



Here's the deal:

- The pre-filing period is an important part of an initial public offering ("IPO"), requiring a number of management, organizational considerations and structural changes before a company can effectuate an IPO.
- Before a company can complete an IPO, the underwriters will want to complete their due diligence process and ensure that any necessary third-party consents have been obtained.
- A company should consider the variety of underwriting arrangements, including "firm commitment" or "best efforts" underwriting arrangements, before an underwriting agreement is finalized.
- Throughout the pre-filing period, the company and its underwriters will want to be cognizant of the limitations on public communications in order to avoid any "gun-jumping" violations.

What's the Deal?

The pre-filing period in an IPO begins once the company and its underwriters have agreed to proceed with an IPO and continues up through the public filing of the registration statement with the Securities and Exchange Commission ("SEC").

Corporate "Housekeeping" in Preparation for an IPO

Most companies consider making legal and operational changes before undertaking an IPO. Some of these preparations and considerations often include:

- Meeting federal securities law requirements (including those arising as a result of the Sarbanes-Oxley Act) as well as applicable exchange requirements once the IPO registration statement is filed with, or declared effective by, the SEC, or committing to satisfy these within the applicable compliance periods;
- Adopting anti-takeover defenses, such as a staggered board of directors and blank check preferred stock;
- Analyzing its capitalization to determine whether it will be appropriate after the IPO; and
- Reviewing executive compensation arrangements and benefit plans.



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A company will also want to address other corporate governance matters, including:

- Board structure and directors;
- Management committees and member criteria;
- Senior management;
- Identifying, disclosing and/or terminating related party transactions; and
- Directors' and officers' liability insurance.

Reviewing Management Structure

A public company must comply with corporate governance requirements imposed by federal securities laws and regulations and the rules and regulations of the applicable stock exchange, including with respect to the oversight responsibilities of the board of directors and its committees. A critical matter is the composition of the board itself. All exchanges require that, except under certain limited circumstances, a majority of the directors be "independent," as defined by both federal securities laws and exchange regulations. In addition, boards of directors should include individuals with appropriate financial expertise and industry experience, as well as an understanding of risk management issues and public company experience. A company will want to begin its search for suitable directors early in the IPO process even if it will not appoint the directors until the IPO is consummated. The company can turn to its large investors as well as its counsel and underwriters for references regarding potential directors and also designate a committee of the board to undertake the director search.

Board Committees

In addition to assembling its new board of directors, a company will also have to consider the board committees. The passage of Sarbanes-Oxley in 2002 significantly enhanced the independence and expertise requirements for audit committees. The exchanges all require listed companies to have an audit committee, consisting only of at least three independent directors who meet certain standards. At least one of the audit committee members must be a "financial expert."

Separately, the Nasdaq Stock Markets require, subject to certain phase-in rules, a compensation committee comprised of independent directors, but not a nominating committee; while the New York Stock Exchange requires a compensation committee and a nominating/corporate governance committee consisting only of independent directors. The functions of a nominating committee can be performed either by a committee consisting solely of independent directors or by a majority of the company's independent directors operating in executive session. Pursuant to the Dodd-Frank Act and the SEC's implementing rules, exchanges must require that listed companies' compensation committees, among other things, be comprised entirely of independent directors.

Under the rules of the exchanges, the audit, compensation and nominating/corporate governance committees must maintain their own charter, which describes the specific responsibilities of the committee, including the committee's purpose, member qualifications, appointment and removal, board reporting and performance evaluations. If any of the responsibilities of these committees are delegated to another committee, the other committee must be comprised entirely of independent directors and must have its own charter.



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Initial Stages of the IPO Pre-Filing Process

Organizational Meeting

The IPO process usually begins with an organizational meeting attended by representatives of the company, its accountants and counsel, the underwriters and their counsel. The meeting generally includes discussion of the timeline for the offering, the general terms of the offering and the responsibilities of the various parties. The timing of the audited financial statements to be included in the prospectus and any accounting matters or policies that may be of concern should also be discussed. The participants will also discuss reasons for potential timing delays, which may include significant acquisitions or the need to retain additional executive officers.

