors and audit committee, based on my most recent evaluation of internal control over financial reporting, all significant deficiencies and any material weaknesses in 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, involving management or employees who have a significant role in internal control over financial reporting.

Section 906 Certifications.

- The periodic report fully complies with the requirements of Section 13(a) or 15(d) of the Securities Exchange Act.
- The information contained in the report fairly presents, in all material respects, the financial condition and results of operations of your company.
- What are the potential penalties for violations?

Section 906 Certifications.

Section 906 provides for two levels of criminal penalties depending on the intent of the signing officer. It is a crime punishable by a fine of up to \$1 million and up to 10 years in prison to give the certification described above knowing that it is false, and a crime punishable by a fine of up to \$5 million and up to 20 years in prison to willfully give this certification knowing that it is false. The certifying officers are subject to criminal and civil penalties if the second certification described above is false.

Section 302 Certifications.

A principal executive officer or principal financial officer providing a false certification could be liable to the SEC for violating Section 13(a) or 15(d) of the Securities Exchange Act and to both the SEC and private litigants for violating Section 10(b) of the Securities Exchange Act and Securities Exchange Act Rule 10b-5. Therefore, these public affirmations could also expose principal executive officers and principal financial officers to an increased likelihood of being personally named as defendants in shareholders' suits under Section 10(b) of the Securities Exchange Act, as well as derivative suits, if matters turn out to be different than as represented in the certification.

Under Section 304 of the Sarbanes-Oxley Act, if, as a result of misconduct your company restates its financial statements due to a material noncompliance with any financial reporting requirement under the securities laws, they must forfeit to your company any bonuses, or other incentive-based or equity-based compensation, and any profits from the sale of securities of your company, received by them during the 12 months following the first public issuance or filing with the SEC of the financials being restated.

Are there any unstructured disclosure obligations?

The foregoing discussions have dealt principally with the requirements for filing periodic, structured disclosure documents with the SEC. However, if a material event occurs between periodic reports or it is an event that is not specifically covered by such reports or a current report, it is generally recognized that good corporate practice would dictate the prompt disclosure of such material event to the public unless there is a bona fide corporate justification for a delay in such disclosure. The trend of the applicable case law, as well as the SEC's current enforcement position, favors full and fair disclosure.

While there is nothing in the federal securities laws which expressly imposes an affirmative duty on a public company to provide immediate disclosure to the public of all important events (excluding those specific events to be reported on Form 8-K), the general antifraud provisions of both the Securities Act and the Securities Exchange Act, and specifically, Rule 10b-5 promulgated under the Securities Exchange Act, have been held to impose duties on public companies to make unstructured disclosure of material facts in certain circumstances. These duties are described below:

Duty to Disclose.

First, a public company must disclose all material facts to the investing public when it or any of its insiders are trading in the company's securities, or, alternatively, it or its insiders must refrain from trading until such information is disclosed or ceases to be material. Specifically, unless material information is available to the public, your company may not be able to purchase its own securities or undertake acquisitions utilizing its securities, and its directors, officers, employees or other insiders with access to such material information may not be able to trade your company's securities, without running a serious risk of violating the Securities Exchange Act.

Duty to Correct.

As discussed below, when a public company makes an unstructured disclosure, whether voluntarily or because of a duty to make such disclosure, the disclosure must be accurate and complete. Therefore, a company must update or correct its preexisting disclosures that are still "alive," or, in other words, on which investors could still reasonably rely, but that are no longer accurate either because of subsequent circumstances or a mistake at the time of initial disclosure. It should be noted that this duty to correct extends only to your company's own statements and not to statements made by, or attributed to, unaffiliated third parties (i.e., consultants, research analysts, investment bankers, etc.).

Rumors.

A public company generally does not have an affirmative duty to respond to rumors and unusual market activity. However, as with the duty to correct, your company might have a duty to respond to or verify a rumor or market report circulated to the public for which your company itself has some responsibility.

As a result of the foregoing, the management of a public company must carefully examine the specific circumstances of each situation in order to determine whether the company is under a duty to disclose. In addition, it should be noted that in the event a public company has its securities listed on a stock exchange, the company is subject to contractual obligations imposed by the exchange or FINRA to make timely public disclosure of material information regardless of the existence or nonexistence of a duty to do so under the federal securities laws.

Materiality.

In accordance with the terms of the antifraud provisions of both the Securities Act and the Securities Exchange Act, once a public company's duty to disclose has arisen, that obligation is further qualified by the concept of "materiality." Simply stated, even when a duty to disclose exists, the failure to disclose a particular fact will result in liability only if that fact was material under the circumstances. Pursuant to applicable case law, a fact has been deemed to be material if a reasonable investor would consider it important in reaching his or her investment decision or, in other words, the fact would have been viewed by a reasonable investor as having significantly altered the "total mix" of information made available.

While it is impossible to create a complete list of what constitutes "material" information, the following types of recurring events are illustrative:

1. Significant mergers or acquisitions.
2. Stock splits.
3. Adoption of a dividend policy or changes in dividends.
4. Significant change in management, borrowing significant amount of funds.
5. Major increases or decreases in revenues or profits.
6. Important new contracts or projects.
7. Important product developments.
8. Commencement of significant litigation or regulatory proceedings.

Again, however, due to the inherently factual nature of the concept of materiality, public companies must evaluate each materiality issue on a case-by-case basis in light of all existing circumstances.

As noted previously, the antifraud provisions of the federal securities laws require that all public disclosures by a company, including both structured and unstructured, be accurate and complete. Therefore, whenever a company or its representatives speak to any outside audience, regardless of the intended purpose, the obligation to speak accurately and completely must be kept in mind. A public announcement, speech to a community or other interested group, an interview with media representatives, a press release, a presentation to or discussion with analysts, or even a response to a telephone inquiry will all be potential sources of liability, and, therefore, will require accuracy and completeness. These communications must also be coordinated under your company's obligations under Regulation FD, discussed below.

Timing of Disclosure.

Generally, a determination that a public company is under a duty to disclose a material fact will require the immediate disclosure of the fact. However, the federal securities laws recognize that a public company may have a bona fide business reason for temporarily delaying the disclosure of material information to the public in certain limited circumstances.

Specifically, courts have permitted delayed disclosure in the following circumstances:

1. A legitimate corporate purpose is served, such as the preservation of a corporate opportunity or the prevention of a significant business loss, if the company is not otherwise under a duty to disclose.
2. The disclosure would be premature in that the information to be disclosed is currently unverified or unverifiable, and, again, if the company is not otherwise under a duty to disclose.

Are there any limitations imposed on our ability to discuss our company with analysts?

Regulation FD sets forth how a company must disseminate information about itself. Regulation FD was intended to place small investors on a level playing field with market professionals.

Regulation FD provides that in the event a person acting on behalf of an issuer (including senior executives, investors and public relations personnel) intentionally discloses material nonpublic information regarding the issuer or its securities (such as earnings information and events regarding the issuer's securities) to certain persons (including securities professionals and holders of the issuer's securities who would be likely to trade on the basis of the information disclosed), the issuer must simultaneously disclose the information to the general public. Unintentional disclosures of material, nonpublic information must be promptly made public. "Promptly" means as soon as is reasonably practicable (but in no event after the later of 24 hours or the commencement of the next day's trading on the market) after the senior official of the issuer learns that there has been a non-intentional disclosure of material nonpublic information. Public disclosure of the information may be achieved through the filing of a Form 8-K with the SEC or through another method or combination of methods reasonably designed to provide broad, non-exclusionary distribution of the information to the public. In some instances, posting information on the company's website may satisfy the disclosure obligations for purposes of Regulation FD.

The SEC has outlined the following three-part test for determining when information on a website is considered public:

1. The company website must be a recognized channel of distribution.
2. Posting of information on a company website disseminates the information in a manner making it available to the securities marketplace in general.
3. There has been a reasonable waiting period for investors and the market to react to the posted information.

Additionally, press releases distributed through a widely circulated news or wire service, or announcements made through press conferences or conference calls of which the general public has adequate notice and which the general public may attend or listen to in-person or by telephone or other electronic means are acceptable methods of public disclosure.

What can we do to ensure compliance with Regulation FD?

In order to comply with the mandates of Regulation FD, a company should take the following measures:

- Develop a written disclosure policy encompassing the company's practices.
- Limit the number of persons authorized to speak to persons covered by Regulation FD and inform other persons that they are not to speak to analysts or other covered persons except when authorized to do so.
- Formalize a consistent process for quarterly earnings releases and interim earnings warnings. Consider issuing a detailed press release with notice of open availability for any upcoming analyst call. Make the analyst call available to all investors and analysts via webcast or conference call. Always open the call or webcast with specifically tailored safe harbor language and use scripts for the presentation and anticipated Q&As. Once the call or webcast is over, make the transcripts available for a reasonable period of time.
- Limit the review of draft analysts' reports. Correct only factual errors found in such reports and do not comment on the analysis or model. The company should neither distribute nor sponsor any analysts' reports.
- Establish a consistent process for presenting at investor conferences. These presentations should be carefully scripted and the presenter must be careful to stay within the bounds of the script. Avoid breakout sessions and consider webcasting the presentation.
- Be aware of concerns with providing bottom-line earnings comfort. Concentrate any guidance in communications via press releases and conference calls. Do not use historic "we are comfortable" guidance unless referring to previously announced company guidance. Avoid "walking the street" up or down guidance on a selected basis.
- Disclaim any duty to update any forward-looking statements because of new developments or otherwise.

- Use written non-disclosure agreements with persons who for business or other reasons are given inside information. These agreements should also prohibit trading in the company's securities until the information is made public.
- Comply with rules regarding the disclosure of non-GAAP financial measures.
- Post the company's Regulation FD disclosure policies on its website.

What are the consequences of violating Regulation FD?

Failure to make public disclosure required by Regulation FD cannot in and of itself be a violation of Rule 10b-5. There is no private right of action under Regulation FD; only the SEC may bring an action in the event of a violation. Further, the SEC may bring an action for disclosures that are confusing and or misleading to investors. Therefore, it is important that companies carefully craft disclosures under Regulation FD to ensure the public has been adequately informed. The SEC has instituted a number of enforcement actions for violations of Regulation FD. The SEC has imposed cease-and-desist orders on public companies and their executive officers and has also imposed significant civil fines. The SEC continues to make Regulation FD a focal point of its enforcement activity.

What can we do to prevent insider trading?

Directors, officers and employees of a company from time to time may come into possession of confidential or proprietary information developed by the company. Most often this information is not publicly available and could be used by a director, officer or employee to realize an advantage in public stock markets either intentionally or unintentionally. It is important that these individuals are aware of the relevant law regarding "insider trading" so that they can maintain the highest level of ethical conduct, avoid the appearance of impropriety, and protect themselves and the company from civil or criminal liability. For this reason, most public companies adopt insider trading policies that generally prohibit their directors, officers and employees from trading while they possess material, nonpublic information or "tipping" others to trade.

Often insider trading policies also establish periods of time, called "blackout periods," during which insiders may not trade in their company's securities, or periods of time, called "window periods," that are the only times it is permissible to trade in company securities, subject to the general prohibition against trading when in possession of material, nonpublic information.

In view of the potential liability for insider trading violations of employees, it is advisable for public companies to adopt policies and programs appropriate to its organization and the nature of its business that are designed to prevent insider trading by directors, officers and employees. Evidence of the existence of such internal procedures would be useful in establishing a company's innocence for violations by employees under the "reckless disregard" standard of liability discussed below.

Companies should adopt an insider trading compliance program that includes the following:

1. Officer and employee education.
2. Confidentiality obligations.
3. Procedures for dealing with the media and investment community (which should be consistent with the company's Regulation FD disclosure policy).
4. Trading windows and pre-clearance procedures for certain individuals.

In addition to carefully crafted insider trading policies, companies should consider allowing executives to enter into Rule 10b5-1 trading plans, which create a detailed schedule for the future sale of stock. Such plans are an ideal method of allowing executives flexibility to sell stock without the limitations imposed by insider trading policies while also complying with SEC regulations and serving as an affirmative defense to allegations of insider trading. Under a Rule 10b5-1 plan, as long as the plan is adopted while the executive has no inside information, the executive is protected from insider trading liability even when in possession of material nonpublic information at the time the sales actually occur. In order to be effective, the plan must be in writing and must meet the following three requirements.

1. The plan must state the number of shares to be bought or sold.
2. The plan must indicate the price at which shares will be bought and sold, such as by indicating a specific dollar price, limit order price, or prevailing market price.
3. The plan must include the timing of the purchases or sales, such as by designating a specific date or time or the time at which a specific event occurs.

If adopted, companies should also consider publicly disclosing the adoption of plans and noting in the executives' Form 4 filings when sales have been made according to Rule 10b5-1 plans.

What are the penalties for securities fraud?

The Sarbanes-Oxley Act created a new criminal antifraud provision, making it a crime to engage in a scheme or artifice to defraud any person in connection with any security registered under the Securities Exchange Act, or to obtain by false means any money or property in connection with the purchase or sale of any security of a public company. This provision broadens the basis for criminal prosecution of securities fraud and increases the potential penalties that may be imposed. The Sarbanes-Oxley Act also increased the criminal penalties for mail fraud, wire fraud, and certain existing antifraud provisions of the Securities Exchange Act.

In addition to criminal charges, violation of the antifraud provisions of the Securities Exchange Act can also expose insiders to civil liability. The Sarbanes-Oxley Act extended the statute of limitations for asserting a private claim of fraud, deceit or manipulation in contravention of the federal securities laws to the earlier of two years after discovery of the facts constituting the violation or five years after the violation. The rule had previously been one year and three years, respectively.

The Sarbanes-Oxley Act also provided that, during the course of an investigation involving possible violations of the federal securities laws by a company with publicly traded securities, the SEC may obtain a temporary order to require the company to escrow any extraordinary payments to any employee or agent (whether compensation or otherwise) for 45 days. During that period, a court must order a hearing to review the merits of the imposed escrow. This period may be extended by the court for an additional 45 days upon a showing of good cause. If the company or other applicable individual is charged with violations of federal securities laws before the expiration of this period, the escrow would continue until the conclusion of any legal proceeding.

Under the Sarbanes-Oxley Act, individual, but not corporate, debts that result from a judgment, order, consent order, or settlement agreement under a claim relating to a violation of federal or state securities laws, or common law fraud in connection with the purchase or sale of any security, are no longer dischargeable in bankruptcy.

What are the requirements of the Foreign Corrupt Practices Act?

The Foreign Corrupt Practices Act (FCPA), which prohibits all U.S. companies from bribing foreign government officials, also contains provisions only applicable to issuers that are designed to reduce improprieties arising from, or made possible by, inadequate accounting procedures or insufficient financial controls. There are two aspects of the accounting provisions: record-keeping and internal controls. The core requirement of the record-keeping provisions is that every issuer "make and keep books, records, and accounts, which, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the issuer." All transactions are covered – not only foreign transactions – and there is no materiality standard.

Records must contain more than just the financial details of the transaction itself. Employees are also required to include information necessary to call a reviewer's attention to any possible illegality or impropriety. For example, in a recent case, a company was found to have bribed the manager of a private steel mill. Though the company was not charged with a violation of the anti-bribery provision for this particular act (because there was no foreign official involved), the SEC charged the company with a violation of the books and records provisions, since the bribes were inaccurately recorded as "sales commissions" or "rebates."

Companies must also maintain adequate internal accounting controls. Issuers are required to "devise and maintain a system" that "provide[s] reasonable assurances that . . . transactions are executed in accordance with the management's general or specific authorization." Specifically, transactions must provide "reasonable assurances" of the following:

- Transactions are executed, and access to assets is permitted, only according to management's authorization.
- Transactions are recorded as necessary to (1) permit preparation of financial statements in conformity with GAAP or any other criteria applicable to such statements and (2) to maintain accountability for assets.
- The recorded accountability for assets is compared with the existing assets at reasonable intervals and appropriate action is taken with respect to any differences.

The records and internal controls must be sufficient to "satisfy prudent officials [as it would in] the conduct of their own affairs."

In addition, rules promulgated by the SEC pursuant to the FCPA prohibit any person from directly or indirectly falsifying any book, record or account subject to the FCPA and directors or officers from making, directly or indirectly, any materially false, misleading or incomplete statement to an accountant in connection with an audit or SEC filing.

What are the requirements of securities laws regarding insider trading?

Rule 10b-5 under the Securities Exchange Act prohibits any person, in connection with the purchase or sale of any securities, from employing any device, scheme or artifice to defraud; making an untrue statement of a material fact, or omitting to state a material fact which is necessary in order to make the statements made, in light of the circumstances in which they were made, not misleading; or engaging in any act, practice or course of business that operates or would operate as a fraud or deceit upon any person.

Rule 10b-5 has been interpreted to mean that officers, directors and affiliates of a company may not trade in the company's securities on the basis of "inside" information as to nonpublic material facts (i.e., facts not generally known to the public) concerning the company until the material facts have been publicly disclosed and enough time has elapsed for such information to be adequately disseminated to the public. Selling or purchasing securities simultaneously with or shortly after a public announcement of a material fact may violate Rule 10b-5 (assuming a carefully crafted Rule 10b5-1 plan as discussed earlier is not in place). Three business days after a public announcement is sometimes suggested as a rule of thumb, but long-awaited disclosures or "hot" information may be expected to be broadly disseminated more quickly, while disclosures related to a complex transaction may require a longer delay. What constitutes a "material fact" and when information becomes public or "generally known" may, of course, be extremely difficult to determine at the time. If material information has not been adequately disclosed or disseminated, insiders may not trade in the company's securities or pass that information along to anyone else (i.e., a tippee). If the tippee trades in the stock, the "tipper" (and the tippee) may incur Rule 10b-5 or other insider trading liability (see below) as a result of the tippee's transaction.