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

The "Due Diligence" Process

The "due diligence" process is a crucial component of the IPO process as it is an element of the underwriters' diligence defense under the Securities Act of 1933, as amended (the "Securities Act"). More specifically, due diligence is the practice of reviewing information about an issuer in an effort to mitigate liability and reputational risk. After the organizational meeting and during the quiet period, the underwriters and their counsel will spend a substantial amount of time performing business, financial and legal due diligence in connection with the IPO. The process usually starts with a "due diligence request" prepared by the underwriters and their counsel.

Additionally, the company's key management personnel will generally make a series of presentations covering the company's business and industry, market opportunities and financial matters. The underwriters will use these presentations as an opportunity to ask questions. The presentations will also aid the company and the underwriters in drafting the prospectus.

Typical areas of focus for a diligence review include:

- **Business**, including management presentations and discussions, customer and supplier calls or meetings, calls with the company's lenders, trips to company facilities, an in-depth review of the company's financial position and historical results, a review of the company's projections and discussions with the company's accountants;
- **Accounting**, including audits, changes in accounting policies and tax issues, cheap stock issues, capital structure and comfort letters and the level of comfort to be provided;
- **Legal**, including outstanding and even closed claims and litigation, loan agreement restrictions, third-party consents, FINRA issues, the company's intellectual property portfolio, labor issues, environmental, regulatory or other issues and the scope of requested legal opinions; and
- **Management and corporate governance issues**, including composition of the board, director independence, background reports conducted by the underwriters of the board members and management team, senior management team changes, related party transactions and board actions relating to the IPO.



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Third-Party Consents

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

- Shareholder agreements that may require consents in connection with share issuances or that require the company to register a shareholders' shares as part of the IPO;
- Loan or credit agreements that restrict share issuances or the use of proceeds from the offering; or
- Operating agreements with significant business partners that contain broad "change of control" provisions that may be triggered by the IPO.

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

Underwriting Process

Different Arrangements with Underwriters

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

Typically, the underwriters will be paid a fixed percentage of the total dollar amount of securities sold, usually about 7%. The percentage varies depending on a number of factors, such as the size of the company, its profitability, its industry, etc., but cannot exceed 10%.

Underwriting Agreements

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



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The most important provisions of an underwriting agreement are:

- **Description of the nature of the underwriters' obligation.** The opening paragraphs describe the offering, whether the underwriters have a firm commitment or best efforts obligation and the underwriters' compensation.
- **Representations and warranties.** The company will make statements about its business, finances and assets, the offered stock and the accuracy of the registration statement.
- **Conditions to closing.** Conditions usually include the continued effectiveness of the registration statement and the absence of material adverse changes in the company's business, the results of operations and prospects.
- **Required deliverables.** As a condition of closing, the company will provide opinions of counsel and other experts, certificates confirming the accuracy of the representations and warranties, the initial accountants' comfort letter delivered at the time of pricing the offering and the bring-down letter delivered at closing and other closing documents.
- **Division of expenses.** The underwriting agreement will specify which expenses of the offering are paid by the company.
- **Lock-up agreements.** The underwriting agreement will prohibit the company as well as directors and executive officers from selling equity, except for certain limited purposes, during a period of up to 180 days (subject to negotiation) following the IPO without the managing underwriter's consent. This "lock-up" will also often extend to all, or certainly the largest shareholders, of the issuer. The exceptions from the lock-up provisions can be highly negotiated.
- **Indemnification.** The indemnification section is probably the most important part of the underwriting agreement. In the indemnification section, the company (and sometimes the primary shareholder) agrees to indemnify and be responsible for the underwriters' damages and expenses in the event of any litigation or other proceedings regarding the accuracy of the registration statement and prospectus. The indemnification section will also provide that the underwriters will be liable to the company for misstatements in the prospectus attributable to the underwriters, which information is typically limited to the underwriters' names and the stabilization and similar disclosures. Each underwriter has its own form of indemnification provision and in light of the importance of this section, underwriters are usually reluctant to make changes. It should be noted that the SEC has a long-standing position that indemnification for Securities Act liabilities is unenforceable and against public policy.