The Insider Trading Sanctions Act of 1984 (the Insider Act) provides that any person (including a tippee) who has violated any provision of the Securities Exchange Act or the rules and regulations thereunder (such as Rule 10b-5) by purchasing or selling a security while in the possession of material nonpublic information is subject to a civil penalty of up to three times the profit gained or loss avoided as a result of such unlawful purchase or sale. The SEC may pursue this civil penalty together with any other remedies available to it, including criminal penalties. The Insider Act applies to all transactions (except those which are part of a public offering) on or through the facilities of a national securities exchange or from or through a broker or dealer. For purposes of the Insider Act, "profit gained" or "loss avoided" is the difference between the purchase or sale price of a security and the value of that security as measured by the trading price of the security a reasonable period of time after public dissemination of the nonpublic information. The Insider Act extends to derivative securities such as options, warrants, puts and calls. In addition, the Insider Act applies to persons who aided and abetted a transaction by communicating material nonpublic information (e.g., tippers), making them liable for the full civil penalty even though they may not have received a direct financial benefit from the sale or purchase of securities.

The Insider Trading and Securities Fraud Enforcement Act of 1988 (ITSFEA) provides similar penalties for controlling persons. The ITSFEA authorizes federal district courts to impose on a controlling person a civil penalty equal to the greater of \$1 million or three times the profit gained or the loss avoided by an insider's trades or tips. Significantly, controlling persons are subject to this penalty regardless of whether they personally receive any benefit from the illegal insider activity. For purposes of the ITSFEA, the term "controlling person" has been interpreted broadly. It includes any person or organization with the power to control the transaction that constituted the primary violation, regardless of whether such power is actually exercised. Thus, the definition encompasses any person with the power

to influence or control the direction, management, policies or activities of another person, even if such power is not actually exerted. A person or entity can be deemed a “controlling person” by virtue of an employer-employee or principal-agent relationship, through stock ownership, or simply because of the corporate structure (e.g., a corporation is generally deemed to control its officers and to be controlled by its directors). Notably, a person or entity can be treated as a “controlling person” even if such person was in no sense a culpable participant in the primary violation. However, controlling person liability exists only if the controlling person “knew or recklessly disregarded” the risk that a controlled person would violate the securities laws and “failed to take appropriate steps to prevent” such a violation before it occurred.

It should be emphasized that compliance with the Securities Act (through Rule 144 or otherwise) may be irrelevant to the question of insider trading liability or disclosure under Rule 10b-5, and that, in any event, neither compliance with the Securities Act (through Rule 144 or otherwise) nor satisfaction of the requirements of Rule 10b-5 precludes the applicability of Section 16(b) (discussed below).

What are the filing obligations under Section 16(a) of the Securities Exchange Act?

Officers, directors and certain shareholders of public companies are subject to various provisions of the Securities Exchange Act, including Section 16 and Section 10(b) (described above), when they purchase, sell or otherwise transfer the company’s securities. Section 16 of the Securities Exchange Act contains two provisions. Subsection (a) deals with reporting of transactions in the company’s securities and subsection (b) provides for disgorgement of short-swing profits (gains on a sale and purchase of company securities within six months). Section 16 applies to every director and executive officer of a public company and every person who, directly or indirectly, is the beneficial owner of more than 10% of any class of the company’s publicly held equity securities. (Officers, directors and greater than 10% beneficial shareholders are sometimes collectively referred to as “insiders.”)

For purposes of Section 16, SEC rules generally define “officer” to include the president; principal financial officer; principal accounting officer or controller; officers in charge of a principal business unit, division or function of the company; and others who perform significant policy-making functions for the company. In most cases, officers subject to Section 16 are the same persons designated as “executive officers” in the company’s proxy statements and other periodic reports. Unless an officer has been designated an executive officer for purposes of the company’s proxy statement, he or she is probably not an “officer” subject to Section 16. (One general exception to this rule is the principal accounting officer or controller of the company.) However, the company should urge officers to contact counsel if there is any question as to Section 16’s applicability.

The concept of “beneficial ownership,” rather than legal or record ownership, is critical to understanding Section 16. SEC rules include two beneficial ownership concepts. The first, used in determining who is a greater than 10% shareholder required to file Section 16 reports, focuses on a person’s voting or investment power over securities in determining beneficial ownership. As a practical matter, when a person has sole or shared voting or investment power over securities, that person will be deemed to beneficially own those securities for purposes of Section 16.

Once a person is required to file Section 16 reports, the SEC uses a second beneficial ownership concept, based on a person’s direct or indirect “pecuniary interest” in securities, to determine which transactions need to be reported and are subject to potential profit disgorgement. This second test is predicated on an insider’s ability to profit from purchases or sales of securities. In determining the existence of a pecuniary interest, there is a rebuttable presumption that a person has a pecuniary interest in securities held by members of his or her immediate family if they share the same household. A person may also be held to be the beneficial owner of securities that he or she owns indirectly through a partnership, corporation, trust or other entity. Notably, because derivative securities (such as options, warrants, convertible debt, etc.) are deemed to be the same class of equity security as the underlying security, beneficial ownership of an option to purchase common stock is deemed to be beneficial ownership of the common stock and is therefore subject to Section 16. Finally, special rules exist for fiduciaries and beneficiaries of trusts and partners of partnerships.

Section 16(a) of the Securities Exchange Act requires insiders to file with the company and the SEC an “Initial Statement of Beneficial Ownership” on Form 3 within 10 days of the date such person becomes a director, officer or greater than 10% shareholder of the company. A Form 3 must be filed by all insiders no later than the effective date of the registration statement if the company is registering securities for the first time under the Securities Exchange

Act. Note that directors and officers must file a timely Form 3 regardless of whether they own any equity securities. Form 3 requires the insider to list all equity securities of the company that he or she beneficially owns.

Whenever a filing person acquires or disposes of any equity securities of the company, he or she must file a Form 4 with the company and the SEC within two business days of the transaction. All purchases, sales and other acquisitions or dispositions (including exercises of options or conversions into the company's common stock), unless exempt, must be reported on Form 4. If for any reason, a person ceases to be an officer or director of the company, he or she must also file a Form 4 to report any changes in beneficial ownership that occur within six months of any change in ownership that occurred while he or she was still an officer or director. Trading information reported on Form 4 is used by the SEC to monitor illegal activity and by the general investing public to discern insiders' opinions on the company's prospects and the value of the company's stock. Accordingly, failure to file these reports may result in an SEC injunctive action and penalties, or in the case of willful violators, criminal proceedings. In addition, the company must disclose the names of any insiders who failed to file any reports, or who filed delinquent reports, in its proxy statement for its annual meeting of shareholders.

What are the disgorgement provisions of Section 16(b) of the Securities Exchange Act?

Section 16(b) of the Securities Exchange Act provides that a company may recover from any officer, director or greater than 10% shareholder any actual or paper profit realized on purchases and sales or sales and purchases of the company's stock within any period of fewer than six months (short-swing profits). The six months may be calculated from the date of any transaction, is not dependent on whether the purchase or sale occurred first, and may be carried backward as well as forward. Thus, a sale in May followed by a purchase in July would fall within the ambit of Section 16(b), as would a purchase in May followed by a sale in July. In the case of officers and directors, it should be assumed that Section 16(b) would apply even if the hypothetical May transaction occurred before becoming an officer or director, or the hypothetical July transaction occurred after ceasing to be an officer or director.

Grants of options, stock awards and certain other acquisitions from the company will generally be exempt from Section 16(b). In the absence of such approval, a sale of such securities will be exempt from the restrictions of Section 16(b) upon satisfaction of the usual six-month holding period. For purposes of Section 16(b), an important consideration is that SEC rules deem the grant of a stock option (rather than its exercise) a "purchase" of the security underlying the option. This effectively permits officers and directors who have held options for six months or more to exercise such options and immediately resell the underlying stock without having to disgorge any profits under Section 16(b). Officers and directors, therefore, need not face the risk that shares acquired upon exercise of an option (and thus after an outlay of cash or other permitted consideration) might decline in value while they wait for the six-month holding period to run. Other exemptions to Section 16(b) exist for certain transactions pursuant to tax-conditioned plans and for certain dispositions made by an officer or director to the company.

Insiders are liable to the company for short-swing profits regardless of their good faith or intent. If a court can find a "profit" by matching any two transactions during a six-month period, this profit must be paid over to the company along with any legal fees incurred in connection with collecting such sums. The existence and amount of profit is determined on the basis of complex rules and, in general, profit will be determined according to the method of calculation that results in the maximum liability. Many times a transaction will give rise to liability under Section 16(b), not because of a conscious desire on the part of the insider to make a quick profit, but because of inadvertence, oversight, or lack of proper planning by the company or the shareholder.

Can an insider engage in short sales?

Section 16(c) of the Securities Exchange Act makes it unlawful for an insider to engage in any "short sale" or "sale against the box." In other words, insiders may only sell stock that they own (not stock that they have borrowed), and then only if they make prompt delivery. The basis of this prohibition appears to be a presumption that insiders would make short sales primarily on the basis of inside information about the company that, if generally known, would reduce the price of its securities in the trading markets. Thus, in addition to violating Section 16(c) and presenting potential Section 16(b) problems, a short sale also raises questions under the antifraud rules.

Are there any reporting requirements for significant shareholders?

In addition to the reporting requirements of Section 16 of the Securities Exchange Act, Sections 13(d) and 13(g) of the Securities Exchange Act provide that any person who beneficially owns more than 5% of the company's stock must file a Schedule 13D or 13G with the SEC when he or she initially becomes a 5% shareholder and must thereafter file amended Schedules 13D or 13G for subsequent material changes in ownership. When two or more persons act as a group for the purpose of acquiring, holding or disposing of 5% or more of the stock of a company, the group will be deemed a "person." The group is formed when two or more persons agree to act together for such purpose. The group is deemed to have acquired the beneficial ownership of all of the stock of the company held by the individual members of the group as of the date of the agreement.

After we complete our IPO, can insiders sell their shares?

The resale of restricted securities is subject to a number of limitations and requirements. Accordingly, shares of stock that are considered restricted securities should not be sold unless (1) a registration statement relating to those shares is currently effective or (2) counsel has advised the selling shareholder and the company that registration is not required. In general, securities of the company may become "restricted" in two ways: (1) when stock is obtained from the company or an affiliate in a "private placement" or (2) when stock is sold by an affiliate of the company in a private sale.

Generally, the company may not sell or offer to sell any of its securities, including those held in its treasury, without registering the transaction under the Securities Act. This prohibition applies to both equity securities, such as stock, and debt securities that might be issued by the company. However, the company is not required to register a transaction if the Securities Act specifically exempts either the particular securities or the transaction in which they are sold. The exemption most commonly used by issuers exempts transactions not involving any public offering, often referred to as the exemption for "private placements." A "private placement" is an offer and sale of securities to a limited number of qualified persons who agree to acquire the securities as an investment and without any intention to resell or otherwise distribute them. Securities sold by the company in a private placement or in a transaction or chain of transactions not involving a public offering (and thus not subject to registration) are "restricted securities" and are subject to the resale restrictions discussed below.

All securities owned by "affiliates" of the company, whether or not such securities are restricted, are called "control securities." (Control securities include shares of stock bought by affiliates in the open market.) Control securities are generally subject to limitations on disposition similar to those applicable to the company itself: absent an exemption, the securities owned by an affiliate may be sold only in a registered offering.

The two most common exemptions from registration for control securities are the following:

1. A sale pursuant to Rule 144.
2. A non-statutory private sale, similar to a private placement by the company and commonly known as a "Section 4(a)(1 1/2)" exemption.

In addition, in December 2015, the FAST Act amended the federal securities laws to add a new registration exemption for private resales of securities.

The term "affiliate" includes any person or entity that is in control of, is controlled by, or is under common control with an issuer. Directors, executive officers and major shareholders of the company (including members of their families, family trusts, and other businesses or entities that they may influence or control) should be considered affiliates unless the given person or entity clearly has no real or potential influence on the management of the company. Typically, it is assumed that persons listed in the "Management" section of a prospectus or subsequent proxy statements are "affiliates." In addition, other persons or entities that might now or in the future control the company may be deemed affiliates of the company.

How can an insider sell shares using Rule 144?

Rule 144 provides a means of selling limited amounts of restricted and control securities without registering such securities under the Securities Act. Although Rule 144 is not the only exemption from Securities Act registration, compliance with its terms provides a “safe harbor” from the registration requirements of the Securities Act. Rule 144 provides that an affiliate may sell any securities (i.e., control securities and restricted securities), or any person may sell restricted securities if the securities are sold in accordance with each and every term and condition of Rule 144. The requirements of Rule 144 are as follows:

Volume Limit.

Rule 144 limits the number of securities that may be sold in any three-month period to the greater of the following:

1. 1% of the outstanding shares of the same class of the issuer’s securities being sold.
2. The average weekly reported volume of trading in the same class of the issuer’s securities during the four calendar weeks preceding the filing of the notice of sale (Form 144) required by Rule 144.

Form 144.

If an affiliate of the company proposes to sell during any period of three months more than 5,000 shares or shares with an anticipated aggregate sales price in excess of \$50,000, a notice of sale on Form 144 must be filed with the SEC and any national securities exchange on which such securities are admitted before or concurrently with the placing of the sell order with the broker.

Only Certain Transactions Qualify.

Stock sold under Rule 144 must be sold in ordinary brokerage transactions. This means the shares must be sold in a transaction in which the broker does no more than execute the customer’s order as his or her agent, receives only the usual brokerage commission, and neither solicits nor arranges for the solicitation of the order to buy the shares. Rule 144 also obligates the broker to make a “reasonable inquiry” to satisfy himself or herself that the proposed sale does in fact meet the conditions of Rule 144. Ordinarily, the broker will document this inquiry by means of a questionnaire and a letter of representation by the seller confirming compliance with the various requirements of Rule 144. Brokers normally request that counsel for the company review the necessary documents to ensure that it is proper under the Securities Act to remove the restrictive legend and stop-transfer instructions on the shares to be sold under Rule 144.

Holding Period.

If the securities to be sold are restricted securities, the seller must have beneficially owned them for a period of at least six months so long as the issuer has been subject to and has complied with the reporting requirements of the Securities Exchange Act for a period of 90 days immediately preceding the proposed sale. The holding period is one year if the issuer has not been subject to or has not complied with the reporting requirements of the Exchange Act for at least 90 days. The holding period will not begin until the full purchase price or another consideration has been paid for the securities. Generally, the seller is permitted to tack holding periods for securities converted or exchanged in connection with the IPO. The same holding periods apply to nonaffiliate sellers, but most other restrictions under Rule 144 do not apply to nonaffiliates.

A common question is whether securities held by officers, directors and other affiliates may be used as collateral for bank loans, and, if so, what the status of such securities is under Rule 144. Such transactions are not objectionable in principle, provided they are entered into in good faith. In the event of default, a sale by the bank or by a purchaser from the bank may be aggregated with the pledgor’s own sales for up to one year following default in computing the volume limitations of Rule 144. A similar question often arises in the case of stock presented by affiliates as gifts to charitable organizations or other donees. Here too, sales by donees may be aggregated with the donor’s own sales for up to one year following the gift. Shares sold by the pledgee or donee are also subject to the other requirements of Rule 144, but these requirements will not be burdensome if the pledgee or donee is not an affiliate and the securities have been beneficially owned for at least one year (including the pledgor’s or donor’s period of ownership).

Section 4(a)(2) of the Securities Act provides an exemption from the registration requirements of the Securities Act for transactions by an issuer not involving any public offering. Because this exemption applies only to issuers, technically it is not available for secondary sales of securities (i.e., sales by persons who acquired common stock from an issuer). The SEC has, however, taken a “no action” position with respect to private sales by controlling persons where the sales meet at least some of the requirements of Section 4(a)(2) and Rule 144. This hybrid exemption is referred to as the Section 4(a)(1 1/2) exemption. The purchaser in such a transaction acquires restricted securities and

usually cannot resell them until the applicable holding period of Rule 144 is satisfied, unless they are registered or another exemption is available.

In addition, the FAST Act amended the federal securities laws to add new Section 4(a)(7) of the Securities Act, which is essentially a nonexclusive safe harbor for private resales under the so-called Section 4(a)(1^{1/2}) exemption. Therefore, controlling persons may be able to use this new statutory exemption to the extent they are able to meet the requirements of the exemption as provided in the Securities Act.

Can employees sell shares that have been issued pursuant to our employee benefit plans prior to the IPO?

Rule 701 provides an exemption from registration under the Securities Act for offers and sales by private issuers of securities pursuant to compensatory benefit plans and contracts that relate to compensation. The exemption can be used to issue securities to employees during the years before an IPO. Shares acquired under a Rule 701 transaction exemption are restricted securities and, as a result, must be resold only pursuant to a registration statement filed by the issuer or a valid exemption, such as Rule 144 discussed above. Once the issuer has been subject to the reporting requirements of the Securities Exchange Act for 90 days, an employee may resell shares acquired under Rule 701 pursuant to a Rule 144 resale exemption without being subject to holding period requirements of Rule 144.

What type of document retention policy is required for a public company?

There were numerous allegations in the corporate scandals of 2001 and 2002 that investigations were being impeded and relevant documents destroyed. Although there were already rules in place to address this perceived problem, the Sarbanes-Oxley Act enacted additional ones as well. Together with the preexisting rules, they provide a mosaic of requirements for document retention and destruction, as well as the way that companies under investigation and their employees should conduct themselves.

Is there a duty to preserve documents?

The duty to preserve documents (notwithstanding the company's document retention policy) depends on which of the three general stages discussed below a company is in:

- **When Litigation or an Investigation is Pending.** When a party is on notice that litigation or an investigation has commenced, there is a duty to preserve all materials relevant to that proceeding, in their original form.
- **When Litigation or an Investigation is Reasonably Foreseeable.** The duty to preserve materials may arise before the commencement of a lawsuit or investigation if it is reasonably foreseeable that the lawsuit or investigation will be commenced. Thus, for example, in transactions where regulatory approvals are required or investigations or shareholder or other litigation is anticipated, documents should be retained, especially once it is clear to the parties that the transaction will proceed.
- **When No Litigation or Investigation is Reasonably Foreseeable.** Absent pending or reasonably foreseeable future litigation or investigative proceedings (or a specific statutory or regulatory requirement), a company generally has the right to dispose of its own property, including documents and tangible objects, without liability. If litigation or an investigation ultimately develops, the prior destruction of documents will be carefully scrutinized, however, and negative inferences may be drawn regarding any destruction, particularly if it was not done in the ordinary course of business. You should always remember that in hindsight, litigation or an investigation always appears to have been more foreseeable than it was.

What are the penalties for destroying documents that should have been retained?