FINRA Requirements

FINRA is the largest non-governmental self-regulatory organization for all securities firms doing business in the United States. FINRA determines whether the terms of the "underwriting compensation" and arrangements relating to "public offerings" are "unfair and unreasonable." Underwriters' counsel will submit the underwriting agreement, the registration statement and other offering documents for review to FINRA. FINRA reviews the terms of the offering and the underwriting arrangements to determine whether they are "fair and reasonable." FINRA will focus on the compensation to be paid to the underwriters, which could also include certain items of value received in the six months before the IPO. An IPO cannot proceed until the underwriting arrangement terms have been approved by FINRA.



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Pre-IPO Disclosures

Limitations on Corporate Public Statements

During the pre-filing period, a company will typically be subject to limitations on its public communications. More specifically, those communications by an issuer more than 30 days prior to the filing of a registration statement are permitted as long as they do not reference the securities offering. However, those statements made within 30 days of the filing of a registration statement, which may be considered an attempt to pre-sell the public offering, will be considered an illegal prospectus, and thereby, potentially be viewed as a “gun-jumping” violation. This could then also result in the SEC delaying the public offering or requiring prospectus disclosure of these potential securities law violations.

Section 5(c) of the Securities Act prohibits offers of a security before a registration statement is filed. Section 5(b)(1) prohibits written offers other than by means of a prospectus that meets the requirements of Section 10 of the Securities Act, such as a preliminary prospectus. These limitations are designed to prohibit inappropriate marketing, conditioning or “hying” of the security before investors have access to publicly-available information about the company so they can make informed investment decisions. Generally, a company contemplating an IPO does not have much publicly-available corporate information and none of that information has been subject to regulatory review. Until 2005, the Section 5 bans were quite prohibitive, created significant uncertainty about the effects of ordinary business communications and did not address the explosion of new communication technologies since the 1930s. In 2005, in order to modernize the offering process, the SEC adopted the “Securities Offering Reform,” which added a number of communications safe harbors to the Securities Act.

Quiet Period

The pre-filing period begins when a company and the underwriters agree to proceed with a public offering. From the first all-hands organizational meeting and going forward, all statements concerning the company should be reviewed by the company’s counsel to ensure compliance with applicable rules.

Communications by an issuer more than 30 days prior to filing a registration statement are permitted as long as they do not reference the securities offering. Statements made within 30 days of filing a registration statement that could be considered an attempt to pre-sell the public offering may be considered an illegal prospectus, as discussed above. Press interviews, participation in investment banker-sponsored conferences and new advertising campaigns are generally discouraged during this period. In general, at least four to six weeks will pass between the distribution of a first draft of the registration statement and its filing with, or confidential submission to, the SEC.

Gun-Jumping

“Gun-jumping” refers to written or oral offers made before the filing of the registration statement and written offers made after the filing of the registration statement, other than by means of a Section 10 prospectus, a free writing prospectus or a communication falling within a safe harbor from the gun-jumping provisions. There are several safe harbors from the gun-jumping provisions applicable to IPOs, including:

- **Rule 134 – Communications Not Deemed a Prospectus.** Rule 134 provides a safe harbor for certain limited information about an offering, such as the name and address of the issuer, the title and amount of the securities being offered, a brief indication of the issuer’s business and the names of the underwriters.



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

Checklist of Key Questions

- Has the company had an opportunity to undertake a review of its corporate structure, its benefits plans, its executive compensation arrangements, its material agreements, and other matters prior to commencing the diligence process?
- Has the company considered necessary changes to its capital structure prior to engaging with the underwriters? Has the company contemplated changes that it will implement in its bylaws and amended and restated certificate of incorporation upon consummation of the IPO?
- Has the company assessed whether it will need to bolster its senior management team or its board of directors prior to undertaking its IPO?
- Are there any third-party consents required to be obtained prior to undertaking the IPO?
- Does the company have an IPO preparedness plan to address all of its corporate governance requirements, as well as its public reporting obligations?
- Have the underwriters and the company agreed upon an underwriting arrangement that adequately reflects the company's needs and the current market conditions?
- Are there sufficient safeguards in place to avoid any communications violations?