Whether civil sanctions will be imposed on a company that wrongfully destroys documents depends upon the surrounding facts and circumstances. Sanctions are more likely to be imposed where the party who destroyed the evidence did so in bad faith, though some sanctions may be imposed even where the party merely acted negligently.

Also, the likelihood that sanctions will be imposed increases with the level of prejudice to the opposing party as a result of the destruction.

Criminal liability may arise out of federal statutes that prohibit the obstruction of justice and the obstruction of agency, department and congressional proceedings.

The Sarbanes-Oxley Act contains two provisions that make it a crime to change records in order to affect official proceedings and investigations. It is now a specific criminal offense, punishable by up to 20 years of imprisonment, to alter, destroy, mutilate, conceal, falsify, or make a false entry in any record or document with the intent to impede, obstruct or influence the investigation or proper administration of any federal investigation or bankruptcy case. It is also a crime, punishable by up to 20 years of imprisonment, to alter, destroy, mutilate or conceal a record or document or to otherwise obstruct, influence or impede an official proceeding.

What are the requirements for a Risk Management Program?

Today more than ever, risk oversight and management should be considered a critical component of a company's overall business strategy. A company preparing for an IPO should take steps to create appropriate systems for reporting and oversight with respect both to general economic risks and risks unique to the company's particular business. Typically, risk oversight is delegated to the audit committee of the board of directors but may reside in a dedicated committee or subcommittee of the board. This committee will be responsible for educating itself and the rest of the board with respect to all forms of risk affecting the company. It is recommended that the committee include at least one member with experience in the industry and who should be aware of risk factors unique to the company.

The committee must also ensure that the company has appropriate risk management systems in place to monitor current and material future risk factors in a manner that effectively informs business decisions made both by company executives and by the board. The effectiveness of a company's risk oversight and management functions will depend upon open channels of communication among persons at various levels within the company. Regular meetings between the committee and members of management responsible for risk management are recommended.

What is the Sarbanes-Oxley Act and what did it do?

The Sarbanes-Oxley Act contained a number of provisions that became law automatically without any further action. Other provisions required the SEC to adopt rules to implement the law or to supplement it.

Much of the Sarbanes-Oxley Act was focused on the accounting profession and created a whole new quasi-governmental entity to regulate accountants that audit the financial statements of public companies. The legal profession also was the subject of the Sarbanes-Oxley Act. These provisions do not affect companies directly and are not discussed in this publication.

The provisions of the Sarbanes-Oxley Act that directly affect issuers are discussed below and elsewhere in this text where appropriate.

What are the limits imposed on loans to directors and officers?

The Sarbanes-Oxley Act prohibits companies from extending, maintaining, arranging for, or renewing a loan to or for any director or executive officer or his or her affiliates. This provision became effective when the Sarbanes-Oxley Act became law and applies to all public companies whether or not listed. Loans outstanding on the date of enactment of the Sarbanes-Oxley Act are exempt, but any material modification of their terms or their renewal is prohibited. Depending upon how the Sarbanes-Oxley Act is finally interpreted by courts, the term "credit" may be applied broadly to include financial arrangements not traditionally thought of as loans. For example, the prohibition may extend to loans made by third parties at the request or with the cooperation of the company. Clearly, a company may not guarantee the repayment of a loan to any of its directors or executive officers.

There are exceptions to the prohibition for companies that are in the business of making loans. Loans to directors and executive officers by private companies are not prohibited. But any such loan made or material modified after Sarbanes-Oxley was passed would have to be repaid before the company could file a registration statement.

What are the standards for audit committee members imposed by the Sarbanes-Oxley Act?

The Sarbanes-Oxley Act required the SEC to adopt rules to regulate the composition and operation of audit committees of the boards of directors of listed companies. The rules require stock exchanges to impose certain standards on companies that have securities listed and traded on these organizations. These standards must be at least as restrictive as the SEC's rules require, but they may be more demanding at the discretion of the organization. Thus, to determine the strictures applicable to a listed company, one needs to go beyond the SEC's rules and consult the requirements of the exchanges. The requirements proposed by the NYSE and Nasdaq are discussed elsewhere in this text. The SEC's rules are described immediately below.

The SEC's rules require that audit committees of listed companies consist entirely of independent directors except for certain narrow exceptions described below. In order to be considered independent, a person must satisfy the following two-part test:

1. An audit committee member may not receive any consulting, advisory or compensatory fee from the company (other than compensation as a director). This prohibition extends to any indirect receipts and therefore proscribes any payments to spouses, minor children or stepchildren or children or stepchildren sharing a home with the member, as well as payments to an entity in which the member is a partner, member or principal or occupies a similar position, including entities that provide accounting, consulting, legal, investment banking, financial or other advisory services or any similar services to the company.
2. An audit committee member may not be an "affiliated person" of the company or any of its subsidiaries. A person is affiliated with another if it directly or indirectly controls, is controlled by or is under common control with the other person. Control means the power to direct or cause the direction of the management and policies of a person, whether through the ownership of voting securities, by contract, or otherwise. Obviously, these definitions require that a determination be made on a case-by-case basis after considering the particular facts in any given situation. In order to introduce some certainty in the area, however, the SEC has provided a safe harbor under which any person who is not an executive officer or 10% stockholder of a company is deemed not to control the company. Executive officers, employee-directors, general partners and managing members of affiliated persons are themselves deemed to be affiliated persons.

For U.S. companies, there are only two narrow exemptions from the rules requiring that all audit committee members be independent. The first of these applies to companies immediately after they have gone public. Because the boards of private companies typically consist of insiders and representatives of large stockholders such as venture capital funds, and because it is difficult to recruit directors for companies about to go public (because of, among other things, the personal liability for the registration statement and the uncertainty about whether the public offering will occur), the SEC has required only that one audit committee member be independent at the time a company goes public, that a majority of audit committee members be independent within 90 days after the public offering, and that all members be independent within one year. The second exemption permits an audit committee member of a parent to sit on the board of directors of a subsidiary despite the affiliated person prohibition so long as the other independence requirements are met for both the parent and the subsidiary.

The tests for independence first apply at the time a director becomes a member of the audit committee. There is no look-back period for which the tests must be satisfied.

The SEC's rules require listed companies to disclose in their Form 10-K's and proxy statements whether the members of their audit committee are independent using the definition of independence included in the listing standards applicable to the company. Non-listed companies with audit committees must disclose whether their audit committee members are independent using any definition that has been approved by the SEC.

The SEC also imposed the requirement that a company disclose in its Form 10-K or proxy statement whether, in the opinion of its board of directors, it falls in one of the following categories:

1. It has at least one financial expert serving on its audit committee.
2. It does not have a financial expert serving on its audit committee, in which case it must explain why it does not.

The Sarbanes-Oxley Act did not require that a company have a financial expert on its audit committee, instead requiring only that a company disclose whether it had one. The SEC added to this requirement by mandating additional disclosure for companies without a financial expert as a means of encouraging companies to have an audit committee member with the requisite qualifications.

In order to qualify as an audit committee financial expert for SEC purposes, one must possess the following attributes:

- An understanding of GAAP and financial statements.
- The ability to assess the application of GAAP to the accounting for estimates, accruals and reserves.
- Experience in preparing, auditing, analyzing or evaluating financial statements that present a breadth and level of complexity of accounting issues that are comparable to the breadth and complexity of issues that can 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 control over financial reporting.
- An understanding of audit committee functions.

These attributes must have been acquired through one or more of the following means:

- 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, audit or evaluation of financial statements.
- Other relevant experience (which may not be merely educational). If this means it is relied upon to support the qualifications of an audit committee financial expert, then the company must disclose what the relevant experience was.

Who is responsible for hiring the independent auditors?

If an outside auditor were to view the company's management, rather than its board of directors or audit committee, as its employer with hiring, firing and compensatory powers, then the auditor might have an incentive not to raise concerns about management or the financial reporting by management and the auditor's objective review might be jeopardized. Even the appearance of this situation would undermine investor confidence. In order to prevent this from occurring, Sarbanes-Oxley requires that the audit committee be solely responsible for hiring, firing and compensating the company's auditors, overseeing their work, and resolving any differences between the auditor and management. As part of this responsibility, the audit committee has the power to approve audit engagement fees and terms as well as all significant non-audit engagements of the auditors.

This rule does not affect any requirement that a company's auditors be elected, approved or ratified by the company's stockholders. Rather, the rule relates only to the allocation for responsibility between management and the audit committee. If a company seeks a shareholder vote on the issue, however, the recommendation that the stockholders elect, approve or ratify the auditor should come from the audit committee.

What are the whistleblower provisions of the Sarbanes-Oxley Act?

Company employees are often in the best position to report questionable practices and irregularities, but they may fear management reprisal if they do. Accordingly, the audit committee is required to establish procedures to receive, retain and handle complaints regarding accounting, internal controls or auditing matters and to provide a method for employees to report them anonymously. This is intended to bolster the other provisions of the Sarbanes-Oxley Act that specifically protect whistleblowers, as described below.

Can the audit committee engage outside advisors?

To be effective, an audit committee must have adequate funding and the ability to hire advisors to guide it. The SEC, therefore, has required that the audit committee have the authority to engage such outside advisors, including counsel, as it determines necessary, and that the company is required to provide for appropriate funding as determined by the audit committee for it to function and pay any public accounting firm or other advisor employed by the audit committee.

What are the requirements for disclosure controls and procedures and internal control over financial reporting?

The Sarbanes-Oxley Act imposed certain requirements on companies regarding their disclosure controls and procedures and internal control over financial reporting. To understand these new provisions, it is important to focus on the difference between the meanings of those two terms.

“Disclosure controls and procedures” are controls and procedures of a company that are designed to ensure that all the information required to be disclosed by the company in the reports filed with the SEC is recorded, processed, summarized and reported within the periods specified. The information that is subject to disclosure controls and procedures is broader in nature than the information covered by internal control over financial reporting in that it includes non-financial information that is required to be included in SEC filings. The SEC requires management of every reporting company to periodically evaluate these controls and procedures and to disclose conclusions regarding the effectiveness of the company’s disclosure controls and procedures as of the end of each period covered by a quarterly or annual report.

“Internal control over financial reporting” is the process designed by, or under the supervision of, the issuer’s management to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with GAAP and includes those policies and procedures pertaining to the maintenance of accurate, detailed and timely records of financial transactions.

The Sarbanes-Oxley Act requires that the SEC prescribe rules requiring each annual report to contain an internal control report that would do the following:

- State the responsibility of management for establishing and maintaining an adequate internal control structure and procedures for financial reporting.
- Contain an assessment, as of the end of the most recent fiscal year of the issuer, of the effectiveness of the internal control structure and procedures of the issuer for financial reporting.

These rules are presently effective. They dovetail with the certification requirements adopted by the SEC pursuant to the Sarbanes-Oxley Act.

Public companies are already required by the Securities Exchange Act to maintain adequate internal control for financial reporting. In addition, no accounting firm can render an audit opinion without having evaluated a company’s internal control over financial reporting and found them to be adequate. Today, public companies commit enormous amounts of money and resources in completing the comprehensive documentation and evaluation that is required to support management’s conclusions regarding the effectiveness of the internal control over financial reporting and to form a basis for the accountant’s audit of the effectiveness of the internal control. Any public company must expect to meet this obligation. In so doing, management should do the following:

- Understand the definition of internal control over financial reporting.
- Organize a project team to conduct the evaluation.
- Conduct the evaluation at the overall entity level and lower levels, such as at the process, transaction and application levels.
- At all levels, evaluate the overall effectiveness of internal control over financial reporting, identify matters for improvement, and establish monitoring systems.

The SEC has implemented certain rules that require expanded disclosure on the subject of internal control over financial reporting. Under these rules, management's report on internal control over financial reporting must be included in the company's annual report filed with the SEC and must contain the following:

- A statement of management's responsibility for establishing and maintaining adequate internal control over financial reporting for the company.
- A statement identifying the framework used by management to evaluate the effectiveness of internal control over financial reporting.
- Management's assessment of the effectiveness of internal control over financial reporting as of the end of the company's most recent fiscal year and disclosure regarding any "material weaknesses" in such control.
- A statement that the company's auditor has issued an attestation report on management's assessment as well as its audit report on internal control over financial reporting.

A company must also disclose any material changes in internal control over financial reporting that arise during a period covered by a quarterly report.

What limits did the Sarbanes-Oxley Act impose on the use of non-GAAP financial information?

The Sarbanes-Oxley Act required the SEC to adopt rules governing the disclosure of non-GAAP financial measures. On January 22, 2003, the SEC did so by adopting Regulation G, which applies to all public companies.

The rules apply to all public disclosures of information that include material non-GAAP financial measures, including earnings and other press releases, investor calls and webcasts, investor conferences, Securities Exchange Act reports, annual reports to stockholders (including the CEO's letter), and the slide shows presented at investor conferences or meetings of shareholders. The specific requirements vary with the manner of disclosure. As described below, the use of non-GAAP financial measures in SEC filings is subject to stricter rules than their use in other public disclosures. In the case of oral, webcast and similar presentations, there are ways to simplify compliance.

The requirements do not apply to pro forma disclosures about a proposed business combination because those are governed by other SEC rules.

A "non-GAAP financial measure" is a numerical measure of historical or future financial performance, financial position, or cash flows that excludes or includes amounts (or is subject to adjustments that have the effect of excluding or including amounts) that are not excluded or included in the most directly comparable GAAP measure in the financial statements.

The following items are not considered non-GAAP financial measures:

- An operating or other statistical measure (such as unit sales, number of employees, number of subscribers or number of advertisers).
- Any financial measure required to be disclosed by GAAP, SEC rules, or any other applicable governmental or self-regulatory organization requirements.
- A ratio or statistical measure calculated using only one of the following:
 - Financial measures calculated in accordance with GAAP.
 - Operating measures or other measures that are not non-GAAP financial measures.
- Any financial measure required to be disclosed by GAAP, SEC rules, or any other applicable governmental or self-regulatory organization requirements.

The following are examples of non-GAAP financial measures:

- A measure of operating income that excludes one or more expense or revenue items that are identified as "non-recurring."

- EBITDA, which could be calculated using elements derived from GAAP financial presentations but, in any event, is not presented in accordance with GAAP.
- A ratio that is calculated by dividing one measure by another, where either measure or both were not calculated in accordance with GAAP.

The SEC does not intend the rules to capture all measures of operating performance or financial measures. In addition to operating and other statistical measures, the following are examples of what the SEC does not consider non-GAAP financial measures:

- Disclosure of amounts of expected indebtedness, including contracted and anticipated amounts.
- Disclosures of amounts of repayments that have been planned or decided upon but not yet made.
- Disclosure of estimated revenues or expenses of a new product line, so long as such amounts were estimated in the same manner as they would be computed under GAAP.
- Measures of profit or loss and total assets for segments required to be disclosed in accordance with GAAP.
- Ratios and measures such as sales per square foot or same-store sales (in each case, assuming the sales figures were calculated in accordance with GAAP).
- A ratio that is calculated by dividing one measure by another, where both measures are calculated in accordance with GAAP.

In addition, the SEC staff has stated informally that:

- The ratio of earnings to fixed charges (using GAAP calculations) is not a non-GAAP financial measure within the meaning of the rules since disclosure of this measure is required by SEC rules.
- Disclosure of revenues generated by a particular product line will not be considered as a non-GAAP financial measure, so long as the company also discloses total revenues.

What steps must be taken if we want to present non-GAAP financial information?

The following requirements apply each time a non-GAAP financial measure is disclosed in any fashion, even if it has been previously disclosed in another context.

Disclosure of material non-GAAP financial measures must be accompanied by the following:

- The most directly comparable financial measure calculated and presented in accordance with GAAP.
- A quantitative reconciliation of the differences between the non-GAAP financial measure and the most comparable GAAP financial measure.
- While companies have flexibility in deciding which is the “most directly comparable financial measure calculated and presented in accordance with GAAP,” the SEC’s position is that:
 - Non-GAAP measures of cash generated from operations should be balanced with the disclosure of amounts from the statement of cash flows.
 - Non-GAAP measures that depict performance should be balanced with net income, or income from continuing operations, taken from the statement of operations.

If the non-GAAP financial measure is forward-looking and the respective GAAP equivalent is not available without unreasonable effort, a company must identify the information that is unavailable and its probable significance and provide whatever reconciling information is available.

The reconciliation must be a schedule or other clearly understandable method. In the case of ratios or measures calculated using non-GAAP financial measures, a reconciliation for each non-GAAP financial measure used in the calculation must be provided. In addition, the ratio or measure as calculated using the most directly comparable GAAP financial measure or measures must be presented.

The SEC release does not elaborate on the requirement that the comparable GAAP measure and reconciliation “accompany” the non-GAAP financial measure. The overriding standard will be that the disclosure not be misleading. If the disclosure is in a document that will be filed with the SEC, the comparable GAAP measure must be presented with a prominence equal or greater to that of the non-GAAP measure.

Of course, a non-GAAP financial measure may not be used if, taken together with the accompanying information and discussion, it contains an untrue statement of a material fact or omits to state a material fact necessary in order to make its presentation, in light of the circumstances under which it is presented, not misleading. Companies will be well advised to implement the following policies:

- Avoid allowing non-GAAP financial measures to obscure GAAP results.
- Avoid presenting any non-GAAP financial measures before the comparable GAAP measure.
- Make sure there is a sound rationale for using the non-GAAP financial measure.
- Maintain consistency (for example, if unusual charges are excluded, exclude unusual credit items as well).
- Follow the more detailed requirements of Item 10(e) of Regulation S-K (described below) even if it does not technically apply.
- Disclose any change in the method of calculating or presenting a particular non-GAAP financial measure from one period to another and why it was made.
- Calculate any per share measure on a fully diluted as well as a primary basis.

How do we comply with Regulation G if we make an oral statement that includes non-GAAP financial information?

For disclosures of non-GAAP financial measures orally, telephonically, by webcast or broadcast, or by similar means, Regulation G allows the use of the company website to provide the required disclosures so long as the following is true:

- The Regulation G disclosures appear on the website at the time the non-GAAP financial measure is presented.
- The presentation directs the audience to the location of the website.

This provision will apply, for example, to remarks at annual shareholder meetings or to an investor conference call to discuss an earnings release. Obviously, to take advantage of it a company must plan ahead to make sure that the disclosures have been posted by the time of the call.

This provision will not apply, however, to a slideshow or written handout that accompanies an oral presentation. Slideshows, handouts and similar material must contain the required Regulation G disclosures if they present material non-GAAP financial measures.

There are two important caveats associated with using this provision:

- If any oral disclosure relates to a prior, completed fiscal period and has not previously been made public, the press release announcing the time of the disclosure must include instructions on when and how to access the Regulation G information on the website. Otherwise, the Regulation G information must be filed on Form 8-K. In this circumstance, it is not sufficient to wait until the call itself to announce the location of the Regulation G material on the company’s website.
- In contrast to the treatment of inadvertent disclosures by Regulation FD, it is not possible to make an inadvertent disclosure of a non-GAAP financial measure and still comply with Regulation G after the fact. The Regulation G information must either be already posted to the website or it must be provided on the spot.

This is true even if you are in compliance with Regulation FD because the conference call was previously announced.

This differs from the Form 8-K, Item 2.02 requirement for disclosure of material nonpublic information (as discussed below), under which companies have up to four business days to furnish the new information to the SEC in lieu of the contemporaneous website posting.

How does Regulation G affect earnings releases?

Quarterly or annual earnings releases containing a non-GAAP financial measure (whether or not material), must contain the disclosures described above and also comply with the following when that release is filed with the SEC on Form 8-K:

- The most directly comparable GAAP financial measure (as discussed above) must be presented with a prominence equal or greater to that of the non-GAAP financial measure.
- As a practical matter, this means that this presentation must be used in the original earnings release as well. For example, a headline in the earnings release that contains a non-GAAP financial measure would also need to contain the corresponding GAAP figure.

Unless included in the most recent Form 10-K the following information must be disclosed:

- The substantive reasons why management believes that presentation of the specific non-GAAP financial measure, in the context in which it is presented, provides useful information to investors (not just industry analysts) about the company in light of its business and industry.
- To the extent material, any additional purposes for which management uses the non-GAAP financial measure.

A company that anticipates frequent use of non-GAAP financial measures should consider including this information in its Form 10-K to avoid restating it in each release.

Non-GAAP financial measures (whether or not material) that are included in filings with the SEC will be subject to all the presentation, reconciliation, explanation and non-misleading requirements described above.

In addition, the company must comply with Item 10(e) of Regulation S-K. This provision, which codifies some of the SEC's historical views on non-GAAP information, prohibits any filing from the following:

- 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. EBIT and EBITDA are not covered by this prohibition but, if used, must be accompanied by the appropriate GAAP reconciliation.
- Including a non-GAAP performance measure to eliminate or smooth items identified as non-recurring, infrequent or unusual, when the nature of the charge or gain is such that it is reasonably likely to recur within two years, or there was a similar charge or gain within the prior two years.
- Presenting a non-GAAP financial measure on the face of GAAP financial statements or in the accompanying notes.
- Presenting non-GAAP financial measures in any pro forma financial information required to be disclosed by SEC rules relating to business combinations.
- Using titles or descriptions of non-GAAP financial measures that are the same as, or confusingly similar to, titles or descriptions used for GAAP financial measures.

What disclosure must be made about off-balance sheet financing?

The Enron scandal is generally thought to have resulted at least in part from Enron's use of derivatives and off-balance sheet financings under which it was liable for certain obligations that were not disclosed to investors. In response, the Sarbanes-Oxley Act required the SEC to adopt rules to require that reports filed by a company disclose all material off-balance sheet transactions, arrangements, obligations (including contingent obligations) and other relationships with unconsolidated entities or other persons.

Companies are required to disclose in any registration statement, annual report and proxy statement that requires financial statements, in a separately-captioned section, their off-balance sheet arrangements that have or are reasonably likely to have a current or future effect on their financial condition, revenues, expenses, liquidity, capital expenditures or capital resources that would be material to investors. The disclosure must include the following elements:

- The nature and business purpose of the off-balance sheet arrangements.
- The importance of the off-balance sheet arrangements to liquidity, capital resources, market risk or credit risk, or other benefits of the arrangements.
- The amounts of revenues, expenses and cash flows arising from the arrangements.
- The nature and amounts of any interests retained, securities issued, and indebtedness incurred in connection with the arrangements.
- The nature and amounts of any other obligations or liabilities (including contingent obligations or liabilities) arising from such arrangements that are or are reasonably likely to become material and the triggering events or circumstances that could cause them to arise.
- Any known event, demand, commitment, trend or uncertainty that is reasonably likely to result in the termination, or material reduction in availability, of the off-balance sheet arrangements, and the course of action that will be taken in response.

The term “off-balance sheet arrangement” means any transaction, agreement or another contractual arrangement to which an entity that is unconsolidated with a company is a party, under which the company has:

- Any obligation under certain types of contingent guarantees to make payments based on changes in underlying aspects of the guaranteed party or the guaranteed party’s failure to perform, indemnification arrangements, and indirect guarantees of the indebtedness of others that are not otherwise excluded from the initial recognition and measurement provisions of applicable accounting standards.
- A retained or contingent interest in assets transferred to the unconsolidated entity or a similar arrangement that serves as credit, liquidity or market risk support to that entity for those assets.
- Any obligation, including a contingent obligation, under a contract that would be accounted for as a derivative instrument, except that it is both indexed to the company’s own stock and classified in stockholders’ equity in the company’s statement of financial position.
- Any obligation, including a contingent obligation, arising out of a variable interest in an unconsolidated entity that is held by, and material to, the company, where such entity provides financing; liquidity; market risk or credit risk support to; or engages in leasing, hedging or research and development services with, the company.

In addition to the disclosure referred above, companies are required to disclose in any registration statement, annual report and proxy that requires financial statements the amount of its known contractual obligations identified by their maturity dates and tabulated into the following categories:

- Long-term debt.
- Capital lease obligations.
- Operating lease obligations.
- Purchase obligations.
- Other long-term liabilities on the balance sheet.

Is there liability for improper influence on the conduct of audits?

The SEC has adopted rules prohibiting officers or directors from taking any action to mislead any accountant for the purpose of making the company’s financial statements materially misleading.

The rules prohibit any action to influence, coerce, manipulate or mislead the accountant of the company’s financial statements in a manner that could reasonably be expected to result in the financial statements becoming materially misleading. The rules apply to any director or any officer who performs a policy-making function, and would also cover any person acting under their direction. For example, customers, vendors or creditors who, under the direction of a director or officer covered by the rules, provided false or misleading confirmation or other information to an auditor are covered by the rules.

The rules state that conduct by an officer, director or person acting under the direction of an officer or director, who engaged in conduct to improperly influence an accountant is culpable if he or she knew or should have known that the conduct, if successful, could result in rendering a financial statement materially misleading.

The rules pertain during the entire professional engagement period of the auditor and thereafter when the auditor is considering whether to consent to the use of the audit report. It could even begin before the auditor's engagement in some circumstances, for example, if a director offers to engage an accounting firm on the condition that it will issue an unqualified report on financial statements that do not conform to GAAP.

The SEC has sole jurisdiction to bring an action under these rules; there is no private right of action.

Will our officers forfeit their bonus if a restatement occurs?

The Sarbanes-Oxley Act provides that if a company is required to restate its financial results due to material noncompliance with any financial reporting requirement under the securities laws resulting from misconduct, then the CEO and CFO must reimburse the company for any bonus or other incentive-based or equity-based compensation received and any profits realized from the sale of company securities during the 12 months following the first publication of the financial document being restated. This "clawback" provision has been used by the SEC to recover stock sale profits and bonuses earned by executives while their companies were misleading investors.

Are there any other provisions of the Sarbanes-Oxley Act that may affect directors or officers?

The Sarbanes-Oxley Act lowers the standard for determining when a person is unfit to serve as an officer or director of a public company. In any cease-and-desist proceeding, the SEC may issue an order prohibiting any person who has violated certain provisions of the Securities Exchange Act or the Securities Act from acting as an officer or director of a public company if the person's conduct demonstrates "unfitness" to serve in such positions. This important change, which became effective with the enactment of the Sarbanes-Oxley Act, makes it easier to bar individuals from future positions in public companies.

The Sarbanes-Oxley Act contains two separate provisions to protect individuals who assist in investigations from suffering retaliatory acts. The first makes it a crime to take intentional retaliatory action against any person for providing to a law enforcement officer any truthful information related to the possible commission of any federal offense. The second prohibits any public company or any officer, employee, contractor, subcontractor or agent of a public company from taking any adverse or discriminatory actions against an employee because the employee provided information regarding, or assisted with an investigation or proceeding for, alleged violations of SEC rules or federal securities fraud laws. A civil damages remedy, including attorney's costs, is further provided for aggrieved employees.

The Sarbanes-Oxley Act contained several other provisions, which are discussed elsewhere in this document. These include the following:

- Requiring that the CEO and CFO certify the accuracy of reports filed with the SEC.
- Making it a crime to alter, destroy or conceal a document to impede an investigation or bankruptcy case.
- Allowing the SEC to freeze payments by a company to its executives if they are being investigated.
- Making penalties for fraud and securities violations against individuals not dischargeable in bankruptcy.
- Requiring the SEC to adopt a rule that requires current reporting of all material events.

What is the Dodd-Frank Act and what did it do?

On July 21, 2010, President Obama signed into law a comprehensive financial regulatory reform bill authored by Senator Christopher Dodd (D-CT) and Representative Barney Frank (D-MA). The legislation, known as the Dodd-Frank Wall Street Reform and Consumer Protection Act, (Dodd-Frank Act) contained a number of significant changes in response to the financial crisis, including the regulation of swaps and the Volcker Rule, but also included several

significant executive compensation provisions that apply to public companies. Set forth below are some of these key provisions:

Shareholder Approval of Executive Compensation (Say-on-Pay).

The Dodd-Frank Act requires a non-binding shareholder vote to approve the compensation of executive officers at shareholder meetings for which the SEC requires compensation disclosure. Shareholders may choose to have a say-on-pay vote every two or three years, as opposed to annually. At least once every six years companies must allow shareholders a non-binding vote on whether the say-on-pay votes will occur every one, two or three years. For companies that do not qualify as an EGC, the initial say-on-pay vote is required at the first post-IPO shareholder meeting. For companies that qualify as an EGC, the initial say-on-pay vote is not required until the first year after exiting EGC status.

Shareholder Approval of Golden Parachute Compensation.

The Dodd-Frank Act contains new provisions regarding disclosure and shareholder approval of “golden parachute” arrangements with named executive officers. In any proxy statement relating to the approval of an acquisition, merger, consolidation, proposed sale or other disposition of all or substantially all assets, companies must disclose any compensation arrangement with a named executive officer that is based on or otherwise relates to the transaction. Additionally, the Dodd-Frank Act requires a non-binding shareholder vote to approve any compensation arrangement as disclosed, unless the arrangement was previously subject to a say-on-pay vote. For companies that do not qualify as an EGC, these new requirements apply to post-IPO shareholder meetings relating to an M&A transaction. For companies that qualify as an EGC, these requirements do not apply.

Compensation Committee Independence.

Under the Dodd-Frank Act, compensation committees of all U.S. listed companies must be entirely independent. Furthermore, compensation committees are only permitted to select compensation consultants, legal counsel and other advisors to the compensation committee after considering independence factors determined by the SEC. The Dodd-Frank Act gives compensation committees the sole discretion and direct responsibility to hire and oversee compensation consultants, legal counsel and other advisors they retain. Also, companies must provide specific disclosure in their proxy statements regarding whether the following is true:

1. The compensation committee had retained or received advice from a compensation consultant.
2. Whether the consultant’s work raised any conflict of interest and, if so, how that conflict is being addressed.

Notably, the Dodd-Frank Act has added a new exception from these requirements for controlled companies. The SEC, NYSE and Nasdaq have promulgated rules to implement these requirements.

Executive Pay Versus Performance and Pay Ratio Disclosures.

The Dodd-Frank Act requires the SEC to amend the proxy statement disclosure rules to require companies to disclose information that demonstrates the relationship between executive compensation that was actually paid and the financial performance of the company. The SEC issued proposed rules related to pay versus performance in April 2015, but as of the printing of this publication it has not finalized these rules. The proposed rules would require, among other things, a clear description of both the relationship between executive compensation actually paid to named executive officers and the cumulative total shareholder return, as well as the relationship between the registrant’s total shareholder return and the total shareholder return of a peer group chosen by the registrant, over each of the registrant’s five most recently completed fiscal years. The proposal foresees exempting EGCs, registered investment companies and foreign private issuers from these additional disclosure requirements.

The Dodd-Frank Act also mandated that the SEC adopt rules requiring the disclosure of the pay ratio between the CEO’s total compensation and the median compensation of all employees (other than the CEO). Beginning in the 2018 proxy season, registrants were required to provide this pay ratio disclosure in registration statements, proxy and information statements, and annual reports (but not current or quarterly reports) required to include executive compensation information. Newly public companies would be required to comply with respect to compensation for the first fiscal year commencing on or after the date the company became subject to the reporting requirements. EGCs, smaller reporting companies, and foreign private issuers would not be subject to these requirements. Registrants are permitted to exclude non-U.S. employees from the pay ratio calculations if its non-U.S. employees account for 5% or less of its total employees (provided, however, that if any non-U.S. employees are excluded, all must be excluded).

Recovery of Erroneously Awarded Compensation (Clawback) Policies.

The Dodd-Frank Act requires companies listed on the national securities exchanges to develop, implement and disclose a clawback policy providing that, in the event a company must restate its financials due to material noncompliance of the company with any financial reporting requirement under the securities laws, the company would recover incentive-based compensation (including stock options) from any current or former executive officers in excess of what would have been paid to them under the restated financials for the three years preceding the date on which a company is required to prepare the restatement. The SEC issued proposed rules related to compensation clawbacks in July 2015, but as of the printing of this publication it has not finalized these rules.

Employee/Director Hedging.

As required by the Dodd-Frank Act, in December 2018 the SEC adopted rules to require companies to disclose in their annual proxy statements whether they permit any employees or directors to purchase financial instruments (including prepaid variable forward contracts, equity swaps, collars, and exchange funds) that are designed to hedge or offset any decrease in the market value of equity securities granted for compensatory purposes or otherwise held by the individual.

This publication is intended to outline the public offering process in general terms and is not intended to be legal advice. Please contact any member of Bass, Berry & Sims PLC for any specific legal needs that you would like addressed.

APPENDIX A

Sample Timetable For An Initial Public Offering Of Common Stock

Week 1	<ul style="list-style-type: none"> <input type="checkbox"/> Organizational meeting <input type="checkbox"/> Begin legal review <input type="checkbox"/> Begin due diligence
Weeks 1 - 2	<ul style="list-style-type: none"> <input type="checkbox"/> Commence preparation of Registration Statement and Underwriting Agreement
Week 3	<ul style="list-style-type: none"> <input type="checkbox"/> Circulate drafts of Registration Statement and Underwriting Agreement <input type="checkbox"/> Meetings to discuss drafts of Registration Statement and Underwriting Agreement
Week 4	<ul style="list-style-type: none"> <input type="checkbox"/> Draft of Registration Statement to printer or filing services provider <input type="checkbox"/> Circulate proofs of Registration Statement and Underwriting Agreement <input type="checkbox"/> Meeting to discuss Registration Statement
Weeks 5 - 6	<ul style="list-style-type: none"> <input type="checkbox"/> Meetings to discuss revised proofs of Registration Statement
Week 6	<ul style="list-style-type: none"> <input type="checkbox"/> Meeting of board of directors to approve filing of Registration Statement and other matters in connection with offering <input type="checkbox"/> File FINRA materials
Week 7	<ul style="list-style-type: none"> <input type="checkbox"/> Meeting to finalize Registration Statement <input type="checkbox"/> Listing Application filed with NYSE/Nasdaq <input type="checkbox"/> Registration Statement filed with SEC
Week 11	<ul style="list-style-type: none"> <input type="checkbox"/> Receive comments from SEC <input type="checkbox"/> Meeting of all parties to discuss SEC comments (if necessary) <input type="checkbox"/> File amendment to Registration Statement with SEC
Week 12	<ul style="list-style-type: none"> <input type="checkbox"/> Commence "roadshow" marketing efforts
Weeks 12- 13	<ul style="list-style-type: none"> <input type="checkbox"/> Receive additional comments from the SEC and finalize Registration Statement
Week 14	<ul style="list-style-type: none"> <input type="checkbox"/> Registration Statement becomes effective; determine offering price of stock and underwriting discounts; sign Underwriting Agreement; commence sale of stock
Pricing + 3 Business Days	<ul style="list-style-type: none"> <input type="checkbox"/> Closing

ABOUT BASS, BERRY & SIMS' CAPITAL MARKETS PRACTICE

Bass, Berry & Sims is nationally known for its extensive experience in securities transactions and currently serves as principal securities counsel to more than 35 public companies. Our attorneys have served as legal advisors to issuers or underwriters on more than 150 public offerings of debt and equity securities and Rule 144A offerings valued in excess of \$47 billion.

By leveraging both the experience of our attorneys and the strength of our national platform, attorneys in our Capital Markets Practice regularly advise issuers and investment banks on significant equity and debt offerings. We are particularly adept at helping clients access the capital markets and completing transactions quickly and efficiently.

We represent clients in various types of debt and equity financings, including:

- IPOs.
- Follow-on public offerings of common and preferred stock.
- Public offerings of debt securities, including medium-term notes.
- Rule 144A offerings.
- Institutional private placements, including PIPE (private investment in public equity) transactions.
- Real estate investment trust (REIT) joint ventures, conversion transactions and securitization transactions.

We work with clients across a wide range of industries, including the following industry sectors:

- Healthcare.
- Specialty pharmacy and pharmaceuticals.
- Food and beverage.
- Defense.
- Energy.
- Media and telecommunications.
- Financial services.
- Real estate investment trusts (REITs).
- Business development companies (BDCs).
- Retail.
- Hospitality.
- Manufacturing.

Join Us

Our corporate and securities attorneys are leaders in industry organizations and are frequently recognized for their significant contributions to clients and for their accomplishments. We regularly host reoccurring thought leadership conferences and webinars and author updates on related topics to share insights and developments

You can join the conversation by following the [Securities Law Exchange blog](#), where our attorneys provide commentary and insights related to SEC guidance, proxy issues and exchange developments, as well as resources to support executive leaders in legal and financial roles at public companies.

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